20 February 2016

Woodhall's Weekly

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Big week on ASX 200

- **Is OPEC serious?**
- **Is China debt sustainable?**
- **And what about our labour market?**

Overview

Two Saturdays ago I wrote, "But I am feeling quite hopeful – much more so than in recent weeks. The tree has been shaken, some have fallen and next week's big set of company reports to the ASX might give us a welcome boost well above 5,000. But Monday may not be pretty."

Last Saturday I wrote, "Despite last week's carnage, I am still confident about the future for the markets. I just have to accept the volatility along the way like the rest of us."

Well, it was the week (before last) that wasn't pretty (and not just the Monday) but the reporting season threw up some gems. I held a number of stocks that went up double digits growth on the day including AZJ, COH, and PRY. Stocks had been so oversold they fought back with a vengeance when they saw the chance. Of course some nice news on oil helped a lot.

Our market was up +3.9% on the week with Energy (+6.1%) and Materials (+7.7%) leading the charge. Discretionary wasn't far behind at +5.5%.

Qatar, Saudi Arabia, Russia and Venezuela met in Qatar (practicing for the 2022 World Cup but in an air-conditioned hotel?) to discuss to prices and decided to freeze production at the (unsustainable?) January levels. Iran didn't like the party invitation because they are still not back at 'normal levels' after the (nuclear related) sanctions we all imposed on them were lifted. It seems that problem can be accommodated but at least it is a start at oil price stability.

Saudi Arabia caught one in the face during the week when S&P downgraded its credit rating from A+ to A-. So the general message is getting through (but slowly).

I'm calling these common-sense (but putative) steps have formed a bottom in the oil market but the top is out of sight. But at least (for now) we can carry on.

Besides launching a surface-to-air missile during the week to establish its presence in its man-made islands in the South China Seas, China put its hand up for more fiscal stimulus. But the question being asked now is not whether the economy will grow but whether the government expenditure went to productive uses.

I still maintain we are a long way from a problem – let alone a big problem – so I am going to 'keep on running'.

At home the silly boys and girls mistakenly interpreting our labour market data are at it again. The seasonally adjusted unemployment rate rose from 5.8% last month back to 6.0% for January. Employment fell by -7,900 and it was worse when you look at the f/t p/t split. We lost -40,600 f/t jobs.

To me it is like asking 24 mates down the pub if they had a good week – and the multiplying the response by one million to get the 24m population for Australia result. [The ABS samples only 29,000 households for the labour data] The preferred "trend estimate" by our *Australian Bureau of Statistics* said that the unemployment rate improved from 5.9% to 5.8% over the month. But what do they know? ABS staff don't hang out at the Ivy using their corporate credit cards for drinks after the data releases.

I would rather the market was higher than where it is but I firmly believe it will get back up there soon – in spite of a few big wobbles along the way.

Market stats

Our market volatility index (Chart 1) came back a little to 23.3%. Our Fear Index (Chart 2) is well above the normal zone at 17.6% but it is off the recent highs. The VIX is 21.6 which is so much lower than we expect when investors are really fearful. It was an organised sell-off. Our Disorder index (Chart 3) is within the normal zone. This is still a risky cocktail of conditions for trading but we seem to be very close to good conditions – possibly as early as this coming week.

Our 12-month capital gains forecast (Chart 4) has remained at +11.4%. Indeed, the trend over the last 12 months is particularly encouraging. The market is underpriced at -6.3% (Chart 5). So that leaves the adjusted 12-month capital gains' forecast at +18.5%. The comparable 12-month adjusted capital gains forecast for the S&P 500 stands at +19.5%.

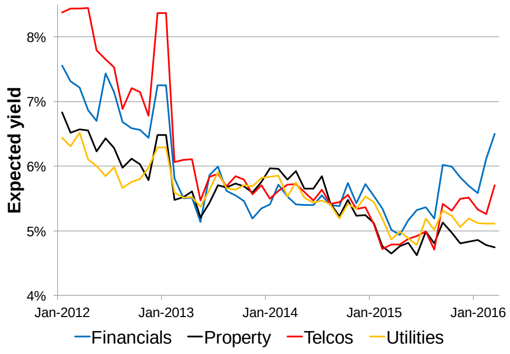
Eight of the sectors on the ASX 200 are cheap (Chart 6). Property is the most overpriced at +2.6%.

As can be noted from the Dividend Compression chart I have updated, Financials (the blue line) is continuing to break away from the other three high-yield sectors – and by the most since the story began in early 2013.

The expected yield for Financials is 6.5% plus franking credits. Of course some are worried about the sustainability of bank dividends but CBA reported well.

The yield play is definitely waning with 'other' sectors beating high yield sector total returns by +7.4% y-t-d. High yield have lost -9.6% this year while other has only lost -2.2%.

Dividend Compression



The IOZ:IVV Update

The strategy jumped back to almost flat after a stellar week. It is now at -0.9% pa since inception but the IVV leg is up +6.8% pa. The IOZ part of the strategy is still well behind with a loss of -8.2% pa.

