



Ron Bewley PhD, FASSA

# Woodhall's Weekly

## Nothing shakes the markets – or does it?

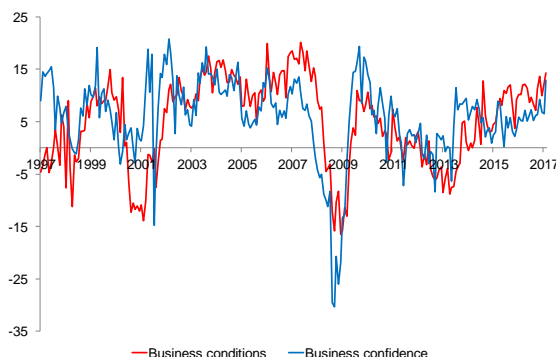
- VIX < 10 first time since 1993
- NAB business confidence and conditions make recent highs
- Boring Budget Blues

### Overview

Elections in Europe, problems in the White House and commodity price gyrations – but the VIX closed under 10 during the week for the first time since 1993. Why?

The VIX is low because people aren't taking out options to cover falls in the cash market. But a smart guest on Bloomberg TV suggested that improvements in algo-trading make it less important to take out insurance because they can now move more quickly in the cash market when it falls. We don't know if that is correct but the VIX has been quite low for some time – even when the S&P 500 broke through 2,400 for part of a day last week.

### Chart of the week: NAB indexes



The NAB Business Confidence and Conditions indexes came out this week – and they are shown in the Chart of the Week.

Business conditions in red are at their highest since the GFC started. Business confidence is the highest since 2009 – but only a tad off taking it also back to 2007.

Why are we so happy? The Budget forecast unemployment for the near term is 5.75% and Shorten has already started his blocking tactics. It can't be the macro-economy.

There was a lot in the Budget but nothing too controversial. We liked the tipping of an extra 300k or 600k into super for downsizers – if it gets through. The infrastructure spend is good but the plan is over 10 years and not much will start soon.

The bank tax is a bit of a worry because once the door is open it will be a walk in the park for either side to increase the rate whenever it likes. And don't movie and rock stars – and sports people – earn more. Oh yes – but they don't wear navy blue suits.

China released some excellent trade data into the mix at the start of last week and OPEC has a big meeting scheduled for May 25.

Macron sailed through the presidential election so that's one more problem averted. Moody's reaffirmed our AAA rating. It's all beer and skittles

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going forward – except for our labour market. The last month was stellar but we think it was an aberration. The next data dump is on Thursday. We should know then.

The banks certainly had a bad time of it this week. The question is, “Are the banks oversold or is their more pain to come?” You may recall that we had the banks overbought for the past little while (it was +4.7% at the start of May – just shy of the 6% trigger). And this sell-off only took exuberance to a modest negative number (-1.4%).

There is no doubt that tax will be shared by shareholders and customers alike – and the initial reaction may glide to some new level over time. But, for our money, the sell-off hasn’t been enough to stick our necks out yet. We would want exuberance to get down to around -3% or lower to feel confident of a good bounce back. But this is not a sell signal now either.

The US CPI and Retail Sales overnight missed expectations but were reasonable. Given the momentum for a June hike we think they will still hike then but it could be the last for the year. The US economy is not strong

So, in the week just gone, the ASX 200 index started and finished at the same point – but there were some nice gains in Resources to be offset by losses in Financials.

### Market expectations

Our start-of-year 2017 eoy forecasts for the ASX 200 are given in Table 1a (left column) together with the latest calculations (right column) and last week’s (middle column) for comparison. Chart 1a includes a trace of the index to compare with the forecasts highs and lows. And we report the FY17 forecasts in Table 1b that were made last June 30<sup>th</sup>.

**Table 1a: ASX 200 range forecasts 2017**

Forecast	Forecast origin		
	30-Dec-2016	5-May-2017	12-May-2017
<b>Low</b>	5,350	5,600	5,600
<b>High</b>	6,300	6,350	6,350
<b>End</b>	6,000	6,100	6,100
<b>Fair value</b>	5,600	5,850	5,850
<b>Exuberance</b>	1.5%	-0.5%	-0.6%
<b>ASX 200</b>	5,666	5,837	5,837

**Table 1b: ASX 200 range forecasts FY2017**

Forecast	Forecast origin		
	30-Jun-2016	5-May-2017	12-May-2017
<b>Low</b>	5,100	5,700	5,700
<b>High</b>	6,350	6,050	6,000
<b>End</b>	6,150	5,900	5,900
<b>Fair value</b>	5,350	5,850	5,850
<b>Exuberance</b>	-2.1%	-0.5%	-0.6%
<b>ASX 200</b>	5,233	5,837	5,837

Note: the latest forecasts in the right hand column do not provide updates of the original forecasts in the left column of numbers. Rather the latest forecasts facilitate an assessment of 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 current date to the end-of-year and the greater is any mispricing.

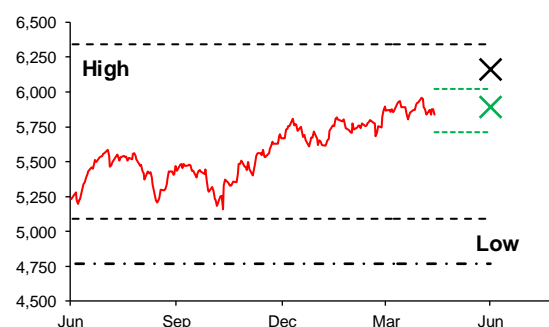
The eoy forecast for 2017 (left-hand column in Table 1a) was 6,000 with a forecast high of 6,300 and a forecast low under normal volatility of 5,350. The ‘high-volatility’ forecast low was 4,950. [See the IOZ:IVV:IHVV section for the decision rules surrounding these low and high forecasts.]

The updated eoy 2017 forecast (Table 1a, last column) is steady at 6,100 over the week – well above where it was at the start of the year (at 6,000)! Fair value is steady at 5,850. The updated eoy forecast in Table 1b is 5,900.

