Woodhall's Weekly

Ron Bewley PhD, FASSA

Fed dithering spooks markets

- **Yellen needs medical attention as she backs up from FOMC**
- **Aus consumer confidence surges on new PM**
- **Japan adds three more arrows to its quiver**

Overview

When markets had digested the Fed's dithering at the FOMC over the weekend before this one, they didn't like it. In essence the Fed caused the ongoing volatility by mumbling about China – which is not in its policy mandate.

The chair, Dr Yellen, gave what would normally have been a low-key speech at the University of Massachusetts, Amherst, yesterday – but it turned out to be much anticipated than otherwise as markets wanted clarification about her FOMC press-conference comments. Yellen had to make pauses and not take questions – and then was helped off the podium to receive medical attention. Was she under incredible stress for having been shown to have stuffed up? Either way I wish her well.

The main point of that speech for markets is that she was clear that the Fed is still on track to hike this year – unless some left-of-field event hits the world. Given there is no scheduled press conference after the October meeting and no meeting in November, December – just before Christmas – is leading the field for the first hike.

European markets surged on the news but Wall Street is still struggling under the biotech and VW news. The CNNC report I read on the VW affair is that two men discovered the emissions problem and they happened to be called Mr Mock and Mr German. Is someone playing a practical joke?

But in the US economy, Q2 growth was revised up to +3.9% (annualised) from +3.7% and an initial estimate of +2.3%. Isn't that very strong growth and above trend?

At home the weekly ANZ Roy Morgan consumer confidence index surged +8.7% which is the biggest increase in the seven years since the series started. What a difference a prime minister makes! The Coalition is now well ahead of the opposition in the polls and Turnbull is streets ahead of Shorten.

Importantly Turnbull is being effective in refusing to make-up policy on the run at the whim of journalists. There is now every chance long-run business and consumer confidence will stabilise at appropriately high levels for solid business investment, economic growth and jobs.

Japan's Abe was reinstated during the week as leader by his party for another three years. At the same time CPI inflation came in negative (-0.1%) but, excluding oil, it was a more reasonable +0.8%. Low inflation has dogged Japan for much of two decades

On top of that (or was it because of), Abe added three more policy 'arrows' to his quiver: economic growth, assistance for families and social security. One of his big problems is the natural decline in

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population. Currently population is about 127 million and Abe is trying to stop it from falling below 100 million! In other words, the Japan population is destined to fall by more than the population of Australia in the forecast period.

China's 'Beige Book' on regional conditions (mirroring the US Fed's Beige Book) in the country distanced itself from the hard landing commentators.

In Greece, Alexis Tsipras was re-elected with a clear majority in a coalition with a few right-leaning independents. This move looks set to stabilise the debt control process and European Unity.

I think markets will now slowly start to settle down but we do get the US nonfarm payrolls on Friday night – the day after the official PMI for China is released. Barring big surprises in those two numbers, the week after might be the start of a run-into Christmas.

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 now 5,300 because the base-line assumption is that the -11.7% underpricing will take 12 months to be eroded. The new high forecast for the rest of 2015 is only 5,400 but fair value is steady at 5,700! The index closed at 5,042 being -11.7% underpriced. Near-term action is heavily dependent on how quickly underpricing is eroded.

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 is now 6,000 and the end is for 5,850.

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 2,040 the high forecast is at 2,080. And fair value stayed at 2,140 over the week. The closing price was 1,931. Exuberance is -9.8%.

Since the ASX 200 is just under the 2015 low forecast of 5,200 and the S&P 500 is also just below its low forecast of 1,970 I conclude that there is insufficient information to claim that the markets have gone off track – they are, in my opinion, just underpriced.

Market stats

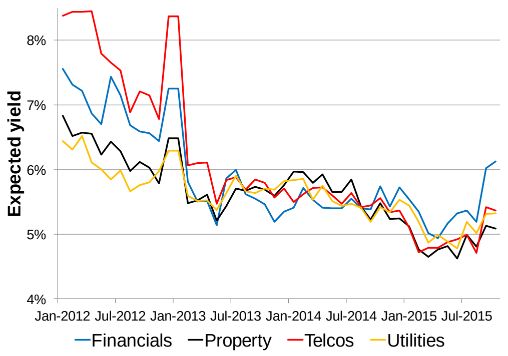
Our market volatility index (Chart 1) is still high at 21%. Our Fear Index (Chart 2) is also quite high. Our Disorder index (Chart 3) is at the low end of the normal zone. Normally these are not the conditions for trading stocks (even if only for rebalancing).