The previous week would have been the most costly to date to have bailed out – had I been so inclined. It would have cost $48,000 to bail out of a million dollar position last week which was well within my tolerance given my view of the markets, volatility and my income stream. I could now bail out for $7,000 but, on the positive side, I am fully loaded below 5,000 on the ASX and 2,000 on the S&P 500. While volatility will continue – to some extent – I am of the belief that the strategy is working.

I should point out that baling out is not the same as being a wimp. Had I sold last week, I could still buy back in at well below the old buy signals. This 'not going down with the ship' scenario' is an important part of the strategy – as is the phased sell at the top – when we get there!

I should also point out that the buy and sell signals were based on 'normal' volatility of 12.5%. Had I better predicted the volatility on January 1st at above 20%, the current lows would have been well within what would have been the predicted bounds. It was the forecast error in volatility not direction that produced the recent below the lower-forecast trading.

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	9.3%
II	28/11/2014 - 15/1/2015	400	400	0.9%
III	26/8/2015 - 4/9/2015	200	200	-2.5%
IV	4/11/2015 - 8/1/16	500	300	-3.5%
Total		1,200	1,000	-0.7%
Internal rate of return (pa)		-8.2%	6.7%	-0.9%

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

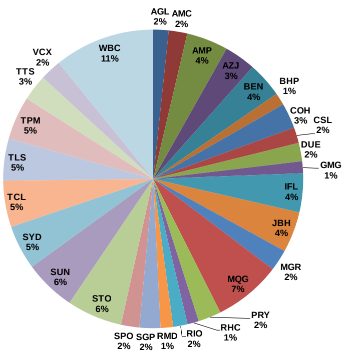
There is nothing in recent behaviour to suggest to me that the underlying forecasts for the ASX 200 or the S&P 500 have been proven to be invalid. Indeed, my ASX forecasts have improved over 200 bps over the last 12 months. The strategy is on track. We are experiencing an extreme bout of volatility following 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 +3.6% (annualised) in nearly 18 months.

Annualised returns (since June 25th 2014)

	Portfolio	ASX 200	Alpha
Cap gains	-2.5%	-5.1%	2.6%
Tot rets	2.8%	-0.8%	3.6%

A few of my stocks reported last week. Some had stellar results and 11 of the 29 returned more than +5.0% capital gain with PRY at 32.4%!! But it is far too soon to call the market settled enough to make rational decisions about rebalancing.

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.

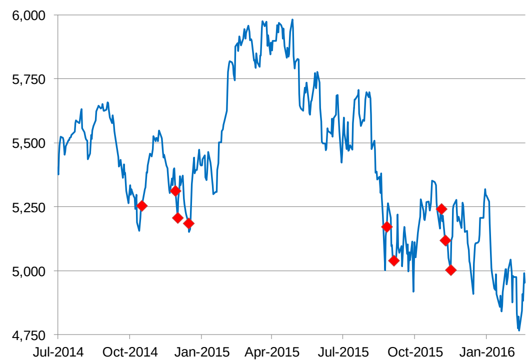
The basis of the strategy is to buy when the indexes (using ETFs) get very close to or cross the beginning of the year predicted low – and to sell when the indexes reach the predicted highs – as indicated in the 'Market Expectations' section. I do not use the weekly updated lows and highs for this purpose.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

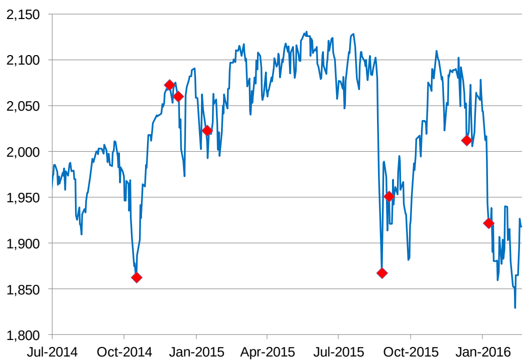
Please note that the irr is a single annualised return to summarise all of the buys of both ETFs and the current value.

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).

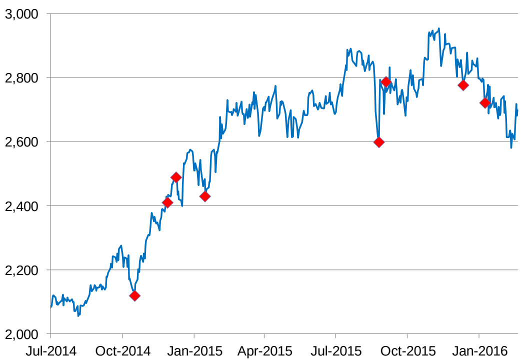
IOZ buy points on the ASX 200



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.