**Chart 1a: Graphical representation of Table 1a**



**Chart 1b: Graphical representation of Table 1b**



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.

Our eoy 2017 – and our FY17 – forecasts for the S&P 500 are given in Tables 2a and 2b. Because overnight data are not available to us 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.

Our original forecast for eoy 2017 was 2,680 with a high of 2,750 and a low of 2,180. The 'high-volatility' low was 2,050.

The updated eoy forecast for the S&P 500 is 2,580. Fair value is steady at 2,400. The eoy forecast update in Table 2b is 2,430.

**Table 2a: S&P 500 range forecasts 2017**

Forecast	Forecast origin		
	30-Dec-2016	4-May-2017	11-May-2017
<b>Low</b>	2,180	2,310	2,310
<b>High</b>	2,750	2,670	2,670
<b>End</b>	2,680	2,580	2,580
<b>Fair value</b>	2,250	2,400	2,400
<b>Exuberance</b>	-1.2%	-0.2%	-0.3%
<b>S&amp;P 500</b>	2,239	2,390	2,394

**Table 2b: S&P 500 range forecasts FY 2017**

Forecast	Forecast origin		
	30-Jun-2016	4-May-2017	11-May-2017
<b>Low</b>	2,050	2,340	2,350
<b>High</b>	2,610	2,490	2,480
<b>End</b>	2,530	2,430	2,430
<b>Fair value</b>	2,100	2,400	2,400
<b>Exuberance</b>	-0.8%	-0.2%	-0.3%
<b>S&amp;P 500</b>	2,099	2,390	2,394

Note: the latest forecasts in the right hand column do not provide updates of the original forecasts in the left column of numbers. Rather the latest forecasts facilitate an assessment of 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 current date to the end-of-year and the greater is any mispricing.

**Chart 2a: Graphical representation of Table 2a**



**Chart 2b: Graphical representation of Table 2b**



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.

## Market stats

Our market volatility index (Chart A-1 to be found in the Chart Appendix) is below average at 10.9%. Our Fear Index (Chart A-2) climbed just above the zone (12.5%) at the end of the week. The VIX stands at 10.4% which is well below average. Our Disorder index (Chart A-3) is in the zone at 0.7%. Conditions are calm.

Our 12-month capital gains forecast (Chart A-4) is steady at +6.3%. The market is slightly under-priced -0.6% (Chart A-5). So that leaves the adjusted 12-month capital gains' forecast at +6.9%. The comparable 12-month adjusted capital gains forecast for the S&P 500 stands at about +12.5%.

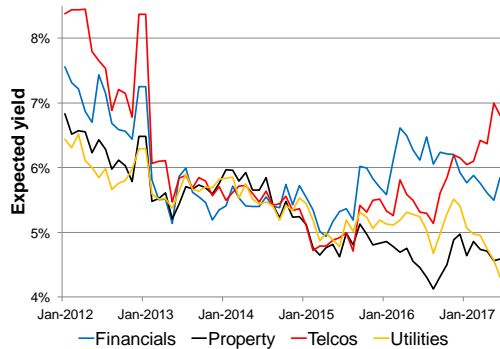
Sector pricing (Chart A-6) is such that Utilities (+5.5%) and Industrials (+5.1%) are close to the danger zone. IT (+4.3%) and Health (+3.1%) are somewhat overpriced, All of the rest are minimally over-priced or cheap. Telcos (-13.4%) are extremely cheap but it is likely that the new order in that sector has not yet been priced in.

We are not yet worried about Utilities pricing. There is a lot going on in that sector. Our forecast capital gains for that sector is well above average – and it's on a great momentum run – so we expect that the high level of exuberance will be eroded quite quickly without tears.

As can be noted from Dividend Compression (Chart 3), the co-movement we observed for about three years from January 2012 broke down. They were starting to get back together – but only slowly. However, recent price falls in Telcos have put

upward pressure on its expected yields and Utilities yields are falling with the over-pricing.

**Chart 3: Dividend Compression**



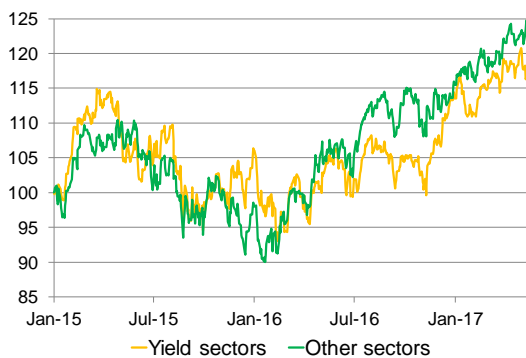
The yield play definitely waned during 2016 but there was a big comeback which can best be seen from Table 3. Yield gained over 6 months compared to 'Other' but that gain has reversed in shorter time periods. The bank tax effect will need to work its way through the system.

**Table 3: Yield play - total returns**

Period	Sector		Difference
	Yield	Other	
1 year	10.7%	16.5%	-5.9%
6 months	11.6%	10.0%	1.5%
3 months	2.2%	4.8%	-2.6%
1 month	-2.5%	-0.4%	-2.1%

Chart 4 shows another interesting angle on the yield play. The yield sector lost relative to 'other' around the end of 2015 but the two lines got back together in February and broke free again at the end of June. The bank tax effect is quite clear at the very end of the yellow line.