Our 12-month capital gains forecast (Chart 4) has fallen from +8.2% to +7.8% largely on the back of a big drop in the Energy sector forecast gain. The market is underpriced at -11.7% (Chart 5). So that leaves the adjusted 12-month capital gains' forecast at +20.4%. The comparable 12-month adjusted capital gains forecast for the S&P 500 stands at +22%.

All sectors are cheap on the ASX 200 (Chart 6) and the S&P 500.

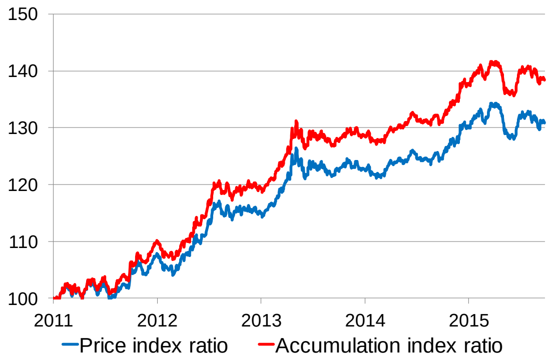
The forecast dividend yield for the ASX 200 now stands at 5.1% with Financials at a lofty 6.1% (plus franking credits) which is the highest since 2012. Indeed Financials has broken away from the other three high-yield sectors that have yields between 5.1% and 5.4%. Is this the end of the yield play? I don't think so! The following chart illustrates this movement.

Dividend compression



When I plot the ratio of the total returns of the high-yield sectors to those for the other sectors since 2011 the ratio stands at nearly 140 – meaning that investors would have been better off by nearly 40% by investing in high-yield against other. If the ratio started to fall that may signal the play was over. However, the ratio has just gone sideways for much of 2015 meaning that the benefit is not there but nor is it getting worse. Such pauses have happened from time to time (as the following chart shows) so it is too early for me to announce the end of the play. When the banks have clearly finished their recapitalising moves, the play could return in strength.

Ratio of indexes for high yield sectors to other



The IOZ:IVV Strategy

Please see the section after The Glossary for details.

Tranche	Buying window	Approx. Index value of buys	Total
I	16/10/2014	100	12.8%
II	28/11/2014 - 15/1/2015	400	4.1%
III	26/8/2015 - 4/9/2015	200	0.7%
Total		700	4.3%
Internal rate of return (pa)			7.3%

NB The top four returns are not annualised. See notes after the Glossary for further explanation and charts.

Given the state of the markets over this period, +7.3% seems healthy for now. Obviously if the underpricing in both markets gets eroded quickly, the returns should pop. All three tranches are in the black even at this low point.

Since both indexes are at or below the low forecasts, I would normally add to the play but that would then take my total exposure to more than what I would be comfortable with. I am quietly waiting for a sell signal when the high forecasts are reached!

Hybrid Yield-Conviction Portfolio

Please see the section after The Glossary for details.

My Hybrid yield portfolio (the current stocks and weights are shown after the Glossary below) – including the impact of the March 5th 2015 rebalance – is up +0.4% against -6.7% for the ASX 200 since late June 2014. Including dividends, the figures are +7.8% and -0.9%, respectively. That corresponds to an outperformance of +8.7% in nearly 15 months.

Three of my stocks had their target prices upgraded over the week while three were downgraded out of my 12 Hybrid stocks. However, two stocks had their buy-sell-hold broker recommendations improve over the week while none deteriorated.

I constructed my September 1 portfolio and it has an increased number of stocks (15) but the market is still too 'fearful' for me to start rebalancing yet. I will again be keeping a very close eye on the market this coming week. But October 1st is getting close and I might just wait for that portfolio.

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 was 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.

