25 July 2015

Woodhall's Weekly

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The US is now the problem!

- **Very mixed US reporting season**
- **Aus CPI just fine**
- **What is trend growth?**

Overview

The US reporting season has been unusually mixed. Amazon reported well and its stock jumped 18% in after-hours trading but Caterpillar – the bellwether for global growth – missed and its stock fell nearly -4%. As a result many markets finished the week on a low note. Even the Shanghai Composite lost -1.3% on Friday!

The price of gold fell for 10 straight days – a record held since 1996. At $1,084 it is far below its 2015 high of $1,302. Most commodities lost ground over the week and our Energy (-3.5%) and Resource (-4.5%) sectors got hammered. Our market was down -1.8% on the week but it is still up +2.0% on the month-to-date. Unfortunately, the SPI futures are pointing to a sell-off on Monday with a lead of -49 pts.

HSBC has handed over the sponsorship of the flash China PMI to CAIXIN and that came in at 48.2 from an expected 49.7. We still don't attach much weight to that measure due to sample size and coverage. But the market didn't like it.

At home, inflation came in at +0.7% from +0.2% the previous quarter and the annual figure was +1.5% up from +1.3%. These reads are obviously below the "over the cycle" range of 2% to 3% but not that far below and it is moving in the right direction.

The market is pricing in a 60% chance of another cut this year – most likely September but it could be August. With the dollar now below $US 0.73 some would argue that no more cuts are needed – but neither could they hurt. 1.5% is hardly a sign of rampant inflation! The RBNZ cut last week to 3.0%.

Business confidence was the best since last September according to the NAB survey. Of course, consumer confidence should follow business confidence as the former needs a job or a pay increase to feel good.

The latest idea floated by the Governor of the RBA is that what will become trend growth might be below what used to be. In other words, we might already be close to trend. This is consistent with Nobel Laureate Paul Krugman's view stated on Bloomberg TV last week that nobody really knows what constitutes full employment anymore in the US.

As expected Greece has done the right thing and Greek banks are re-opening. The Iran nuclear deal has been ratified by the UN and the EU – but it still has to pass in the US Congress to get over the line.

Iran's oil supply would take a while to ramp up but there looks like there is further downward pressure on oil prices down the track.

I am flying out to England on Saturday, August 1st until September 4th so the Weeklies will be delayed

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– possibly until Sundays because of the time difference. The next one should be normal though.

For those interested, there are now 23 collected reports – LAST UPDATED ON 23rd JUNE – 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 is back down to 5,800. The new high forecast for the rest of 2015 fell to 6,050. Fair value is steady at 5,750. The index closed at 5,561 being -3.0% underpriced.

Our forecast for FY16 was for an end of 6,200, a high forecast (during FY16) of 6,500 and a low forecast of 5,300. The high forecast has slipped to 6,400 and the end to 6,100.

So when will we break 6,000? A good run at 6,000 could happen this quarter but last week took a bit of wind out of the sails. I still think Q3 is the go – but it will take some good news in our reporting season to keep it above that level!

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 updated e-o-y stands at 2,230; the high forecast is at 2,310. And fair value is 2,140. The closing price was 2,079. Exuberance is about -3%.

Market stats

Our market volatility index (Chart 1) is close to – but not quite back to normal. Our Fear Index (Chart 2) is back in the range. Our Disorder index (Chart 3) is just fine. Normally these are the conditions for regular investors to get back in the market but we need the US reporting season to be fully digested first. The markets are a bit twitchy. The VIX inched above its low range overnight – but is still well below its historical median.

Our 12-month capital gains forecast (Chart 4) has continued to slip and is now down to +7.2%. The market is underpriced at -3.0% (Chart 5). So that leaves the adjusted capital gains' forecast at +10.4%. The comparable 12-month adjusted capital gains forecast for the S&P 500 stands at +15%.

Most sectors are underpriced (Chart 6) and nothing is expensive.

The first tranche of my geared IOZ/IVV portfolio is up +19.2% from mid October 2014 and the second tranche is up +10.0% since December 2014. The complete new geared portfolio so far has an unrealised capital gain of +11.7% since I invested much more in the second tranche. The total return is +15.3% (including dividends to date). With our dollar falling a further -1.6% over the week, the overseas component is looking a lot stronger.

My Hybrid yield portfolio – including the impact of the March 5th 2015 rebalance – is up +9.0% against +3.0% for the ASX 200 since late June 2014. Including dividends, the figures are +15.3% and +7.8% respectively. That is an outperformance of +7.5% in a little over a year.

The dust certainly did not settle last week as I had hoped so I did nothing about jettisoning any stocks.

Three of the 12 Hybrid stocks had their target prices from consensus broker forecasts lifted a little last week. Four were down and five were unchanged. Macquarie reported well and its target price was lifted from $85 to $90!

Next week is going to be interesting as we are sandwiched between a mixed US reporting season and our season is just about to begin. So I think I'll sit this week out and watch from a different time zone and news flow the week after.

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!

