Ron Bewley PhD, FASSA

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Woodhall's Weekly

Santa's sleigh slips backwards

- **US strength continues**
- **China strength continues**
- **Australian confidence slips on Ford, Qantas, QBE and Holden**

Overview

Last week looked as though it was going to be promising – that was before the market opened on Monday! The +25 point weekend lead from the SPI futures was quickly squandered. At least the fall of -1.7% on the ASX 200 over the week has put paid to those who call Santa Claus rallies every year on the basis of flawed statistical analyses of historical data.

The correction from the October high of 5,441 is only about -6% so far – the SPI futures are pointing down for Monday (-16 pts) despite the S&P 500 having finished flat overnight. Much of what has gone on this week has been the result of signs of strength in the US economy and a resultant expectation of early tapering. The Fed meets on Tuesday and Wednesday next week so we will know the outcomes on tapering at least by market open on Thursday 19th December.

Although analysts' expectations have increased the chance of tapering being announced next week, it seems unlikely to me as the new-found optimism has only lasted a month or two. The Fed cannot afford to have to go back on a taper if, indeed, it starts that process any time soon.

What may happen is that the Fed increases its clarity on how, rather than when, tapering will start. Given that we have our estimate of mispricing of our index at -4.4%, a 'good outcome' from the Fed meeting on Tuesday night might produce a big 'pop' in our market. This would not, of course, constitute a Santa Claus rally as we are very likely to finish the year well below the end-of-October levels. Perhaps a *Santa-recovery-party* would be a better term if a pop occurs.

The US Congress has seemingly averted the January 15th and February 7th deadlines for shutdowns and debt ceiling debacles. As we suggested, the Republicans could not afford more bad press. They have come up with a bipartisan solution that pushes the deadlines out two years by renegotiating the sequester cuts that clouded the start of 2013. The long-term unemployed missed out. The extension of social security payments from 26 weeks to 99 weeks during the GFC will revert to 26 weeks. The House of Reps overwhelmingly passed the bill last night with approximately equal numbers from both sides supporting it! The Senate is to consider the bill next week and only 60 votes are needed to get it through. However, such is the bad blood on the Hill that it might not be easy.

US retail sales came in at +0.7% for November on the back of a +0.6% increase for October. The November figure obviously included 'Black Friday' but not 'Cyber Monday' which fell in December this year.

I was bemused by reports by some media that China growth had slowed. Industrial Production came in at 10.0% against an expectation of 10.1%.

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Surely that tiny miss cannot be called a slowdown? The previous month came in at 10.3% but Industrial Production was in single digits for earlier months. China Exports and Imports both came in strongly.

Japan's growth for Q3 was revised down from an annualised +1.9% to +1.1%. Prime Minister Abe has re-stated his determination to use stimulus to target inflation at 2%. It is too soon to call a falter in their economic progress after the two previous quarters of very strong growth.

With Ford having announced a 2016 exit from manufacturing cars here, Qantas and QBE reporting big losses and, now, Holden announcing a 2017 exit from manufacturing it is not surprising business and consumer confidence both took hits this week.

It is important to remember that Julia Gillard brokered a deal with the car industry in 2012 that was said to 'guarantee' auto production for a decade in return for a $275m assistance package. Barely more than a year later (with Ford already packing its bags), it was reported that Holden would have needed an extra $80m a year for seven years taking total industry assistance to over $1bn for the period!

While industry restructure is always painful, it has to happen on a continual basis. Since at least the time that people in the North of England (called Luddites) smashed the newly introduced mechanical looms that would replace their hand weaving, people have resisted change. But we are all so much better off than in pre-Industrial Revolution days. Of course much can and should be done by the government to make transitions easier.

Our unemployment rate was reported to have nudged up a notch to 5.8% from 5.7% but a closer examination shows that rate increased from 5.74% to 5.76%. Given the sample size of the labour force survey, that change translates to about 12 more humans becoming unemployed in the survey sample! 21,000 jobs were created of which +10,000 were full-time positions.

Market expectations

As we turn our attention to 2014, our 12-month adjusted forecast for the ASX 200 is +14.3% on the back of substantial underpricing (-4.4%). Dividend yields are strong at 4.8%. Importantly the sell-off in the banks has now made them very attractive (again) with expected dividends yields for the sector (5.7%) well off the 'floor' of about 5.1% we have talked about. Financials are underpriced (-2.8%) and unadjusted capital gains of +6.6% produces an adjusted forecast of +9.6%.

Our e-o-y forecast for 2014 remains at 5,900. Of course, that estimate is a 'fair value'. I think of that figure being a sort of average over the December/January period – as I always do.