The IOZ:IVV Strategy

I plan to use the Table in the 'Market Stats' section to keep readers informed about the performance of my geared portfolio [an approximate equal mix of two ETFs: IOZ for the ASX 200 and IVV for an unhedged exposure to the S&P 500]. Since I have borrowed against my home, I will limit my investments even if additional opportunities present themselves. I will await the sell signals in times to come.

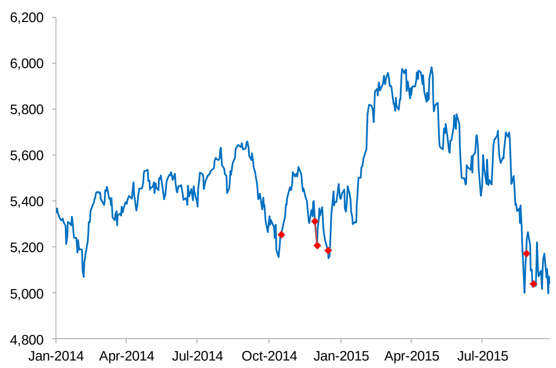
The basis of the strategy is to buy when the indexes get very close to or cross the beginning of the year predicted low – and to sell when the indexes reach the predicted highs – as indicated in the 'Market Expectations' section. I do not use the weekly updated lows and highs for this purpose. These statistics help me consider whether or not the strategy is going awry.

Since the IVV ETF is unhedged it benefits from $A depreciations and vice versa. I will switch to IHVV – the hedged version of the S&P 500 ETF – when I think the currency is more likely to appreciate.

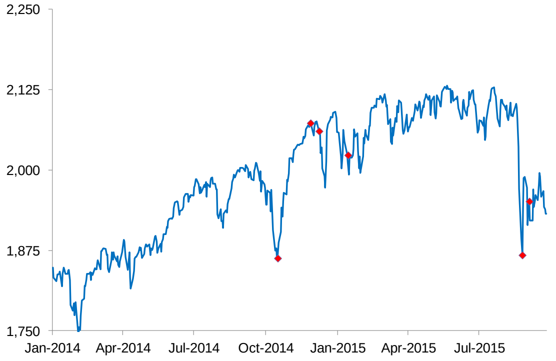
Please note that the irr is a single annualised return to summarise all of the buys of both ETFs and the current value.

The following charts (which are only updated infrequently – usually only when there are fresh buys or sells) show where I bought. Since the buy signals are based on the S&P 500 I show both the S&P 500 expressed in $US and $A.

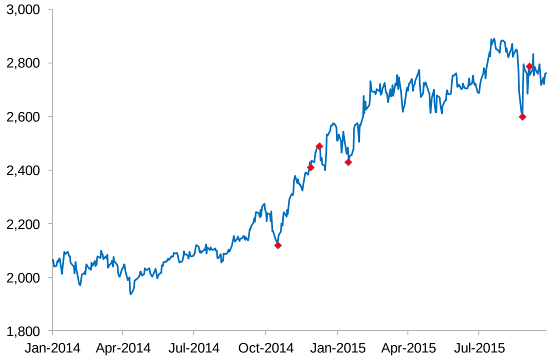
IOZ buy points on the ASX 200



IVV buy points on the S&P 500 ($US – hedged)



IVV buy points on the S&P 500 ($A – unhedged)



Hybrid Yield-Conviction Portfolio

Current holdings

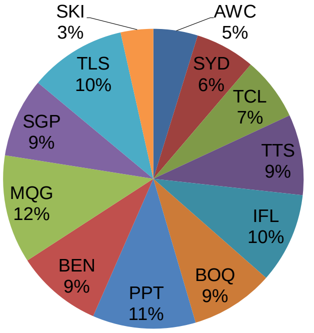
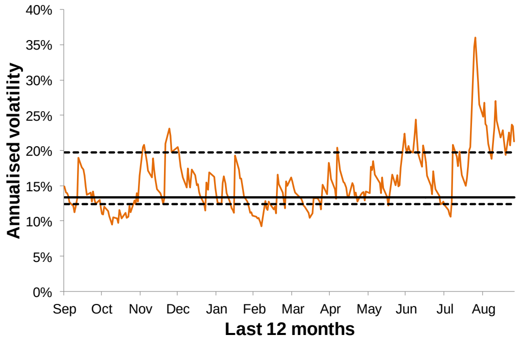
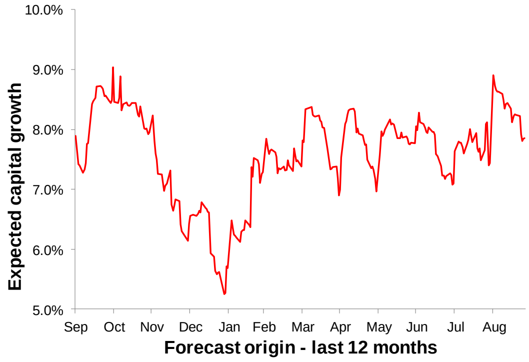


