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Woodhall's Weekly

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US jobs puzzle

- **US nonfarm payroll data miss expectations**
- **China manufacturing steadies**
- **But broker forecasts bounce back**

Overview

Overnight, US nonfarm payrolls data recorded a big miss at +142,000 against an expected +230,000 jobs. But unemployment did drop to 6.1% from 6.2% on lower participation in the labor force. After a string of 200,000+ data drops, economists were at a loss to explain this number.

The best analysis so far is that August, being the holiday month in the US, often has aberrant jobs data which are subsequently revised upwards. From 2010 – 2013, the August number was revised upwards by an average +55,000 a month which, if in happens again, would take the final estimate to within a whisker of 200,000.

The S&P 500 first fell on the news but then it climbed over the session as traders realised the number was too soft for the Fed to raise rates anytime soon. Indeed, the patchy results across sectors back Yellen's view that caution must be exercised in interpreting labor force data this time around.

With our unemployment rate at 6.4%, it is looking a bit sick by comparison. All eyes will be on next Thursday's drop of our data to see if that statistical anomaly story we passed on to our readers has any legs.

That our GDP growth came in during the week at +0.5% for the quarter and +3.1% for the year-on-year is not too bad. However, when adjusted for population growth, the last two financial years' per capita growth came in negative – we are slowly becoming worse off!

The official China PMI manufacturing number came in at 51.1 last Monday which was a tad down on the previous month (51.7) and expectations. However, it still came in well above the 50 level that separates a weakening economy from one that is strengthening.

Iron ore prices have fallen to a five-year low and under $85 / tonne. Some of this is due to the big three – BHP, RIO and Vale – pushing out supply. These actions have helped close poorer quality China ore mines and are naturally hurting our junior miners.

Last week I pointed out that there had been a dramatic deterioration in our broker-based forecasts for the Industrials' sector for a couple of days and this had knocked off about 1% from our ASX 200 forecast.

We pointed out this type of behaviour sometimes happens in reporting season when analysts are temporarily withdrawing their forecasts while they revise them. By Tuesday, the Industrials' sector forecast was back up to within the same ballpark as before and the ASX 200 forecast is now even higher at +7.7% for the next 12 months (Chart 4). Last week's result was just a statistical aberration.

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 stable at 5,750. Our 'high' forecast for the remainder of the year is 5,950.

Our 12-month-ahead capital gains forecast for the ASX 200 has settled back to +7.7%%. The adjusted gains' figure stands at +8.0% since the market is now slightly underpriced at -0.4%.

Our end-of-FY '15 forecast is creeping up towards 6,000. It started FY '15 at 5,900 and is now at 5,950. The 'high' forecast is 6,250. Therefore, we maintain our position held since September 2013 that 6,000 is unlikely to stick until the second half of 2015 – but a temporary visit above 6,000 level is quite likely in the first half of next year.

Market stats

Volatility (Chart 1) remains in single digit territory. Disorder (Chart 2) remains in the lower end of the normal range. Our Fear Index (Chart 3) remains in the normal range in spite of the geopolitical crises.

Chart 4 clearly shows the short-term impact of the revisions to the Industrials' forecasts but the market is now seen to be gaining strength after a long time in decline.

Market mispricing (Chart 5) is almost negligible at -0.4%. Only Property (+4.9%) and Telcos (+5.2%) are far too expensive (Chart 6) for us to consider a good buy. Given the buy back in Telstra it will be interesting to follow the price of that stock as some try to buy back into Telstra after having sold to get the tax advantage – particularly from franking credits. With the Telco sectors' expected yield at 5.4% there is no indication that yields are too low at this price to consider a yield play.

With the S&P rallying strongly into the close at 2,008 – just shy of its all-time high – our market at 5,599 – and the SPI futures at just -2 points, we might have a reasonable Monday market.

Iron ore prices and BHP going ex-div hurt the Materials sector last week with a fall of -2.6% which took mispricing to -4.5%. BHP looks to have been oversold. I'll be keeping an eye on that one.

I am now home in Australia after a month staying with my brother in England who does not subscribe to business channels. And I haven't watched any business channel TV since my return on Tuesday night. With a month of freedom from all of the chatter, my life feels so much better. I have been quietly reading though!

After two very solid weeks on the market, the slightest of pullbacks (-0.3%) came just after a fresh post-GFC high of 5,651. At the same time, the S&P 500 broke through 2,000 for the first time but that index ended the month on a high note.

There was very little official data of significance published in this last week. On the geopolitical front, the build up on the Russia-Ukraine border continues but the markets have not taken much notice.

Iron ore prices have slipped under the $90 / tonne mark and that took some shine of the miners after the rally following BHP's great result.