Market stats

We finished the week more or less in line with the S&P 500 but our level of fear (Chart 2) was heightened due to big swings in the index during the days. Fear is not high enough to prevent a rally but not much is likely to happen until Thursday – after the Fed meeting. The next three days could be the last opportunity to get set if tapering does not start until at least Q2, 2014.

Despite the rise in fear, volatility (Chart 1) remains low. Volumes were reasonable over the week. One analyst on Sky claims to have matched stock market activity with currency trading to conclude much of the sell offs during the week was due to big overseas investors getting out.

Our capital gains forecasts (Chart 4) have recovered a little to +9.4% for the next 12 months. Combined with our exuberance measure (Chart 5), our adjusted gain for the next 12 months is +14.3% and a dividend yield of 4.8%.

All sectors (Chart 6) are now cheap but the Telco exuberance of -0.8% is not enough to make the adjusted gain for that sector attractive at +4.5% although the expected yield is back up to 5.8% plus franking credits.

With the Aussie back under 90c confidence might start to build but the flak from Holden will hang around for some time.

Interestingly, our analysis of personal debt (credit cards, car loans, etc) has ended the deleveraging cycle and indeed, is starting to climb. This pattern is so similar to what happened after the 1990/91 recession. I reiterate, 2014 is looking healthy but 2015 might be really good!

Tomorrow I'll win it all back!

As a student in the Statistics Department at the University of Sheffield, I was naturally interested in gambling – particularly as my studies in Statistics and Mathematics in the Science Faculty were accompanied my studies in Economics in the Social Sciences Faculty (1968-1971).

I vividly recall an article it the colour supplement of either the *Observer* or the *Sunday Times* in the late 60s. I can't remember which but both were (equally) quality Sunday newspapers I read when I could. The front cover of this particular supplement was a picture of the floor of an empty betting shop (TAB in Australia) with crumpled up betting slips on the floor (losing ones I presume!).

The article made two main points (in my opinion) and the title of the piece was the same as the header for this section – my memory of that article is that vivid.

The first point was that poorer people typically placed riskier bets than richer people. A man with a few dollars who bets a dollar to win a dollar changes almost nothing in his life if he wins. He is still poor. But a winning 50-1 shot changes his life at least for a week.

A richer person could afford to bet much more and possibly win a good night out (or more) without risking the family fortune. Life carries on (almost) as normal after any loss for this man. I totally agreed then with this argument and I still do now. The same logic applies to the stock market. Risks and investment strategies should be tailored for the individual.

The other point was about desperation. The richer person, by this argument, is not much worse off after a loss (except for pride!). The poorer person may have lost a few meals or even the rent for a week or more.

As a student working in factories in Liverpool over those summers I saw men lose money at lunchtime on Thursdays (paydays) only to back it up with bigger bets that same day 'to win to all back'. Sometimes they had to go home to their families to tell them that they had lost everything. So sad, so irresponsible! But in a way, I can understand it, but I can't condone it.

Australia is obviously not in the same position as those labourers I worked with in the 60s and 70s (many of them fine interesting, fun people – happy memories for me) – they were just people trying to escape their very unhappy life styles. But the principle is the same. To keep backing an industry after each failure is to fall into the trap so many gamblers have fallen into.

Listening to Sky Business as I write, someone was saying more or less "shouldn't we pump money into Holden until the dollar comes back". Crumpled betting slips on the floor.

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.

Australian debt ceiling – Labor brought in a debt ceiling in mid 2018 of $75bn to self-impose some fiscal discipline during the onset of the GFC. Within seven months that ceiling was almost trebled to $200bn and it has since been raised to $300bn during Labor's term in office. Since before 2008 we had no debt ceiling that is equivalent to an infinite ceiling!!!

Black Friday – This term is used for the Friday after Thanksgiving in the US to denote the start of the shopping season for the holidays. Black refers to the accounts going back into the black from increased sales – it is certainly not a negative term!

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.

GOP – stands for Grand Old Party which is an alternative name for the US Republican Party.

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.

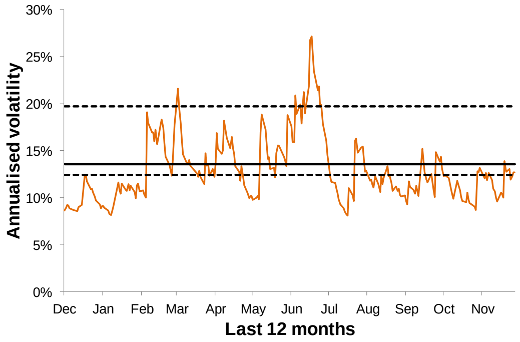
PMI – This acronym stands for Purchasing Managers Index. There is one for most countries and separate statistics for manufacturing and services. Manufacturing typically gets more attention. The statistics are published in the first few days of each month – with China on the 1st. A reading less than 50 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.

