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Woodhall's Weekly

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Against the wind

While the world market was flat (+0.1) and the S&P 500 fell (-1.4%), the ASX 200 posted a very nice gain (+1.2%) for the week. Our market did sell off a little on Friday but that could not stop the steam roller resource linked sectors having another great week: Energy (+2.3%), Materials (+2.8%) and Industrials (+3.0%). Financials (+1.4%) moved with the broader market.

These differences in sector performance did give our disorder index (Chart 3) a bit of a jolt but it s still in normal territory. Volatility (Chart 1) and Fear (Chart 2) both look really good. Since the index has strong projected capital gains (Chart 4: 11.1%) for the next 12 months and it is only a little overpriced (Chart 5: +1.5%) all of the ingredients are there for a continuation of the rally.

Turning to the sector mispricing in Chart 6, all of the serious underpricing in the resource-related sectors has now gone – along with the quick gains that could have been made – but also most of the serious overpricing in many sectors – by as much as +12% earlier in the year – has gone. The market is well balanced for an orderly rally.

So what has caused this turnaround in the ASX 200? On the macro front only the stubborn would still think China had anything but a solid future. Expectations for Industrial Production was +8.4% and China delivered +9.7%. Iron ore prices have been hanging around $140 / tonne – a far cry from the sub $90 last September. The Q3 weakness in iron ore prices due to seasonality hasn't happened, nor has the big increase in supply most touted.

CBA posted a very good report and dividend – but no special dividend. ANZ disappointed in its update. So it seems the rotation from high yield to cyclical might continue a little – Health was down -2.7%, Property down -1.7% and Utilities were down -1.2%.

The four high yield sectors (Financials, Property, Telcos and Utilities) have expected yield of 5.6% to 5.9% so the yield play is still on for cash sitting in term deposits.

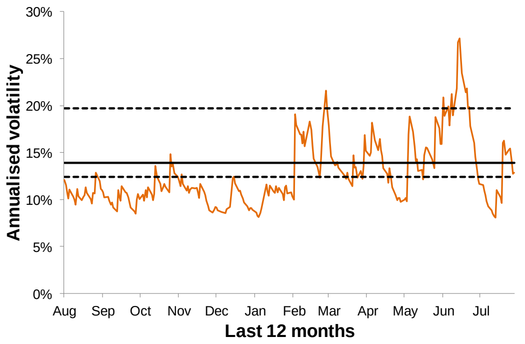
Gold (+4.3%) and Silver (+12.4%) had stellar weeks and copper (+1.6%) continued its climb from the bottom. Our dollar was roughly flat.

So with the eurozone out of recession this week and Japan posting growth of +2.6% the only problems that seem to be in the wings are our election and the appointment of the next Federal Reserve Chairman to commence in January. It seems from overnight polls that there will be a decisive election victory in three weeks which bodes well for confidence – the Westpac index jumped +3.5% to 105.7 in a poll taken just after the economic statement.

Janet Yellen was the hot favourite for the Fed Chair. She would likely continue Bernanke's policies and maybe even soften them. However, Larry Summers is gaining momentum with the apparent backing of Obama. He doesn't believe in stimulus and his appointment would be bad for markets.

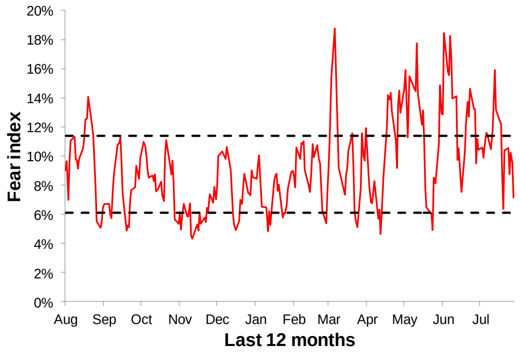
WoodHall Investment Research

Chart 1: Market volatility



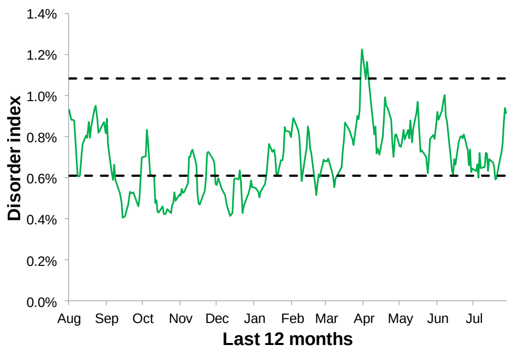
Notes: The solid black line depicts the average volatility since January 2010; the lower dotted line depicts the average volatility pre the GFC; the higher dotted line depicts the average level of volatility during the GFC - up to December 2009. The brown line is a daily estimate of the ASX 200 index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

Chart 2: Fear index



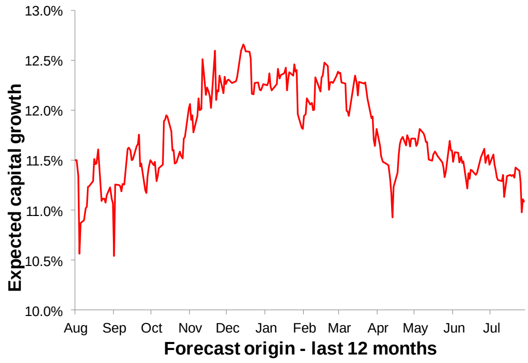
Notes: The fear index is a measure of 'excess' volatility denoting behaviour outside the open/close values each day. The two dotted lines depict the band in which the fear index resided before the GFC in two thirds of days. Extended periods below the lower dotted line might indicate complacency. Extended 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



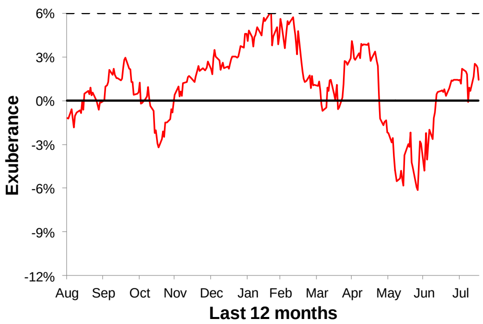
Notes: The disorder index measures the degree to which the 11 sectors' daily returns move in harmony. The two dotted lines depict the band in which the disorder index resided before the GFC in two thirds of days. Extended periods below the lower dotted line might indicate belief that there is little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



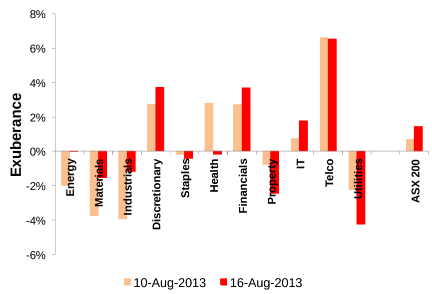
Notes: Each business day we update our estimates for capital gains on the ASX 200 for the following 12 months. For example, the left-most estimate on the vertical axis is a forecast for the 12 months concluding today. The right hand estimate is for the 12 months from today.

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