31 May 2014

Woodhall's Weekly

Ron Bewley PhD, FASSA

Flat week ends flat month on ASX 200

- **ASX 200 flat but some movement in sectors**
- **S&P 500 and Dow end May on a high**
- **Next week won't be as quiet!**

Overview

Very little data of significance dropped this week and so the market didn't even move one point over the week. However, Energy, Industrials, Discretionary and IT were all up by more than +1%. Materials on China worries fell -1.5% as the main detractor from gains.

The S&P 500, however, gained +1.2% and the DAX rose by +1.8% and both reached all-time highs. The budget might be bothering investors at home but the main source of gloom was again China – as people speculate about property and iron ore prices.

The EU elections turned out better than expected. They showed that people are increasingly against European expansion but not enough yet to upset the process of government.

Forty Chinese boats surrounded one Vietnamese fishing boat off its own coast and rammed it. The crew was thankfully saved. But this sort of aggression is not going to help investor confidence here. But, in the US, consumer confidence came in very strongly. US Q1 growth was downgraded but no one is looking at that weather-effected quarter.

Our Capex data disappointed a little but there were some positive shreds in the detail for those who looked hard enough.

But next week will unlikely be as quiet. The official China PMI for manufacturing is due out tomorrow (Sunday) and this drop could be quite interesting. Last month it came in at 50.2 down from 50.5 the month before but it beat expectations. The late month HSBC flash PMI was a big beat and a good number tomorrow might wash away some investor fears.

On Tuesday the RBA meets but it is very unlikely to change rates or even say anything interesting. Wednesday's GDP data for Australia will interest. Since recent RBA forecasts have been far more optimistic than Treasury's, we might get some insight into who knows what they are talking about. I'll go with the RBA!

The big one for the coming week is Friday's US Labor Market data – the non-farm, payrolls. Of course it drops after our market closes but it can shake our SPI for the following Monday's open. The last few months have been reasonably strong and over 200,000. With the last jobs at 288,000, a break through the psychological 300,000 figure could really excite.

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 drifting between 5,700 and 5,750 from week to week and the high forecast is just hanging on to 6,000.

Our July 1st 2013 forecast for FY14 was for a June 30th 5,450 – not far from where we are now at 5,493.

Deutche downgraded its e-o-y 2014 ASX forecast from 6,000 to 5,700 – about in line with our current forecast but we were never at 6,000. Deutche has also lowered its June 30, 2015 forecast to 5,900 – again now in line with us.

The deterioration in our 12-month capital gains forecast (Chart 4) has stabilised at +6.6%. With current underpricing at -0.5% (Chart 5), the adjusted-gain forecast for the next 12 months is +7.1%. The forecast yield stays at +4.6%.

As I wrote last week it is time to freshen up our portfolios for the second half. I made eight biggish trades to cash. I will be looking for some bargains over the next few weeks across the board. But I do have a soft spot for Atlas Iron and they, like the sector, look very oversold.

Market stats

Volatility (Chart 1) is below 10% and our Fear Index (Chart 2) is below the normal range. The US VIX is just above 11 – an historically low value for even the good times.

Low volatility has caused some commentators to call a correction soon. Since we had very low volatility and fear in the 2003 – 2006 bull market, I do not see the connection.

Our market is slightly cheap at -0.5% (Chart 5) and Materials is at -4.4%. I would want to see the PMI number tomorrow before diving in but I will be tempted if the PMI comes in anywhere near 51.

Telcos (+3.1%) and Utilities (+2.4%) are a little bit on the pricey side. With Consumer Discretionary at -2.6%, the retail sales data mid week might direct some buying interest in that direction.

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.

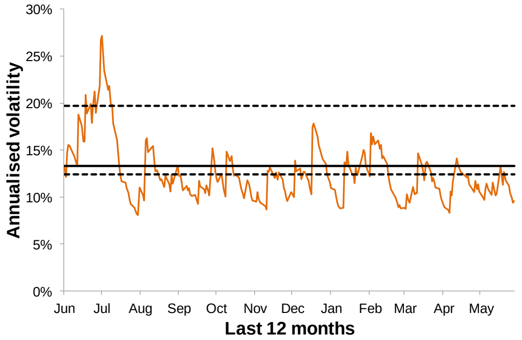
PMI – This acronym stands for Purchasing Managers Index. There is one for most countries and separate statistics for manufacturing and services. Manufacturing typically gets more attention. The statistics are published in the first few days of each month – with China on the 1st. A reading less than 50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

