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Woodhall's Weekly

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Event-driven volatility

- **Everything and the kitchen sink thrown at markets**
- **Don't worry about our ABS Labour data**
- **German woes might be part of the solution!**

Overview

Our market has gone up and down over the week but this is not traditional volatility. Rather it was event driven.

The market fell sharply on Wednesday because the IMF downgraded its world growth forecasts. We rallied strongly on Thursday because the previous night the Fed minutes were particularly dovish about rate rises. Then Germany posted some very poor Industrial Production and Export data – probably on the back of Ukraine and the associated sanctions – and our market tumbled on Friday.

Perhaps surprisingly, the weekly loss was only -2.4% compared with -2.2% a fortnight before and -2.2% in the week ending August 8th. This last week seemed worse because of the even larger intra-day volatility. We see this in our fear index (Chart 2) jumping well above the comfort zone. Market volatility (Chart 1) was only just above average until Friday!

Will the (excess) volatility continue? Will the market continue to fall? We have an unusual number of serious crises around: ISIS, Ukraine, Gaza, Hong Kong, and Ebola. On top of that, there is a renewed focus on growth – particularly in Europe and, to some extent, China. It is extremely unlikely that all will be well from Monday but we do have the chance to move forward soon.

The likes of Cochlear and CSL are kicking off the AGM season. If they surprise on the upside – and they could given $A forecasts – that would be good. The big miners will start their quarterly production reports – and they look likely to be strong – that would be good.

In short, if our companies perform well from next week we could start to disconnect from other world indexes. It's a big call, but we are looking to get out of this one with only a flesh wound (as the cowboys used to say in movies of another era after being shot).

At home, we saw chaos over the unemployment data. The 'new' numbers were better than the 'old' but why the problem? Since I see clarity while seemingly everyone else is running away suggests I (or them?) am mad. Let me state my case and you can be the judge.

The only real problem was in the monthly *changes* in employment. That number is the sum of a whole lot of apples and, recently, even more oranges. A full-time worker on average puts in about four times as many hours as a part-timer – yet the ABS adds them. As I pointed out last month, part-timers make the grade if they work only *one hour* in a week.

If we look at full-time workers, there are *no obvious anomalies in the data*. It's all in the part-time data. Now, there are about twice as many full-time workers as part-timers. On top of that, part-timers

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are often used as a short-term solution to a staffing problem. So we shouldn't care too much if a guy (or gal) works one hour in a given week one month and zero hours in the next. So we should really forget the part-timers' blip in this equation.

The next issue is seasonal adjustment. I've been teaching this stuff for over 40 years so I think I have a handle on it. The ABS has warned us against using these seasonally-adjusted data for decades. They recommend their trend data (which didn't show any problems) and I agree – as I often write in this newsletter.

Let me give a true example to highlight the problem. In my youth in England, there was a massive car show each October. As a result, new car sales peaked shortly thereafter. In the early sixties (Just as the Beatles in my home town released Love me Do) the UK introduced rego plates that included a letter (initially A, then B, etc) to denote the year of sale.

Nobody wanted to buy in October anymore because their new car would look a 'year old' three months later in the January when the new number plate kicked in. So the seasonal peak moved from October to January.

Before the new number plates, the seasonally adjusted data were scaled down for October/November, and the other 10 months scaled up to remove the car-show effect. After the number plate change, January data needed to be scaled down and the other 11 months scaled up.

So what happened before people spotted the problem? The data wobbled as ours just did. Seasonal adjustment procedures only work on historical data and historical patterns. The ABS is not wrong in its methodology. Something funny just happened with part time data.

Final point. If August was traditionally a low part-time employment month, it would have been scaled up. If, on top of this, there was a 'normal' extreme sample result, a really big number (like the one we got) might come through. But when we look at changes, if we have one big number, there is a big change up and then there has to be an equally big change down the following month.

There is no problem in my opinion! It was a blip which necessarily has a switchback the next month. We do know that our labour situation has stabilised. Is the ABS gaming it by not explaining it as I have done? Well, they are lobbying for more funding at the moment!