**Chart 4: Total returns indexes for 'yield' and 'other' aggregated sectors**

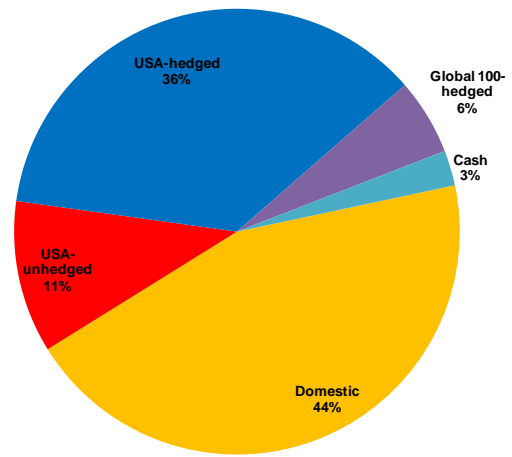


## SMSF Share Portfolio

I last rebalanced my domestic share portfolio in my SMSF on May 1<sup>st</sup> 2017. It is now 50% High Conviction and 50% High Yield by my definitions. I will keep my narrative on the rebalance in the section just after the Chart Appendix until the next rebalance.

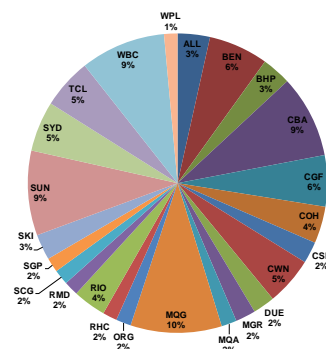
The current allocation pie chart is shown in Chart 5.

**Chart 5: Asset allocation on SMSF**



There are currently 24 stocks in my direct equity portfolio. My current holdings are given in Chart 6.

**Chart 6: Current holdings**



The performance of my domestic equities in my SMSF portfolio – including various rebalances – against the ASX 200 since late June 2014 is shown in Table 4. That corresponds to an outperformance of +3.0% p.a. (annualised) since inception. After all of the turbulence of recent times the portfolio is still returning +10.4% p.a. for nearly three years.

**Table 4: Total returns from SMSF (domestic equities)**

Period	Portfolio	ASX 200	Alpha
Since inception	10.4%	7.4%	3.0%
2 years	5.9%	5.6%	0.3%
1 year	14.0%	13.5%	0.5%
6 months	12.0%	11.8%	0.2%
3 months	3.5%	3.5%	0.0%

Note: Since June 25th 2014. Returns include dividends. For periods above one year, the returns are annualised.

In Tables 5 and 6 I show more detail on the recent activity to better understand how the May 1<sup>st</sup> 2017 rebalance is going. Since the rebalance, my SMSF has outperformed the benchmark by +0.4% in two weeks.

**Table 5: Recent total returns from SMSF (domestic equities)**

Period	Portfolio	ASX 200	Alpha
Since May 1 rebal	-1.4%	-1.8%	0.4%

Note: Since May 1<sup>st</sup> 2017. Returns include dividends.

In Table 6, I show the performance of the individual stocks since the last rebalance.

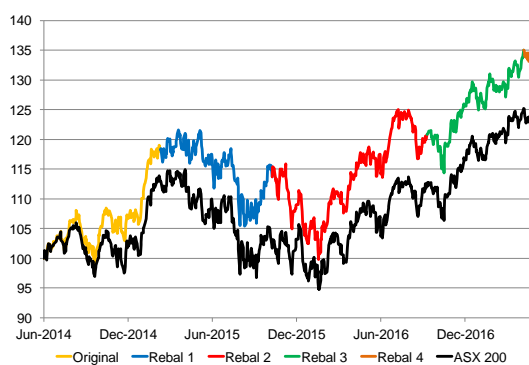
**Table 6: Individual stock total returns**

	ALL	BEN	BHP	CBA	CGF	COH	CSL	CWN
Return	-1.4%	-2.6%	-0.4%	-6.6%	-2.7%	4.2%	1.1%	0.2%
Alpha	0.5%	-0.7%	1.4%	-4.8%	-0.9%	6.0%	2.9%	2.0%
	DUE	MGR	MQA	MQG	ORG	RHC	RIO	RMD
Return	0.0%	-1.6%	2.5%	-1.4%	7.7%	2.5%	0.0%	0.3%
Alpha	1.8%	0.3%	4.4%	0.5%	9.6%	4.3%	1.9%	2.1%
	SCG	SGP	SKI	SUN	SYD	TCL	WBC	WPL
Return	-1.4%	-2.5%	-0.2%	2.7%	2.1%	-3.2%	-7.6%	0.8%
Alpha	0.4%	-0.6%	1.7%	4.6%	4.0%	-1.3%	-5.7%	2.6%

Note: Since May 1<sup>st</sup> 2017. Returns include dividends.

The returns chart (Chart 7) shows the recent performance 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. That's when the yield play took a big hit.

**Chart 7: SMSF and ASX 200 total returns**



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

Table 7 shows the gap between broker forecasts for one year hence (Target) and current price. A negative value for T/P - 1 expressed as a percentage change therefore indicates brokers on average think the stock is overpriced.

