13 December 2014

Woodhall's Weekly

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A week to forget

- **Oil prices dominate news**
- **US economy still strong**
- **Our labour market not bad**

Overview

After struggling to make gains on the ASX 200 in the two previous weeks, those gains were given back and more. Our market fell -2.2% on the week compared to -3.5% on the S&P 500 and -6.6% on the FTSE. But we are carrying a SPI futures loaded with a -63 point fall pencilled in for Monday.

Although there were other bad data around, most consider oil prices to have been the culprit for this last week. WTI oil has fallen from a 2014 high of $107.30 to close this morning at $57.77. Brent fell from $115.43 to $61.69.

Lower oil prices have knocked off a dollar a gallon in the US – which translates into consumers having an extra $100bn to spend in 2015 if prices stay low. Consumer confidence is running high in the US and retail sales of +0.7% for November shows that US consumers are prepared to spend.

The big problem with plummeting oil prices is that countries that are highly dependent on oil – like Venezuela and Nigeria – are really feeling the pinch. Bloomberg reported that Venezuela has even taken to include diamonds and the like in their reserves in an attempt to hide their weakness.

Saudi Arabia is also missing out from this deliberate over-supply but they have three quarters of a trillion dollars in reserve to sit this one out. It's a bit like a poker game between Kerry Packer and my grandson. We know who will win. We just don't know how long it will take.

Energy companies are suffering too. Santos has taken some massive hits despite its rosy long-term future. With its debt downgraded one notch to BBB by Standard and Poor's, it had to cut CAPEX by 25% to ward off an equity capital raising at depressed prices.

At home, our labour data weren't too bad. Unemployment was up one notch to 6.3% but there were 43,700 new jobs – of which only 1,800 were full time. But the participation rate was up as potential workers hunted for jobs.

The call for rate cuts in Australia grew louder over the week but Glenn Stevens put a dampener on that prediction yesterday. He also called for a 75c dollar.

Shinzo Abe goes to the polls over the weekend. A good result for him might boost sentiment for next week. They certainly need it as Japan GDP Q3 growth was revised downwards from -1.6% to -1.9%.

China data last week were not good. Exports were only +4.7% and imports were down -6.7%. With CPI inflation coming in at only+1.4% and PPI inflation at -2.7%, China is as close to deflation as many. Falling oil prices contribute to that direction.

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 e-o-y is almost certainly a miss but our fair value is still 5,550. A 'pop' to fair value is possible but unlikely.

If the SPI futures fall translates into a fall on the ASX 200 on Monday, the index will be close to the low forecast 'in the box' of 5,50 and will be a trigger to top up my margin loan as soon as our fear index subsides.

Falling oil prices put further pressure on our Energy sector 12-month ahead forecast – it now stands at -1.5% and the forecast for Property is also negative. The ASX 200 forecast for (unadjusted) capital gains (Chart 4) down to +7.1% from +7.3% the week before.

Naturally these forecast revisions have further softened our current end-of-FY15 forecast. It now stands at 5,600. Our 'high' forecast also fell to 5,800, which is now well below the original high forecast of 6,200.

Therefore, we maintain our position held since September 2013 that 6,000 on the index is unlikely to stick until the second half of 2015. Yield compression is still limiting growth and Energy and Materials are cactus – at least for a while.

Market stats

With all of the events of the week our market volatility index (Chart 1) is elevated but it did fall in the last couple of days as the index fought to stay above 5,200. Our Disorder index (Chart 2) jumped up but stayed inside the box. Our Fear Index (Chart 3) is quite high because of the recoveries that took place on Thursday and Friday.

The market is very cheap this week (-6.1%) (Chart 5), but bargain hunters beware. Markets can stay cheap for extended periods of time or fall further when exuberance is negative and the fear index is high.

Chart 4 shows that our capital gains' forecast has fallen to +7.1% largely on downgrading of Energy and Material stocks. With exuberance (Chart 5) at -6.1%, our adjusted capital gains' forecast for the next twelve months is a respectable +13.6%.

My yield portfolio is now up only +1.7% since the end of June but the ASX 200 is down -3.4%. When dividends are included, the figures are +4.6% against -1.3%. The stocks I sold in June to be able to buy the yield portfolio are down -7.4%.

The first tranche of the geared IOZ/IVV portfolio is up +8.1% from October 16th and the second tranche is down -0.6% after two weeks. There is every chance I will add a third tranche to this strategy in coming days or weeks. I am planning to write a paper for this website on this strategy over Christmas.

