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Woodhall's Weekly

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Our market took a thumping

Our market took a thumping in the last two days of the week. The ASX 200 fell -3.8% over the week – the biggest fall in 18 months – which was well out of line with other major indexes that all fell around -1%. So what brought on this panic attack? As we noted last week, our fear index (Chart 2) was at an elevated level and exuberance (Chart 5) was moderately high at 2.9%. The -7.3% fall in the Nikkei on Thursday was possibly the shock (or was it tidal?) wave that set off our market.

Our dollar was only off about -0.8% on the week, copper was flat and so there were no strong leads to savage our market. Of course the FOMC minutes and Bernanke's testimony confused the markets with hints that QE could start being eased back as early as June of this year. Later comments supported the need for unemployment to get down to 6.5% and that isn't likely to happen until well into 2014.

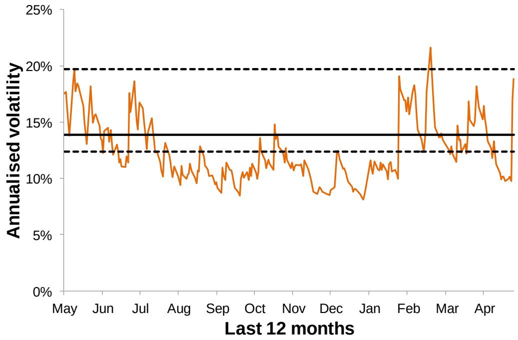
The clear-out in our market actually put sectors back into better shape. The high yielding sectors (Financials, Property, Telcos and Utilities) are still moving in harmony but only Telcos are now above the magic 6% line (at 6.9%, Chart 6). Fair value for the market is still above 5,000 – at 5,050 – but the index lost steam yesterday and closed under that 5,000 mark.

The Materials sector was the best performer after IT with a loss of just -0.4% for the week. The high yielding sectors took the bigger hits. Perhaps those investors seeking better returns than term deposits just couldn't take the heat of equity markets. Materials still look cheap and its fundamentals are strong, as in the expected capital gain for the ASX 200 (Chart 4).

It is a no brainer that volatility spiked on back-to-back major falls on Thursday and Friday (Chart 1) and fear stayed elevated (Chart 2) but disorder (Chart 3) is in the range. What this means is our market is less likely to bounce back without some very strong leads and that does not look likely in the short term. US Durable Goods orders last night bode well for a strong second half of 2013 but all that could do for the S&P 500 was to cut some early losses. Our SPI futures index is down -0.1% for Monday's open. But the +16 point lead last Friday didn't do us much good!

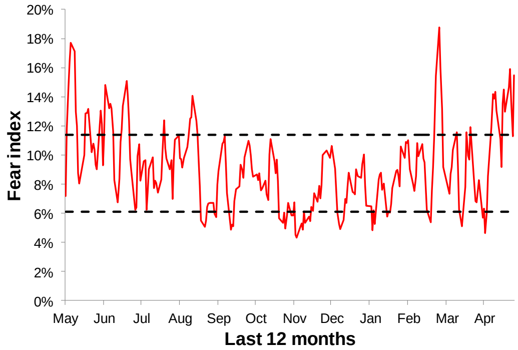
The main game in town is likely to be the China PMI due on the first of the month. The flash PMI mid-month was under 50 but iron ore prices were well behaved. Since the flash PMI and the official PMI measure different parts of the manufacturing sector it is by no means a given that another sub 50 is coming our way. The new government did try to slow things down so the question is, did they try too hard?

Chart 1: Market volatility



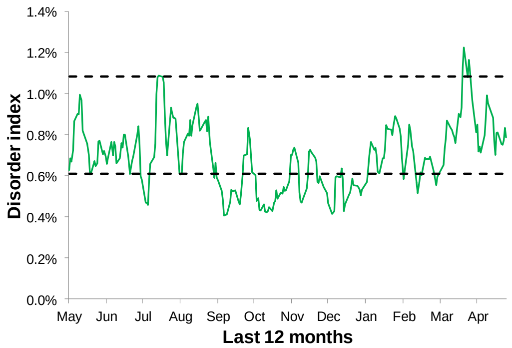
Notes: The solid black line depicts the average volatility since January 2010; the lower dotted line depicts the average volatility pre the GFC; the higher dotted line depicts the average level of volatility during the GFC - up to December 2009. The brown line is a daily estimate of the ASX 200 index volatility.

Chart 2: Fear index



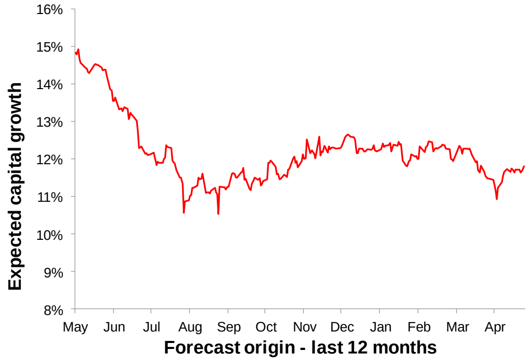
Notes: The fear index is a measure of 'excess' volatility denoting behaviour outside the open/close values each day. The two dotted lines depict the band in which the fear index resided before the GFC in two thirds of days. Extended periods below the lower dotted line might indicate complacency. Extended periods, or extreme values, of the index above the higher dotted line might indicate a propensity for the market to overreact in an irrational manner.

Chart 3: Disorder index



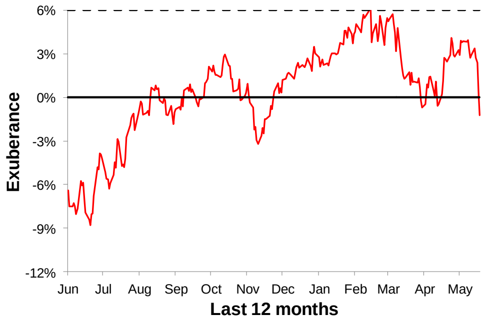
Notes: The disorder index measures the degree to which the 11 sectors' daily returns move in harmony. The two dotted lines depict the band in which the disorder index resided before the GFC in two thirds of days. Extended periods below the lower dotted line might indicate belief that there is little information to have different impacts on different sectors. Extended periods, or extreme values, of the index above the higher dotted line might indicate investors and traders are lurching from sector to sector in search of a new trend.

Chart 4: 12-month-ahead capital gains forecasts



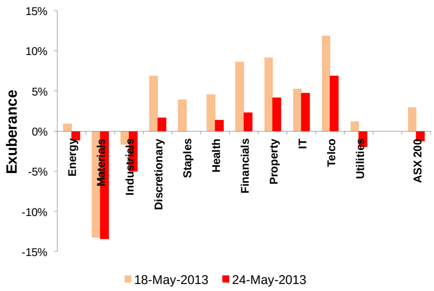
Notes: Each business day we update our estimates for capital gains on the ASX 200 for the following 12 months. For example, the left-most estimate on the vertical axis is a forecast for the 12 months concluding today. The right hand estimate is for the 12 months from today.

Chart 5: Market exuberance



Notes: Exuberance is our measure of mispricing on the ASX 200. A value below the solid black line denotes the market is perceived to be cheap and above that line expensive. Experience suggests that exuberance above +6%, denoted by the dotted line, is an indicator of a potential correction of 6% to 10% - or for the market to move sideways for an extended period.

Chart 6: Sector exuberance



Notes: The estimates in this chart are based on the same notions as for Chart 5. More detailed information on mispricing is contained in our companion weekly publication in the same section of our website