21 February 2015

Woodhall's Weekly

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Ever so close to 6,000!

- **Records aplenty on markets**
- **Greek (part) solution**
- **German recovery**

Overview

On Thursday, the ASX 200 got within 54 points of breaking through 6,000. Unsurprisingly, the market couldn't hold even that level for the day or the week. We suspect that the index will have a number of runs at 6,000 before it crosses for any length of time.

We have the market overpriced by +4.0%. Since our correction-territory mispricing level is +6.0%, it might be a while before 6,000 sticks. Exuberance for the four high-yield sectors and Health are all above +6.0% but, importantly, the target prices for many stocks have recently been upgraded as reporting season flows through.

Our Energy sector forecast for capital gains over the next 12 months has risen from -5.5% last week to +16.5% today – and where it was before the oil price crash. This upgrad was the main reason why our gains' forecast for the broader index lifted from +6.5% to +7.5% over the week. Our end-of-year forecasts have also improved.

The Dow hit an all-time high overnight for the first time in 2015 and the S&P 500 closed at 2,110.3 – yet another record.

Wall Street started a bit wobbly overnight until a Greek deal was thrashed out. It is only a four-month extension to the bailout but that is enough to take fear off the table for now. A real conclusion will take some time and a hair-cut seems inevitable.

Germany recorded economic growth of +0.7% for the quarter and +1.6% for the year taking thoughts of recession off the table. Japan also recently recorded modest growth of +2.2% after two negative quarters due to bring-forward purchases prior to the stiff hike in sales tax on April 1st.

So, in summary, with the SPI futures up +14 points for Monday and BHP to report next week, we see the market holding around these levels. If we crack the 6,000 soon, expect a mild correction! Our fundamental value for the ASX 200 is only 5,650 – more than 200 points from where we stand.

We watch with bated breath for revisions in analysts' forecasts. We fully anticipate some serious upgrades over the next two weeks that will flow through into our market and forecasts. Both oil and ore prices seem to have settled and may be even ready to rise. Our dollar has also been flat but, if Stevens pulls the trigger again – as almost certainly he will one day – being short Aussie might still be the play.

For those interested, I have collected 17 reports I have previously had published elsewhere that detail my thinking about *my own* portfolios over the last year – my "Diary". I feel (from occasional emails) that there is a demand for this sort of info.

I will update this file on my portfolios as I write and I am preparing some more factual information about what I hold and why. Check out the *Investment Strategy* tab for the reports and updates.

Market expectations

Our start-of-year 2015 forecasts for the ASX 200 were for an e-o-y of 5,900, a high of 6,200 and a low of 5,200. The updated e-o-y forecast has now exceeded the original forecast to sit at 6,050! The high is now up to 6,450. Fair value rose to 5,650. The index closed at 5,882 being +4.0% overpriced.

Note that last week the index was -4 points lower but exuberance was then higher at +4.6%. The reason is that the fundamental rose over the week. We see the fundamental rising even quicker after the March 1st forecasts kick in. New capital gains forecasts only enter the system on the 1st of each month.

With just over four months to go, our current e-o-FY15 forecast is now up to 5,950 – or above the original June 2014 forecast of 5,900 after spending many months languishing near 5,600. Our 'high' FY15 forecast has settled at 6,200 which is spot on the original high forecast.

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. But we have a much better chance of some fleeting visits above 6,000 sooner than we then thought!

Our long-run pricing model suggests we are only just shy of fair pricing at -0.6% which is the least underpriced we have been since March 2011.

Our January 1st 2015 forecasts for the S&P 500 were: e-o-y 2,240; high 2,360; low 1,970. Fair value was 2,070. Our current e-o-y has fallen to 2,230; high to 2,340; low to 1,990.The latest closing price was 2,110. Exuberance is just short of +2%.

Market stats

Our market volatility index (Chart 1) is coming back to normal levels at 13.5% Our Fear Index (Chart 2) continues to fluctuate above the normal range but not by too much. Our Disorder index (Chart 3) is in the zone. Now worries from these statistics.

Our capital gains forecast has further improved (Chart 4) to +7.5% as the worries over the Energy sector have evaporated.

The market is now overpriced at +4.0% (Chart 5). And that leaves the adjusted capital gains' forecast at a modest +3.2%. But wait for the upgrades – or even try to pre-empt them!

We still believe that broker forecasts have not yet factored in the full extent of the fall in the $A. We suspect a re-rating will flow through as we work through reporting season.

Five sectors are seriously overpriced: Health, Financials, Property, Telcos and Utilities (Chart 6). The expected dividend yields on Property and Telcos are well below 5% and have just been joined below 5% by Utilities. If these stocks do not deliver in reporting season, there could be problems. But, so far, so good.

The first tranche of my geared IOZ/IVV portfolio is up +19.6 % from mid October 2014 and the second tranche is up 10.4% since early December 2014. The complete new geared portfolio so far has a capital gain of +12.1%. Soon we might be getting to the point at which I unwind some of the gearing – but not yet. I discuss this strategy in the 'Diary'.

My Hybrid yield portfolio is now up +12.9% since the end of June 2014 while the ASX 200 is up +8.9% over the same period. When dividends are included, the figures are +17.2% against +11.9%.