**Table 7: Price and current broker forecasts**

Sector	Stock	Percentage change over week			Price	Target	Rec	T/P - 1
		Price	Target	Consensus				
Energy	ORIGIN ENERGY (EX BORAL)	5.0%	2.2%	3.7%	7.71	7.75	2.38	0.5%
	WOODSIDE PETROLEUM	2.7%	2.9%	5.2%	32.45	25.33	2.53	-21.9%
Materials	BHP BILLITON	5.0%	-3.8%	5.1%	23.75	21.09	2.42	-11.2%
	RIO TINTO	4.6%	-2.4%	5.5%	59.80	53.38	2.25	-10.7%
Industrials	MACQUARIE ATLAS ROADS	-0.7%	-1.2%	6.4%	5.66	5.59	2.50	-1.3%
	SYDNEY AIRPORT	1.6%	1.8%	-4.7%	7.18	6.90	2.66	-4.0%
	TRANSURBAN GROUP	-3.2%	-0.6%	0.0%	11.98	12.25	2.33	2.3%
Discretionary	ARISTOCRAT LEISURE	-2.0%	0.5%	0.0%	19.75	19.80	2.00	0.3%
	CROWN RESORTS	0.9%	0.0%	-3.7%	12.59	13.00	2.77	3.3%
Health	COCHLEAR	1.8%	3.8%	-5.1%	146.09	128.25	3.50	-12.2%
	CSL	0.4%	-1.4%	0.5%	134.13	96.93	2.16	-27.7%
	RAMSAY HEALTH CARE	-2.4%	9.1%	-1.2%	72.42	75.11	2.27	3.7%
Financials	RESMED CDI	-1.5%	2.4%	-8.0%	9.19	7.25	2.70	-21.1%
	BENDIGO & ADELAIDE BANK	0.7%	-0.6%	1.9%	12.12	11.68	3.64	-3.7%
	CHALLENGER	-2.9%	0.0%	0.4%	13.05	13.03	2.42	-0.2%
Property	COMMONWEALTH BK OF AUS.	-3.2%	-3.2%	2.2%	81.67	83.80	3.13	2.6%
	MACQUARIE GROUP	-2.4%	9.1%	-1.2%	92.63	97.68	2.57	5.5%
	SUNCORP GROUP	1.5%	0.0%	0.4%	14.39	14.06	2.42	-2.3%
	WESTPAC BANKING	-3.8%	0.2%	-2.6%	32.57	34.00	2.80	4.4%
Utilities	MIRVAC GROUP	-1.3%	0.6%	0.0%	2.27	2.36	2.08	4.0%
	SCENTRE GROUP	0.5%	0.0%	3.3%	4.27	4.69	2.66	9.7%
Utilities	STOCKLAND	-1.4%	0.4%	-2.5%	4.76	4.83	2.92	1.5%
	DIET GROUP SUSP - SUSP.050/	0.0%	-5.5%	6.7%	3.02	2.74	2.40	-9.3%
	SPARK INFRASTRUCTURE GP.	1.2%	0.0%	0.0%	2.56	2.53	2.30	-1.4%

Note: T/P - 1 is the broker target price divided by the current share price minus one giving an indication where the price might move to over the coming 12 months.

There are only three stocks with a recommendation at 3.0 or worse: BEN, CBA, and COH. None of these were recommended by my algorithm. They are "Captain's picks" that have served me well over the years. I also held onto them to reduce churn in the last rebalance.

**Table 8: Analysis of returns since rebalancing**

Sells		Buys	
AGL	0.45%	ALL	-0.7%
AMC	-2.99%	CWN	0.5%
BHP	-0.04%	DUE	
CGF	-1.70%	MQA	4.4%
GMG	-0.40%	MQG	-0.7%
IPL	-4.48%	MGR	-1.7%
JBH	-3.98%	ORG	8.4%
RIO	-0.71%	SCG	-1.5%
STO	3.74%	SGP	-2.9%
TPM	0.68%	SKI	1.2%
		SUN	3.4%
		SYD	3.5%
		TCL	-2.5%
		WBC	-6.9%
		WPL	1.1%
<b>Sells</b>	<b>-1.1%</b>	<b>Buys</b>	<b>-0.1%</b>
<b>ASX 200</b>	<b>-1.5%</b>	<b>Profit</b>	<b>1.0%</b>

Note, prices are based on traded prices and the ASX is taken from the close on April 28<sup>th</sup> 2017..

I've included Table 8 to show the real action in my rebalance over the first week using actual buy and sell prices – and yesterday's closing prices. Those stocks I sold would have lost -1.1% over the week had I not sold – while the 'buys' lost only -0.1%.

That's about a +1.0% benefit from not having sat on my hands in two weeks on about one third of my portfolio! The performance of the buys against the benchmark is even stronger. Note that Duet is not currently trading. It is expected to be back on line come Monday.

## The IOZ:IVV:IHVV Update

**Decision rules:** given the data in Tables 1 and 2, I use the following decision rules – until new rules are formed, expected to be July 1 2017:

Buy IOZ at 5,350 from Table 1a (up to maximum levels determined by risk assessments) and start to sell at 6,300 for new investments. If the ASX 200 falls to 4,950 (high-volatility low) it might be prudent to exit the strategy until clarity emerges and then buy back in at (well) above 4,950 but below 5,350.

Buy IVV:IHVV at 2,180 (up to maximum levels determined by risk assessments from Table 2a) and sell at 2,750 for new investments. If the S&P 500 falls to 2,050 (high-volatility low) it might be prudent to exit the strategy until clarity emerges and then buy back in at (well) above 2,050 but below 2,180.

For old investments start to take profits (lightly) at 2,610 (the FY17 forecast high in Table 2b) and more aggressively at 2,750 from Table 2a.

The difference between the price index for the ASX 200 in Chart 7 and the IOZ accumulation index in Chart 11 is more than stunning. IOZ has not kept pace with its price index benchmark but it has so with its accumulation index benchmark.

Charts 7 to 10 are based on the price indexes as this is the metric where the signals are being made.

**Table 9: Total returns on IOZ:IVV strategy**

12-May-2017	Inc divs.	Current allocation	
ETF	IRR pa	Total	USA
IOZ	11.2%	49%	
IVV+IHVV	14.4%	51%	100%
IVV	12.2%		37%
IHVV	18.4%		63%
<b>Total</b>	<b>12.8%</b>	<b>100%</b>	
Indexes		Alpha pa	
ASX 200	7.6%	3.7%	
S&P 500	9.3%	2.9%	
S&P 500 (\$A)	13.0%	5.4%	

NB: IRR is the internal rate of return (p.a.) that compensates for the different buy and sell points and include dividends on the day they were paid and not the ex-div date. See notes in the Strategy Section for further explanation and charts. The index returns are based on a start date of 1/7/2014 for the ASX 200 and S&P 500 when the strategy was launched. The S&P 500 (\$A) return starts from 22/12/2014 when IHVV first became available.

The strategy has been returning +12.8% p.a. since inception (Table 9) (including dividends). The IVV-IHVV leg is up +14.4% p.a.. The IOZ part of the strategy is up +11.2% p.a.. The table below shows that I am 63% hedged in the Wall Street component. The domestic share of the portfolio is 49%.

