21 March 2020

Woodhall's Weekly

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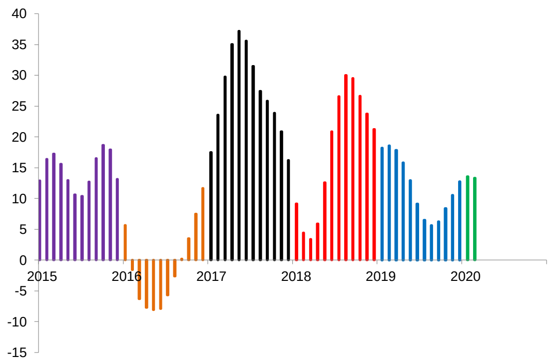
- **Latest Australian economic data still strong but RBA acts anyway**
- **Most governments piling in on stimulus**
- **Saudis continue to take on Russia and US shale oil**

Overview

If one didn't know that there was a massive global health crisis in play, one should have concluded that the results of Thursday's Australian Labour Force Survey were reasonably strong.

The headline unemployment rate fell back to 5.1% from the previous month's 5.3%. From the chart of the week, trend full-time employment grew at the same rate as in the previous month and p/t employment was also strong.

Chart of the week: Change official trend f/t Australian employment '000



Since we are all aware that a health crisis has swept across most of the world, the next month (for March) will not be so bright. At least we entered this crisis in a relatively good position.

The RBA for once was ahead of the curve and called for an emergency board meeting on Wednesday to follow that data release. They were expected to cut another 25 bps after the March 4th cut and announce a QE programme.

The cut to 25 bps came in but the language around stimulus was a bit vague. The RBA is to 'target' the three-year bond yield at 25 bps but no specific sequence of bond purchases was mentioned with which QE is usually associated. Our dollar fell sharply (-3.2% on day) and the stock market – after a +3% open was well down after the 2:30 statement – closing -3.4% on the day.

The government has promised over $700m to the airline industry in terms of forgone landing fees and taxes. A bigger stimulus package than last week's $17m starter is expected over this weekend.

It has not been possible for us to keep track of all of the central bank and government virus-related activities. However, it seems like everyone is stepping up to the plate. The US at last has stimulus in process and the Democrat/Republican spat over impeachment has been put to one side. The ECB just launched an 800bn euro stimulus package – even Japan and Germany are seemingly doing what it takes.

The Saudis do not seem to be pulling out of their squeeze on the oil industry. Oil prices lost more 50% in a few weeks but did bounce back a fraction on Thursday before another sell-off overnight. It is not obvious when they will restore order by trimming supply. All suppliers are losing money (reputedly between $10 - $60 /barrel). When the price war ends, it can all start over again so what is the point?

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WOODHALL INVESTMENT RESEARCH

So, what should we make of the markets? Anyone who sounds authoritative on the subject should be dismissed as belonging on the lunatic fringe. But that doesn't mean we can't form some relevant views – just not the whole picture.

The first point is to distinguish this market turmoil with past volatile downturns. Had it not been for the virus – a purely exogenous health problem and not an economic or financial problem – we would all still be dancing in the street (with Mick Jagger and David Bowie if you are old enough – or Martha and the Vandellas if you are even older).

That does not mean there may not be (or are) economic and financial consequences from this truly black swan event. A black swan event is something that could not have reasonably be predicted rather than a rare event we didn't happen to predict.

The GFC happened because companies and households got severely over-leveraged and were then caught by <u>not knowing who held the debt obligations or how big they were</u>. The fear of not knowing what was going on crippled the world.

COVID-19 seems relatively harmless to anyone big and strong. Kids seem to be almost immune (but they might carry). Old folk and the sick are really the only ones at risk. Thankfully, our children seem to be worried about us. The UK was going to allow the virus run its course and sort itself out (the herding solution) which is great for the under seventies.

It seems massively probable that testing for COVID-19 will be properly sorted soon and even a vaccine will be found so the health issues will be resolved within a finite period – say at most eighteen months. Eighteen months after the GFC problems started to emerge, Lehman Bros still seemed like a viable bank! This time is really different. But our market volatility and indexes have reached higher highs than back in 2008.

