26 July 2014

Woodhall's Weekly

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China on a charge

- **China takes BHP with it**
- **RBA hands are tied**
- **US reporting season soli**

Overview

Normally I don't pay much attention to the 'flash' PMI read for China manufacturing. The official number comes out a week or so later, is based on a much, much bigger sample survey, and includes companies of all sizes - not just the smaller ones as in the flash sample.

The flash PMI was the main one to upset analysts earlier this year. It sank to 48.1 in March - below the 50 threshold' while the official didn't get below 50. What grabbed me this time is that the flash read jumped from 50.7 the previous month to 52.0 and beat the expected 51.0 by a country mile. In short it is at an 18 month high.

While I still don't put much faith in this number, it has made me sit up in anticipation of the official read next Friday. Our market has already put on +3.5% this month with Materials up +7.2% and taking that sector into positive territory for the calendar-year-to-date.

BHP, in particular, helped things along with a mammoth production read last Wednesday. Iron ore prices have slipped back a few dollars this week upsetting some mid-tier miners, but the big boys are looking good. That upward revision from analysts can't be far away. Our reporting season gets under way the week after this next one.

Our CPI read came out mid-week. There are so many numbers dropped at the same time (core, headline, trimmed, q-o-q and y-o-y) that you can almost take your pick. But whichever way you spin it, inflation is too close to the upper bound of the target band held by the RBA to give it any room to drop rates again.

But with unemployment coming in at 6.0% the week before - against 6.1% in the US - the RBA can't even think about raising rates. So if it can't cut and it can't raise 'em, rates aren't going anywhere anytime soon. And we think that means no correction anytime soon - as Ron talked about last Thursday on Switzer TV.

The US reporting season is ticking along quite nicely. Expectations are always set low enough for the majority to beat. The nonfarm payrolls are out on Friday. Another 200,000+ will really give our market a boost on the following Monday - especially if the official China PMI jumps out of the box on Friday. Anybody who 'went away in May' should surely stop bleating that old catch phrase next year.

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.

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Our current forecast e-o-y on the ASX 200 is steady at 5,700. Our high forecast for the remainder of the year is also solid at 5,950.

Our 12-month-ahead capital gains forecast for the ASX 200 is fluctuating around +6.0% and sits at 5.9% today. Since we have our market slightly overpriced at +0.4%, that makes the adjusted capital gains forecast +5.5% for the next 12 months.

Our June 30, 2015 forecast is also solid at 5,850 with a high up a tad to 6,250.

Our Materials and Property sector gains' both sit at -1.9% but we expect the Materials forecast to be lifted in the next few weeks to align it with BHP's view of the world.

Market stats

Volatility (Chart 1) rose and fell over the week. It now sits just below 9% or where it was during the halcyon days of the 2003 - 2005 dream run on the market.

Disorder (Chart 2) sits at close to an all-time low. This statistic measures co-movements in returns across sectors on a daily basis. That disorder is low means that all the sectors are running up more together than normal. That isn't particularly good as it will take Property and Telcos (Chart 6) into significant overpricing. Must keep an eye on those sectors!

Our fear index (Chart 3) crept out of the zone the week before but it is back where it belongs again.

There has been a levelling out in capital gains forecasts (Chart 4) and the market is now close to fair pricing (Chart 5). The dividend yields for the four high-yield sector have converged to a particularly tight low range (5.3% - 5.4%). That is down a notch from last week. They can't fall much more from here and so price gains are less likely.

Materials backed up its big week the week before - with a strong +0.9% gain over the week.

Volume was big on Friday after a few ordinary days. We argue that volume should be low in the current yield-play environment. Yield stocks are largely 'buy and hold' while growth attracts the traders. Perhaps the volume came in on Friday as cash left the sidelines to join the rally on the morning dip.

As someone said this week, corrections come when everyone sees blue sky ahead. While we have so many calling corrections and others disagreeing, there is scope for a continued rally. But a Black Swan can always appear from nowhere.

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.

