30 April 2016

Woodhall's Weekly

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All about rate changes

- **FOMC admits US economy weak**
- **Australia economy deceptively weak**
- **Commodity prices stay high**

Overview

After two strong weeks on the ASX 200 (+4.5% and +1.5%) the +0.3% this week consolidates the gains rather than challenges them. Especially after major overseas indexes posted losses (S&P 500 -1.3%)! There were no real stand-out sectors at home – good or bad – just a market on hold before this next data deluge.

The FOMC did not change rates mid-week. It did remove the comment about global concerns in its statement. It did add a comment about its domestic economy softening. Good thing because the next day US GDP for Q1 came in at +0.5% when +0.7% was expected (both figures annualised!).

The US has had a problem with Q1 data for a while – usually blaming cold weather or the like. Perhaps they do have a seasonal adjustment problem? Our dollar fell over -2% on the FOMC statement. The RBNZ was also on hold the same day. The BoJ had teased the market with near promises of more stimulus but again didn't deliver.

Our inflation data also surprised this week. We got only a -0.2% for Q1 against an expected +0.2% and +1.3% for the year against +1.7%. We do not have an inflation problem. But we are getting closer to a deflation problem.

Together with what we saw as bad employment data when others didn't we think we badly need a cut on Tuesday but I don't think Glenn is the man to deliver. Yes it is also Budget day but Kenny Rogers taught us we have to know when .....

The big danger to me is that – if the downward trend in full-time employment continues into negative growth next month – somebody else will then notice it and then what?

Iron ore prices did break $70 but they have since slipped back closer to $64. Oil on the other hand is kicking goals – Brent was up +9.5% on the week. The big shock was the release of the Saudi plan to diversify its economy at last. Floor under price – game over!

But the big worldwide problem is lack of gains in productivity. Towards the end of my academic career in the late nineties I worked with the best and brightest professors that measured productivity for a living – and we socialised too. Having worked in open plan offices I am convinced we have a productivity problem.

Who is sending out all of the tweets? Who is reading them? And Facebook? And shopping on line? And the gaps between tweets while waiting for a response – it is a surprise we are not back further than we are. Computers have had many negative impacts as well as positive. I wouldn't employ anyone with access to a mobile phone etc during working hours!

So looking forward. China PMI tomorrow. Budget and RBA Tuesday; US non-farm payrolls Friday and the list goes on. To me I am sitting tight and riding the waves. At last I am ahead for 2016 but I want more. And change for the sake won't help me.

But the big news could surround ANZ, NAB and WBC's earnings reports. Have they been oversold? Will the payout ratios be cut?

So my predictions are nothing stand-out. China is fine; the US is fine; the Budget won't rattle the cage. But somebody sometime needs to.

Market expectations

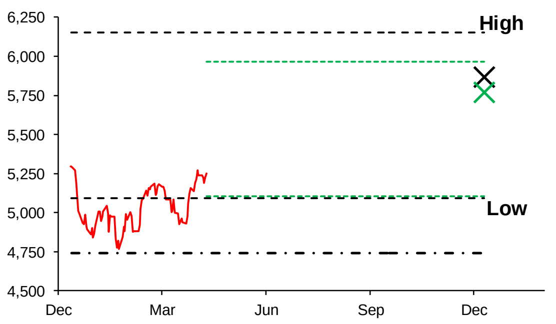
Our start-of-year 2016 forecasts for the ASX 200 are given in Table 1 together with the latest calculations and last week's for comparison. Chart 1 includes a trace of the index to compare with the forecasts highs and lows

Table 1: ASX 200 range forecasts

Forecast	Forecast origin		
Cal '16	1-Jan-2016	29-Apr-2016	22-Apr-2016
Low	5,100	5,100	5,100
High	6,150	5,950	5,950
End	5,850	5,750	5,750
Fair value	5,350	5,200	5,200
Exuberance	-0.7%	0.5%	0.5%
ASX 200	5,296	5,252	5,236

Note: the latest forecasts in the right hand column do not provide updates of the original forecasts in the middle column. Rather the latest forecasts facilitate an assessment to the degree to which the original forecasts are on track, or not. Moreover, exuberance is assumed to be eroded over a 12-month period and so the 'latest' forecasts are less reliable the closer is the date to the end-of-year and the greater is any mispricing.

