28 September 2013

Woodhall's Weekly

Ron Bewley PhD, FASSA

Confidence is bubbling under

- **Will the US government shut down?**
- **What are people talking about a house price bubble in Australia?**
- **When will the ASX 200 break 6,000?**

Overview

For the first three days of last week we were following negative overseas leads – but our market fought against them and made some very respectable gains finishing up +0.6% on the week.

There has been a lot of disturbing news from the US about the debt ceiling and the possible government shutdown from as early as October 1st. This is a repeat of the debacle in 2011 which caused S&P to remove of the USA's AAA rating. The government shut down certain services on a number of occasions in the 1990's but the longest stretch was only 21 days. It would not be the end of the world if it happened again but there would likely be a volatility spill-over into equity and bond markets. Annoyingly, the Republicans are trying to bargain for things which have do direct impact on the shutdown – other than the standoff.

The debt ceiling limit could kick in on October 17th and that is far more serious. But, as Winston Churchill famously said, 'You can count on the United States to do the right thing – after they have exhausted all other options.' So there may be some volatility during October but it is most unlikely to be a game changer.

If the debt squabble was not enough, various members of the Federal Reserve came out giving their own takes on tapering. Confusion – yes – but we still think tapering will not start until well into 2014. The economic data just are not strong enough. A US confidence indicator released during the week slipped again.

Not to be outdone, our local media started a beat-up about there being a property bubble in Australia. Inflation-adjusted Sydney house prices are lower than they were during 2010 so why talk of a bubble now? Of course a bubble is possible at some point in the future – but not yet. A different matter is whether people are buying properties without being able to afford any future rate increases that come through. Banks do build in some buffer when calculating repayment structures and they might extend the period of the loan if a client gets in financial trouble. The Reserve Bank and others have said there is no property bubble.

In Germany, Dr Angela Merkel almost got voted in without any coalition support in her third victory. All in all, this is a good result for stability in Europe.

In China, the HSBC flash PMI again beat expectations with a 51.2 against an expectation of 50.9. HSBC has now upgraded its China GDP growth forecast from 7.4% to 7.7%. We never lowered ours! The official China PMI is due out on Tuesday and, if the US government isn't forced to shut down the department, nonfarm payrolls are due out on Friday. The RBA meets on Tuesday but no change seems to be the call

Our market expectations

Our market has moved onwards and upwards for seven weeks on the run or 13 of the last 14 weeks! However, as we wrote last week, 6,000 is not likely anytime soon since capital gains in the high yield sectors (Financials, Property, Telcos, and Utilities) are likely to be constrained by dividend yields. Unless there are some big changes in earnings – and there may be some announced early next year – we believe 6,000 is at least 12 months away and probably it will not occur until 2015. But our forecast for the ASX 200 is still for 10% capital gains over the next 12 months with some very healthy dividends along the way. But with our market overpriced by +2.8%, that translates into an adjusted gains forecast of only +7.2%.

So the fundamentals are fine but there may be some volatility during October. Our indicators suggest we can take it on the chin.

Market Stats

The ASX 200 finished the week at a fresh 5-year high of 5307 (up +0.6%) while the S&P 500 was down -1.0%, the FTSE down -1.3% and the DAX was down -0.2%.

Our 12-month-ahead capital gains forecast (+10.0%) slipped -0.4% during the week (Chart 4). Given current overpricing (Chart 5) of +2.8% for the market and +5.7% for Financials (Chart 6) big gains across the board in Q4 are unlikely. Besides the excess exuberance, the yield on Financials is down to 5.3% which seems like a lower bound. So a big chunk of the market is going nowhere much soon.

Materials are still a little cheap at -1.0% and its 12-month sector forecast is +17.2%, but down from +19.7% a week ago. But the Energy sector is the one to watch. It is a little overpriced at +3.3% but its capital gains forecast is stable at +22.5% with a volatility forecast that has been tumbling (see our Quant Quarterly to be released this week).

Major commodities (gold, copper, iron ore, oil) didn't do much during the week but the Aussie was off a cent.

The quarter finishes on Monday and so the old adage of 'go away in May' again didn't pay off. In July, the ASX 200 was up +5.2%, in August +1.6% and with only one day to go September is up +3.4%.

Glossary

Abenomics – Japan's Prime Minister Shinzo Abe came to power early in 2013 and has brought a new economic style to managing that economy.

FOMC – The Federal Open Market Committee determines monetary policy in the United States. It can be thought of as being similar to our Reserve Bank board.

HSBC 'flash' PMI – HSPC publishes an alternative to the official PMI for China. It is based on a survey of predominantly small to medium sized firms – unlike the official version. The number on the 1st of the month gets much less attention than the official but the preliminary, or 'flash', reading gets attention as a read a week or two before the official numbers.

Long-run mispricing – This measure is based on analysing trends over more than a century of data. The average period of over- or under-pricing is about 18 months. That is, we do not expect the market to rapidly approach its fair value.

