Ron Bewley PhD, FASSA

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Woodhall's Weekly

She sang her heart out!

- How far can the market go for Christmas?
- US zinging
- China still a force

Overview

Last week I wrote "After a miserable Monday, our market had four positive days and the SPI futures are up +68 points for every chance of a magic Monday start to next week." Well the ASX 200 posted a gain for the week of +2.7%. The 'fat lady' did indeed sing last week.

But the S&P 500 beat us with a +4.1% but they did fall in the previous week when we did +1.6%. Let's call it Even Steven.

All our sectors were up but Energy (+0.8%) and Utilities (+1.0%) did drag their feet. Oil prices are in the doldrums; and AGL's AGM was disrupted by frackin' protesters.

Oil prices seem to be affecting the broker-based forecasts for that sector. In the month-to-date, our 12-month-ahead capital gains' forecast has fallen from +15.7% to +10.6%. Because of other smaller changes, that had little impact on our forecast for the broader index.

The US didn't react calmly to the Ebola cases on home soil but their consumer sentiment index hit a 7-year high. US company reports have been beating on top line growth and CPI inflation stands at +1.7% which is just below their +2% target. That Caterpillar reported really well might give some boost to our ailing mining services industry.

Markets of course shook when a gunman killed a soldier in Ottawa and then got into the parliament building.

In China, GDP growth came in at +7.3% and Industrial Production rose from +6.9% the previous month to +8.0%. These are not great numbers but good enough not to feel gloomy. The HSBC flash PMI rose a fraction from 50.2 to 50.4. Next weekend we get the official PMI.

There were even signs of life in Europe. Yes, it is struggling but Spain's unemployment is now at its lowest since 2011.

Our inflation read came in at 2.3% and everybody yawned. Rate rises are unlikely in this financial year.

Our market is now 5% up from the low and the SPI is up +18 points for Monday. The geared index portfolio I started on borrowed money a week last Thursday (50:50 ASX 200 and S&P 500 via IOZ and IVV) is already up +4.2%. My WPL purchase from that week is only up +0.6% but that was meant to be a yield play! My new yield portfolio bought 25th – 27th June 2014 is up +4.8% to date including dividends and franking credits in my SMSF.

WoodHall Investment Research

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.

The problem about forecasting this close to the year end is that it is never clear how mispricing will play out. Exuberance is now only -3.2%, up from -7.5%. So 5,850 will take some heavy lifting but, with fair value at 5,600, we could take a tilt at it.

Our current end-of-fy '15 forecast had slipped from 5,900 at the start of June 30th 2014 – to 5,850 last week– but it is back at 5,900 now. Our 'high' forecast climbed further during the week to be at 6,100 which is just below the high forecast of 6,200 at June 30th. Therefore, we maintain our position held since September 2013 that 6,000 is unlikely to stick until the second half of 2015. But, unlike last week, a 6,000 breach has a chance in FY'15.

Market stats

Our market volatility (Chart 1) estimate has already returned to normal. Disorder (Chart 2) is below normal. Our Fear Index (Chart 3) is a smidgen above the normal range. This is as good as it gets.

Chart 4 shows that our capital gains' forecasts have stabilised at +8.6% so, with exuberance (Chart 5) at -3.2%, our adjusted capital gains forecast for the next twelve months is +12.1%. Not as good as last week because of the +2.7% gain on the market.

With expected yields at 4.8%, franking credits and +12.1% adjusted capital gains expected for the next 12 months, we could well be sitting pretty this time next year.

All sectors (except for Health at +1.5%, Property at +2.5% and Telcos +2.8%) are underpriced. Some sectors are extremely cheap but watch out for Energy until the capital gains forecasts settle down.

Since the Fear Index is all but in the zone, a shopping spree might be on the cards. Three of the big banks are about to report and the sector is just below fair-pricing. The yield play is still very much alive.

Since China's PMI is due out next Saturday, and US nonfarm payrolls is out the week after, the coming week could be very nice for investors!

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.

