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Woodhall's Weekly

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On your marks, get set ...

- **Focus on China**
- **USA shrugs off Q1 data**
- **Big week ahead for data**

Overview

The HSBC 'flash' PMI is usually irrelevant as it is a) preliminary and b) a small survey of small companies' expectations. And while the official PMI that comes out on the 1st of each month has been above the critical '50' level all year, the flash read was below – before last Monday. Flash jumped out of the blocks on Monday to massively beat expectations at 50.8 – solid by anyone's standards.

While there is no obvious relationship between the two PMI reads it does suggest to us that last month's official PMI (also) of 50.8 might be an easy target to beat. And a big beat on Tuesday should breathe real life into our market. China seems to have orchestrated a beautiful return to 7.5% growth.

Iron ore prices rose during the week. Having sunk to $89 / tonne two weeks ago, the price climbed steadily all week to be $95.30 yesterday. While it is too soon to call an iron ore rally, the pundits who were expecting $115 in the second half of 2014 might be on the money.

The US Q1 GDP growth was revised down from -1% to -2.9% but everyone had written off the weather-affected quarter and the market rallied. Non-voting Fed members talked about an early rate rise due to the strength of the economy. US home sales jumped +18.6% on the month which is not surprisingly a 22+ year record! US consumer sentiment came in at a 6 year high. And Team USA made it to the knockout stage of the World Cup – unlike England (Why was England surprised it got knocked out? I don't know anyone who gave them a chance). The USA looks very good and that is also good for China and Europe.

At home, about the only signal was a nice increase in job vacancies for Q1 – at +2.1%.

The fallout from Ukraine and Iraq didn't gain any strength and market fear indexes are low.

With the China PMI out on Tuesday and US nonfarm payrolls on Thursday night, it might be champagne next Saturday! I have been writing about going to cash for an end-of-year rebalance. Well I got set on the last three days. Interested readers can go to the 'In the Media' tab on the website and get a copy of my slides on this topic from last Thursday's Switzer TV interview. The video clip is on www.switzer.com.au.

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 back at 5,700 with half a year to go. The high forecast (during 2014 H2) has stabilised at 5,900. Our end-of-financial-year (June 30th 2015) forecast is 5,900 but more on that next week when we have welcomed in the New Fin Year.

Our July 1st 2013 forecast for FY14 was for a June 30th 5,450. With one day to go and 5 points short with a mild SPI upward start for Monday's open, all looks good. While it is luck to be that close it does support our broker-based forecast methodology.

Market stats

Volatility (Chart 1) has been around normal levels over the week. Given that we had options expiry and 'fundies' window dressing to contend with, that is a very good result. Of fear index (Chart 2) was particularly low but it climbed back into the middle of the normal range for Friday. Disorder (Chart 3) is unusually low suggesting that there had been no major sector rotation – yet!

Our market is still cheap at -1.6% (Chart 5) despite the second consecutive week of steady gains on the market. With our gains' forecast (Chart 4) of only +6.3%, our adjusted (for mispricing) target is +8% for the new financial year – which is why I constructed a new yield/conviction portfolio and got set last week. We have six sectors with predicted adjusted double digit returns for FY15: Energy, Industrials, Discretionary, Staples, Health, and IT.

Having fixed up my SMSF equity portfolio, I will now turn my attention to me margin loan (outside super).

No sector is too expensive (Chart 6) right now and none are so cheap as to be a screaming buy. Great conditions to get set for the year ahead! On April 1st we wrote we expected a sideways quarter and we got one. With only a month to go to reporting season and the world economy looking even better, modest gains are quite possible for Q3.

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.

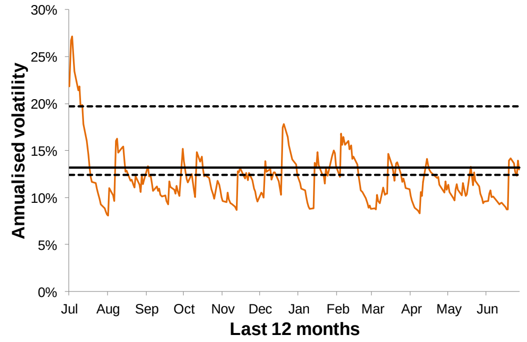
PMI – This acronym stands for Purchasing Managers Index. There is one for most countries and separate statistics for manufacturing and services. Manufacturing typically gets more attention. The statistics are published in the first few days of each month – with China on the 1st. A reading less than 50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

