21 December 2013

Woodhall's Weekly

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Santa-recovery-party in full swing

- **ASX 200 bounces back**
- **MYEFO dulls the landscape**
- **No taper tantrums!**

Overview

Last week I argued that a Santa rally was all but impossible because the fall from the late October peak was so big. I did, however, point out we could have a recovery party effect – from Thursday after the FOMC meeting – and we got one in spades.

After a -7% correction into this week from October, our market bounced back +4% in two days. The SPI futures contract is pointing to a modest increase on Monday. All sectors were up over the week but that wasn't because of 'MYEFO' (Mid-Year Economic Forecast Outlook), delivered by the Treasurer on Tuesday.

Unsurprisingly, Joe Hockey blamed the previous Labor government as much as he could. Of course a lot of it was justified but where the problem lies is with the Coalition not being able to enact its election promises – such as a repeal of the Carbon Tax.

There was an interesting change in the way that Treasury's forecasts were presented. Treasury gives the Treasurer a range of expectations and the Treasurer chooses from that range. The Labor government had predicted unemployment to peak at an average over the year of 6.25% but then to fall back sharply to 5.0% – or the long-run level. Such a sharp recovery has never happened before. The Coalition is using the same 6.25% peak but it has unemployment staying there until at least 2015/16.

There is no doubt that parts of manufacturing in Australia have to change quickly. One only had to listen to the complaints Toyota has made about its agreement with the unions over conditions. But the production side of mining is coming through in strength. The iron ore price did slip a bit through the week but it is still well above $130 / tonne.

Ben Bernanke, in his post-FOMC meeting address, told us 'tapering' would start in January by reducing bond buying by $10bn a month. That is, the stimulus package is to be $75bn per month from January and the benchmark interest rate is unchanged.

The market looked as though it would react negatively to the start of tapering – as it did back in May. However, there were three unexpected outcomes associated with the announcement.

First, this $10bn reduction is a one off and not part of a defined process. The next change, *up or down*, will depend upon the data. It was this statement that really caught my attention. Second, he stated that interest rates are likely to stay lower for longer. And third, the previous target of 6.5% unemployment for the end to stimulus has been changed to 'well less than 6.5%'. Good times keep on rolling. And too boot, the Q3 GDP growth was revised up to +4.1% from +3.6% last night to give Obama something positive to talk about last night.

Market expectations

Our 12-month capital gain forecast for the ASX 200 slipped back to +9.1% from +9.4% and exuberance climbed from -4.4% to -1.2%. That gives an adjusted +10.5% forecast ending 2014 at 5,850 – down a fraction from our e-o-y last week. Our mid-2014 forecast is still 5,600.

The markets are settled and our market statistics reflect that a slow and steady climb is on the cards.

Market stats

The ASX 200 climbed +3.3% over the week with the Telcos sector (+4.6%) leading the way. Financials (+3.1%) and Property (+2.7%) also did well but Materials (+3.8%) and Industrials (3.9%) had their best run in a while. But Materials is still down on the year at -5.6%.

These gains eroded a lot of mispricing taking some sectors back into a slightly expensive range. Telcos (Chart 6) is the only sector (+3.6%) overpriced by more than +0.5% as Telstra buyers took advantage of the higher yield available at the beginning of the week. Energy, Property and Utilities are still quite cheap.

The temporary lift in capital gains forecasts (Chart 4) is over but, at +9.1%, expected growth is well above trend. Exuberance for the market (Chart 5) is -1.2% and so most of those buying opportunities I wrote about last week have gone – at least for a while.

Volatility (Chart 1), Fear (Chart 2) and Disorder (Chart 3) are all in the zone to sustain a rally. Volumes were large later in the week but with two days off next week (plus Friday for those not in recovery mode!) and one day the week after, high volumes are not expected. As a result, this is the time to reflect on how our portfolios are positioned with a view to eking out another good year.

And a Happy Christmas to our readers.

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.