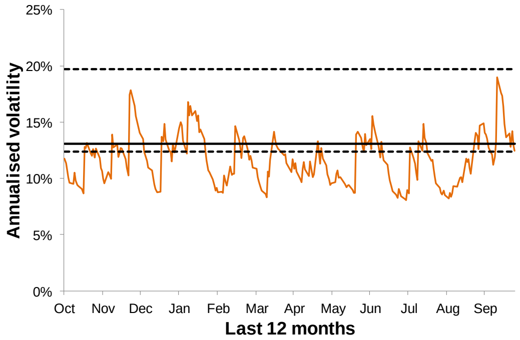
PMI – This acronym stands for Purchasing Managers Index. There is one for most countries and separate statistics for manufacturing and services. Manufacturing typically gets more attention. The statistics are published in the first few days of each month – with China on the 1st. A reading less than 50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

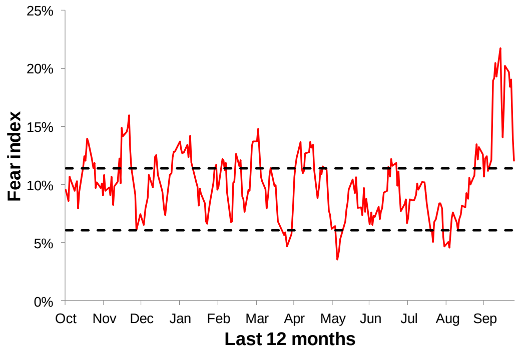
US non-farm payrolls data – are usually published on the first Friday of each month. They are generally considered to be the most reliable indicators for employment and unemployment in the US. Roughly speaking, a 200,000 increase in jobs is considered strong – particularly in the context of the tapering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

Chart 1: Market volatility



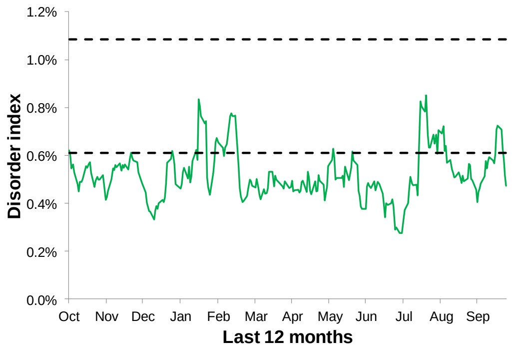
Notes: The solid black line depicts the average volatility since January 2010; the lower dotted line depicts the average volatility pre the GFC; the higher dotted line depicts the average level of volatility during the GFC - up to December 2009. The brown line is a daily estimate of the ASX 200 index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

Chart 2: Fear index



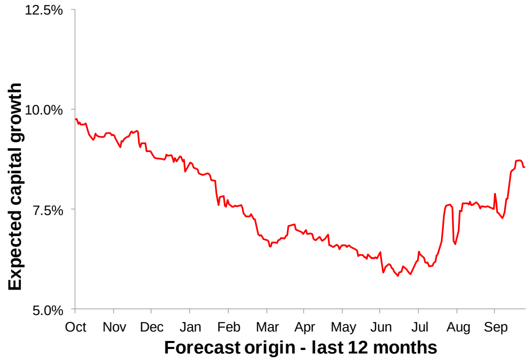
Notes: The fear index is a measure of 'excess' volatility denoting behaviour outside the open/close values each day. The two dotted lines depict the band in which the fear index resided before the GFC in two thirds of days. Extended periods below the lower dotted line might indicate complacency. Extended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



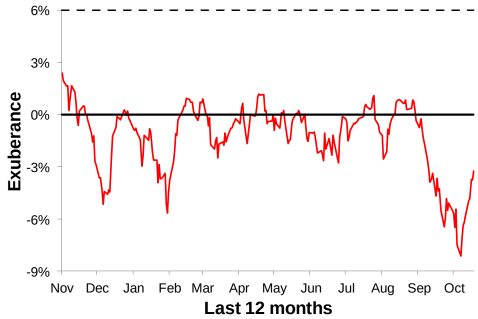
Notes: The disorder index measures the degree to which the 11 sectors' daily returns move in harmony. The two dotted lines depict the band in which the disorder index resided before the GFC in two thirds of days. Extended periods below the lower dotted line might indicate belief that there is little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



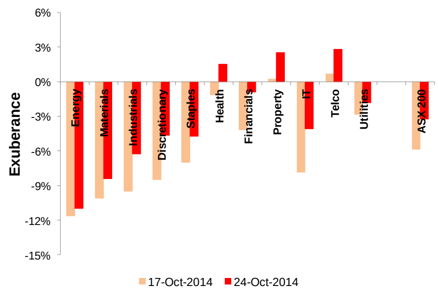
Notes: Each business day we update our estimates for capital gains on the ASX 200 for the following 12 months. For example, the left-most estimate on the vertical axis is a forecast for the 12 months concluding today. The right hand estimate is for the 12 months from today.

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