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# Woodhall's Weekly

## Budget fails to make a dent in the market

- **ASX 200 slightly up on week**
- **S&P 500 breaks 1,900**
- **China data just good enough**

### Overview

After much anticipation for a tough budget and a sell-off in equities, Joe Hockey delivered a budget that would best be described as interesting.

The high point was the commitment to a future high-tech Australia. He established a \$20bn Medical Research 'Future Fund', a venture capital style programme and a deregulation of university fees to enable one or two top universities to compete with the very best in the world.

Much of the expenditure changes amounted to a switch rather a cut. On the revenue side modest changes were made with the debt levy on incomes over \$180,000, the return of a fuel tax indexation and co-payments in the health sphere.

All in all, the market was up +0.3% on the week but the budget is not done and dusted. It will meet the Greens and Labor head on in the Senate but the new Senate takes control from July. It is not clear what will actually get through but it would be a great shame if Australia does not distance itself from the hand-out mentality it recently acquired.

On the other side of the Pacific, the S&P 500 broke through 1,900 for the first time but it couldn't hold that level.

China released its Industrial Production, Retail Sales and Fixed Assets Investment growth data. All

were close misses but good enough not to upset the markets.

The Commonwealth Bank gave its quarterly update and broke through \$81 – but again not holding on to the new highs. BHP too had a good week in part due to its focus on its core assets.

Japan reported a stellar quarter for GDP growth – at +5.9% (annualised) but the impending hike in sales tax from 5% to 8% on April 1<sup>st</sup> would have had an impact on Q1 activity. Japan imports and exports were both up about +6%.

Today marks Portugal's exit from the bailout programme but its growth is sadly nothing to write home about.

### 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 still hanging on to 5,750 and the high forecast is again 6,000.

Our July 1<sup>st</sup> 2013 forecast for FY14 was for a June 30<sup>th</sup> 5,450 – about where we are now at 5,479.

The deterioration in our 12-month capital gains forecast (Chart 4) has stabilised at +6.8%. With

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current underpricing at -0.4% (Chart 5), the adjusted-gain forecast for the next 12 months is +7.2%. The forecast yield stays at +4.6%.

With the budget now behind us there is only end-of-year window dressing seemingly between us and Christmas. It is time to freshen up our portfolios for the second half.

## Market stats

The stats are again pretty good. Volatility (Chart 1) is below the long-run average and it has been stable. The Fear Index stayed inside the normal bound (Chart 2) for all but a fraction.

With two of the big banks going ex-div last week, The Financials index was down -0.4%. My continued faith in CBA and WBC seems to have been warranted.

Since the week was largely flat, there was not much change to our exuberance measures (Charts 5 and 6). Materials are still a little cheap at -2.1% and Discretionary is the cheapest at -3.1%. Telcos and Utilities are the most expensive but each only at +2.8%

## 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** – HSBC 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 1<sup>st</sup> 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 1<sup>st</sup>. A

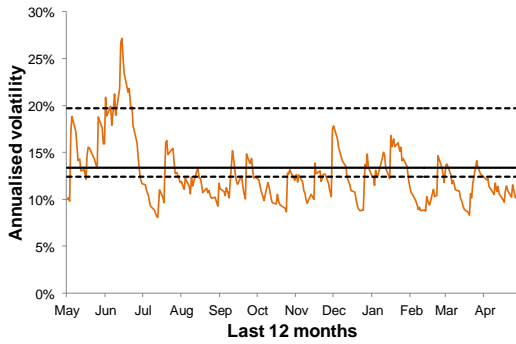
reading less than 50 means the sector is decreasing in its growth rate – so If China growth slows from 8% to 7%, its PMI should be below 50. If the US speeds up from 2% to 2.5%, its PMI should be above 50.