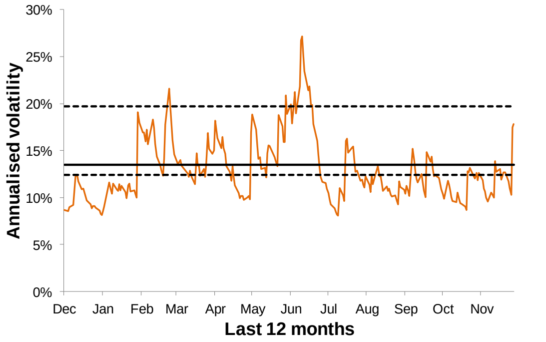
PMI – This acronym stands for Purchasing Managers Index. There is one for most countries and separate statistics for manufacturing and services. Manufacturing typically gets more attention. The statistics are published in the first few days of each month – with China on the 1st. A reading less than 50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

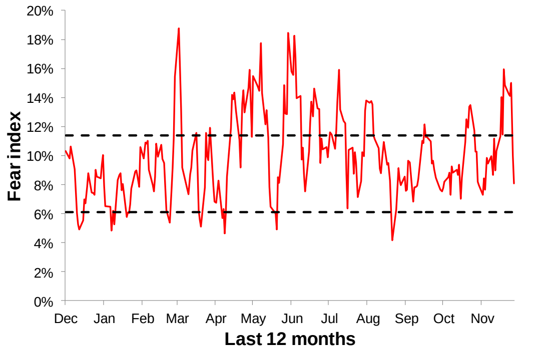
US non-farm payrolls data – are published on the first Friday of each month. They are generally considered to be the most reliable indicators for employment and unemployment in the US. Roughly speaking, a 200,000 increase in jobs is considered strong – particularly in the context of the tapering discussions.

Chart 1: Market volatility



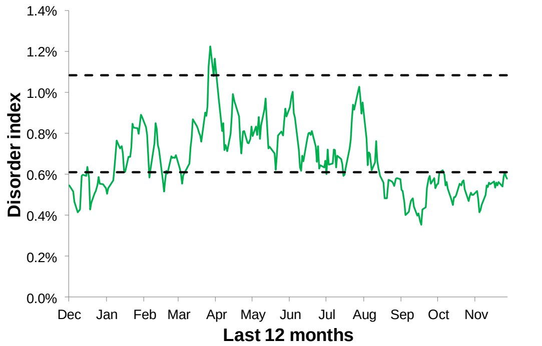
Notes: The solid black line depicts the average volatility since January 2010; the lower dotted line depicts the average volatility pre the GFC; the higher dotted line depicts the average level of volatility during the GFC - up to December 2009. The brown line is a daily estimate of the ASX 200 index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

Chart 2: Fear index



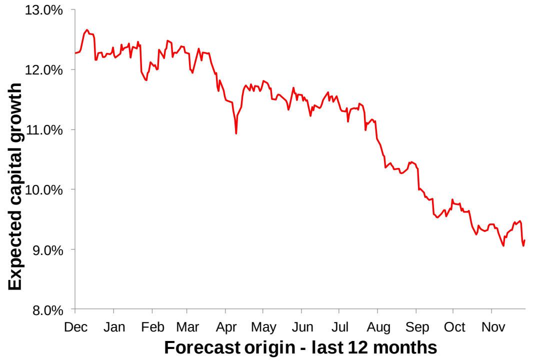
Notes: The fear index is a measure of 'excess' volatility denoting behaviour outside the open/close values each day. The two dotted lines depict the band in which the fear index resided before the GFC in two thirds of days. Extended periods below the lower dotted line might indicate complacency. Extended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



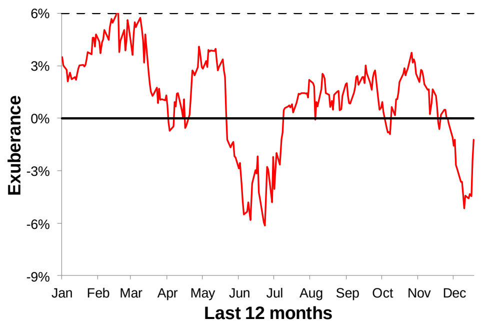
Notes: The disorder index measures the degree to which the 11 sectors' daily returns move in harmony. The two dotted lines depict the band in which the disorder index resided before the GFC in two thirds of days. Extended periods below the lower dotted line might indicate belief that there is little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



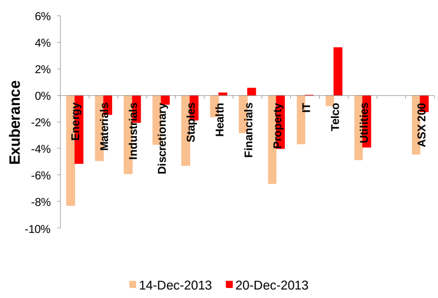
Notes: Each business day we update our estimates for capital gains on the ASX 200 for the following 12 months. For example, the left-most estimate on the vertical axis is a forecast for the 12 months concluding today. The right hand estimate is for the 12 months from today.

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