Chart 1: Graphical representation of Table 1



Note: the low and high are based on 'normal' volatility levels. The high volatility low allows for well above normal volatility and a breach of which starts to suggest the base-line forecasts may no longer be relevant. The dashed black lines are derived from average volatility assumptions; the dot-dash line corresponds to high volatility.

The index remains well and truly above the buy signal and the updated data in Table 1 hasn't changed over the week. The SPI is down -6 pts for Monday.

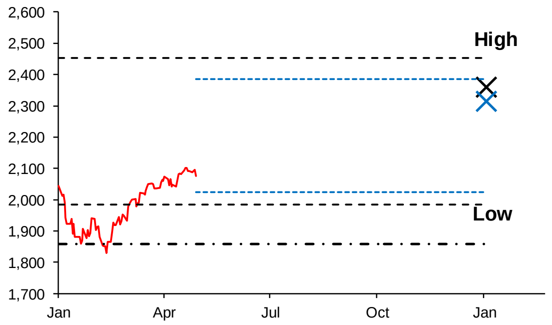
Our updated 2016 forecasts for the S&P 500 are given in Table 2. Because overnight data are not available until the afternoon, the latest data for Wall Street will usually be presented for the day before the ASX 200 in this Weekly that we try to publish around 10am on a Saturday.

Table 2: S&P 500 range forecasts

Forecast	Forecast origin		
Cal '16	1-Jan-2016	28-Apr-2016	21-Apr-2016
Low	1,980	2,020	2,030
High	2,450	2,390	2,380
End	2,360	2,310	2,310
Fair value	2,100	2,090	2,080
Exuberance	-3.3%	-0.5%	0.6%
ASX 200	2,044	2,076	2,091

Note: the latest forecasts in the right hand column do not provide updates of the original forecasts in the middle column. Rather the latest forecasts facilitate an assessment to the degree to which the original forecasts are on track, or not. Moreover, exuberance is assumed to be eroded over a 12-month period and so the 'latest' forecasts are less reliable the closer is the date to the end-of-year and the greater is any mispricing.

Chart 2: Graphical representation of Table 2



Note: the low and high are based on 'normal' volatility levels. The high volatility low allows for well above normal volatility and a breach of which starts to suggest the base-line forecasts may no longer be relevant. The dashed black lines are derived from average volatility assumptions; the dot-dash line corresponds to high volatility.

The S&P 500 is also well above buy territory on the IOZ:IVV strategy. The eoy for 2016 held over the week but did the high did climb a little.

Market stats

Our market volatility index (Chart A-1 found in the Chat Appendix) is normal at 12.5%. Our Fear Index (Chart A-2) is a fraction high at 16.2% The VIX is 15.7 – or around its average. Our Disorder index (Chart A-3) back to normal.

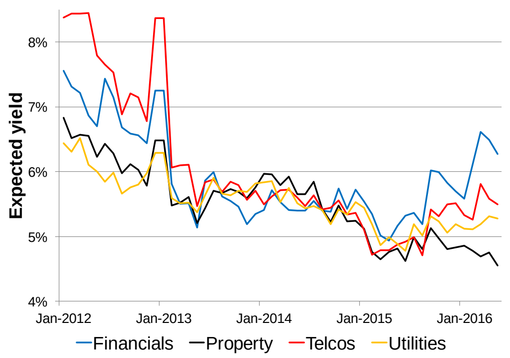
Our 12-month capital gains forecast (Chart A-4) held the recent increases at +15.0%. The market is overpriced at +0.5% (Chart A-5). So that leaves the adjusted 12-month capital gains' forecast at +14.3%. The comparable 12-month adjusted capital gains forecast for the S&P 500 stands at +17%.