CAIXIN (formerly HSBC) flash PMI – CAIXIN 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.

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.

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.

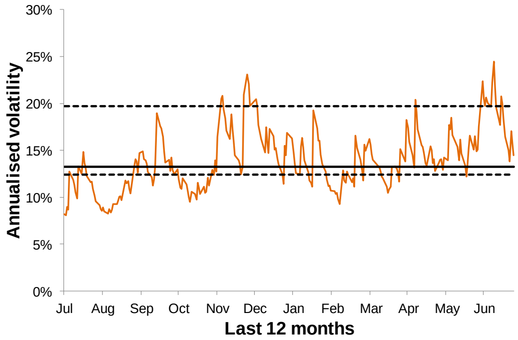
PMI – This acronym stands for Purchasing Managers Index. There is one for most countries and separate statistics for manufacturing and services. Manufacturing typically gets more attention. The statistics are published in the first few days of each month – with China on the 1st. A reading less than 50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

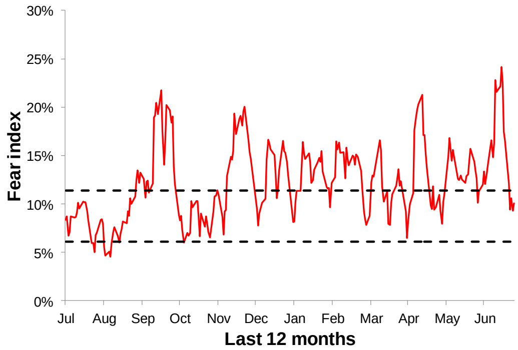
US non-farm payrolls data – are usually published on the first Friday of each month. They are generally considered to be the most reliable indicators for employment and unemployment in the US. Roughly speaking, a 200,000 increase in jobs is considered strong – particularly in the context of the tapering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

Chart 1: Market volatility



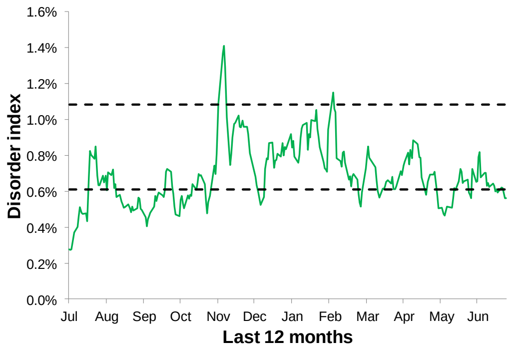
Notes: The solid black line depicts the average volatility since January 2010; the lower dotted line depicts the average volatility pre the GFC; the higher dotted line depicts the average level of volatility during the GFC - up to December 2009. The brown line is a daily estimate of the ASX 200 index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

Chart 2: Fear index



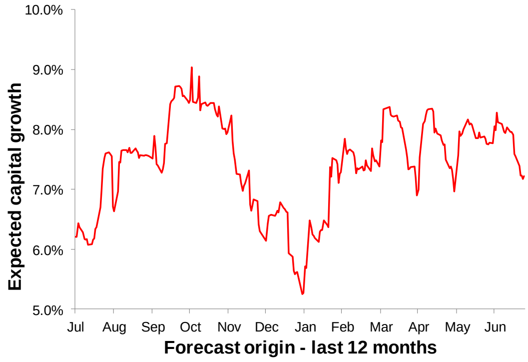
Notes: The fear index is a measure of 'excess' volatility denoting behaviour outside the open/close values each day. The two dotted lines depict the band in which the fear index resided before the GFC in two thirds of days. Extended periods below the lower dotted line might indicate complacency. Extended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



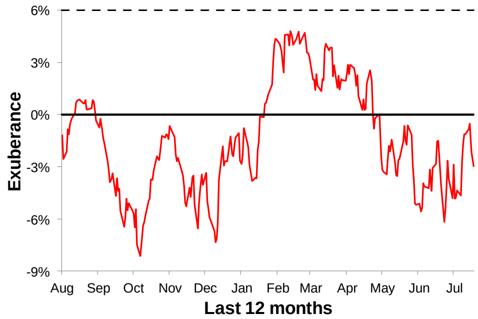
Notes: The disorder index measures the degree to which the 11 sectors' daily returns move in harmony. The two dotted lines depict the band in which the disorder index resided before the GFC in two thirds of days. Extended periods below the lower dotted line might indicate belief that there is little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



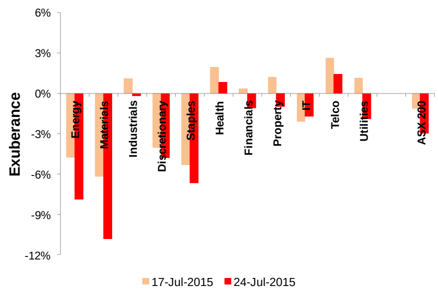
Notes: Each business day we update our estimates for capital gains on the ASX 200 for the following 12 months. For example, the left-most estimate on the vertical axis is a forecast for the 12 months concluding today. The right hand estimate is for the 12 months from today.

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