29 March 2014

Woodhall's Weekly

Ron Bewley PhD, FASSA

Soft Q2 looking likely

- **Stimulus talk from Germany to China**
- **Joe Hockey floats infrastructure plan**
- **US consumers getting happier**

Overview

With the EU economy not yet that strong and Germany succumbing to strikes for more pay, at last Germany is talking about supporting the EU to print money. This behaviour is so 'un-german' but it might give that part of the world a boost that would help us all.

The Ukraine seems set to receive a $20bn bailout from the IMF providing conditions can be agreed upon.

Barack Obama visited Europe to seek to improve trading relations (not bailouts) and China visited France for the same reason. It is great to see major powers going about their businesses rather than solving major crises.

China's HSBC 'flash' PMI for manufacturing came in at a lowly 48.1 adding to the speculation by some that China overcooked its slowdown. Two things should be noted. The flash PMI is based on a sample of just 420 small and medium firms across China. The official PMI that came out on March 1st at 50.2 is based on a sample of 3,000 firms across the board.

But credible speculation grew during the week that China is about to add some stimulus – and when they add stimulus, they add it. So, two scenarios are worth thinking about. First China has slowed down too much and stimulus will give a big boost to second half growth in China. Second, China is doing fine so the rest of the year will be good.

Either way, the worst case is that we experience a soft Q2. Mining stocks have had a bleak March but they started to bounce back last week with a gain of +0.9% on stimulus talk.

Treasurer Hockey gave an interesting press conference yesterday. He canvassed a number of topics on infrastructure. One involved state-based asset sales and another was about trying to make new opportunities for superannuation savings to be diverted towards Australian infrastructure.

If Hockey pulls it off, there could be big gains for our economy and some of our Industrials stocks. Since this is a domestic programme, the current high dollar just means cheaper imports and no exports.

In the US, consumer confidence was up and then consumer spending was better than expected. The S&P 500 had a nice rally overnight only to fizzle a bit at the end due to squaring books for the end-of-quarter.

Brazil had its credit rated moved down a notch by S&P to just above junk status with the World Cup just a few months away.

WOODHALL INVESTMENT RESEARCH

Market expectations

We started the year with our 2014 ASX forecasts for e-o-y at 5,850; a low of 5,150; and a high of 6,150.

Our forecast e-o-y on the ASX 200 has been fluctuating between 5,700 and 5,750. The predicted high is slipping below 6,000 largely because the12-month-ahead capital gains forecast continues to slip. It now stands at +6.8% a full 2.0% below the forecast at the beginning of the year. Materials stocks have largely done the damage in this calculation.

Financials stocks rallied strongly over the week to push down yields to 5.4% – well down on the 6.0% for Property. With resource stocks currently a bit weak and dividends constraining high-yield sector capital gains, investors are struggling to win a trick.

With the SPI futures up 12 points for Monday and the official China PMI out on Tuesday (nobody cares about the RBA's April Fools' rate decision on Tuesday) the week could start off well. All sectors except Financials and IT are currently cheap. So I continue to hold my view that mid-2014 will be a bit soft but the latter part of the year will be much stronger.

Market stats

Volatility (Chart 1) is just below the long-run average. Fear (Chart 2) nipped just above the range on Friday but that is nothing to worry about. The market could hold a rally if it got a trigger but – apart from a possible good post-Lunar-New-Year PMI from China on Tuesday – there doesn't seem to be much on our near term horizon to feel positive about.

The rolling 12-month unadjusted capital-gains' forecast dropped half a percent over the week to land at +6.8% (Chart 4). But, allowing for mispricing, that capital-gains' target increases to +8.1%.

The Materials sector capital-gains forecast slipped to only +0.9% for the next 12 months but, being underpriced at -4.9% (Chart 6) makes that sector slightly attractive with either improving PMI's or China stimulus to carry the rally.

Our market is still cheap (-1.3%, Chart 5) after moderate growth over the week of +0.5%.

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.

ASX forecasts - We have further supplemented our forecasting process for the ASX 200 by including not just a forecast of the peak (at some unspecified time during the year) but also the low. Thus, we now have an end point (e-o-y forecast) and a range for the whole year. Naturally, on a rising market the low is more likely to occur earlier in the year and the high nearer the end. Since we publish our forecasts to the nearest 50 points to reduce the sense of false accuracy a change of just a couple of points can kick the forecast over by 50 points at around the 25 and 75 marks.

Australian debt ceiling – Labor brought in a debt ceiling in mid 2008 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!

