30 January 2016

Woodhall's Weekly

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End of story?

- **Oil on troubled waters**
- **We want China growth to fall**
- **US recession? I think not!**

Overview

The intra-day low (so far!) on the ASX 200 for the year was 4,804 on Monday, 18th January. The intra-day high for the same period was 5,010 on Wednesday 27th January. That's a nice turn around. So was that the bottom?

Many factors (many spurious) have been put forward as the cause of the January woes. Oil was certainly a factor. Brent got down to $25.91 / barrel in January and some analysts were calling for $20 and some even for $10! Ten dollars was equivalent to a further -60% fall but we instead got a +33% increase into the end of the month.

Of course lots can happen in the future, but seemingly knowledgeable people on Bloomberg TV are saying that an 'equilibrium' price for oil is around $50 - $60. Less than that and most go bust; more than that and shale oil comes back on stream. I buy that logic.

Whether the oil price gyrations were due to speculation/shorting, stock-building and depletion or whatever, I am calling $25.91 a fortnight ago as the bottom for the foreseeable future (say 2016 and possibly beyond). As a result (and because of more fundamental analysis – not reported here), I think 4,804 was probably the intra-day low for the year on the ASX 200. Nice to have it behind us so early in the year! Let's move on.

For my sins, I held Santos through this last little while. Although its price has been hammered, its price was up +7.5% yesterday and more than +10% since morning tea on Monday. I try to keep the rule that if I can't get out quickly enough, I should hang on for the bounce after it having been oversold.

But oil wasn't the only game in town. Many thought China was to blame. Their stock market is way, way down but it is still above the pre margin-loan-fuelled boom levels of 2014/15. That's no cause. As I often write, the economy is just fine and unrelated to the economy.

Anyone who doesn't want China's growth rate to continue to fall (in coming decades) to around the 3% - 4% level that the USA, Europe and Australia aspire to is a fool. All developing countries go through different phases and China is gliding to a sustainable future. It is just a question of how quickly growth falls!

The "hard landing" phrase was coined by economists to characterise a country tightening interest rates too quickly to pull inflation back. A "soft landing" was doing it at the right speed.

China is not tightening – in fact, it is doing the opposite! It is blending its government infrastructure spend with a focus on a 'capitalist economy'. There is neither a hard nor soft landing in store – there is volatility as the transition develops. End of story.

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China's currency? Just like us – they want a market rate that satisfies its trading partners not just the US dollar. Another volatility story another "end of story".

And the newest kid on the block – a recession in the USA! As one erudite interviewee said on Bloomberg TV (paraphrased), "a recession is only a recession if the labour market contracts". The FOMC statement on Thursday called 4.9% as full employment and the US rate has been 5.0% for a while. The last non-farm payrolls' number was a whopping 292,000 new jobs.

There will continue to be under-employed analysts and commentators trying to make up a new definition of a recession (or any other scary term) but they will add nothing useful to the macro picture. End of story.

Our inflation read came out a little on the warm side thus reducing the chance of a cut by the RBA. But this tack, with the drifting chance of any rate hikes in the US has buoyed our dollar. I think a cut in the next few months at home is a reasonable bet. But I remain 100% unhedged in my international exposure.

As I was writing many months ago, the previous open-arms approach to refugees entering the EU was unsustainable. Sweden is now planning on sending many back and there is talk of authorities confiscating any valuables up to $1,500 to offset costs of assimilation. Even wedding rings are possibly up for grabs!

And, at the last breath for the week, the Bank of Japan has opened the door for negative interest rates, plus more QE, and a forecast rate of inflation of 2% for 2017/8 after decades of deflation.

I am glad I wasn't in a tropical paradise during January, hidden from market moves. Soon, I think we will be back to semi-normal and a market more like 5,200 – 5,400 than where it closed yesterday, with our nose just above 5,000.

World markets surged last night – the S&P 500 up about 2.25%. Our SPI futures are up about +37 points for Monday. Who needs idle weekends – bring on Monday!

Market expectations

Our start-of-year 2016 forecasts for the ASX 200 were for an e-o-y of 5,850, a high of 6,150 and a low of 5,100. The new high is 6,000 and an e-o-y of 5,800 – up 50 pts from last week. Fair value is steady at 5,350 and the index closed at 5,006.

Our forecast for FY16 was for an end of 6,200, a high forecast (during FY16) of 6,500 and a low forecast of 5,350. The updated high forecast is 5,500 and the new end is for 5,350. That is, it will take five months to return to fair value under the 'gentle' scenario but a pop to erode the -6.4% mispricing should not be ignored.