Which reminds me of a story from the late 80's. I was talking to people in the ABS building in Canberra about data volatility. It got to 4:54pm and people (rather rudely) left for the door rather quickly. I asked what was going on and my colleague said they can clock out at 4:55. I had a three hour drive home but they weren't going to hang around another minute!

So, what would I do if I had power? I would buy a grey cardigan so I looked the part at the ABS and I would not add full and part-time employment data together – or at least I would turn the part-time data into full-time equivalent positions as we did at university and the CBA. Problem solved – but where do they sell grey cardigans?

Only a few months ago, Germany was looking strong and shunned requests from the rest of Europe for economic help. Now they have data going backwards (exports -6%, industrial output -5% etc) largely because of the bilateral sanctions following on from the Russia-Ukraine crisis. Germany might now be willing for packing a stimulus punch and solve lots of problems in other countries!

The Fitch probability of default for Western Europe has noted the problems. The probability is now at 1.13% from a 2014 low of 0.71%. But 1.1#% is much less than the 4% in the GFC and 2% in the European debt crisis. The US equivalent figure has not budged from 0.25%.

But the scary thing is Ebola. Obviously those affected may fear the worst – but will it impact international travel and trade? If it does, economic growth really will suffer. As Christine Lagarde (IMF President) it is rare for the IMF to advocate fiscal spending but she said it is always fine to solve a health issue like this one. Big words.

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. If the SPI futures for Monday's open of -38 points comes through for the ASX 200 we will hit our low target almost spot on! Will the market bounce off it! It might just.

With one quarter to go, the underpricing at -7.5% will largely determine where we will finish 2014. We have fair value at 5,600 so a rapid return to that level and then growth at +7.8% pa could easily take us above 5,700. However, there are far too many major geopolitical and economic issues on the boil to reasonably expect that to happen.

The end-of-the-year is too close to make sensible short-run predictions when the market is this underpriced.

Our 12-month-ahead capital gains forecast for the ASX 200 has lifted slightly to +7.8%. The adjusted gains figure stands at +15.9% since the market is now quite underpriced at -7.5%.

Our current end-of-FY '15 forecast has slipped from 5,900 at the start of June 30th 2014 – to 5,800 now. The 'high' forecast has slipped a fraction more than that to 5,950. Therefore, we maintain our position held since September 2013 that 6,000 is unlikely to stick until the second half of 2015. In fact, a 6,000 breach (even for a brief moment) in FY '15 is now less likely.

Market stats

Except for Property and Utilities (which were flat), all sectors took a big hit over the week (with losses of -2.0% to -4.6%).

Until last week, our volatility measures were fine but this week the market took a big hit. Market volatility (Chart 1) jumped out of the box to the average level during the GFC (the upper dotted line). Fear (Chart 2) is now well above the normal range with a level of 20% for four successive days. Disorder (Chart 3) climbed but only to the low end of normal.

The fear and disorder indexes say that the underpricing is unlikely to be eroded until those indexes retreat. Fearful people do not buy. The best we can hope for in the short run is a flat market.

Chart 4 shows that our capital gains' forecasts have crept back up to around +7.8%. There has been some slight day-to-day variation but, again, nothing to worry about.

With expected yields at 5.0%, franking credits and +15.9% adjusted capital gains expected for the next 12 months, we could well be sitting pretty this time next year. But we will feel battle weary by then.

Market mispricing (Chart 5) is -7.5%. All sectors (except for Property at +0.0%) are underpriced. When the fear and disorder indexes retreat to the normal zone, buying opportunities could present themselves – but that is a little way off.

The high-yield sectors' expected dividends have climbed to the high end of the 5% - 6% range but they are still moving together. The yield play has not ended yet so I am sitting tight.

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.