Sadly, COVID-19 will 'shake the tree' for some businesses. Lots of retail and the like looked in possible trouble in 2019 so the virus might end some of those ventures. Will BHP, Woolworths, Telstra etc still be in business in a couple or more years? Almost certainly!

For the companies that don't go under, the rest will bounce back with a strength not seen for ages. The old revenue levels will be re-tested and, for those companies with goods and services that will be building up a pent-up demand for the future – it will be like 'all of our tomorrows' coming at once.

For index players, that means they can sit and wait (although they might need to keep up with their blood pressure meds). For those with individual stock holdings, the sooner we get rid of the seemingly doomed stocks the better (even if that means taking a right hook to the chin).

We (as we always advised in the day) entered the virus crisis with at least two years of (almost) risk-free income. We remember while we were at the CBA in late 2008 a client with about $100m in cash in a non-big-4 bank wanted to transfer to the CBA. We did that transaction in a few hours. The other bank didn't go under but 'risk free' is in the eye of the beholder.

So, we will not be selling anytime soon. We even made a small buy a while back (too early as it turns out but we didn't know). With dividend cheques starting to roll in, when will we reinvest them?

Since we have close to zero medical/microbiology credentials we won't try to make a fool of ourselves by trying to contribute to that debate. But we have a vast experience in modelling the growth paths of new 'things' like new products, markets share and diseases!

We think (but we do not know) that the market will turn up well before the economy does. We think (but we do not know) that it won't take much to create positivity. We are thinking of

a) Sufficient testing facilities
b) A potential vaccine
c) An approved vaccine

Already there is the chance of an old malaria drug (hydroxylchloroquine) doing a job while a new targeted vaccine is created and tested. Since it is already approved, the US is monitoring its progress in a real-time clinical trial.

One of the big delays in all drug approval is testing them on humans over a reasonably long period. Just because there are no side effects after a week, it does not mean there won't be in a year. That's why a new vaccine is really the solution of next year's problem and not today's.

We take heart from the fact that Wuhan, the birthplace of the coronavirus, just had two consecutive days of no new cases to report. Meanwhile the Italy problem has overtaken the magnitude of that in China.

In our view governments have reacted far more quickly, and probably effectively than in 2008. We plan to continue holding the line and quietly waiting (at home) for the markets to recover.

Market expectations

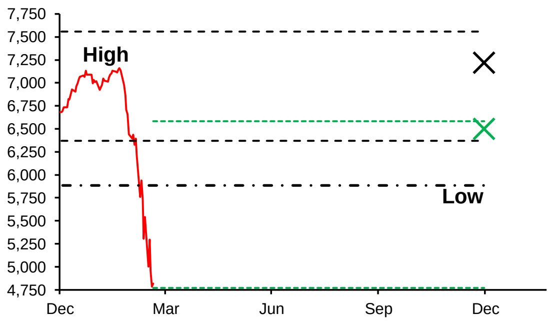
Our start-of-year 2020 eoy forecasts for the ASX 200 are given in Table 1 (left column) together with the latest calculations (right column) and last week's (middle column) for comparison. Chart 1 includes a trace of the index to compare with the forecast highs and lows.

Table 1: ASX 200 range forecasts for 2020

Forecast	Forecast origin		
CY20	31-Dec-2019	13-Mar-2020	20-Mar-2020
Low	6,350	5,450	4,750
High	7,550	7,050	6,600
End	7,200	6,900	6,500
Fair value	6,750	7,000	7,400
Exuberance	-1.3%	-21.1%	-35.1%
ASX 200	6,684	5,539	4,817

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 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 eoy forecast for 2020 (left-hand column in Table 1) was 7,200 with a forecast high of 7,550 and a forecast low under normal volatility of 6,350. The 'high-volatility' forecast low was 5,900. The updated eoy 2020 forecast (Table 1, last column) is 6,500. Fair value is 7,400.

It should be stressed that when markets are heavily mispriced, the speed with which mispricing is eroded is key to making a good forecast. In this table we assume that it takes 12 months to erode the mispricing which is possibly a very conservative assumption.