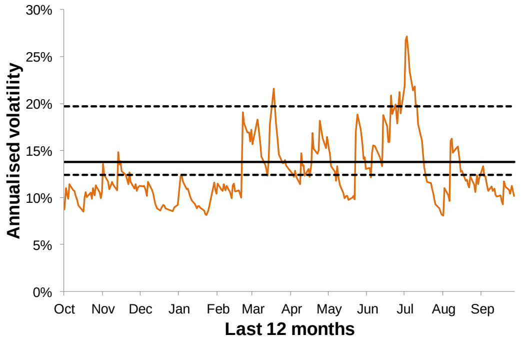
Short-run mispricing – This exuberance measure is our mispricing statistic reported in Chart 5. It is based on 12-month-ahead forecasts of the ASX 200. Please see the notes under Chart 5.

PMI – This acronym stands for Purchasing Managers Index. There is one for most countries and separate statistics for manufacturing and services. Manufacturing typically gets more attention. The statistics are published in the first few days of each month – with China on the 1st. A reading less than 50 means the sector is decreasing in its growth rate – so If China growth slows from 8% to 7%, its PMI should be below 50. If the US speeds up from 2% to 2.5%, its PMI should be above 50.

Savings ratio – In Australia, the ratio of net savings to household disposable income defines the savings ratio. It does not include superannuation contributions.

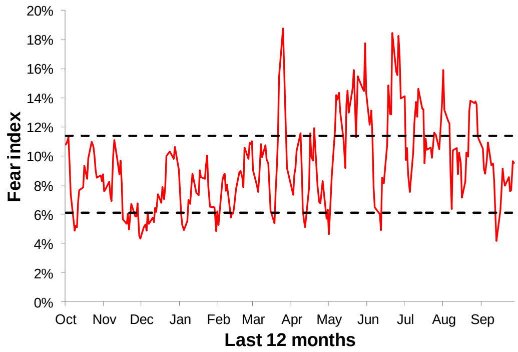
Tapering – It is the name given to the exit strategy from QE3. It is not a tightening monetary policy – just an increasingly less accommodative stimulus.

Chart 1: Market volatility



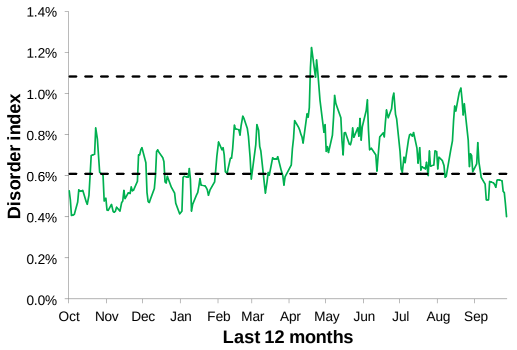
Notes: The solid black line depicts the average volatility since January 2010; the lower dotted line depicts the average volatility pre the GFC; the higher dotted line depicts the average level of volatility during the GFC - up to December 2009. The brown line is a daily estimate of the ASX 200 index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

Chart 2: Fear index



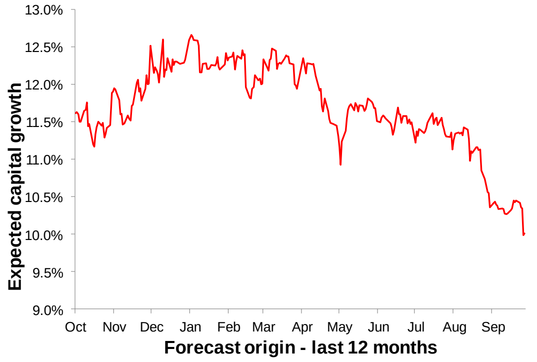
Notes: The fear index is a measure of 'excess' volatility denoting behaviour outside the open/close values each day. The two dotted lines depict the band in which the fear index resided before the GFC in two thirds of days. Extended periods below the lower dotted line might indicate complacency. Extended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



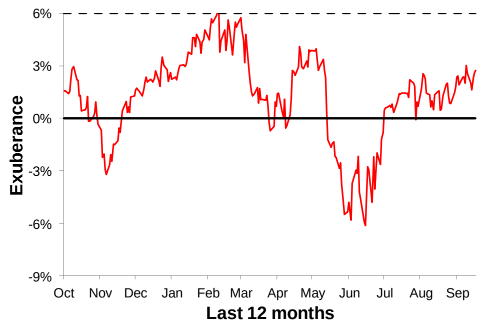
Notes: The disorder index measures the degree to which the 11 sectors' daily returns move in harmony. The two dotted lines depict the band in which the disorder index resided before the GFC in two thirds of days. Extended periods below the lower dotted line might indicate belief that there is little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



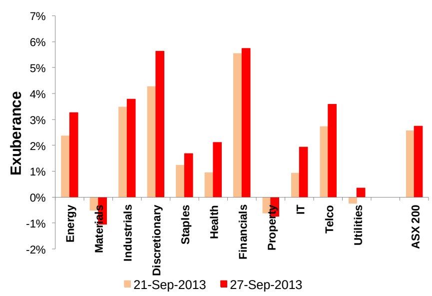
Notes: Each business day we update our estimates for capital gains on the ASX 200 for the following 12 months. For example, the left-most estimate on the vertical axis is a forecast for the 12 months concluding today. The right hand estimate is for the 12 months from today.

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