16 May 2015

Woodhall's Weekly

Ron Bewley PhD, FASSA

Order comes back to ASX 200

- **Benign Budget**
- **Sector mispricing has all but vanished**
- **China cuts again**

Overview

After some heavy losses the week before, the ASX 200 started its bounce-back last week posting a gain of +1.8%. Only Energy and Health lost ground. Discretionary (+3.5%) and Staples (+4.0%) were the best performers – possibly because the Budget's accelerated depreciation for small businesses might send tradies off to stores in their droves.

All-in-all the Budget was a pleasant affair that possibly will send us for a double dissolution before the next budget. But, unless we can change some of the voting rules, the Senate will still be over-represented with people nobody really voted for.

It looks likely that business and consumer confidence might start to gain on the back of the budget. Traditionally, consumer confidence falls at first after any budget – but last year's was a shocker.

The best part about all of the market gyrations over the last month or two have got the market back in balance. The four High-Yield sectors plus Health were precariously over-priced not so long ago. And Energy and Materials were really cheap (see the companion weekly 'ASX 200 Exuberance Statistics' publication next to this one on our website.

Now, all of the 11 sectors have exuberance (mispricing) measures between -2.2% and +2.1%. That's the tightest range in a long time. Surprisingly, the 10 sectors of the S&P 500 also have mispricing in a similar range. With Fear (Chart 2) and Disorder (Chart 3) almost back to normal, buying opportunities may soon abound. With the market a little bit cheap at -1.5%, the index can now continue its run at 6,000 in earnest.

We had five runs at 6,000 with each followed by a sharp retreat. But on each of those occasions, some sectors were quite out of line – especially the then expensive High Yield sectors. With an expected yield of 5.3% and an expected capital gain of +6.5% for Financials, even the banks look like a buy again.

Iron ore prices seem to have stabilised comfortably above $60 / tonne after a recent low of $47.08. But Goldman Sachs is urging us to short iron ore (in anticipation of a price fall) while a Bloomberg expert is now predicting $75 at the end of 2015 and $90 at the end of 2016.

Brent Oil prices were up another +4% on the week finishing off at just under $67 / barrel. Everything does seem to be getting back to normal.

True our dollar did jump above 82c when people feared the Fed would baulk at raising rates – and our RBA left out the outlook statement. While we expect the dollar to get down much lower than it is now, even at this level, our businesses have a fighting chance in the export markets.

WOODHALL INVESTMENT RESEARCH

China released some more data – Industrial Output and Retail Sales – that just missed expectations but the PBOC had already cut rates for the third time this year.

I surprised myself during the week by selling some stock. I reduced my Cochlear exposure because I was very over weight and I had made over 50% on it. It had remained almost the worst rated stock in the top 200 (by Thomson Reuters) for the last couple of years or so. I'll take a breather before I build up that position again – but I still really believe in the company. Since I also recently sold a block at over $91, I can watch a new momentum run for a little while and still make a profit!

With the SPI futures virtually flat for Monday, I'm not expecting too much excitement in the market. I am scheduled to appear on Switzer TV on Tuesday night explaining the recent behaviour of the High Yield sectors and their futures.

For those interested, there are now 21 collected reports – LAST UPDATED ON 2nd MAY – I have previously had published elsewhere that detail my thinking about my own personal portfolios over the last year – my "Woodhall Diary". 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 slipped again over the week to 6,050. The new high during the rest of 2015 rose a little to 6,350. Fair value is down a fraction to 5,800. The index closed at 5,736 being -1.5% underpriced.

With only about six weeks to go, our current e-o-FY15 forecast strengthened to 5,800, down from the June 2014 forecast of 5,900. However, with the market underpriced, a further quick rebound is quite possible and 5,900 might still be achieved.

Our 'high' FY15 forecast has climbed back to 5,950. The new 'low' forecast is 5,650. But with less than two months to go the FY forecasts are less reliable for the reasons regarding assumptions about mispricing erosion. Focus on the Calendar Year forecasts from now!

Our position held since September 2013 is that 6,000 on the index is unlikely to stick until the second half of 2015. We have had five decent runs at 6,000 without any success – and then a big pull-back. We are back on track for a good run at 6,000 possibly before the end of June. We currently estimate that the market could jump to as high as 6,150 without signalling a correction!

We are still thinking 6,000 may stick for good – or at least for a reasonable time – from early Q3.

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 2,080. Our current e-o-y stands at 2,260; the high forecast is at 2,360. And fair value is 2,120. The latest closing price was 2,123. Exuberance is close to zero so there is plenty of room for upside.

Market stats

Our market volatility index (Chart 1) jumped up around the CBA sell-off but it has almost retraced its path to average levels. Our Fear Index (Chart 2) jumped right out of the box over a week ago but that too is retracing nicely it is and nearly back in the zone. Our Disorder index (Chart 3) is at the low end of the zone.

Our 12-month capital gains forecast slipped a fraction (Chart 4) from +8.3% last week to +7.9%. The market is underpriced at -1.5% (Chart 5). So that leaves the adjusted capital gains' forecast at a very healthy +9.5%. The comparable 12-month adjusted capital gains forecast for the S&P 500 stands at +10.8%. All sectors on the ASX 200 are about fair value or cheap (Chart 6).

The first tranche of my geared IOZ/IVV portfolio is up +17.2% from mid October 2014 and the second tranche is up 8.1% since December 2014. The complete new geared portfolio so far has an unrealised capital gain of +9.8% since I invested much more in the second tranche.

