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Woodhall's Weekly

Rotating out of financials

Last week might be remembered for the impact Goldman Sach's call for a rotation from Financials to Materials had on the market. It is a call we first made two to three months but G-S has the gravitas. The impact was big but it did a lot to restore order to the sectoral balance.

For the first time in months, no sector is priced above the 'magic 6% line' for exuberance (Chart 6). Telcos (-2.5%), Staples (-2.5%) and Financials (-2.4%) all fell sharply last week with the index going down by -1.1%. Energy (+1.0%), Materials (+0.7%) and Industrials (+0.7%) were up.

Although the market is now cheap (-2.2%) in Chart 5, it is not ready to rebound yet. The S&P 500 fell into a hole in the last hour of trading on more talk about QE being pulled back so we have a bad lead. More importantly though is the level of fear in our market (Chart 2). Our market has had the jitters all of May but the S&P 500 stayed calm for all but the last few days. We have always argued that fearful cheap markets are more likely to stay cheap for longer – and maybe get even cheaper. The level of fear recently seems worse than the spike early this year for Cyprus or the more general debt crisis wobbles of mid – late 2012.

The falls in prices for the high yield sectors (Financials, Property, Telcos and Utilities) has kept their expected dividend yields closely bunched but they are now closer to 6% (plus franking credits) rather than the near 5% of just a week or so ago. As we argued some time ago, more cash could not come off the sidelines because there wasn't enough room for it in high yield sectors. But now some wealth is starting to move from high yield to resources, there is room again in high yield sectors for more cash off the sidelines. It is this move that can sustain a rally into the year end. Citi just upgraded its e-o-y forecast from 5,200 to 5,400. Our target has been 5,350 for months.

The fundamentals (Chart 4) have remained strong and volatility (Chart 1) is coming back to normal. Of course, not only do we have to contend with mixed messages from Fed members but also end-of-financial-year window dressing might cause some additional volatility.

China's manufacturing PMI number is due out today and that will be more important than usual. After recovering to above 50 last year, it seems to be dipping down again. The last number was 50.6 and the mid month 'flash' number was 49.6. Moves on Monday are likely to be amplified by a sub-50 print.

Moving into latter in the week, the US nonfarm payrolls data are critical. They have been strengthening which is great for the economy but too strong and QE will start to be tapered off sooner rather than later. The Fed is clearly trying to get the market used to being weaned off QE gradually – rather than just announcing it out of the blue. With unemployment 100 basis points above the stated trigger of 6.5% for an end to QE, it is almost impossible to imagine unemployment reaching that goal this year. But markets will gyrate anyway.

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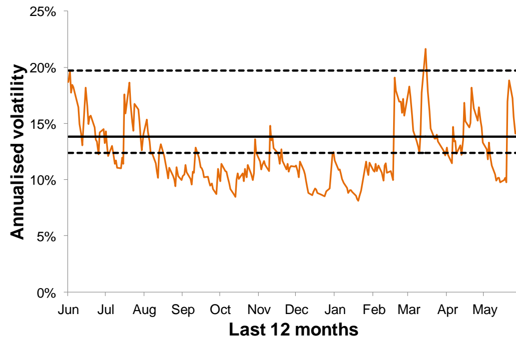
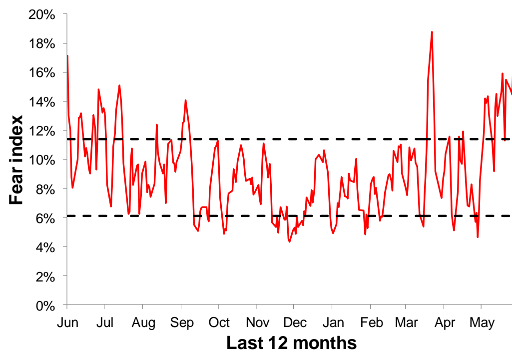
Chart 1: Market volatility



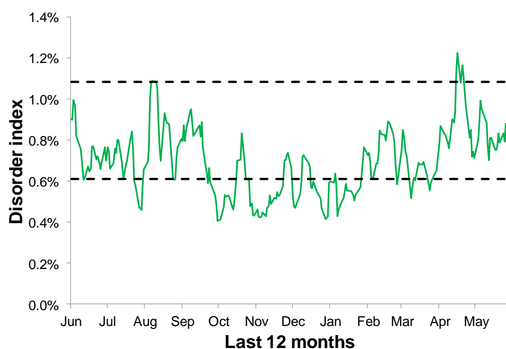
Notes: The solid black line depicts the average volatility since January 2010; the lower dotted line depicts the average volatility pre the GFC; the higher dotted line depicts the average level of volatility during the GFC - up to December 2009. The brown line is a daily estimate of the ASX 200 index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

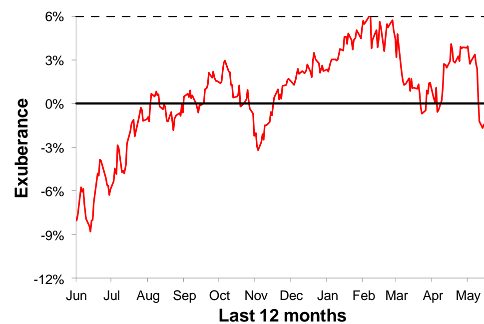


Notes: The disorder index measures the degree to which the 11 sectors' daily returns move in harmony. The two dotted lines depict the band in which the disorder index resided before the GFC in two thirds of days. Extended periods below the lower dotted line might indicate belief that there is little 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

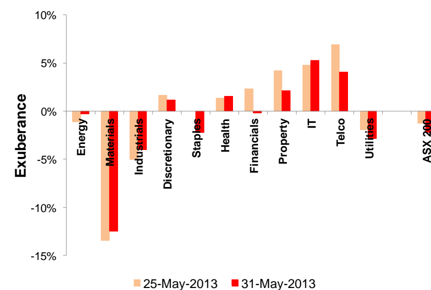
Notes: Each business day we update our estimates for capital gains on the ASX 200 for the following 12 months. For example, the left-most estimate on the vertical axis is a forecast for the 12 months concluding today. The right hand estimate is for the 12 months from today.

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