**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.

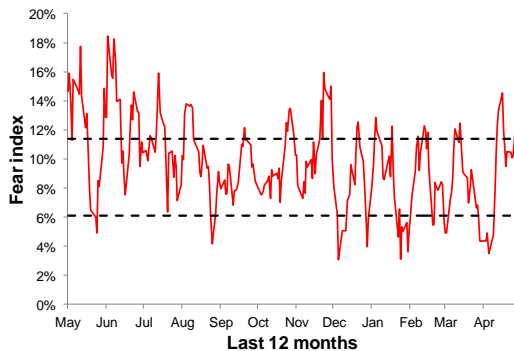
**US non-farm payrolls data** – are usually published on the first Friday of each month. They are generally considered to be the most reliable indicators for employment and unemployment in the US. Roughly speaking, a 200,000 increase in jobs is considered strong – particularly in the context of the tapering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

**Chart 1: Market volatility**



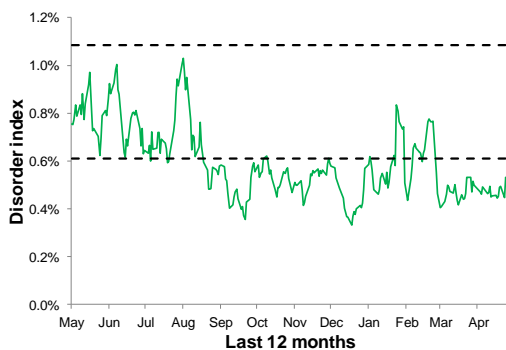
Notes: The solid black line depicts the average volatility since January 2010; the lower dotted line depicts the average volatility pre the GFC; the higher dotted line depicts the average level of volatility during the GFC - up to December 2009. The brown line is a daily estimate of the ASX 200 index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

**Chart 2: Fear index**



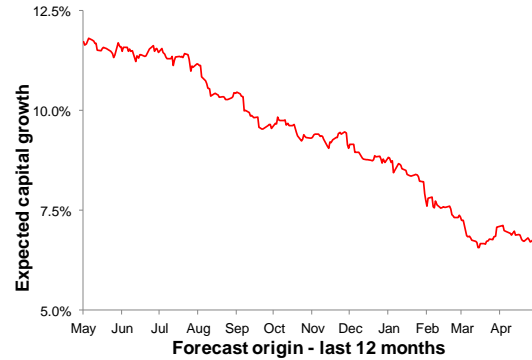
Notes: The fear index is a measure of 'excess' volatility denoting behaviour outside the open/close values each day. The two dotted lines depict the band in which the fear index resided before the GFC in two thirds of days. Extended periods below the lower dotted line might indicate complacency. Extended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



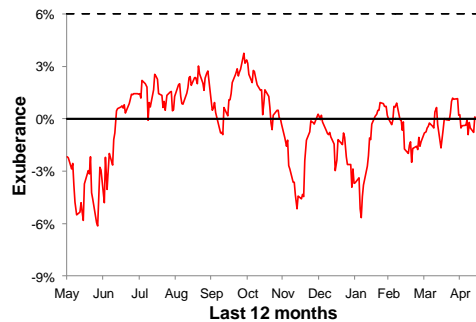
Notes: The disorder index measures the degree to which the 11 sectors' daily returns move in harmony. The two dotted lines depict the band in which the disorder index resided before the GFC in two thirds of days. Extended periods below the lower dotted line might indicate belief that there is little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



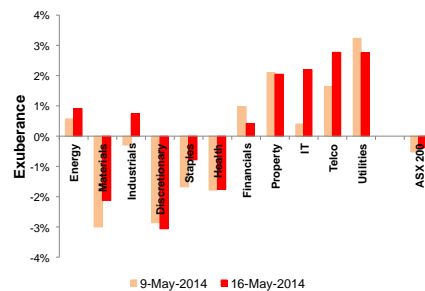
Notes: Each business day we update our estimates for capital gains on the ASX 200 for the following 12 months. For example, the left-most estimate on the vertical axis is a forecast for the 12 months concluding today. The right hand estimate is for the 12 months from today.

**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