The Materials sector is now overpriced (Chart A-6) at +7.7% which is above the 6% trigger level. Given the speed in the recovery of commodities prices, it might take a while for analysts to upgrade their earnings forecasts. I am not worried yet! But Property at +4.8% is getting a bit overpriced.

Except for Financials at -3.0%, no sector is materially cheap at the moment. With the banks reporting next week, there might be some bargains out there.

As can be noted from Dividend Compression (Chart 3) I have updated, Financials (the blue line) has broken away from the other three high-yield sectors. The expected yield for Financials is 6.3% plus franking credits and 4.6% for the ASX 200. Some are calling for payout ratios to be cut on the big four as we glide into their earnings season. That would probably restore the balance across these sectors.

Chart 3: Dividend Compression



The yield play has definitely waned during 2016. 'Other' sectors are now beating the 'high yield' sector total returns by +12.5% y-t-d – the second biggest on record for a calendar year. High yield sectors have lost -5.1% this year while 'other' has gained +7.4%. Yield seekers have been paying the price. Big dividends are not much use if the capital losses more than offset them!

The IOZ:IVV:IHVV Update

The strategy is in positive territory at +3.0% pa since inception (Table 3) but the IVV-IHVV leg is up +6.4% pa. The IOZ part of the strategy is almost at break even at -0.2% pa. The table below shows that I am now 60.1% hedged in the Wall Street component. The domestic share of the portfolio is 49.2%.

Table 3: Returns on IOZ:IVV strategy

29-Apr-2016			Current allocation	
ETF	Return	IRR pa	Total	USA
IOZ	-0.2%	-0.2%	49.2%	
IVV+IHVV	5.7%	6.4%	50.8%	100.0%
IVV	12.8%	5.7%		39.9%
IHVV	1.5%	14.9%		60.1%
Total	2.7%	3.0%	100.0%	

NB The figures in the "Return" column are not annualised; IRR is the internal rate of return (pa) that compensates for the different buy and sell points. See notes in the Strategy Section for further explanation and charts.

The Charts 6 to 9 in the strategy section now include a yellow square to show where the hedging trades were made. The red diamonds denote the buys. I have also included a currency chart to show where the hedging trades were made in that metric.

By comparing Charts 7 and 8 since the yellow squares it can be seen that the hedged index made a nice little profit but the unhedged has been flat. The currency increases cancelled out the SP 500 gains.

The AUD has fluctuated in a range of about 75c – 78c since I started hedging at 76.0c in late February. Although the $A is back to 76c I still feel that there is some upside risk on the currency before we start a slide back down below 70c. I don't see the Fed hiking until after the Presidential elections. We might cut on Tuesday but if we don't that dollar might flip back up.

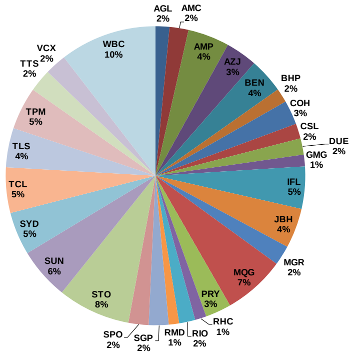
There is nothing in recent behaviour to suggest to me that the underlying forecasts for the ASX 200 or the S&P 500 have been proven to be invalid. Indeed, my ASX forecasts have strengthened over the last 12 months. I plan to flag any perceived weaknesses if and as they eventuate.

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. Indeed, it might already be 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 Chart 4.

Chart 4: 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 +4.3% (annualised). After all of the turbulence of recent times the portfolio is still returning +7.3% pa which I think is not bad for a super fund in these times.