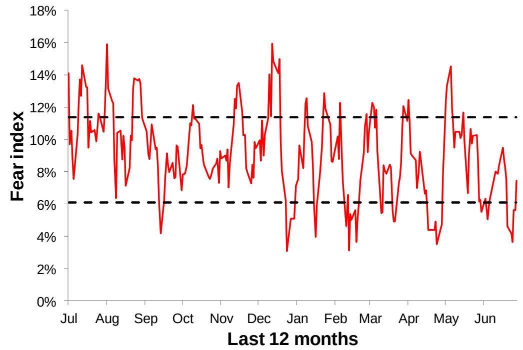
US non-farm payrolls data – are usually published on the first Friday of each month. They are generally considered to be the most reliable indicators for employment and unemployment in the US. Roughly speaking, a 200,000 increase in jobs is considered strong – particularly in the context of the tapering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

Chart 1: Market volatility



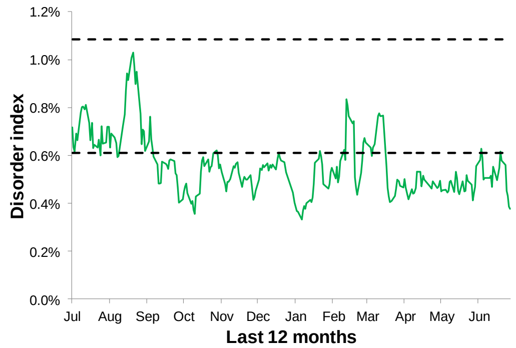
Notes: The solid black line depicts the average volatility since January 2010; the lower dotted line depicts the average volatility pre the GFC; the higher dotted line depicts the average level of volatility during the GFC - up to December 2009. The brown line is a daily estimate of the ASX 200 index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

Chart 2: Fear index



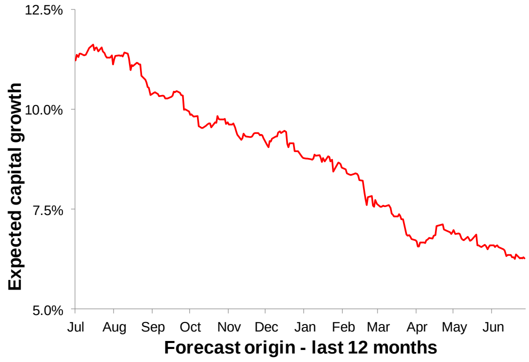
Notes: The fear index is a measure of 'excess' volatility denoting behaviour outside the open/close values each day. The two dotted lines depict the band in which the fear index resided before the GFC in two thirds of days. Extended periods below the lower dotted line might indicate complacency. Extended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



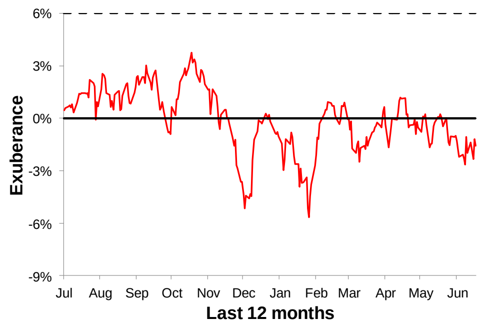
Notes: The disorder index measures the degree to which the 11 sectors' daily returns move in harmony. The two dotted lines depict the band in which the disorder index resided before the GFC in two thirds of days. Extended periods below the lower dotted line might indicate belief that there is little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



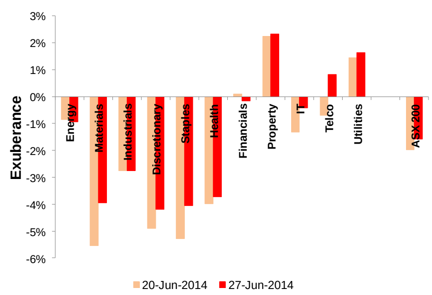
Notes: Each business day we update our estimates for capital gains on the ASX 200 for the following 12 months. For example, the left-most estimate on the vertical axis is a forecast for the 12 months concluding today. The right hand estimate is for the 12 months from today.

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