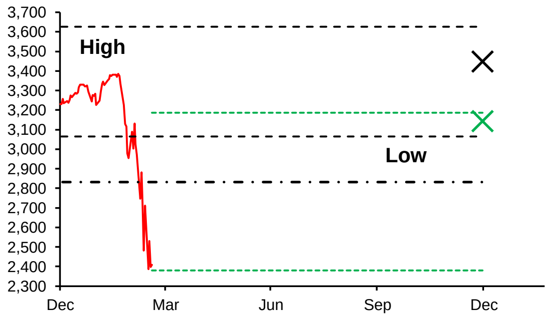
Our eoy 2020 forecasts for the S&P 500 are given in Table 2. Because overnight data are not available to us until the afternoon, the latest data for Wall Street will usually be presented for the day before the ASX 200 in this *Weekly* that we try to post at around 10am on a Saturday.

Table 2: S&P 500 range forecasts for 020

Forecast	Forecast origin		
CY20	31-Dec-2019	12-Mar-2020	19-Mar-2020
Low	3,060	2,450	2,380
High	3,630	3,260	3,190
End	3,450	3,210	3,140
Fair value	3,100	3,280	3,310
Exuberance	4.0%	-24.4%	-27.2%
S&P 500	3,231	2,481	2,409

Note: see notes for Table 1.

Chart 2: Graphical representation of Table 2



Note: see notes to Chart 1.

Our original forecast for eoy 2020 was 3,450 with a high of 3,630 and a low of 3,060. The 'high-volatility' low was 2,830.

The updated eoy forecast for the S&P 500 is 3,140. Fair value is 3,310

Market stats

Our market volatility index (Chart A-1 to be found in the Chart Appendix) is well above average at 76.2%. Our Fear Index (Chart A-2) is above the zone at 52.0%. The VIX stands well above average at 66.0. Our Disorder index (Chart A-3) is above the zone at 4.5%.

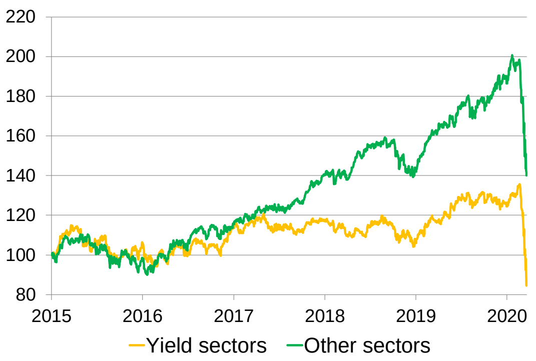
Our updated 12-month capital gains forecast (Chart A-4) is +8.7%. The market is significantly under-priced at -35.1% (Chart A-5). So that leaves the adjusted rolling 12-month capital gains' forecast at +46.8%. The comparable 12-month adjusted capital gains forecast for the S&P 500 stands at about +45%.

Sector pricing (Chart A-6) is such that all sectors are cheap.

Chart 3 shows an interesting angle on the yield play. Our composite yield sector (Financials-x-REITS, REITS, Telcos and Utilities) and the 'other' (seven) sector moved roughly together for 2015, 2016 and the first half of 2017.

Since then the yield play went nowhere up until the coronavirus bear market. After a brief resurgence in 2019 yield had again been going nowhere. The 'other index' performed very strongly except for a brief dip in Q4 of 2019. Both indexes fell very sharply from the end of February 2020.

Chart 3: Total returns indexes for 'yield' and 'other' aggregated sectors



SMSF Share Portfolio

We last rebalanced our share portfolio in our SMSF on 3rd February 2020. We kept the style at 100% High Conviction. There are 16 stocks in the portfolio. No adjustments were made to the new model portfolio prescription.

Table 3: Total returns from SMSF portfolio

Period	Portfolio	ASX 200	Alpha
Since inception	5.8%	2.5%	3.3%
5 years	2.8%	0.0%	2.8%
3 years	2.2%	-1.8%	4.0%
2 years	-1.5%	-6.2%	4.7%
1 year	-14.6%	-18.6%	4.1%
6 months	-30.9%	-26.9%	-4.0%
3 months	-34.8%	-28.3%	-6.5%

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

The performance of domestic equities in our SMSF portfolio – including various rebalances – against the ASX 200 since late June 2014 is shown in Table 3. That corresponds to an outperformance of +3.3% p.a. (annualised) since inception. The portfolio has been returning +5.8% p.a.