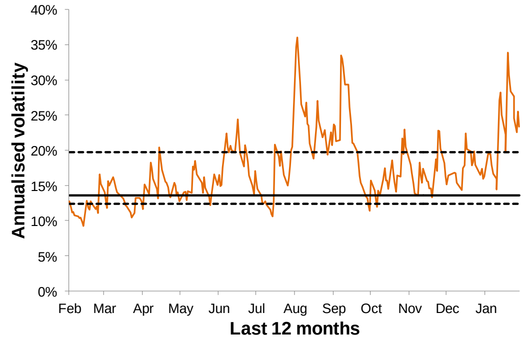
PMI – This acronym stands for Purchasing Managers Index. There is one for most countries and separate statistics for manufacturing and services. Manufacturing typically gets more attention. The statistics are published in the first few days of each month – with China on the 1st. A reading less than 50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

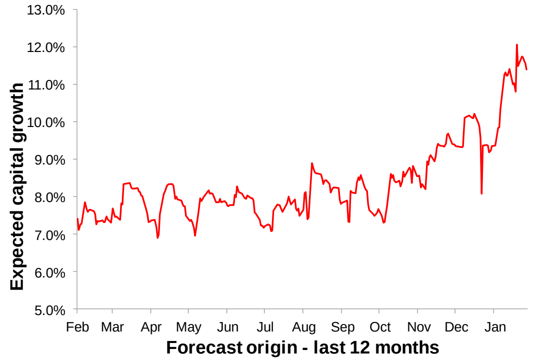
US non-farm payrolls data – are usually published on the first Friday of each month. They are generally considered to be the most reliable indicators for employment and unemployment in the US. Roughly speaking, a 200,000 increase in jobs is considered strong – particularly in the context of the tapering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

Chart 1: Market volatility



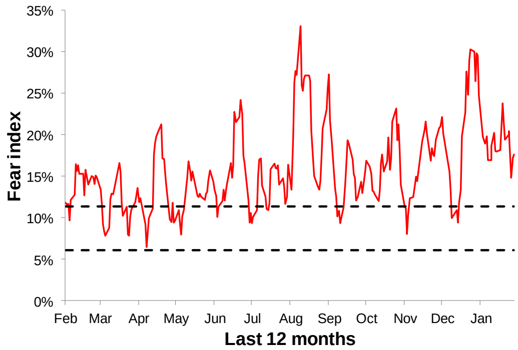
Notes: The solid black line depicts the average volatility since January 2010; the lower dotted line depicts the average volatility pre the GFC; the higher dotted line depicts the average level of volatility during the GFC - up to December 2009. The brown line is a daily estimate of the ASX 200 index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

Chart 4: 12-month-ahead capital gains forecasts



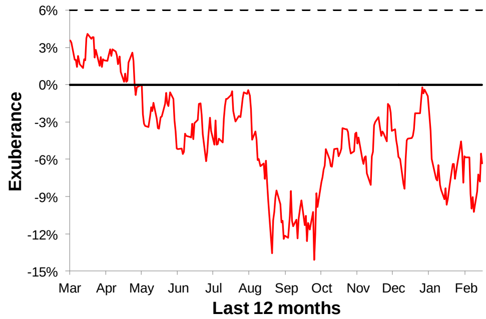
Notes: Each business day we update our estimates for capital gains on the ASX 200 for the following 12 months. For example, the left-most estimate on the vertical axis is a forecast for the 12 months concluding today. The right hand estimate is for the 12 months from today.

Chart 2: Fear index



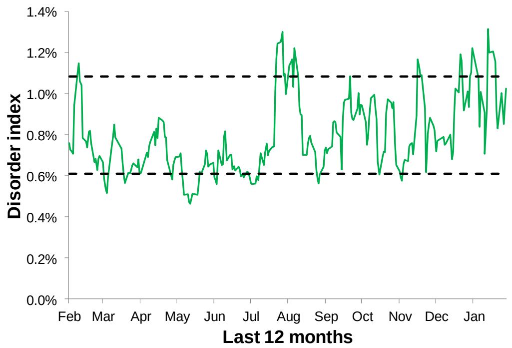
Notes: The fear index is a measure of 'excess' volatility denoting behaviour outside the open/close values each day. The two dotted lines depict the band in which the fear index resided before the GFC in two thirds of days. Extended periods below the lower dotted line might indicate complacency. Extended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



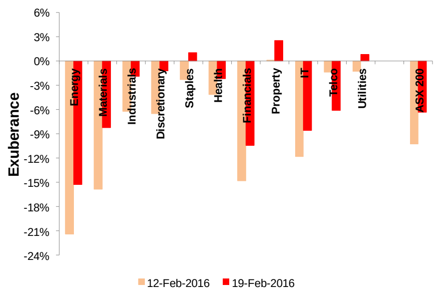
Notes: Exuberance is our measure of mispricing on the ASX 200. A value below the solid black line denotes the market is perceived to be cheap and above that line expensive. Experience suggests that exuberance above +6%, denoted by the dotted line, is an indicator of a potential correction of 6% to 10%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