5 July 2014

Woodhall's Weekly

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July 4th fireworks for ASX 200

- **China bears need to go into hibernation**
- **US data rocked**
- **At last we're smiling at home**

Overview

China bears were ducking for cover on Tuesday when the official China PMI came in at 51.0 – up from 50.8 the month before and beating expectations of 50.8. Not only was the PMI a source of buzz but iron ore prices started to come back. After a low of $89 / tonne in mid-June, prices got as high as $96.50 on Thursday.

Given the PMI is at a six-month high – and a steady climb at that – it's time for the bears to go back into hibernation.

With reporting season less than a month away, it will be great to see the outlook statements from the miners. RIO got upgraded by analysts in London mid week and jumped 3% that day.

The other big data point at the start of every month was the US labour force data out last Thursday – a day early due to the Independence Day holiday on Friday. It was a bit of a block buster with nonfarm payrolls up a staggering 288,000 (at least the market economists who predicted 212,000 must have been staggered). That is five 200,000+ months on the run. Unemployment was down from 6.3% to 6.1% which is only a smidgen above our 5.8% and they had a 'Great Recession' taking unemployment up to double digits.

The US also got some really good PMI and housing data. Janet Yellen smoothed our fears and both the Dow and the S&P 500 closed at all time highs for July 4. Even bigger, the Dow broke 17,000 and it stuck.

The 'volatility is too calm' crew is still out in force. Volatility is lower than during the GFC and that is a Jennifer Hawkins 'that's a no brainer' moment captured on Sky Business promos. Volatility is higher than it was during 2003 – 2005 inclusive.

For people to say investors are too complacent is a bit arrogant. Market participants have a view of the world and plenty of these are very well educated and highly paid. For others to say the market doesn't see the pitfalls ahead is to say that they know things that market participants do not. Yet we all more or less have access to the same data and 24/7 news. So, it follows they think we are not as smart as them! Let them eat cash as Marie Antoinette might say.

Of course out-of-the-blue events often happen. We must just react when they do and enjoy the ride when they don't.

King Canute, aka the Governor of the RBA, talked down the dollar by saying he wasn't talking down the dollar and got an instant sugar hit. However, he thinks the dollar is well overvalued and it needs to come down heaps – so what is the point of getting a temporary one cent hit? I guess at as he is on a million dollars a year he needs to do something or he might look like the CEO of a big commercial bank!

They RBA met on Tuesday and didn't change rates. At least they thought about it and had a nice lunch. Our retail sales went backwards (-0.5%) with all of the brouhaha surrounding the budget. But the big test comes next Thursday when our Labour Force data get released.

If the economy is on the mend, unemployment will only slowly get better. If it is stuck in a rut, we will get much the same result as last month. With a +0.2% (points) change month-to-month not significantly different from zero (either way) – that is the Bureau of Statistics estimate – there is very little chance there will be any useful info in the unemployment number.

Employment is a different matter. We have been getting some interesting data on that front. What to look for is a continuing switch from part-time to full-time employment, rather than a big increase in total employment, and an increase in hours worked.

The resources run on the ASX 200 for the last three days took me back to the good old days. We no longer have that sector underpriced – at last! We didn't quite make a post-GFC high on the broader index but we did get close. There are better things ahead – but don't get carried away. 6,000 is a long way off.

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 5,700 with half a year to go. The high forecast (during 2014 H2) has lifted to 5,950.

Our end-of-financial-year (June 30th 2015) forecast is 5,900 with a high forecast of 6,200 and a low of 5,150. As always, there is at best a modest chance that both the low and the high will be breached. They have equal chances and the e-o-fy forecast stands either way.

Our July 1st 2013 forecast for FY14 was for a June 30th 5,450. I think we were a day out!

Our S&P forecast for our financial year (to June 30th 2015) is 2,130 with a high of 2,250 and a low of 1,890. Our calendar 2014 forecast has been revised upwards from 1,940 to 2,070 during the first six months. Interestingly, our high forecast last Jan 1 was also 2,070!

Market stats

Volatility (Chart 1) is a fraction elevated because of the big positive gains. Yes – volatility treats ups and downs in the same way. Nevertheless, volatility is pretty much at the long-run average we (and, as it happens, the US) have had since data began. We just came out of a massive volatility cluster burst that was the GFC and European debt crisis.

Our fear index (Chart 2) remains quite low in spite of volatility climbing up. That is a great sign. Markets are being well behaved.

Disorder (Chart 3) has been unusually low but there are some early signs that the expected sector rotation has begun!

Our market is no longer cheap at -0.1% (Chart 5) which is why we have been writing about getting set before the end of last financial year. With our gains' forecast (Chart 4) slipping to +6.1%, our adjusted (for mispricing) target is only +6.2% for the next 12 months.

Only the Health sector (Chart 6) looks noticeably cheap at -3.1%. The high-yield sectors are a little bit on the expensive side. All of the other sectors – except for IT – are line-ball fairly priced.

In my quest to shake up my margin loan portfolio, I have designed my portfolio and will now start buying. My SMSF yield portfolio got off to a good start but no yield portfolio will beat a quick surge in resources. If resources continue to rally I will shift some more into my yield portfolio!

