10 May 2014

Woodhall's Weekly

Ron Bewley PhD, FASSA

Budget blues flatten market

- **ASX 200 kept losing steam**
- **Australian labour data stay strong**
- **China trade data better than they seem**

Overview

Several times during the week a decent start to the day got frittered away by the close. The market finished the week 3 points above where it closed the week before. But that was better than the -0.2% fall on the S&P 500.

The Dow closed last night at another record high. The disconnect between the Dow and the S&P 500 is due to the tech sell-off on the latter which is not represented on the Dow.

The most obvious – but far from conclusive – reason for our flat market is investors and traders are glum about the Budget to be handed down on Tuesday night. As usual, the bark is likely to be worse than the bite.

What surprises me – after my own analysis – is how anyone could say our budget deficit / government debt is not of great concern. Just plot the debt series freely available on the RBA website. On top of that, baby boomers are retiring in droves and they are living longer.

Our Labour Force data came out on Friday. Unemployment was flat at 5.8% further backing our notion that the peak (of 6.0%) has passed. A solid, but not stellar 14,200 jobs were created and all of them were fulltime. To put things in context, less than half of the population has a job and, hence, pays tax. There are lots of kids, oldies and parents looking after kids and others not in the official workforce. 5.8% unemployment is a small portion of this half being supported by the other half. The budget needs repair.

China trade data came out with exports only up +0.9% and imports up +0.8% on the year. However, if trade with Hong Kong is removed, double digit growth was the result. Hong Kong is not that important. But a lot of people apparently falsified documents (a lot!) up to April last year to help their own books. Data should be relatively clean from next month.

China imports from Australia were up 14%; China inflation was down to 1.8%; but iron ore prices slipped another couple of dollars.

Europe continues to strengthen and Draghi remains on his toes to act when necessary – maybe even in the coming week. It was also reported that Chancellor Merkel has forsaken sausage sandwiches as snacks in favour of raw carrots in a new trim health kick. While I love the odd snag myself, I eat them for my meal and not in between! Bring it on Angela.

Yellen was more relaxed in her testimony before Congress last week. And she was more upbeat especially for the economy from Q1, 2015.

At home the RBA raised its GDP forecast for FY14 to 3.0% from 2.75% and dropped its inflation

General Advice Warning: This note has been prepared without taking account of the objectives, financial situation or needs of any particular individual. Any individual should, before acting on the information in this note, consider the appropriateness of the information, having regard to the individual's objectives, financial situation and needs and, if necessary, seek appropriate professional advice. Past returns are no guarantee of future performance.

forecast from 3.0% to 2.75% (or the typist just got the numbers mixed up?).

It is hard to imagine the market getting excited by the budget so flat or down seems to be on the cards for this week. But then we only have to get through some end of financial year window dressing by fund managers before we can start the next leg up. Go away in May but make sure you are back in late June?

With another record iron ore shipment from the Pilbara for April; broker upgrades for some of the miners; and cleaner data due from China next month the modest gains so far this year should be bolstered.

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 current forecast e-o-y on the ASX 200 is just hanging on to 5,750 and the high forecast is again 6,000.

Our July 1st 2013 forecast for FY14 was for a June 30th 5,450 – about where we are now at 5,461.

The deterioration in our 12-month capital gains forecast (Chart 4) reversed and stabilised at +6.9% over recent weeks but it has slipped back a little this week to +6.7%.

With current underpricing at -0.5% (Chart 5), the adjusted gain for the next 12-months is +7.3%. The forecast yield stays at +4.6%.

Market stats

The stats are much the same as last week. The Fear Index did rise a little above the normal bound (Chart 2) but it is now back in the zone.

With three of the big banks going ex-div last week and next, some steam is naturally taken out of the market. So with the Budget on Tuesday, Wednesday is going to get a double whammy.

Energy (+2.1%) and Utilities (+2.4%) had a good week and neither are now no longer cheap. Materials at -3.0% underpriced might be worth some attention soon.

The VIX closed the week at just under 13. Markets are ready to take in some good news!

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.

ISM - Institute of Supply Management produces a 'PMI-like' number for the US economy. Like the PMI, 50 is the cut off between improving and worsening expectations.