Our original 2016 forecasts for the S&P 500 were for an e-o-y of 2,360, a high of 2,450 and a low of 1,980. The new high is 2,340 and the e-o-y is 2,280. Fair value is steady at 2,120 and the last close was 1,940.

Our current prediction for mid 2016 on the S&P 500 is 2,060 with a possible high of 2,110!

Market stats

Our market volatility index (Chart 1) is only moderately high at 16.6%. Our Fear Index (Chart 2) is falling and is now at 17.0%. But the VIX is now only 20.2 looking like investors are calm again. Our Disorder index (Chart 3) is near the top of the normal zone.

Our 12-month capital gains forecast (Chart 4) has strengthened to +10.3%. The market is underpriced at -6.4% (Chart 5). So that leaves the adjusted 12-month capital gains' forecast at +17.4%. The comparable 12-month adjusted capital gains forecast for the S&P 500 stands at +19.5%.

Many of the sectors on the ASX 200 are close to fair value (Chart 6). Resources remain very cheap but only the very brave will jump in. Staples are the most overpriced but only at a modest +2.1%.

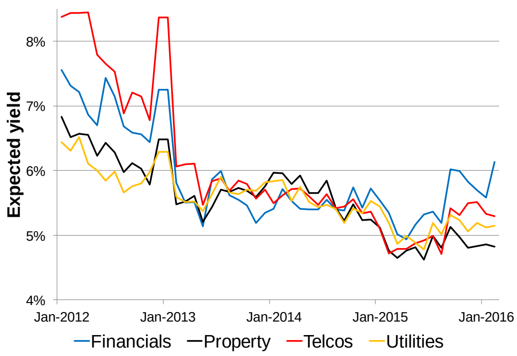
Interesting, Financials are very cheap at -7.1% and the expected dividend yield is 6.1%. As can be noted from the Dividend Compression chart I have updated, Financials (the blue line) is breaking away from the other three high-yield sectors – and by the most since the story began in early 2013.

Of course some are worried about the sustainability of bank dividends but at least two of the banks are starting to look tasty.

High-yield sectors' total returns for January were -6.7% against -4.4% for the rest. The yield play is definitely waning but some exposure to both sides of the play is warranted as I hold in my SMSF below.

The forecast dividend yield for the ASX 200 stands at 4.9% with Financials at 6.1% (plus franking credits) and Property at 4.8%. There is lots of room for the prices of three of the sectors (excluding Property) to increase while maintaining respectable dividends.

Dividend Compression



The IOZ:IVV Update

The strategy has recovered a little further to -1.5% pa but the IVV leg is doing reasonably at +5.5% pa. The IOZ part of the strategy has struggled by comparison and is running at a loss of -8.1% pa. But it did improve this week and, if the SPI futures lead of nearly +1% for Monday eventuates, that leg is starting to get quickly back on track. With Wall Street up so hard overnight, and our dollar stable, IVV could get a kick on Monday too!

The advantage of this sort of buying on the dips is meant to be that losses are not big as bad at times like those we just experienced and it won't take much of a rise to start making serious profits again.

I have no plans to change the buy side of the strategy but I need to do some work on the sell-side. Perhaps I should consider a phased or staged sell into the highs rather than holding until the high is exceeded. I'll keep you posted.

Returns on IOZ:IVV strategy

Tranche	Buying window	Rel. value of IOZ buys	Rel. value of IVV buys	Total
I	16/10/2014	100	100	8.9%
II	28/11/2014 - 15/1/2015	400	400	0.5%
III	26/8/2015 - 4/9/2015	200	200	-2.8%
IV	4/11/2015 - 8/1/16	500	300	-3.7%
Total		1,200	1,000	-1.0%
Internal rate of return (pa)		-8.1%	5.5%	-1.5%

NB The top five returns are not annualised. See notes in the Strategy Section for further explanation and charts.

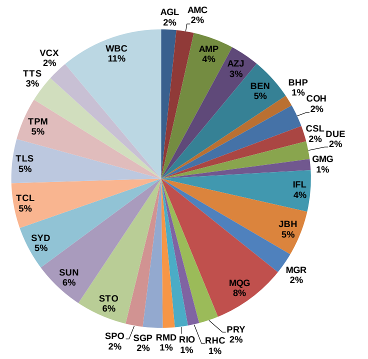
There is nothing in recent behaviour to suggest to me that the underlying forecasts for the ASX 200 or the S&P 500 have been proven to be invalid. Indeed, the strategy is very much on track. We have just experienced a bout of very high volatility following all of the recent news.