In Table 4, we show the performance (including dividends) of the individual stocks since the last rebalance.

We have three stocks (CSL, CWY and RMD) beating the index by more than 10% since February 3rd 2020 and six stocks (ALL, CPU, MQG RWC, VUK and WPL) stocks trailing by more than -10%.

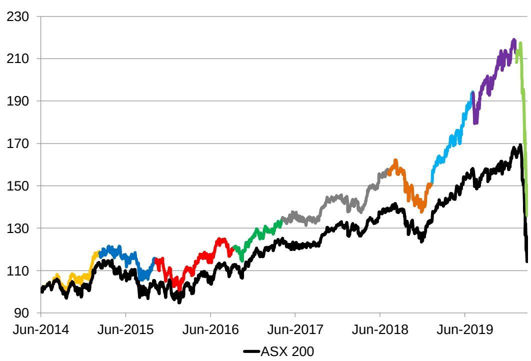
Table 4: Individual stock total returns

	ALL	AMC	AZJ	BHP	CIM	CPU	CSL	CWY
Return	-50.6%	-24.5%	-31.1%	-29.1%	-30.8%	-48.1%	-12.9%	-12.4%
Alpha	-21.0%	5.1%	-1.5%	0.5%	-1.2%	-18.5%	16.7%	17.1%
	LLC	**MQG**	**RMD**	**RWC**	**TWE**	**VUK**	**WPL**	**XRO**
Return	-38.5%	-39.7%	-6.8%	-55.1%	-22.0%	-56.2%	-52.2%	-28.0%
Alpha	-8.9%	-10.1%	22.8%	-25.5%	7.5%	-26.7%	-22.6%	1.5%

Note: Since February 3rd 2020. Returns include dividends.

The returns chart (Chart 4) shows the recent performance using colours to denote the different rebalanced portfolios.

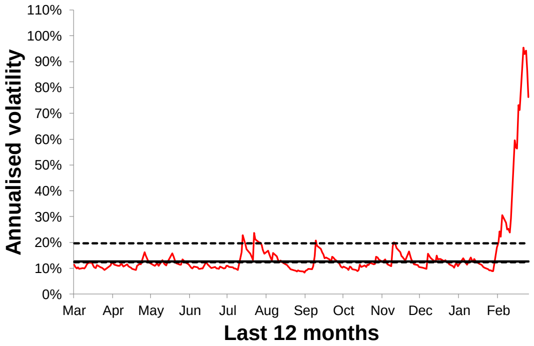
Chart 4: SMSF and ASX 200 total returns



Note: the different coloured sections show the impact of rebalancing.

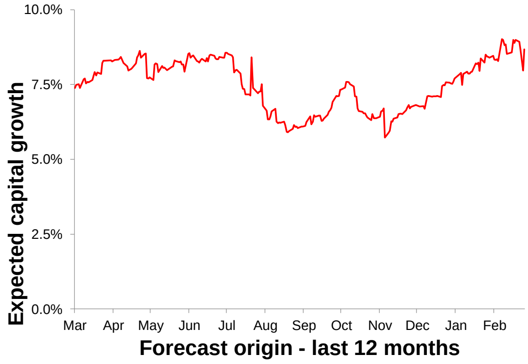
Chart Appendix

Chart A-1: Market volatility



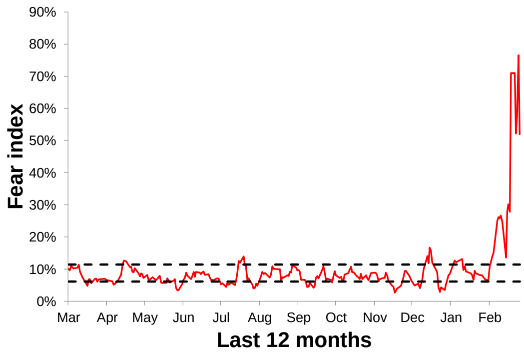
Notes: The solid black line depicts the average volatility since January 2010; the lower dotted line depicts the average volatility pre the GFC; the higher dotted line depicts the average level of volatility during the GFC - up to December 2009. The brown line is a daily estimate of the ASX 200 index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