Last Monday, I decided to de-risk some exposures in my super fund by selling some of each of Cochlear, CBA and Westpac (all having made very good capital gains). I used the proceeds to try to take advantage of our weakening dollar by buying IVV, an iShares ETF that replicates the S&P 500 (unhedged). I also sold off my 'rats and mice' on Friday from both my SMSF and my geared (outside super) portfolio to give me a more robust strategy for the New Year.

My SMSF is now about one third in my Hybrid Yield-Conviction portfolio, 20% in the S&P 500, 5% in cash and the rest in good stocks that will be sold when I find a new strategy to replace them. Some of the cash in my SMSF might find its way into IVV this week!

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.

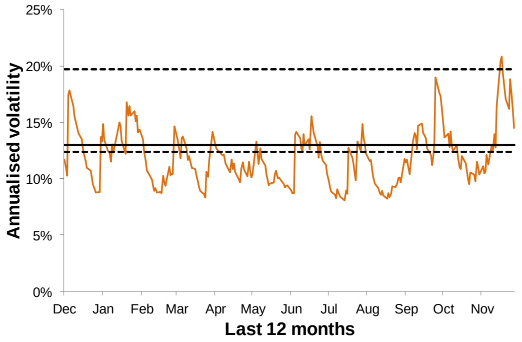
PMI – This acronym stands for Purchasing Managers Index. There is one for most countries and separate statistics for manufacturing and services. Manufacturing typically gets more attention. The statistics are published in the first few days of each month – with China on the 1st. A reading less than 50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

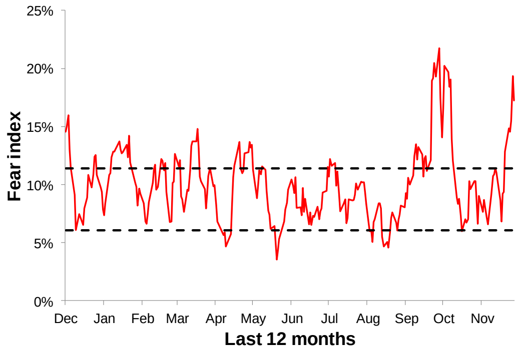
US non-farm payrolls data – are usually published on the first Friday of each month. They are generally considered to be the most reliable indicators for employment and unemployment in the US. Roughly speaking, a 200,000 increase in jobs is considered strong – particularly in the context of the tapering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

Chart 1: Market volatility



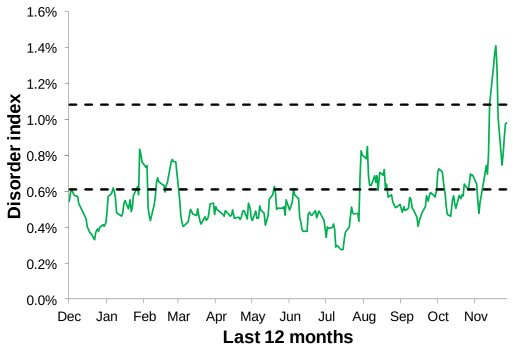
Notes: The solid black line depicts the average volatility since January 2010; the lower dotted line depicts the average volatility pre the GFC; the higher dotted line depicts the average level of volatility during the GFC - up to December 2009. The brown line is a daily estimate of the ASX 200 index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

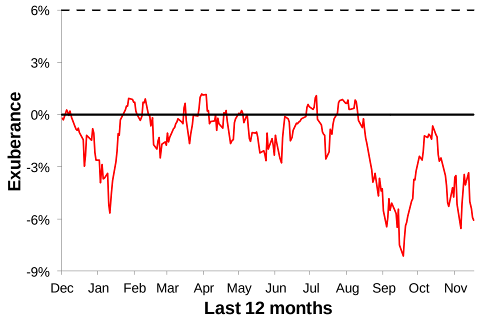


Notes: The disorder index measures the degree to which the 11 sectors' daily returns move in harmony. The two dotted lines depict the band in which the disorder index resided before the GFC in two thirds of days. Extended periods below the lower dotted line might indicate belief that there is little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

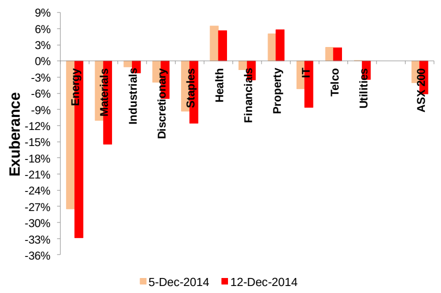
Notes: Each business day we update our estimates for capital gains on the ASX 200 for the following 12 months. For example, the left-most estimate on the vertical axis is a forecast for the 12 months concluding today. The right hand estimate is for the 12 months from today.

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