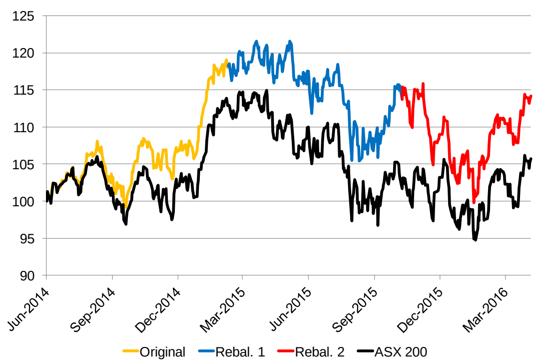
Table 4: Annualised returns from SMSF

	Portfolio	ASX 200	Alpha
Cap gains	1.7%	-1.5%	3.2%
Tot rets	7.3%	3.0%	4.3%

Note: Since June 25th 2014

The returns chart (Chart 5) shows the recent outperformance as well as the trend gains. The period from sometime in November 2015 to sometime in February 2016 was so far the worst for the SMSF.

Chart 5: SMSF and ASX 200 total returns



Note: the different coloured sections show the impact of rebalancing in March and November 2015.

Table 5: Price changes since Nov 2nd, 2015 and current broker forecasts

Stock	Price	Price change: From low	Price change: From high	Target	Rec
SANTOS	4.80	93.5%	-11.2%	4.23	2.57
AMCOR	15.40	26.6%	-1.1%	11.25	2.39
BHP BILLITON	20.68	45.6%	-11.9%	15.17	2.57
RIO TINTO	51.55	39.2%	-1.9%	37.92	2.77
SPOTLESS GROUP HOLDINGS	1.30	42.3%	-41.4%	1.81	2.25
AURIZON HOLDINGS	4.27	24.9%	-24.0%	4.40	2.50
SYDNEY AIRPORT	6.81	16.2%	-0.6%	6.60	2.58
TRANSURBAN GROUP	11.58	17.3%	-0.1%	11.34	2.62
JB HI-FI	21.97	27.0%	-6.9%	23.00	2.56
TATTS GROUP	3.77	6.5%	-14.1%	3.95	2.67
COCHLEAR	108.03	24.3%	0.0%	98.55	2.92
CSL	105.18	14.0%	-2.6%	84.07	2.39
PRIMARY HEALTH CARE	3.47	60.6%	-9.9%	3.00	3.33
RAMSAY HEALTH CARE	64.95	15.8%	-4.5%	65.40	2.50
RESMED CDI.	7.46	3.2%	-10.9%	6.53	2.62
AMP	5.88	17.1%	-0.8%	6.18	2.13
BENDIGO & ADELAIDE BANK	9.32	15.8%	-22.0%	9.50	2.86
IOOF HOLDINGS	8.94	21.0%	-7.6%	8.75	2.25
MACQUARIE GROUP	63.50	8.8%	-23.5%	80.00	2.08
SUNCORP GROUP	12.50	16.8%	-8.9%	12.50	2.23
WESTPAC BANKING	31.05	10.7%	-7.8%	33.06	2.53
GOODMAN GROUP	6.89	19.8%	0.0%	7.00	2.10
MIRVAC GROUP	1.87	7.2%	-7.4%	2.05	2.55
STOCKLAND	4.37	15.6%	-0.5%	4.60	1.90
VICINITY CENTRES	3.32	24.8%	-0.3%	3.09	2.30
TELSTRA	5.36	7.2%	-5.5%	5.62	3.00
TPG TELECOM	10.71	17.7%	-6.7%	11.21	2.44
AGL ENERGY	18.29	12.8%	-3.7%	19.32	2.73
DUET GROUP	2.25	2.3%	-7.8%	2.35	3.00

With six months up from the last rebalance, I will take a serious look at the May 1st portfolios this weekend. Conditions are sufficiently settled to rebalance – in my opinion – it is just a question of how far 'off' my existing portfolio is from the new ones.