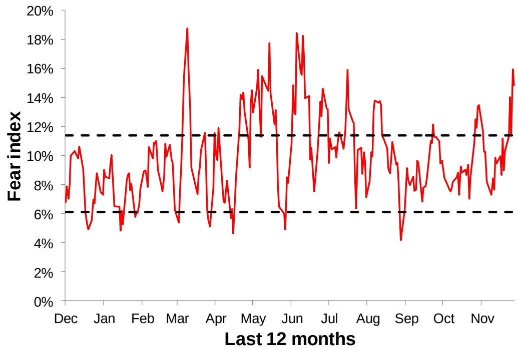
US non-farm payrolls data – are published on the first Friday of each month. They are generally considered to be the most reliable indicators for employment and unemployment in the US. Roughly speaking, a 200,000 increase in jobs is considered strong – particularly in the context of the tapering discussions.

Chart 1: Market volatility



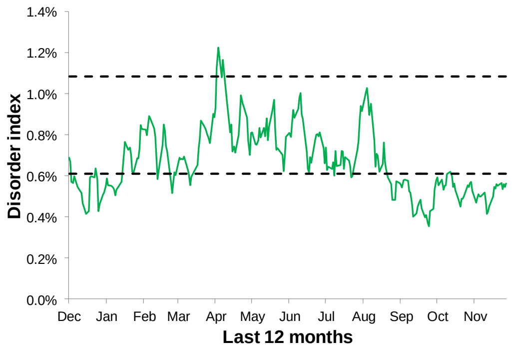
Notes: The solid black line depicts the average volatility since January 2010; the lower dotted line depicts the average volatility pre the GFC; the higher dotted line depicts the average level of volatility during the GFC - up to December 2009. The brown line is a daily estimate of the ASX 200 index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

Chart 2: Fear index



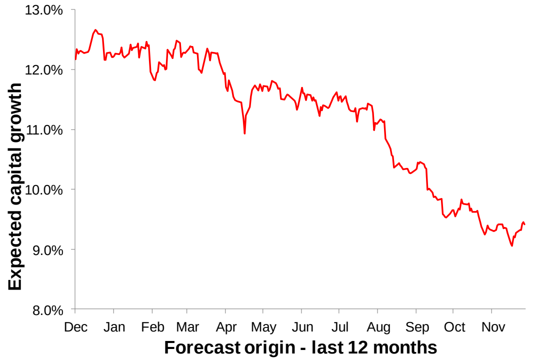
Notes: The fear index is a measure of 'excess' volatility denoting behaviour outside the open/close values each day. The two dotted lines depict the band in which the fear index resided before the GFC in two thirds of days. Extended periods below the lower dotted line might indicate complacency. Extended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



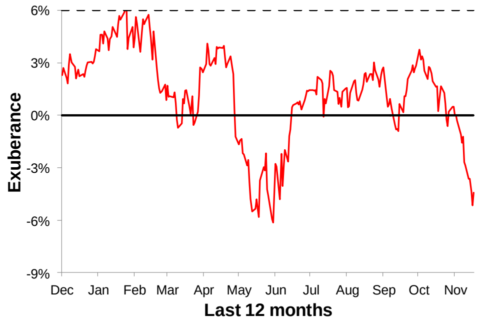
Notes: The disorder index measures the degree to which the 11 sectors' daily returns move in harmony. The two dotted lines depict the band in which the disorder index resided before the GFC in two thirds of days. Extended periods below the lower dotted line might indicate belief that there is little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



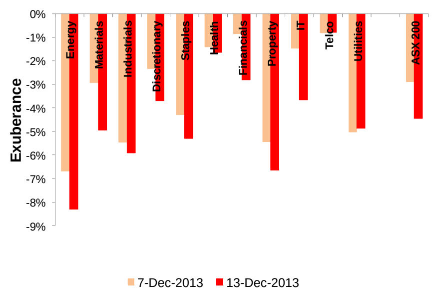
Notes: Each business day we update our estimates for capital gains on the ASX 200 for the following 12 months. For example, the left-most estimate on the vertical axis is a forecast for the 12 months concluding today. The right hand estimate is for the 12 months from today.

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