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Woodhall's Weekly

- **China data impress**
- **Brilliant Q2 for most markets**
- **US nonfarm payrolls – big beats**

Overview

China got the ball rolling last week with industrial profits coming in for the month at +6% which was the first positive reading since November. They kept the momentum going with a pair of beats on PMIs. The manufacturing PMI was 50.9 – the fourth straight month of expansion. The services PMI was 54.4, a full point above expectations.

China did legislate its new security bill for Hong Kong. It's not yet clear how it will be received. Clearly the US will do something but the noise from DC is far from deafening. So far it has put a bill on Trump's desk to sign. We need to keep an eye on that.

Our financial year finished on Tuesday. The total returns index for the ASX 200 was down -7.7% over the twelve months but that was only the second negative FY since the FY10 year started in mid-2009! Q2 was up an impressive +16.5% after a dismal Q1 (-23.1%; both total returns). So far Q3 looks good.

The Nasdaq broke through 10,000 pts and recorded capital gains of +24.4% for our FY20. The S&P 500 had the best quarter in 22 years while the Dow did its best since 1987.

There are worrying signs of a resurgent COVID-19 but, if it can be contained the Fed's support through to at least 2023 looks good enough to carry the day.

Interestingly, Iran issued an arrest warrant for President Trump. That's a bit like Sheldon Cooper,

from Big Bang Theory, collecting restraining orders from Comicon stars!

Trump is starting to slip behind Biden for the November elections but it is still quite early. He leads Biden in the perception of his ability to manage the economy. Usually the sitting president wins when the economy is fine. The US economy was limping along a month or two ago due to the shutdown on health concerns. It now seems to be firing again.

The nonfarm payrolls data came in a day early owing to the Independence Day holiday overnight. It was a real blockbuster. The previous month's new jobs read was a massive (record) +2.5m but this one came in at +4.8m. The unemployment rate fell to 11.1%. Clearly some Americans are getting back to work but, of course, some jobs may be lost for a long time if not forever.

Japan is still struggling with its industrial output going down by -8.4% over the month. They went a bit early in relaxing COVID restrictions and now look to be paying the price.

With our due date for rebalancing our direct equity portfolio now less than a month away, we really need guidance on company earnings. If none, or almost none, is forthcoming our current plan is to delay a month for a then 5-month holding period from September to February. More on that later.

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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 CY20	Forecast origin		
	31-Dec-2019	26-Jun-2020	3-Jul-2020
Low	6,350	5,800	5,900
High	7,550	6,700	6,800
End	7,200	6,550	6,650
Fair value	6,750	6,150	6,050
Exuberance	-1.3%	-4.1%	-0.2%
ASX 200	6,684	5,904	6,058

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 6,650. Fair value is 6,050.

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 CY20	Forecast origin		
	31-Dec-2019	25-Jun-2020	2-Jul-2020
Low	3,060	3,030	3,080
High	3,630	3,560	3,600
End	3,450	3,500	3,540
Fair value	3,100	3,140	3,140
Exuberance	4.0%	-1.9%	-0.2%
S&P 500	3,231	3,084	3,130

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 3,540. Fair value is 3,140

Market stats

Our market volatility index (Chart A-1 to be found in the Chart Appendix) is above average at 20.2%. Our Fear Index (Chart A-2) is above the zone at 17.7%. The VIX stands above average at 27.7. Our Disorder index (Chart A-3) is in the zone at 1.1%.

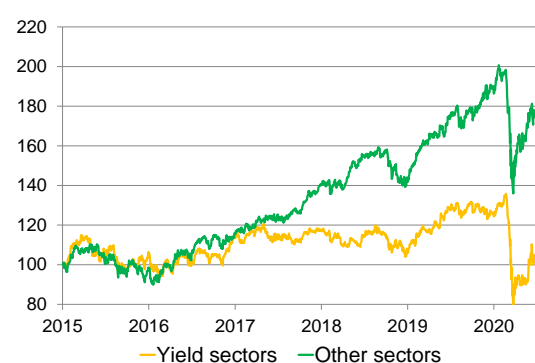
Our updated 12-month capital gains forecast (Chart A-4) is +20.0%. The market is fairly priced at -0.2% (Chart A-5). So that leaves the adjusted rolling 12-month capital gains' forecast at +20.2%. The comparable 12-month adjusted capital gains forecast for the S&P 500 stands at about +28%.

Sector pricing (Chart A-6) is such that IT (9.1%) is materially over-priced; Materials (+3.6%) and Telcos (+3.7%) are moderately over-priced. Industrials (-7.5%) is the cheapest sector.

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 started. 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 and possibly started the recovery from late March.

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	10.0%	6.4%	3.7%
5 years	9.0%	6.2%	2.8%
3 years	9.5%	5.7%	3.7%
2 years	7.5%	2.9%	4.6%
1 year	-4.9%	-6.6%	1.7%
6 months	-14.5%	-8.1%	-6.4%
3 months	20.3%	19.8%	0.4%

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 +3.7% p.a. (annualised) since inception. The portfolio has been returning +10.0% p.a.