I have also included the benchmarks for each ETF in Table 9 so I can calculate any outperformance from the buying low – selling high strategy. Annualised outperformance is eroded in the long-run to zero unless fresh buys are made or a sell signal arrives.

The Charts 8 to 12 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.

The AUD has fluctuated in a range of about 72c – 78c since I started hedging at 76.0c in late February. Because the \$A fell from 78c to 72c before retracing to over 77c and then down again (etc), a fleet-of-foot trader might have better performed than my sit and wait philosophy. I don't have the energy or the predictive ability!

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. I plan to flag any perceived weaknesses if and as they eventuate. I can't define a composite benchmark as the allocations are expected to evolve over time. But all three components are well ahead!

## The IOZ:IVV:IHVV Strategy

(Except for the charts, this section does not usually change week to week)

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.

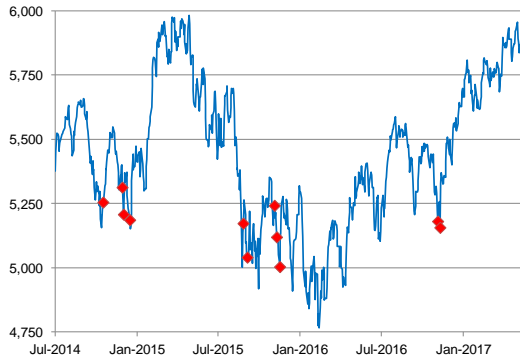
The basis of the strategy is to buy when the indexes (using ETFs) get very close to or cross the beginning of the year predicted low – and to sell when the indexes reach the predicted highs – as indicated in the 'Market Expectations' section. I do not use the weekly updated lows and highs for this purpose.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

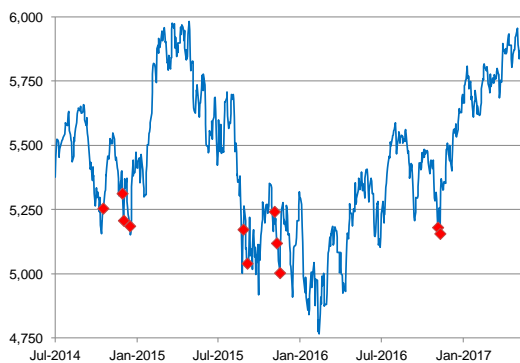
Note that the irr is a single annualised return to summarise all of the buys of the three ETFs and the current value including dividends when paid and not when the ETF went ex-div..

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).

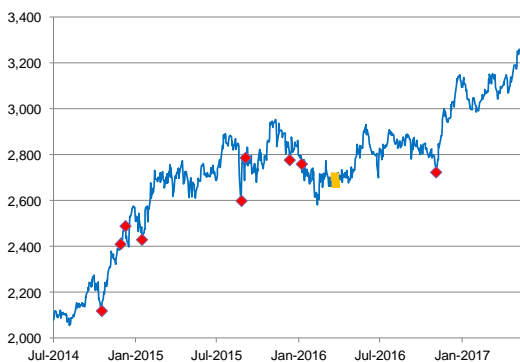
**Chart 8: IOZ buy points - ASX 200**



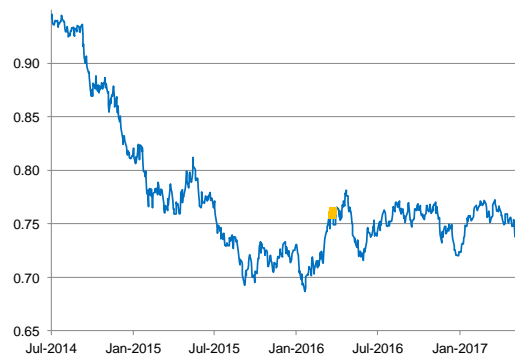
**Chart 9: Buys - S&P 500 (\$US; i.e. unhedged)**



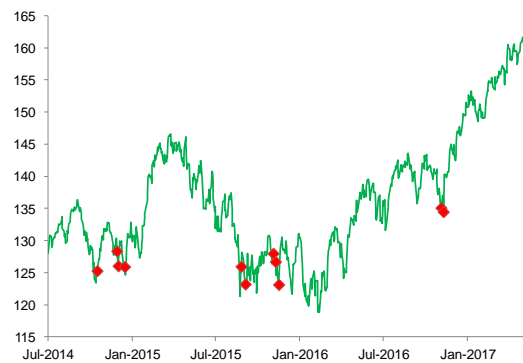
**Chart 10: Buys S&P 500 (\$A; i.e. hedged)**



**Chart 11: AUD hedging points**



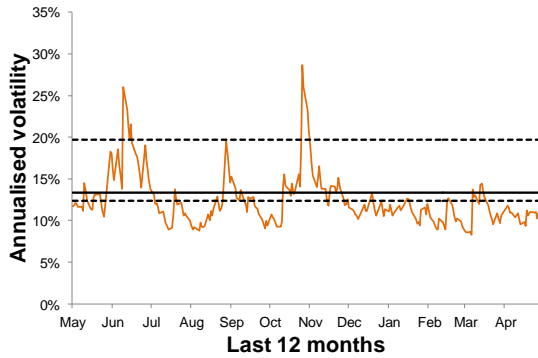
**Chart 12: IOZ buys – IOZ accumulation index**



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. The dots in Charts 9 and 10 refer to either IVVV or IHVV or both. Hedging or not refers only to the underlying index.