SMSF Share Portfolio

I last rebalanced my SMSF on November 2, 2015. I combined my new Yield Conviction portfolio with a High Conviction portfolio in about equal proportions. The notion behind the strategy is to note that I believe the pure yield play might be soon over. This 50:50 strategy is, in essence, an each-way bet which I intend to keep for the medium term given my sectoral analyses.

There are 29 stocks. My current holdings are given in the pie chart below.

Current holdings



The performance of my SMSF portfolio – including the impact of the March 5th 2015 and the November 2nd rebalances – against the ASX 200 since late June 2014 is shown in the table below. That corresponds to an outperformance of +4.0% (annualised) in nearly 18 months.

Annualised returns (since June 25th 2014)

	Portfolio	ASX 200	Alpha
Cap gains	-1.7%	-4.7%	3.0%
Tot rets	3.6%	-0.4%	4.0%

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The IOZ:IVV Strategy

I plan to use the Table in the 'IOZ:IVV Update' 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]. I will await the sell signals in times to come.

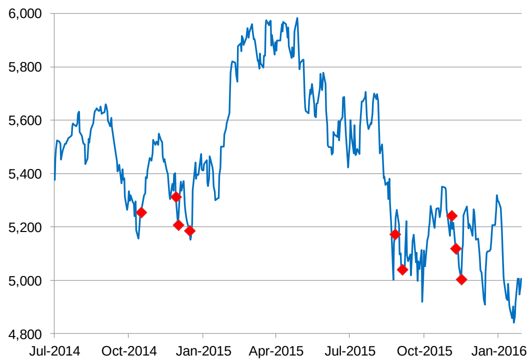
The basis of the strategy is to buy when the indexes (using ETFs) get very close to or cross the beginning of the year predicted low – and to sell when the indexes reach the predicted highs – as indicated in the 'Market Expectations' section. I do not use the weekly updated lows and highs for this purpose. These update 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. When I am unsure, I will blend IVV and IHVV.

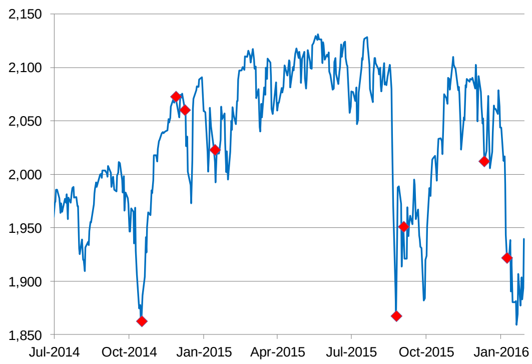
Please note that the irr is a single annualised return to summarise all of the buys of both ETFs and the current value.

The following charts show where I bought. Since the 'buy' signals are based on the S&P 500 (as I do not have credible exchange rate predictions) I show both the S&P 500 expressed in $US (unhedged) and $A (hedged).

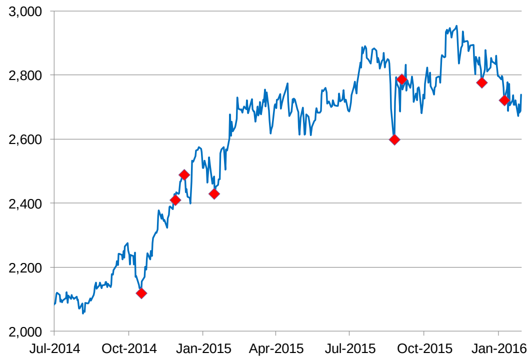
IOZ buy points on the ASX 200



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



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



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.