China's shadow banking – In essence, the China government dictates what all banks must lend at and pay for deposits. As a result, if a potential borrower is deemed too risky at the prevailing rate, the banks refuse to lend (rather than increase borrowing rates as may happen here). The 'failed' borrower may then seek funding from the shadow banking system that is not so regulated.

It appears that any defaults in the shadow banking system would be covered by the Central Bank so there would not be the sort of contagion problems that arose in the US and Europe. However, a serious round of defaults in China would put a bit of a brake on growth.

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.

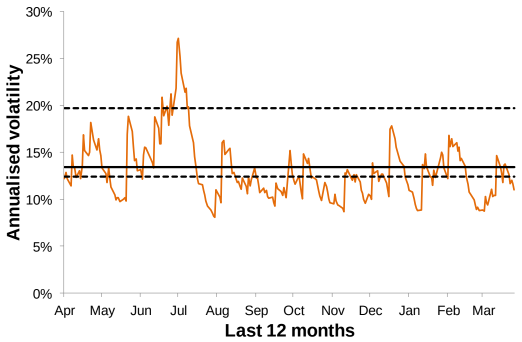
PMI – This acronym stands for Purchasing Managers Index. There is one for most countries and separate statistics for manufacturing and services. Manufacturing typically gets more attention. The statistics are published in the first few days of each month – with China on the 1st. A reading less than 50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

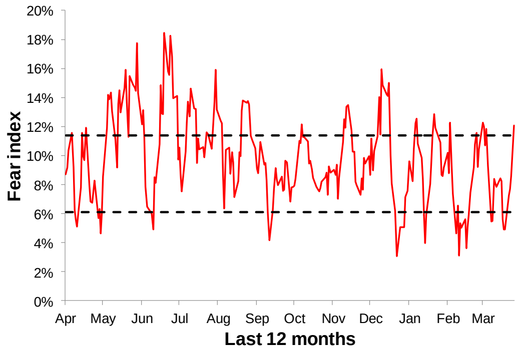


Notes: The solid black line depicts the average volatility since January 2010; the lower dotted line depicts the average volatility pre the GFC; the higher dotted line depicts the average level of volatility during the GFC - up to December 2009. The brown line is a daily estimate of the ASX 200 index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

Chart 4: 12-month-ahead capital gains forecasts

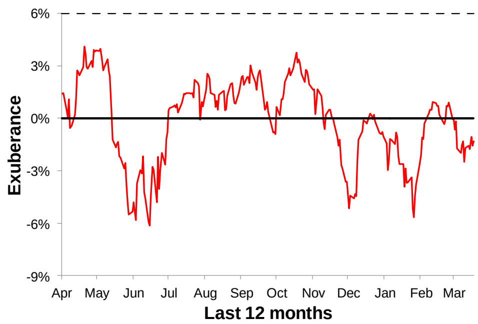
Notes: Each business day we update our estimates for capital gains on the ASX 200 for the following 12 months. For example, the left-most estimate on the vertical axis is a forecast for the 12 months concluding today. The right hand estimate is for the 12 months from today.

Chart 2: Fear index



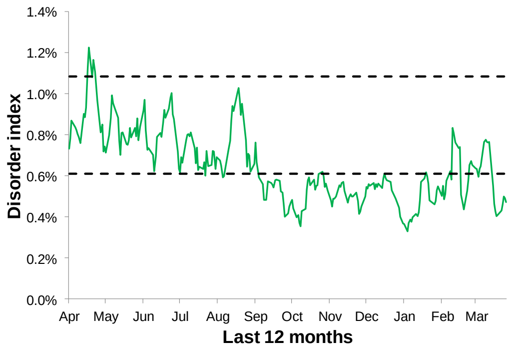
Notes: The fear index is a measure of 'excess' volatility denoting behaviour outside the open/close values each day. The two dotted lines depict the band in which the fear index resided before the GFC in two thirds of days. Extended periods below the lower dotted line might indicate complacency. Extended 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 5: Market exuberance



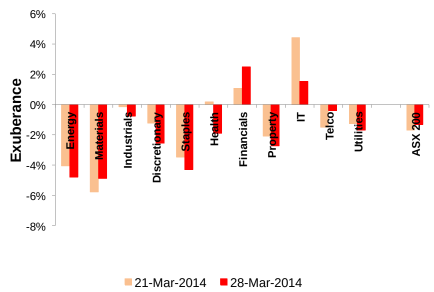
Notes: Exuberance is our measure of mispricing on the ASX 200. A value below the solid black line denotes the market is perceived to be cheap and above that line expensive. Experience suggests that exuberance above +6%, denoted by the dotted line, is an indicator of a potential correction of 6% to 10% - or for the market to move sideways for an extended period.

Chart 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 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