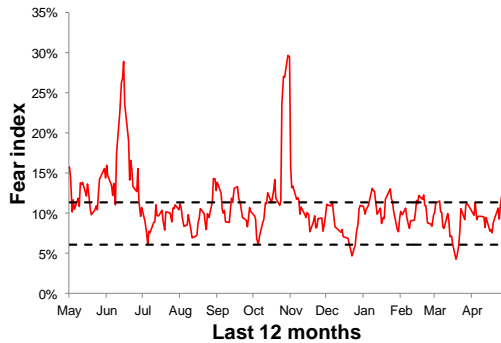
## Chart Appendix

**Chart A-1: Market volatility**



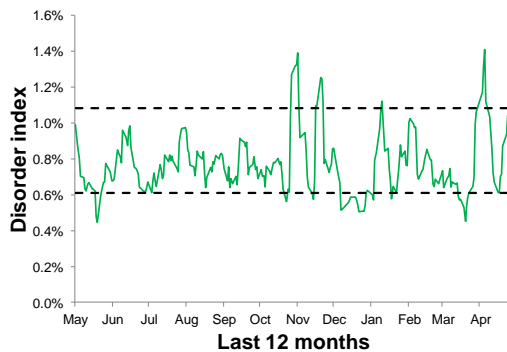
Notes: The solid black line depicts the average volatility since January 2010; the lower dotted line depicts the average volatility pre the GFC; the higher dotted line depicts the average level of volatility during the GFC - up to December 2009. The brown line is a daily estimate of the ASX 200 index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

**Chart A-2: Fear index**



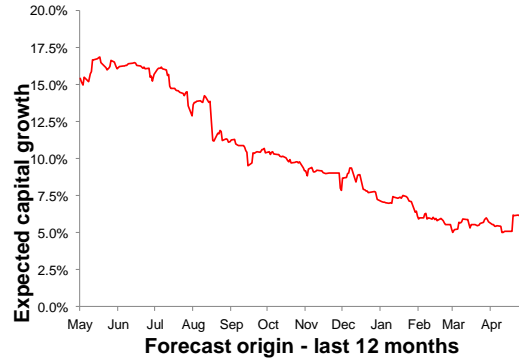
Notes: The fear index is a measure of 'excess' volatility denoting behaviour outside the open/close values each day. The two dotted lines depict the band in which the fear index resided before the GFC in two thirds of days. Extended periods below the lower dotted line might indicate complacency. Extended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



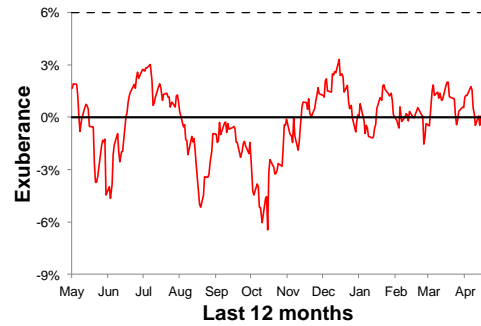
Notes: The disorder index measures the degree to which the 11 sectors' daily returns move in harmony. The two dotted lines depict the band in which the disorder index resided before the GFC in two thirds of days. Extended periods below the lower dotted line might indicate belief that there is little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



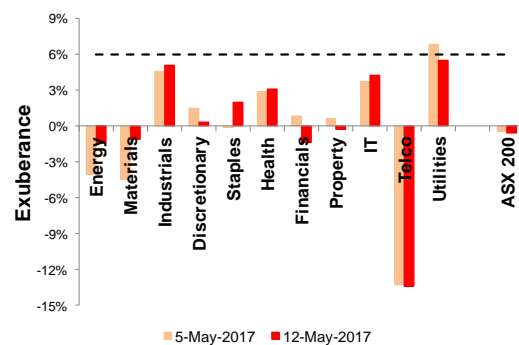
Notes: Each business day we update our estimates for capital gains on the ASX 200 for the following 12 months. For example, the left-most estimate on the vertical axis is a forecast for the 12 months concluding today. The right hand estimate is for the 12 months from today.

**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!!!

**Bad debt, good debt** – Whether one is referring a household or national debt, the classification implies the following. Good debt is expected to produce income or other returns in the future – such as from infrastructure spending or buying a principal place of residence. Bad debt is used to finance 'recurrent' expenditure such as pensions or family holidays.

**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!

**Brexit** – on 23<sup>rd</sup> July 2016 Britain voted to leave the European Union. The process is expected to take at least two years and negotiations must take place to engineer a smooth transition.

**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 1<sup>st</sup> 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.

**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.

**International Monetary Fund (IMF)** – Managing Director, Christine Lagarde (French), since 28<sup>th</sup> June 2011. The IMF is charged with fostering global monetary cooperation.

**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** – Our 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.

**MYEFO** (Mid-year economic and fiscal outcome) is a mid-year update on the Australian Budget situation – usually in December.

**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 official statistics are published in the first few days of each month – with China on the 1<sup>st</sup>. 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. Note also the existence of the CAIXIN measure and its 'flash' or preliminary estimate.

**Savings ratio** – In Australia, the ratio of net savings to household disposable income defines the savings ratio.

**Short-run mispricing** – Our 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.

**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. Of course less new jobs are needed when the economy is running at full employment.

## Key people

**Australia** – Prime Minister, Malcolm Turnbull, (Liberal) since 14<sup>th</sup> September 2015; Treasurer, Scott Morrison, since 21<sup>st</sup> September 2015; Governor of the Reserve Bank of Australia (**RBA**), Dr Philip Lowe, since 18<sup>th</sup> September 2016.

**China** – President Prime Minister, Xi Jinping, since 14<sup>th</sup> November 2013; Premier, Li Keqiang since 15<sup>th</sup> March 2013; President of the People's Bank of China (**POBC**) since December 2002.

**Europe** – President of the European Central Bank (**ECB**), Mario Draghi (Italian), since 1<sup>st</sup> November 2011; Chancellor of Germany, Dr Angela Merkel, since 22<sup>nd</sup> November 2005; President of France, Emmanuel Macron, from May 2017; Prime Minister of Greece, Alexis Tsipras, since 21<sup>st</sup> September 2015.

**Japan** – Prime Minister, Shinzo Abe, since 26<sup>th</sup> December 2012; Emperor, Akihito, enthroned 12<sup>th</sup> November 1990; Governor of the Bank of Japan (**BoJ**), Haruhiko Kuroda, since 20<sup>th</sup> March 2013.