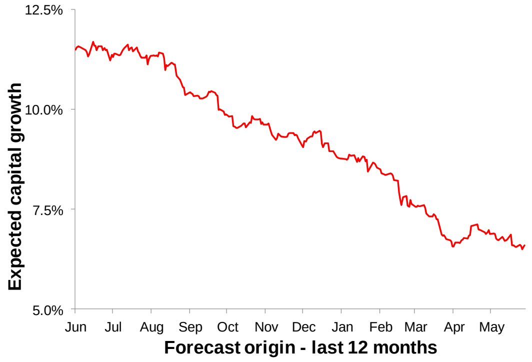
US non-farm payrolls data – are usually published on the first Friday of each month. They are generally considered to be the most reliable indicators for employment and unemployment in the US. Roughly speaking, a 200,000 increase in jobs is considered strong – particularly in the context of the tapering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

Chart 1: Market volatility



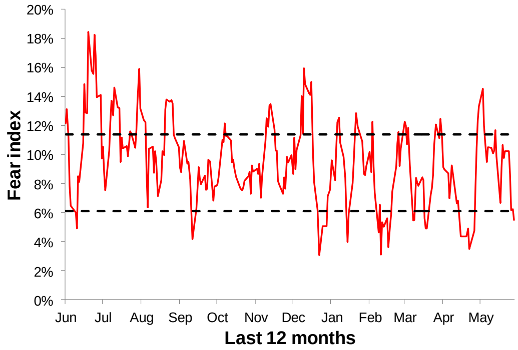
Notes: The solid black line depicts the average volatility since January 2010; the lower dotted line depicts the average volatility pre the GFC; the higher dotted line depicts the average level of volatility during the GFC - up to December 2009. The brown line is a daily estimate of the ASX 200 index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

Chart 4: 12-month-ahead capital gains forecasts



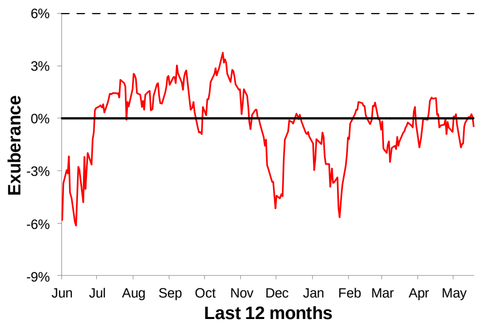
Notes: Each business day we update our estimates for capital gains on the ASX 200 for the following 12 months. For example, the left-most estimate on the vertical axis is a forecast for the 12 months concluding today. The right hand estimate is for the 12 months from today.

Chart 2: Fear index



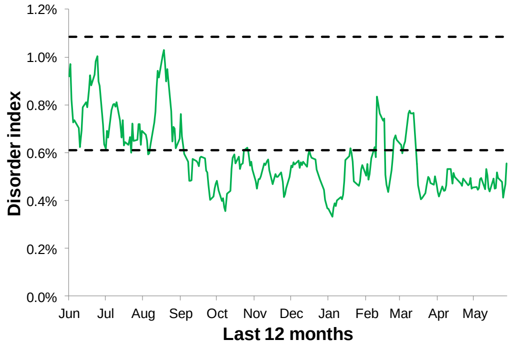
Notes: The fear index is a measure of 'excess' volatility denoting behaviour outside the open/close values each day. The two dotted lines depict the band in which the fear index resided before the GFC in two thirds of days. Extended periods below the lower dotted line might indicate complacency. Extended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



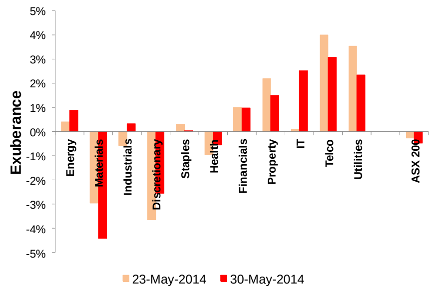
Notes: Exuberance is our measure of mispricing on the ASX 200. A value below the solid black line denotes the market is perceived to be cheap and above that line expensive. Experience suggests that exuberance above +6%, denoted by the dotted line, is an indicator of a potential correction of 6% to 10%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