Importantly, the target prices for 13 of the 15 stocks in this portfolio were upgraded last week while one was unchanged and the other only slightly downgraded. The expected 12-month capital gains based on target prices was only 2.8% in June 2014 and yet the portfolio has so far done +12.9%. It seems that infrastructure and property stocks were upgraded the most last week.

In my 'Other' SMSF portfolio, Cochlear continued to defy the critics reaching around $93 at one point last week. When will the analysts capitulate? I am still holding but watching.

The S&P 500 is less than +2% overpriced so no problems there.

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.

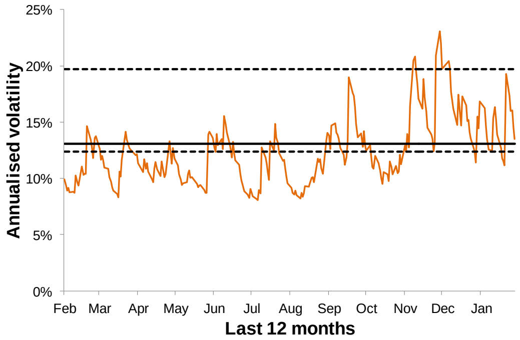
PMI – This acronym stands for Purchasing Managers Index. There is one for most countries and separate statistics for manufacturing and services. Manufacturing typically gets more attention. The statistics are published in the first few days of each month – with China on the 1st. A reading less than 50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

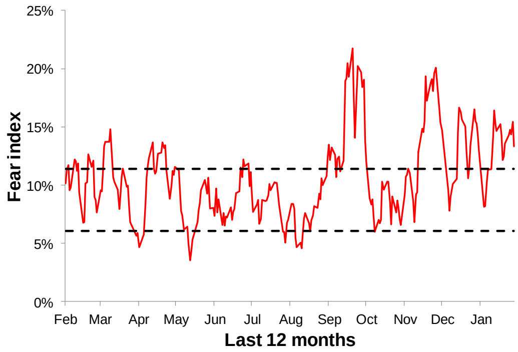
US non-farm payrolls data – are usually published on the first Friday of each month. They are generally considered to be the most reliable indicators for employment and unemployment in the US. Roughly speaking, a 200,000 increase in jobs is considered strong – particularly in the context of the tapering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

Chart 1: Market volatility



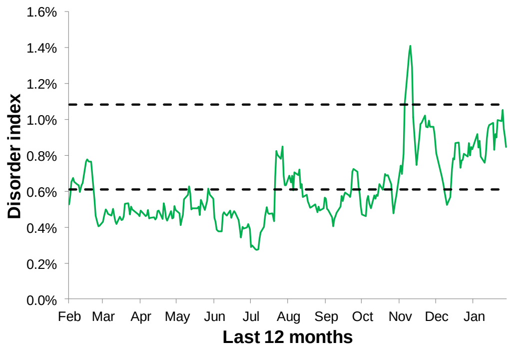
Notes: The solid black line depicts the average volatility since January 2010; the lower dotted line depicts the average volatility pre the GFC; the higher dotted line depicts the average level of volatility during the GFC - up to December 2009. The brown line is a daily estimate of the ASX 200 index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

Chart 2: Fear index



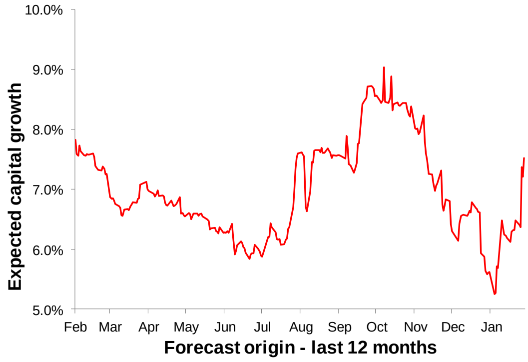
Notes: The fear index is a measure of 'excess' volatility denoting behaviour outside the open/close values each day. The two dotted lines depict the band in which the fear index resided before the GFC in two thirds of days. Extended periods below the lower dotted line might indicate complacency. Extended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



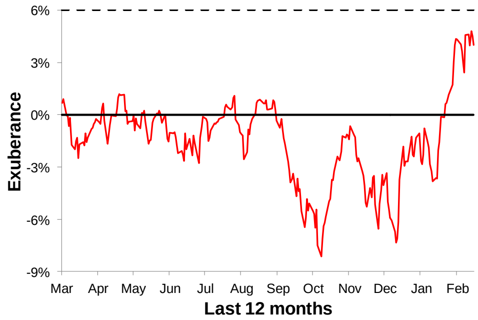
Notes: The disorder index measures the degree to which the 11 sectors' daily returns move in harmony. The two dotted lines depict the band in which the disorder index resided before the GFC in two thirds of days. Extended periods below the lower dotted line might indicate belief that there is little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



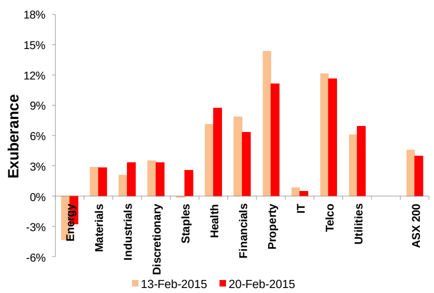
Notes: Each business day we update our estimates for capital gains on the ASX 200 for the following 12 months. For example, the left-most estimate on the vertical axis is a forecast for the 12 months concluding today. The right hand estimate is for the 12 months from today.

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