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.

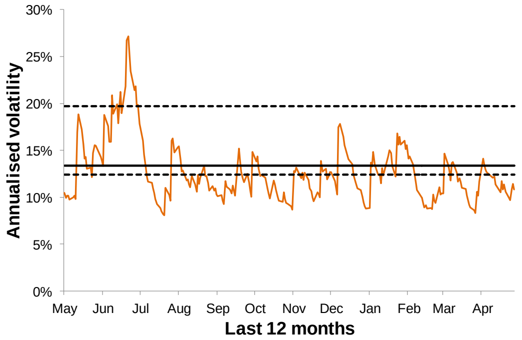
PMI – This acronym stands for Purchasing Managers Index. There is one for most countries and separate statistics for manufacturing and services. Manufacturing typically gets more attention. The statistics are published in the first few days of each month – with China on the 1st. A reading less than 50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

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.

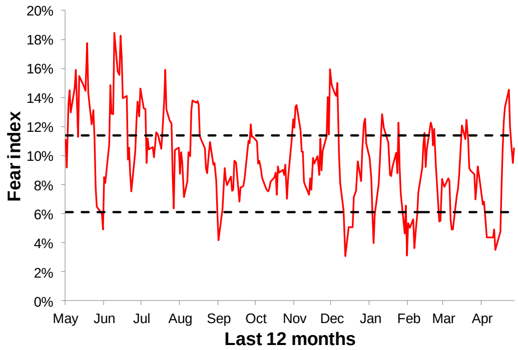
US non-farm payrolls data – are usually published on the first Friday of each month. They are generally considered to be the most reliable indicators for employment and unemployment in the US. Roughly speaking, a 200,000 increase in jobs is considered strong – particularly in the context of the tapering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

Chart 1: Market volatility



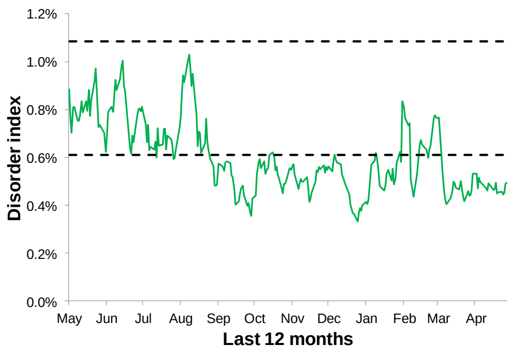
Notes: The solid black line depicts the average volatility since January 2010; the lower dotted line depicts the average volatility pre the GFC; the higher dotted line depicts the average level of volatility during the GFC - up to December 2009. The brown line is a daily estimate of the ASX 200 index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

Chart 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

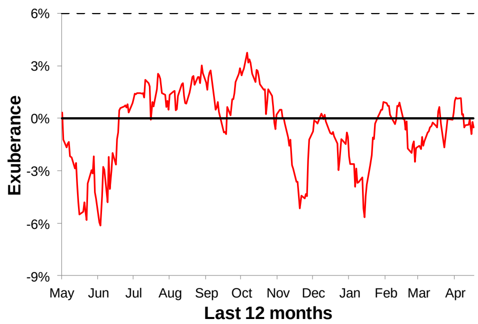


Notes: The disorder index measures the degree to which the 11 sectors' daily returns move in harmony. The two dotted lines depict the band in which the disorder index resided before the GFC in two thirds of days. Extended periods below the lower dotted line might indicate belief that there is little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

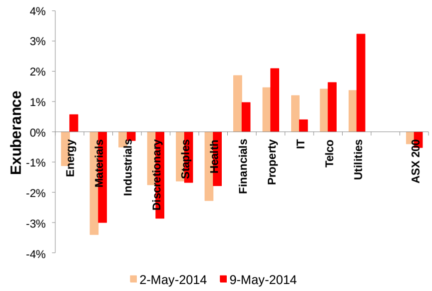
Notes: Each business day we update our estimates for capital gains on the ASX 200 for the following 12 months. For example, the left-most estimate on the vertical axis is a forecast for the 12 months concluding today. The right hand estimate is for the 12 months from today.

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