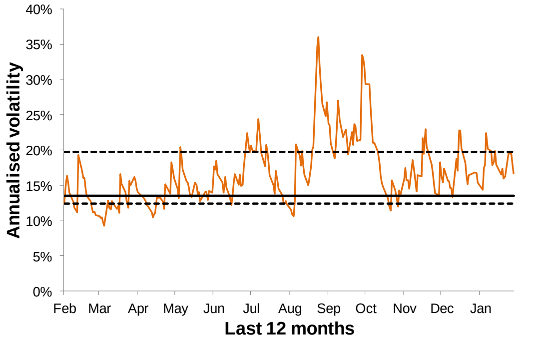
PMI – This acronym stands for Purchasing Managers Index. There is one for most countries and separate statistics for manufacturing and services. Manufacturing typically gets more attention. The statistics are published in the first few days of each month – with China on the 1st. A reading less than 50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

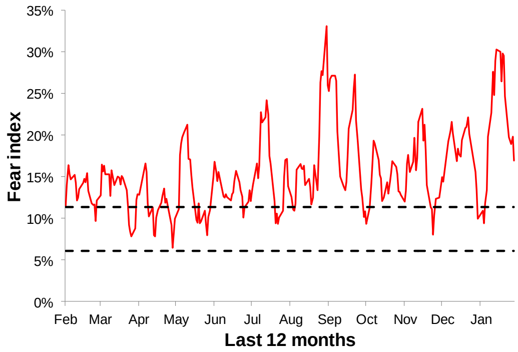
US non-farm payrolls data – are usually published on the first Friday of each month. They are generally considered to be the most reliable indicators for employment and unemployment in the US. Roughly speaking, a 200,000 increase in jobs is considered strong – particularly in the context of the tapering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

Chart 1: Market volatility



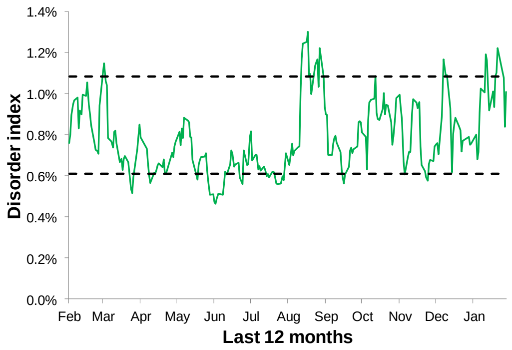
Notes: The solid black line depicts the average volatility since January 2010; the lower dotted line depicts the average volatility pre the GFC; the higher dotted line depicts the average level of volatility during the GFC - up to December 2009. The brown line is a daily estimate of the ASX 200 index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

Chart 2: Fear index



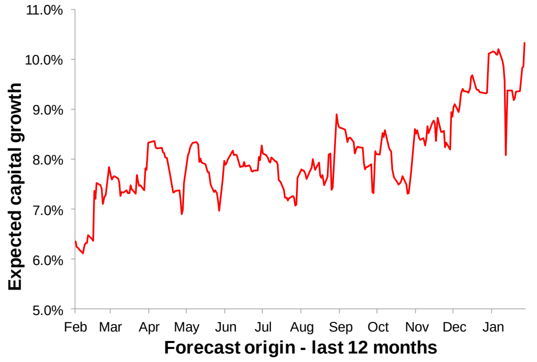
Notes: The fear index is a measure of 'excess' volatility denoting behaviour outside the open/close values each day. The two dotted lines depict the band in which the fear index resided before the GFC in two thirds of days. Extended periods below the lower dotted line might indicate complacency. Extended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



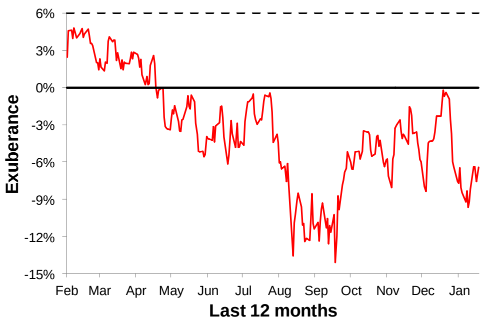
Notes: The disorder index measures the degree to which the 11 sectors' daily returns move in harmony. The two dotted lines depict the band in which the disorder index resided before the GFC in two thirds of days. Extended periods below the lower dotted line might indicate belief that there is little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



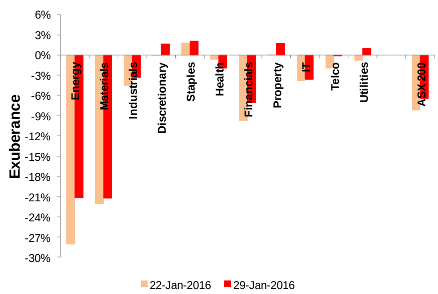
Notes: Each business day we update our estimates for capital gains on the ASX 200 for the following 12 months. For example, the left-most estimate on the vertical axis is a forecast for the 12 months concluding today. The right hand estimate is for the 12 months from today.

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