24 May 2014

Woodhall's Weekly

Ron Bewley PhD, FASSA

Market ignores budget fall-out

- **ASX 200 slightly up on week**
- **S&P 500 closes at 1,900**
- **China flash PMI pleases**

Overview

I still maintain that this was the budget we had to have. When a nation needs redirection as we do, of course people will complain. I gave my budget talks last week and I am writing up a paper for my site over the weekend with my interpretations. Perhaps the market agrees with me because we got another small positive read on the ASX 200 (+0.3%).

The S&P downgrade story got garbled in the rush to the microphones. S&P said they are considering a review of our AAA rating if the budget gets lost along the way. Since our rating can't go any higher they *must* be thinking of a possible downgrade – just as with the US in 2010 – 2011 when they lost their AAA status.

That S&P added to their statement to say that there was no immediate threat of a downgrade is *always* true. S&P reviews before it downgrades and so a downgrade cannot be imminent – but the start of the process could well be! Why didn't the reporters pick up on this? Give it 6 – 12 months before the fall as it seems very unlikely much will pass the Senate before the new Senate in July – and Clive Palmer (in my opinion) doesn't seem to understand our debt situation.

The Westpac Consumer Confidence read mid-week slipped below 100 but this negative effect is common after a budget. Last year the index fell -7% on the last Labor Budget.

The S&P 500 charged up +1.2% on the week and closed above 1,900 for the first time last night. And that is ahead of the upcoming US long weekend! US home sales bounced back after the big freeze had distorted many economic signals.

The HSBC flash PMI is not, in my opinion, a useful read as it only focuses on small to medium companies and it is based on a very small sample. But it jumped up to 49.7 after and a market expectation of about 48.4 – so the market liked it.

The iron ore price fell below $100 / tonne but it recovered a fraction. It was reported on Sky Business TV that the lowest futures price for the rest of this year is about $115 / tonne and so this dip in the spot looks temporary. Materials stocks are cheap by our measure (Chart 6)

Well last Saturday, Portugal escaped from its bailout programme and last night Greece debt was upgraded a notch by Fitch to B (but still 5 notches below investment grade).

Now the so-called 'PIGS' 10 year bond yields are close to ours (at 3.78%): Portugal (3.74%), Italy (3.15%), Greece (6.36%), and Spain (2.98%). We might have to find a new acronym if we get downgraded. At least the European debt crisis is all over bar the shouting.

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 slipped from 5,750 to 5,700 over the week but the high forecast is still 6,000.

Our July 1st 2013 forecast for FY14 was for a June 30th 5,450 – about where we are now at 5,493.

Our 12-month capital gains forecast (Chart 4) slipped a little to +6.6%. With current underpricing measured to be -0.3% (Chart 5), the adjusted-gain forecast for the next 12 months is +6.8%. The forecast yield stays at +4.6%.

We still have to get through any end of FY window dressing but there is plenty if mispricing to help anyone needing to rebalance their portfolios – particularly those who want to shift from Telcos and Utilities into Materials.

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 the week. The Disorder Index (Chart 3) has been unusually low for about nine months.

All four high-yield sectors gained on the week leaving Telco and Utilities (Chart 6) too overpriced to attract buyers – at least with my cash! Both of these sectors have expected dividend yields of 5.4%. Financials and Property are less overpriced but their expected yields are also in the mid 5% range.

Materials are cheap at -3.0% and so a good official PMI for China a week tomorrow (1st June) could cause some excitement and a 'pop' on the following Monday.

With the US on holiday on Monday, not much due in economic statistics for us, and a flat SPI, the month of May might close where it is and that would be flat for the month.

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.

High-Yield Sectors: by this, we mean Financials, Property, Telcos and Utilities.

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.