Chart 1: Market volatility



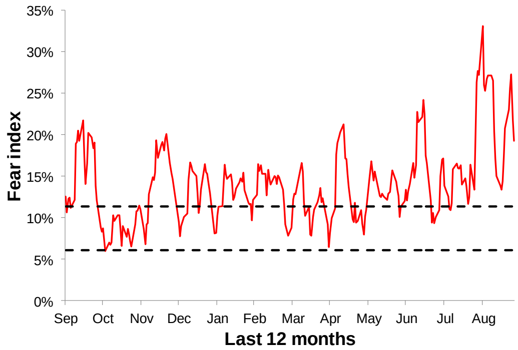
Notes: The solid black line depicts the average volatility since January 2010; the lower dotted line depicts the average volatility pre the GFC; the higher dotted line depicts the average level of volatility during the GFC - up to December 2009. The brown line is a daily estimate of the ASX 200 index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

Chart 4: 12-month-ahead capital gains forecasts



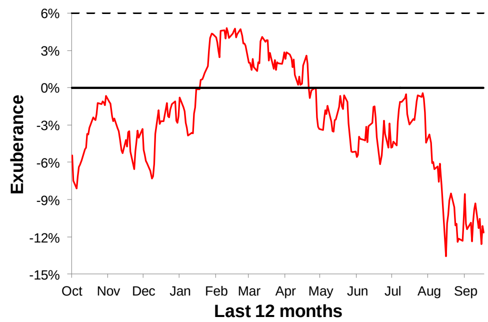
Notes: Each business day we update our estimates for capital gains on the ASX 200 for the following 12 months. For example, the left-most estimate on the vertical axis is a forecast for the 12 months concluding today. The right hand estimate is for the 12 months from today.

Chart 2: Fear index



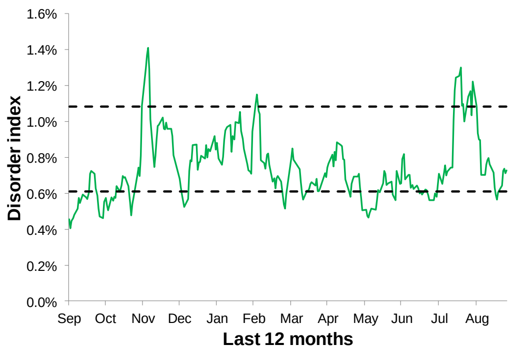
Notes: The fear index is a measure of 'excess' volatility denoting behaviour outside the open/close values each day. The two dotted lines depict the band in which the fear index resided before the GFC in two thirds of days. Extended periods below the lower dotted line might indicate complacency. Extended 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 5: Market exuberance



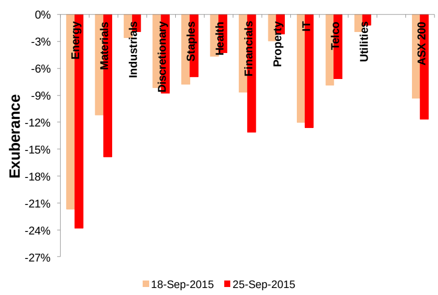
Notes: Exuberance is our measure of mispricing on the ASX 200. A value below the solid black line denotes the market is perceived to be cheap and above that line expensive. Experience suggests that exuberance above +6%, denoted by the dotted line, is an indicator of a potential correction of 6% to 10% - or for the market to move sideways for an extended period.

Chart 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 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