Chart A-4: 12-month capital gains forecasts



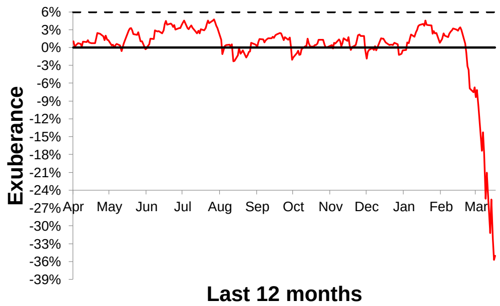
Notes: Each business day we update our estimates for capital gains on the ASX 200 for the following 12 months. For example, the left-most estimate on the vertical axis is a forecast for the 12 months concluding today. The right hand estimate is for the 12 months from today.

Chart A-2: Fear index



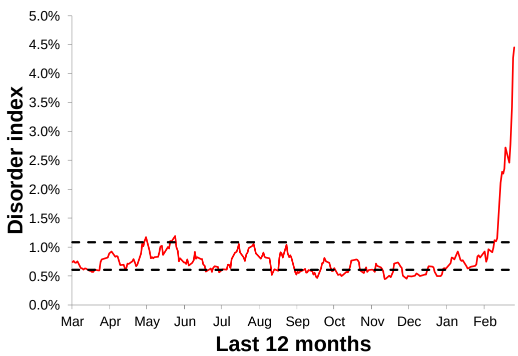
Notes: The fear index is a measure of 'excess' volatility denoting behaviour outside the open/close values each day. The two dotted lines depict the band in which the fear index resided before the GFC in two thirds of days. Extended periods below the lower dotted line might indicate complacency. Extended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

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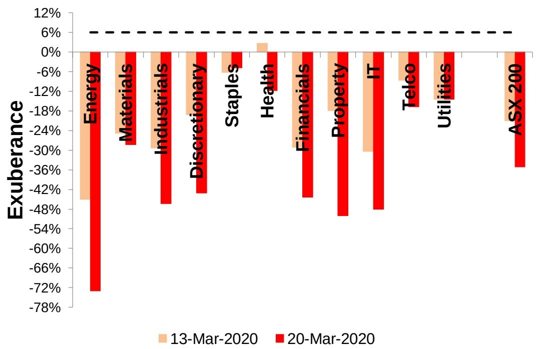
Chart A-6: Sector exuberance



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 23rd 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 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.

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, Kristalina Georgiera (French), since 1st Oct 2019. 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 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. 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, Scott Morrison, (Liberal) since 24th August 2018; Treasurer, Josh Frydenberg, since 24th August 2018; Governor of the Reserve Bank of Australia (**RBA**), Dr Philip Lowe, since 18th September 2016.

China – President Prime Minister, Xi Jinping, since 14th November 2013; Premier, Li Keqiang since 15th March 2013; Yi Gang, President of the People's Bank of China (**POBC**) since March 2018.

Europe – President of the European Central Bank (**ECB**), Christine Lagarde, since 1st November 2019); Chancellor of Germany, Dr Angela Merkel, since 22nd November 2005; President of France, Emmanuel Macron, since May 2017.

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

New Zealand – Prime Minister, Jacinda Arden, October 2017; Governor of the Reserve Bank of New Zealand (**RBNZ**), Adrian Orr, since 27th March 2018.

United Kingdom – Prime Minister, Boris Johnson, since 24th July 2019; Chancellor of the Exchequer, Rishi Sunak, since 13th February 2020; Governor of the Bank of England (**BoE**), Andrew Bailey, since February 2020.

United States of America – President, Donald Trump, from January 20th 2017 (4-year term); Chair of the Federal Reserve Bank (**Fed**), Jerome "Jay" Powell, since 5th February 2018 (4-year term)