The IOZ:IVV:IHVV Strategy

I plan to use the Table in the 'IOZ:IVV:IHVV 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:IHVV for a partially hedged 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 switch to IHVV – the hedged version of the S&P 500 ETF – when I think the currency is more likely to appreciate – or at least insure against it. When I am unsure, I blend IVV and IHVV.

Note that the irr is a single annualised return to summarise all of the buys of the three 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 – hence an implicit no-change assumption) I show both the S&P 500 expressed in $US (unhedged) and $A (hedged).

Chart 6: IOZ buy points - ASX 200

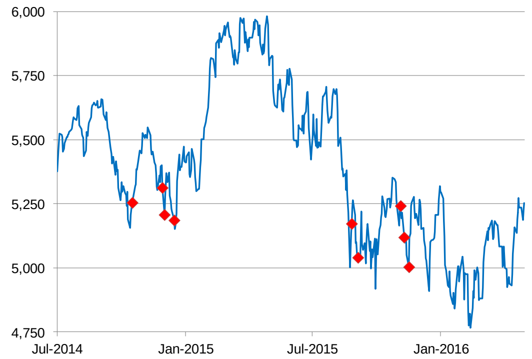


Chart 7: IVV buy points - S&P 500 ($US; hedged)

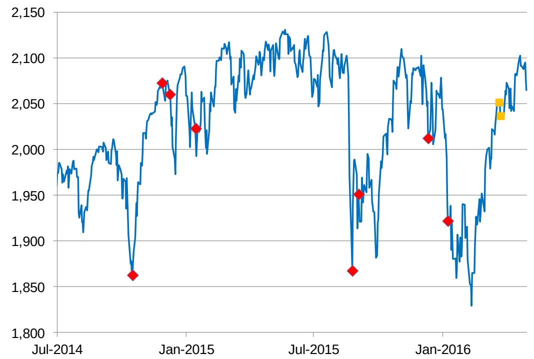


Chart 8: IVV buy points S&P 500 ($A; unhedged)

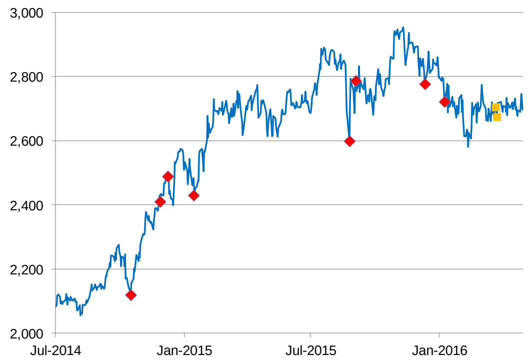
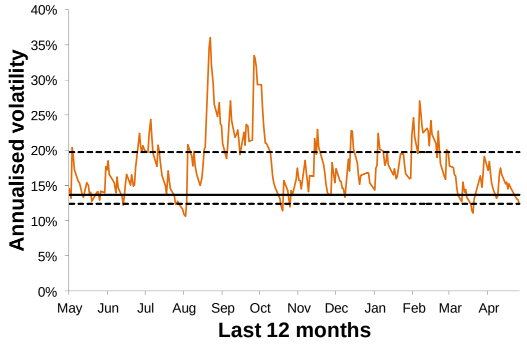


Chart 9: AUD hedging points

The charts in this strategy section include a yellow square to show where the hedging trades were made. The red diamonds are the buys. There is also a chart to show where the hedging trades were made in the AUD metric.