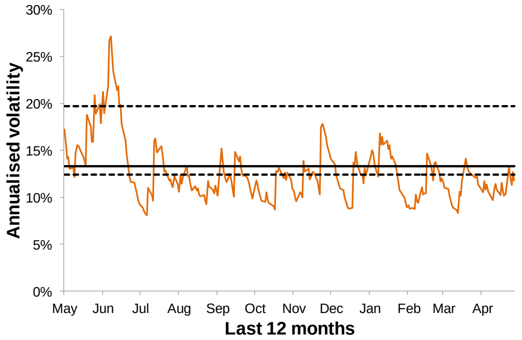
PMI – This acronym stands for Purchasing Managers Index. There is one for most countries and separate statistics for manufacturing and services. Manufacturing typically gets more attention. The statistics are published in the first few days of each month – with China on the 1st. A reading less than 50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

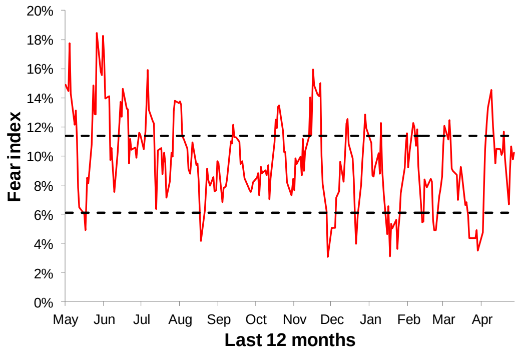
US non-farm payrolls data – are usually published on the first Friday of each month. They are generally considered to be the most reliable indicators for employment and unemployment in the US. Roughly speaking, a 200,000 increase in jobs is considered strong – particularly in the context of the tapering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

Chart 1: Market volatility



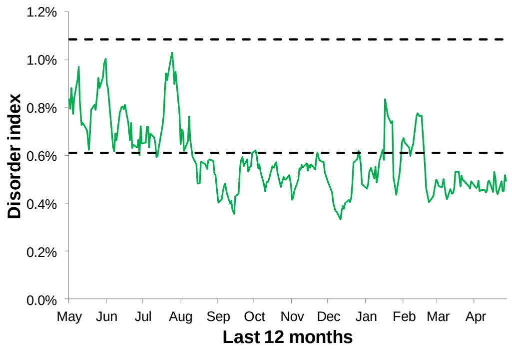
Notes: The solid black line depicts the average volatility since January 2010; the lower dotted line depicts the average volatility pre the GFC; the higher dotted line depicts the average level of volatility during the GFC - up to December 2009. The brown line is a daily estimate of the ASX 200 index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

Chart 2: Fear index



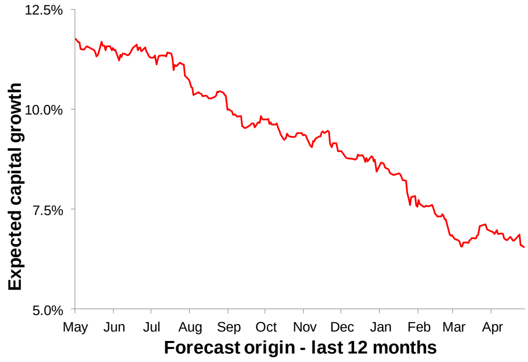
Notes: The fear index is a measure of 'excess' volatility denoting behaviour outside the open/close values each day. The two dotted lines depict the band in which the fear index resided before the GFC in two thirds of days. Extended periods below the lower dotted line might indicate complacency. Extended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



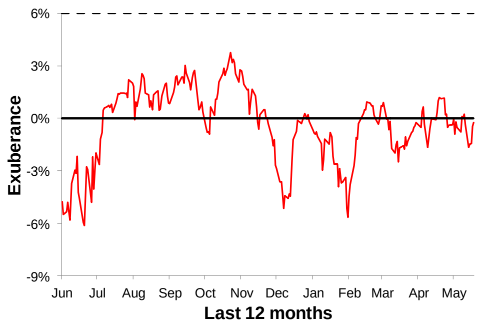
Notes: The disorder index measures the degree to which the 11 sectors' daily returns move in harmony. The two dotted lines depict the band in which the disorder index resided before the GFC in two thirds of days. Extended periods below the lower dotted line might indicate belief that there is little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



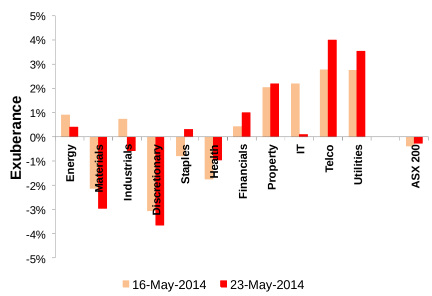
Notes: Each business day we update our estimates for capital gains on the ASX 200 for the following 12 months. For example, the left-most estimate on the vertical axis is a forecast for the 12 months concluding today. The right hand estimate is for the 12 months from today.

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