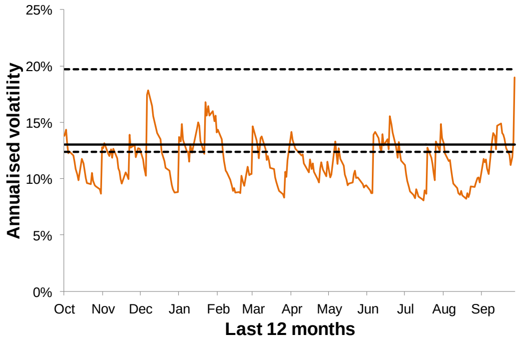
PMI – This acronym stands for Purchasing Managers Index. There is one for most countries and separate statistics for manufacturing and services. Manufacturing typically gets more attention. The statistics are published in the first few days of each month – with China on the 1st. A reading less than 50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

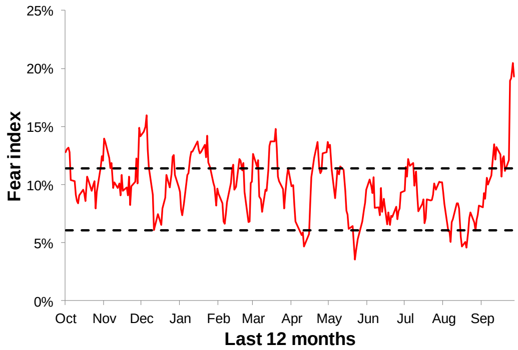
US non-farm payrolls data – are usually published on the first Friday of each month. They are generally considered to be the most reliable indicators for employment and unemployment in the US. Roughly speaking, a 200,000 increase in jobs is considered strong – particularly in the context of the tapering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

Chart 1: Market volatility



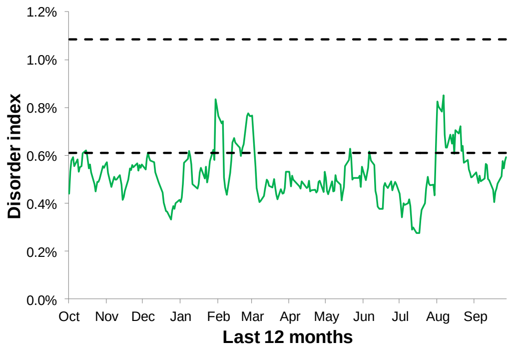
Notes: The solid black line depicts the average volatility since January 2010; the lower dotted line depicts the average volatility pre the GFC; the higher dotted line depicts the average level of volatility during the GFC - up to December 2009. The brown line is a daily estimate of the ASX 200 index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

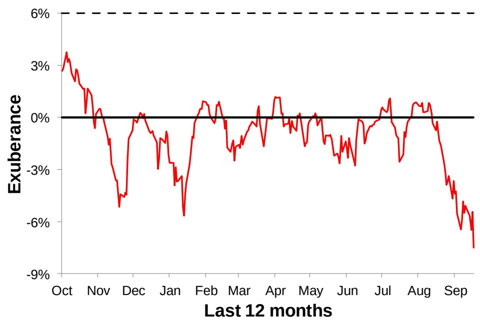


Notes: The disorder index measures the degree to which the 11 sectors' daily returns move in harmony. The two dotted lines depict the band in which the disorder index resided before the GFC in two thirds of days. Extended periods below the lower dotted line might indicate belief that there is little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

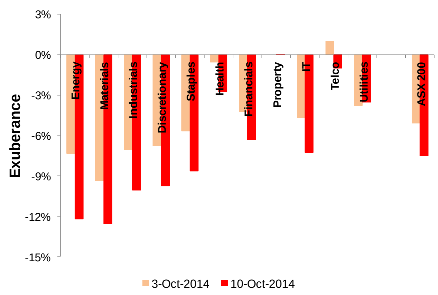
Notes: Each business day we update our estimates for capital gains on the ASX 200 for the following 12 months. For example, the left-most estimate on the vertical axis is a forecast for the 12 months concluding today. The right hand estimate is for the 12 months from today.

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