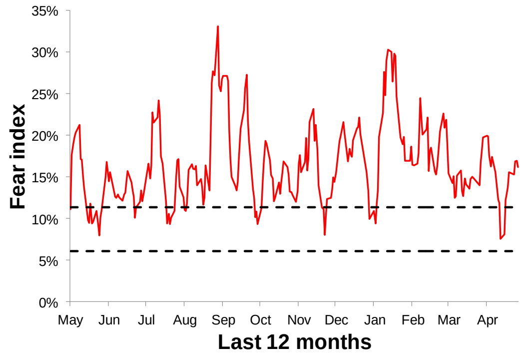
Chart Appendix

Chart A-1: Market volatility



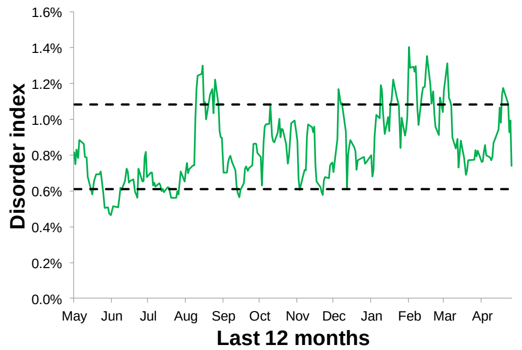
Notes: The solid black line depicts the average volatility since January 2010; the lower dotted line depicts the average volatility pre the GFC; the higher dotted line depicts the average level of volatility during the GFC - up to December 2009. The brown line is a daily estimate of the ASX 200 index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

Chart A-2: Fear index



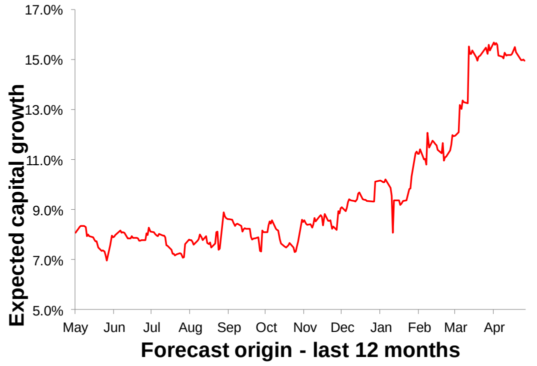
Notes: The fear index is a measure of 'excess' volatility denoting behaviour outside the open/close values each day. The two dotted lines depict the band in which the fear index resided before the GFC in two thirds of days. Extended periods below the lower dotted line might indicate complacency. Extended 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 A-3: Disorder index



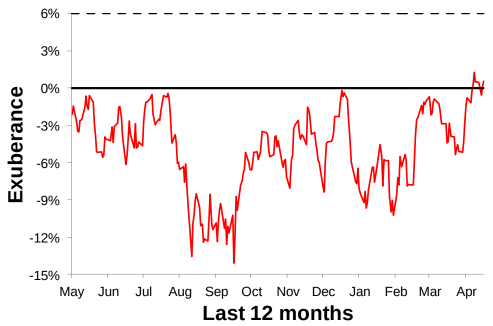
Notes: The disorder index measures the degree to which the 11 sectors' daily returns move in harmony. The two dotted lines depict the band in which the disorder index resided before the GFC in two thirds of days. Extended periods below the lower dotted line might indicate belief that there is little 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 A-4: 12-month capital gains forecasts



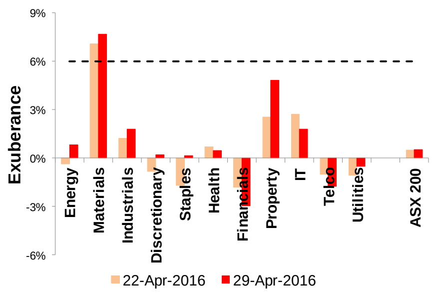
Notes: Each business day we update our estimates for capital gains on the ASX 200 for the following 12 months. For example, the left-most estimate on the vertical axis is a forecast for the 12 months concluding today. The right hand estimate is for the 12 months from today.

Chart A-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 A-6: Sector exuberance



Notes: The estimates in this chart are based on the same notions as for Chart A-5. More detailed information on mispricing is contained in our companion weekly publication in the same section of our website

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.