**New Zealand** – Prime Minister and Treasurer, Bill English, since 12<sup>th</sup> December 2016; Minister of Finance, Steven Joyce, since 20<sup>th</sup> December 2016; Governor of the Reserve Bank of New Zealand (**RBNZ**), Graeme Wheeler, since 26<sup>th</sup> September 2012.

**United Kingdom** – Prime Minister, Theresa May, since 11<sup>th</sup> July 2016; Chancellor of the Exchequer, Philip Hammond, since 13<sup>th</sup> July 2016; Governor of the Bank of England (**BoE**), Mark Carney (Canadian), since 1<sup>st</sup> July 2013.

**United States of America** – President, Donald Trump, from January 20<sup>th</sup> 2017 (4 year term); Chair of the Federal Reserve Bank (**Fed**), Dr Janet Yellen, since 3<sup>rd</sup> April 2014 (4 year term).

## May 1<sup>st</sup> 2017 Rebalance

I was discharged from hospital after 17 nights as an inpatient just after the eom close for April 2017! Over that weekend I updated all our models, thought and planned a rebalancing strategy. I found the new generated portfolio compelling.

So on May 1 (despite it being the day for communists around the world have their May Day Parades) I sold 10 stocks and bought 15 on a bit above one-third of my portfolio. I decided to move into a 50:50 Conviction:Yield portfolio from a 100% Conviction (which was 100% Yield until the October 2016 rebalance).

Under many circumstances it could have been a simple roll-over from the old to the new but I wanted to keep down churn while holdings on to three favourites: BEN, CBA and COH.

The following table shows what a 'disciplined' investor' might have done.

### Table of recommended buys and sells

21 100.00%		-48.79%		24 100.00%		51.21%		7.29%		41.50%		12.36%		-5.09%	
Code	Holding	Sector	Sell All	Code	Desired	Sector	Holding	Change	Buy All	Buy more	Sell some	Code	Holding	Sector	Sell some
AGL	4.31%	Utilities	-4.31%	WPL	1.45%	Energy			1.45%						
AMC	4.27%	Materials	-4.27%	ORG	1.53%	Energy			1.53%						
BEN	6.60%	Financials	-6.60%	BHP	3.19%	Materials	3.90%	-0.71%			-0.71%				
BHP	3.90%	Materials		RIO	3.64%	Materials	4.81%	-1.17%			-1.17%				
CBA	9.61%	Financials	-9.61%	TCL	5.58%	Industrials	3.99%	1.59%		1.59%					
CGF	8.39%	Financials		SYD	5.25%	Industrials	3.68%	1.58%		1.58%					
COH	3.85%	Health	-3.85%	MQA	1.58%	Industrials			1.58%						
CSL	2.22%	Health		ALL	3.51%	Discretionary			3.51%						
GMG	3.08%	Property	-3.08%	OWN	5.20%	Discretionary			5.20%						
IPL	6.12%	Materials	-6.12%	CSL	1.84%	Health	2.32%	-0.48%			-0.48%				
JBH	3.63%	Discretionary	-3.63%	RMD	1.59%	Health	1.57%	0.02%			0.20%				
MQG	7.38%	Financials		RHC	1.75%	Health	1.55%	0.20%			0.20%				
RHC	1.55%	Health		WBC	10.00%	Financials	6.71%	3.29%			3.29%				
RIO	4.81%	Materials		MQG	10.00%	Financials	7.38%	2.62%			2.62%				
RMD	1.57%	Health		SUN	10.00%	Financials	7.02%	2.98%			2.98%				
STO	5.38%	Energy	-5.38%	COF	5.66%	Financials	8.39%	-2.73%			-2.73%				
SUN	7.02%	Financials		BOQ	10.00%	Financials			10.00%						
SYD	3.68%	Industrials		AMP	5.08%	Financials			5.08%						
TCL	3.89%	Industrials		MGR	2.20%	Property			2.20%						
TPM	1.93%	Telco	-1.93%	SGP	1.61%	Property			1.61%						
WBC	6.71%	Financials		SCO	1.66%	Property			1.66%						
				VOC	2.96%	Telco			2.96%						
				DUE	2.39%	Utilities			2.39%						
				SKI	2.72%	Utilities			2.72%						

But I was caught out before by VOC; I don't like AMP and I prefer BEN over BOQ. So I kept all of my BEN, CBA and COH. I steered clear of VOC and AMP and I reduced my additional SUN to make the rebalance work.

Regulars might recall I kept hold of JBH last October instead of ALL. That turned out to have been a big mistake – so I didn't repeat it. At least I took profits on JBH mid-rebalance. I also didn't make a small CSL/RHC switch this time around.

A couple of days later – I did all of my trades on the Monday – VOC fell through the floor yet again. All was looking good until the Budget tax on banks came through but, all in all, I feel confident about the newly constituted portfolio.

## The October 2016 rebalance

After thinking about it for six months, I finally started the process of rebalancing on Monday, October 3<sup>rd</sup> – one month short of a year since the previous rebalance.

With the Monday being a holiday in NSW, I was particularly surprised by the strength of the market. I decided to do most of the 'sells' that afternoon and leave the buys to another day. In the table below, I show the new Conviction portfolio I had produced over the long weekend in my regular monthly update. The right panel shows my September 30<sup>th</sup> portfolio and weights.