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.

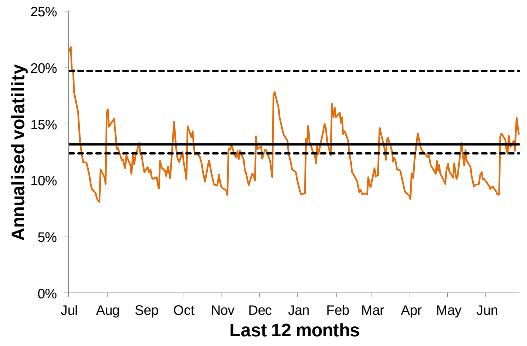
PMI – This acronym stands for Purchasing Managers Index. There is one for most countries and separate statistics for manufacturing and services. Manufacturing typically gets more attention. The statistics are published in the first few days of each month – with China on the 1st. A reading less than 50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

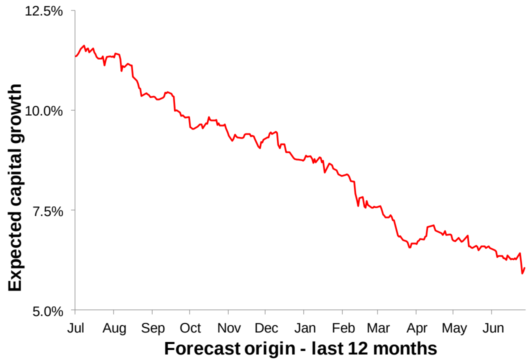
US non-farm payrolls data – are usually published on the first Friday of each month. They are generally considered to be the most reliable indicators for employment and unemployment in the US. Roughly speaking, a 200,000 increase in jobs is considered strong – particularly in the context of the tapering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

Chart 1: Market volatility



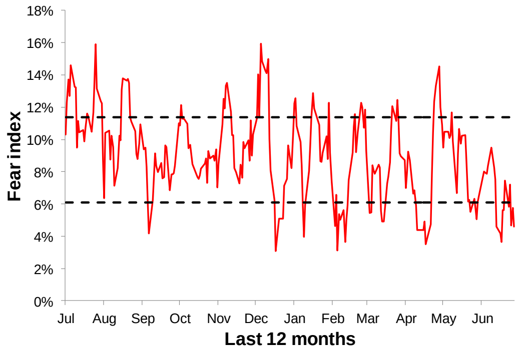
Notes: The solid black line depicts the average volatility since January 2010; the lower dotted line depicts the average volatility pre the GFC; the higher dotted line depicts the average level of volatility during the GFC - up to December 2009. The brown line is a daily estimate of the ASX 200 index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

Chart 4: 12-month-ahead capital gains forecasts



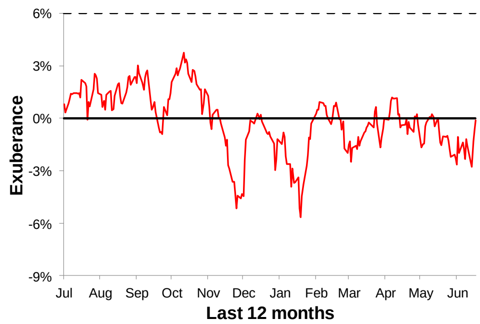
Notes: Each business day we update our estimates for capital gains on the ASX 200 for the following 12 months. For example, the left-most estimate on the vertical axis is a forecast for the 12 months concluding today. The right hand estimate is for the 12 months from today.

Chart 2: Fear index



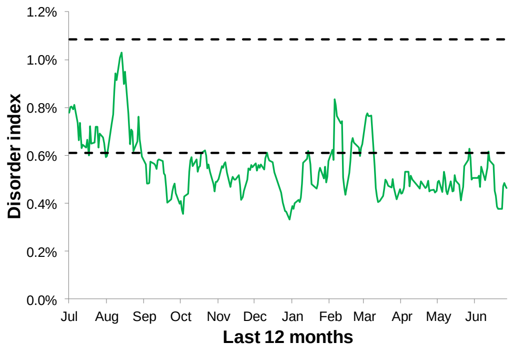
Notes: The fear index is a measure of 'excess' volatility denoting behaviour outside the open/close values each day. The two dotted lines depict the band in which the fear index resided before the GFC in two thirds of days. Extended periods below the lower dotted line might indicate complacency. Extended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



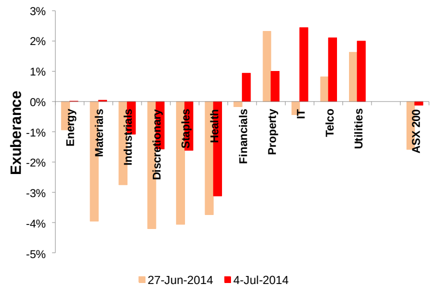
Notes: Exuberance is our measure of mispricing on the ASX 200. A value below the solid black line denotes the market is perceived to be cheap and above that line expensive. Experience suggests that exuberance above +6%, denoted by the dotted line, is an indicator of a potential correction of 6% to 10%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