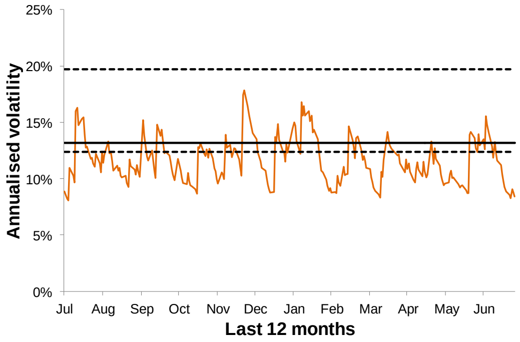
PMI – This acronym stands for Purchasing Managers Index. There is one for most countries and separate statistics for manufacturing and services. Manufacturing typically gets more attention. The statistics are published in the first few days of each month – with China on the 1st. A reading less than 50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

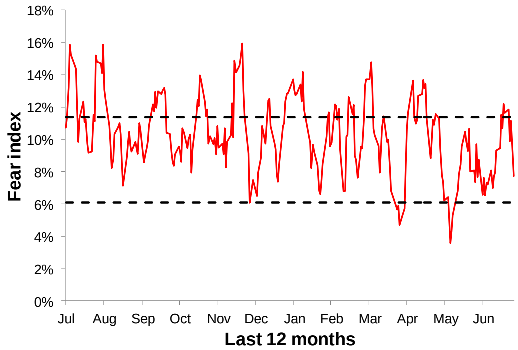
US non-farm payrolls data – are usually published on the first Friday of each month. They are generally considered to be the most reliable indicators for employment and unemployment in the US. Roughly speaking, a 200,000 increase in jobs is considered strong – particularly in the context of the tapering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

Chart 1: Market volatility



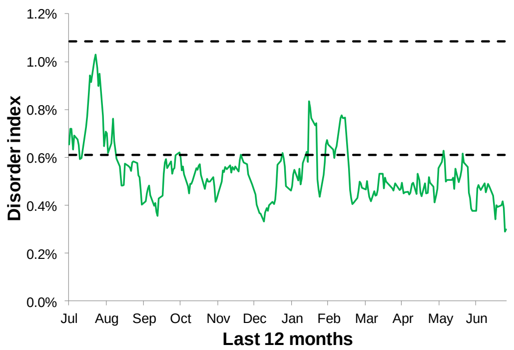
Notes: The solid black line depicts the average volatility since January 2010; the lower dotted line depicts the average volatility pre the GFC; the higher dotted line depicts the average level of volatility during the GFC - up to December 2009. The brown line is a daily estimate of the ASX 200 index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

Chart 2: Fear index



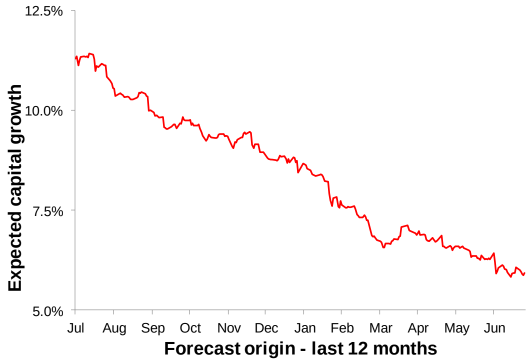
Notes: The fear index is a measure of 'excess' volatility denoting behaviour outside the open/close values each day. The two dotted lines depict the band in which the fear index resided before the GFC in two thirds of days. Extended periods below the lower dotted line might indicate complacency. Extended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



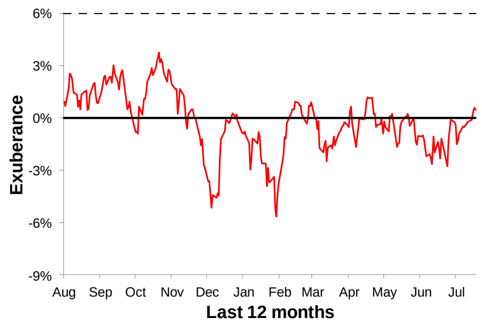
Notes: The disorder index measures the degree to which the 11 sectors' daily returns move in harmony. The two dotted lines depict the band in which the disorder index resided before the GFC in two thirds of days. Extended periods below the lower dotted line might indicate belief that there is little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



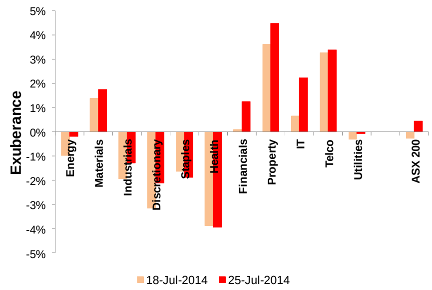
Notes: Each business day we update our estimates for capital gains on the ASX 200 for the following 12 months. For example, the left-most estimate on the vertical axis is a forecast for the 12 months concluding today. The right hand estimate is for the 12 months from today.

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