Table: The rebalancing proposition

Conviction portfolio		Old portfolio	
Code	share	Code	share
AGL	3.50%	AGL	1.59%
ALL	7.24%	AMC	2.05%
AMC	4.66%	AMP	4.10%
BHP	4.25%	AZJ	3.82%
BOQ	6.49%	BEN	4.42%
BXB	3.13%	BHP	1.68%
CGF	7.28%	COH	3.47%
CSL	3.04%	CSL	1.67%
GMG	3.16%	DUE	2.00%
IPL	5.14%	GMG	1.36%
MQG	7.50%	IFL	4.50%
ORG	2.89%	JBH	5.78%
RHC	3.34%	MGR	2.60%
RIO	4.70%	MQG	8.78%
RMD	3.60%	PRY	3.24%
SUN	6.86%	RHC	1.53%
SYD	3.42%	RIO	1.77%
TCL	3.37%	RMD	1.30%
VOC	6.93%	SGP	2.37%
WBC	6.77%	SPO	1.83%
WPL	2.74%	STO	3.64%
		SUN	5.51%
		SYD	4.83%
		TCL	4.64%
		TLS	4.17%
		TPM	2.53%
		TTS	2.42%
		VCX	2.26%
		WBC	10.12%

I had a number of particular considerations to take into account. My old portfolio was a 50:50 blend of my Conviction and Hybrid Yield November 2015 portfolios. Since I decided to go 100% conviction this time around, there was going to be a lot of selling. I also wanted to hold about 20% cash – most unusual for me.

Part of the reason for holding cash was to have a buffer going into the US Presidential elections next month – and part was because I want to invest in my High Octane portfolio. Since I have never invested in an octane portfolio before, I wanted a breather first. Octane – to me – requires quite a few stocks and an emphasis on market timing. More of that next week!

If I did not have a legacy portfolio, I possibly would have just bought the one in the left panel of the table. I chose to modify it because I have come to learn quite a bit about my existing stocks – so I made some substitutions – and it reduced transaction costs and effort.

I had already placed a request to sell all of my TLS in the buy-back offer. That transaction will not be completed until Tuesday 11<sup>th</sup> October. Since I do not yet know how many stocks they will buy, nor for how much, I decided to assume all will be sold and the proceeds will be added to the 20% cash – and I'll sort it all out

later. I also am in the hunt for some extra JBH following their capital raising that hasn't yet arrived.

I chose not to substitute ALL for JBH in my Discretionary holding as the conviction portfolio dictates. I got attached to JBH. Also ALL (gambling) always worries me because of the chance of changes to regulation – and I vividly remember when the stock plunged over 10 years ago when it lost just one big contract in South American.

While I am in stocks for the long-haul, it will take some time to assess whether it was a wise move not to switch. In the first week (from Sep 30<sup>th</sup> to Oct 7<sup>th</sup>) ALL was up +4.2% against -0.1% for JBH. Not enough to sting (too much) – but I can always change my mind later! I think it is fine to rebalance just one stock in such circumstances. ALL does have a very strong recommendation at 2.0 – but that doesn't allow for my perception of its risk.

I also chose not to substitute BOQ for BEN. Both are regional banks but I am also holding the Queensland-based SUN. A little 'regional' diversification! In the first week, BOQ was down -2.8% after a moderate report while BEN was up +2.2%. I'm happy with that and it cancels the ALL:JBH play. Moreover, BEN is about to offer a share purchase plan that might be attractive.

I refuse to sell my COH! I have done so well backing that one for years when it was very unloved by brokers. I bought several times under \$60 and sold most above \$80. With current prices over \$140, this last parcel is 'for the manager'. This meant I did not add to CSL, RHC and RMD as my model portfolio recommended. In the first week, COH was up +0.5% while the other three Health stocks are mixed: CSL (-0.6%), RHC (+1.1%) and RMD (+0.8%). Not much in it overall.

I also held on to STO. It is a bit of a risky stock but I like its chances against ORG and WPL. So no substitution there either. In the first week, STO was up +8.0% while the others were up a little less: ORG (+3.7%) and WPL (+4.3%). Got lucky there!

My final substitution was in the Telco space. My TLS will be sold soon – if only partially – and VOC was the putative substitute. TPM and VOC both took hammerings in recent times. I think the TPM fall was over-done on what didn't seem like a bad report. Therefore, I kept TPM and bought enough VOC to fill the Telco void once TLS has gone. That's about 50:50 TPM:VOC. When in doubt diversify more! VOC fell -10.0% while TPM fell -5.8%.

So, on Monday's rising tide I sold all of my holdings in AMP, DUE, IFL, PRY, SPO, TTS, VCX and the overweight part of MQG, SYD, TCL and WBC.

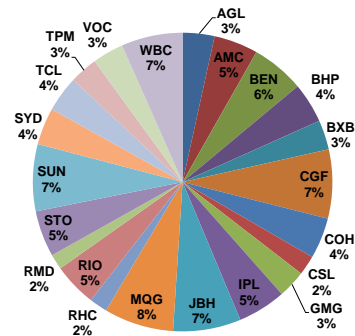
On Tuesday, the market fell so I bought all of my BXB, CGF, IPL and VOC. I topped up AGL, AMC, BHP, GMG, and RIO. I sold AZJ, MGR and SGP. That's 23 trades in two sessions!

I chose not to make some other trades as brokerage does not make small transactions economical – and the paperwork for tax records gets unnecessarily burdensome. I also took capital gains' calculations into account in a similar fashion.

Since I don't transact at closing prices, I wanted to evaluate my performance in making these transactions. As it happens, I sold 58% more than I bought – to generate my cash holding. The sells by the end of the week fell -0.8% while the 'buys' have fallen -0.3%. Not much in it – just a little bit ahead!

The new composition of my portfolio without the cash and TLS at the close on October 7<sup>th</sup> 2016 is in the following pie chart.

Chart: New portfolio after rebalance



The changes in sector weights are shown in the table below. The biggest change is the increase in exposure to Materials which was offset by falls in Industrials, Financials and Property. Although the percentage point increase in Utilities is small, it does represent a doubling of the exposure.

Table: Sector weights at October 7<sup>th</sup> 2016

Sector	New	Old	Change
Energy	5.0%	3.6%	1.3%
Materials	22.2%	9.3%	12.9%
Industrials	7.9%	11.3%	-3.4%
Discretionary	7.3%	8.2%	-0.9%
Health	10.1%	11.2%	-1.1%
Financials	34.6%	37.4%	-2.8%
Property	3.0%	10.6%	-7.6%
Telco	6.4%	6.4%	0.0%
Utilities	3.4%	1.6%	1.8%