My Hybrid yield portfolio – including the impact of the March 5th 2015 rebalance – is up +13.8% against +6.1% for the ASX 200 since late June 2014. Including dividends, the figures are +19.5% and +10.7% respectively.

Again, eight of the 12 Hybrid stocks had their target prices from consensus broker forecasts lifted last week. Two were fractionally down and two were unchanged.

After having sold some Cochlear, I now have a little excess cash in my SMSF looking for a home. Perhaps it is time to de-risk a little by buying some hedged exposure to the S&P 500 (IHVV) to accompany my unhedged IVV?

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.

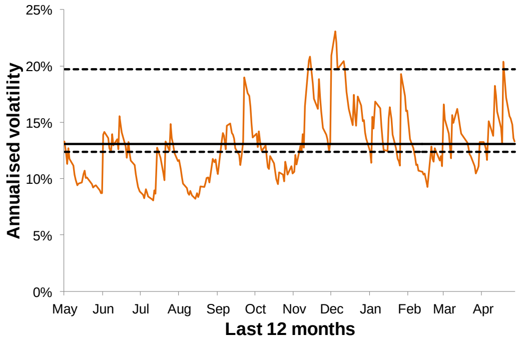
PMI – This acronym stands for Purchasing Managers Index. There is one for most countries and separate statistics for manufacturing and services. Manufacturing typically gets more attention. The statistics are published in the first few days of each month – with China on the 1st. A reading less than 50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

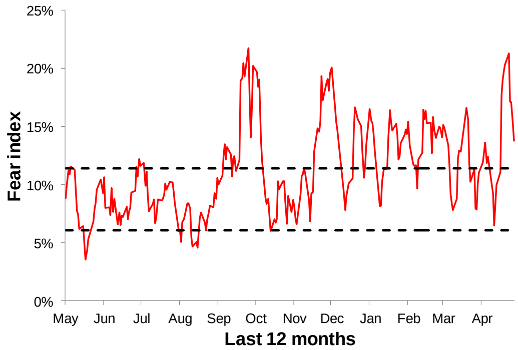
US non-farm payrolls data – are usually published on the first Friday of each month. They are generally considered to be the most reliable indicators for employment and unemployment in the US. Roughly speaking, a 200,000 increase in jobs is considered strong – particularly in the context of the tapering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

Chart 1: Market volatility



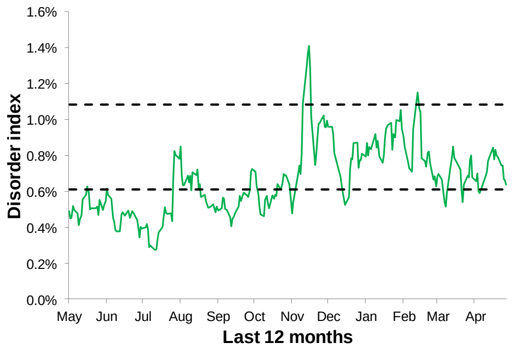
Notes: The solid black line depicts the average volatility since January 2010; the lower dotted line depicts the average volatility pre the GFC; the higher dotted line depicts the average level of volatility during the GFC - up to December 2009. The brown line is a daily estimate of the ASX 200 index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

Chart 2: Fear index



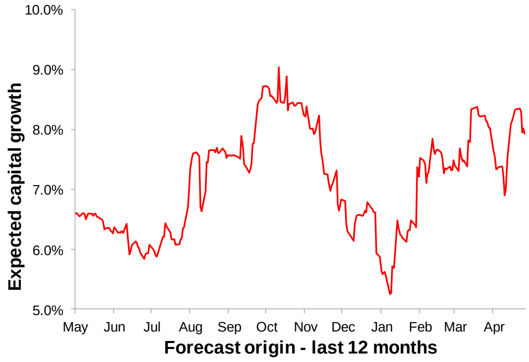
Notes: The fear index is a measure of 'excess' volatility denoting behaviour outside the open/close values each day. The two dotted lines depict the band in which the fear index resided before the GFC in two thirds of days. Extended periods below the lower dotted line might indicate complacency. Extended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



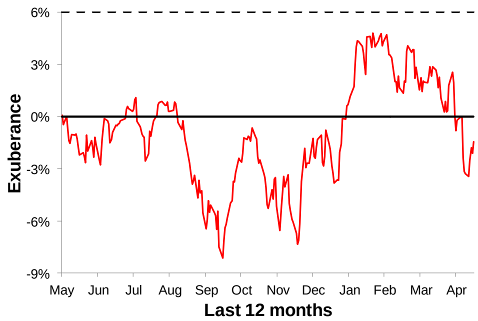
Notes: The disorder index measures the degree to which the 11 sectors' daily returns move in harmony. The two dotted lines depict the band in which the disorder index resided before the GFC in two thirds of days. Extended periods below the lower dotted line might indicate belief that there is little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



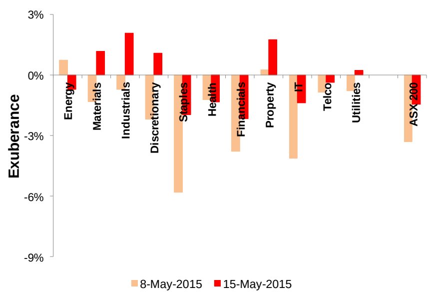
Notes: Each business day we update our estimates for capital gains on the ASX 200 for the following 12 months. For example, the left-most estimate on the vertical axis is a forecast for the 12 months concluding today. The right hand estimate is for the 12 months from today.

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