The last week of reporting season was not as strong as the previous three. Nevertheless, the overall reporting season was quite strong. Typically, analysts need a week or two to update their models and forecasts. Throughout the past few weeks, our Materials' forecasts based on analysts' views improved to finish the week at about +5.6% for capital gains over the next 12 months. Contrast this with the negative forecast we had in June!

Over the last two days, our Industrials' forecasts fell in a hole. It has more than halved down to +7.4%. Before we lock that forecast in, we should recall that temporary changes in forecasts can occur as analysts revise their views and post them. If this Industrials' forecast hasn't bounced back by next week, then we will act on it. Until then we will just have an 'orange alert'.

Of course, next week is also the first week of the month and a plethora of official data will drop. So, as we wrote last week, we should have a pretty good idea where the market is heading to for Christmas by next Saturday.

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.

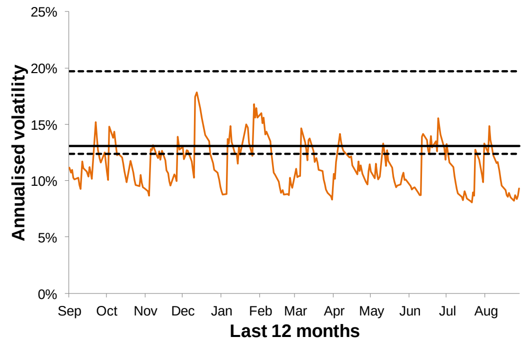
PMI – This acronym stands for Purchasing Managers Index. There is one for most countries and separate statistics for manufacturing and services. Manufacturing typically gets more attention. The statistics are published in the first few days of each month – with China on the 1st. A reading less than 50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

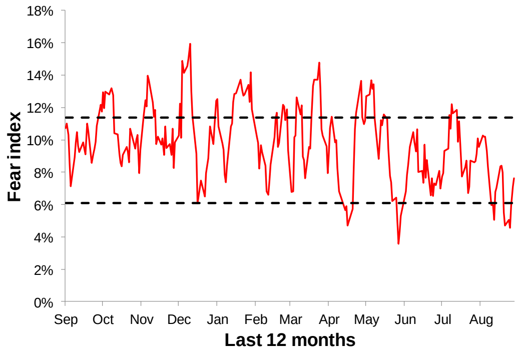
US non-farm payrolls data – are usually published on the first Friday of each month. They are generally considered to be the most reliable indicators for employment and unemployment in the US. Roughly speaking, a 200,000 increase in jobs is considered strong – particularly in the context of the tapering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

Chart 1: Market volatility



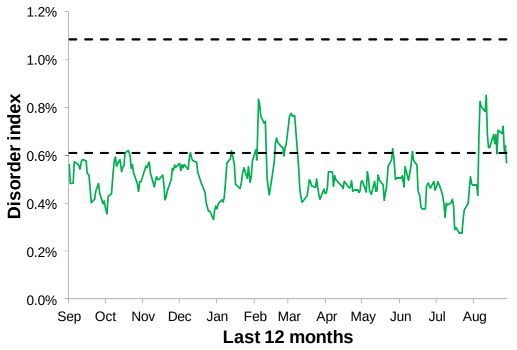
Notes: The solid black line depicts the average volatility since January 2010; the lower dotted line depicts the average volatility pre the GFC; the higher dotted line depicts the average level of volatility during the GFC - up to December 2009. The brown line is a daily estimate of the ASX 200 index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

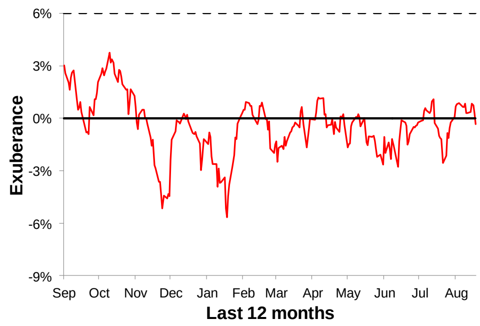


Notes: The disorder index measures the degree to which the 11 sectors' daily returns move in harmony. The two dotted lines depict the band in which the disorder index resided before the GFC in two thirds of days. Extended periods below the lower dotted line might indicate belief that there is little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

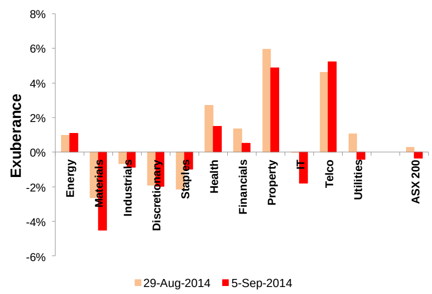
Notes: Each business day we update our estimates for capital gains on the ASX 200 for the following 12 months. For example, the left-most estimate on the vertical axis is a forecast for the 12 months concluding today. The right hand estimate is for the 12 months from today.

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