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

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

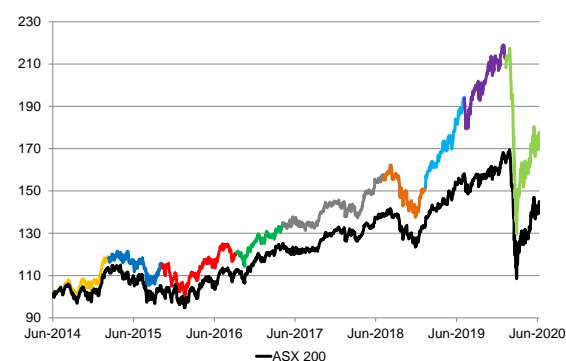
Table 4: Individual stock total returns

	ALL	AMC	AZJ	BHP	CIM	CPU	CSL	CWY
Return	-24.8%	-2.1%	-5.2%	-4.0%	-13.3%	-23.8%	-4.1%	10.6%
Alpha	-13.7%	9.1%	5.9%	7.2%	-2.1%	-12.6%	7.1%	21.8%
	LLC	MQG	RMD	RWC	TWE	VUK	WPL	XRO
Return	-27.0%	-12.2%	18.3%	-34.0%	-10.1%	-47.3%	-34.1%	6.3%
Alpha	-15.8%	-1.0%	29.5%	-22.9%	1.1%	-36.1%	-22.9%	17.4%

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.

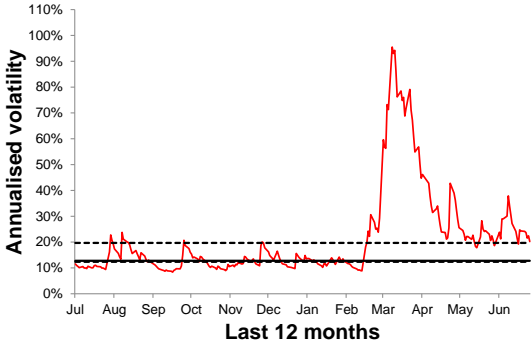
Chart 4: SMSF and ASX 200 total returns



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

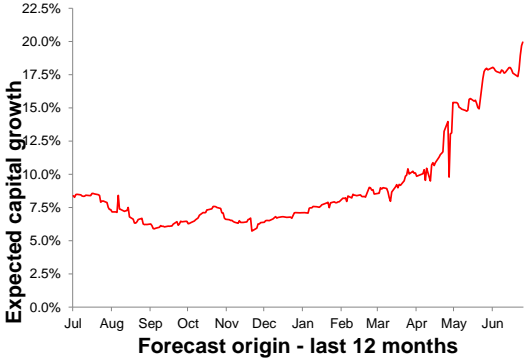
Chart Appendix

Chart A-1: Market volatility



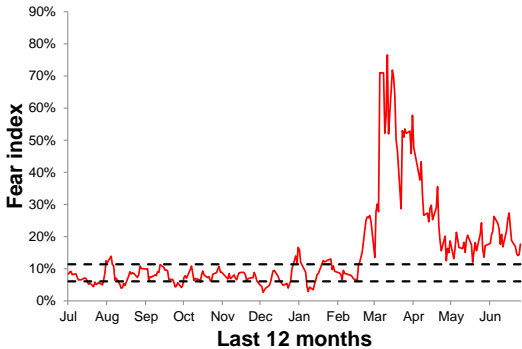
Notes: The solid black line depicts the average volatility since January 2010; the lower dotted line depicts the average volatility pre the GFC; the higher dotted line depicts the average level of volatility during the GFC - up to December 2009. The brown line is a daily estimate of the ASX 200 index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

Chart A-4: 12-month capital gains forecasts



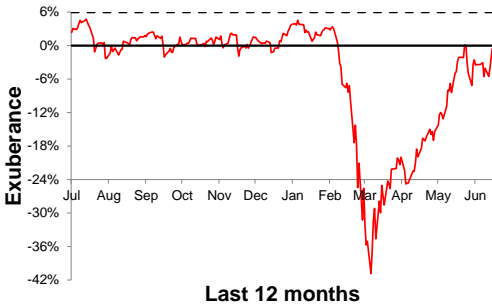
Notes: Each business day we update our estimates for capital gains on the ASX 200 for the following 12 months. For example, the left-most estimate on the vertical axis is a forecast for the 12 months concluding today. The right hand estimate is for the 12 months from today.

Chart A-2: Fear index



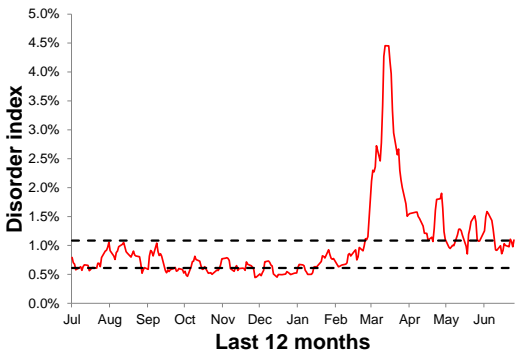
Notes: The fear index is a measure of 'excess' volatility denoting behaviour outside the open/close values each day. The two dotted lines depict the band in which the fear index resided before the GFC in two thirds of days. Extended periods below the lower dotted line might indicate complacency. Extended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



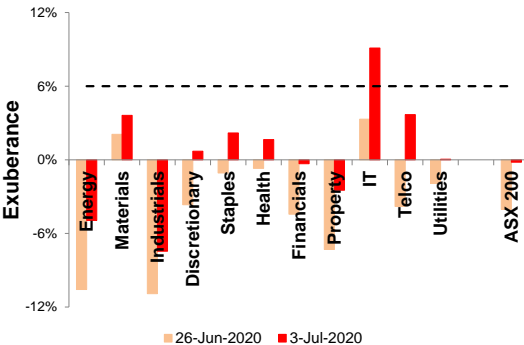
Notes: Exuberance is our measure of mispricing on the ASX 200. A value below the solid black line denotes the market is perceived to be cheap and above that line expensive. Experience suggests that exuberance above +6%, denoted by the dotted line, is an indicator of a potential correction of 6% to 10%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

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 Georgieva (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)