8 August 2020

Woodhall's Weekly

Ron Bewley PhD, FASSA

- **US reporting season was a beat**
- **Aussie retail sales again beats**
- **China and Germany exports were big beats**

Overview

It was reported on CNBC TV last Monday that 82.1% of US companies that had reported beat earnings expectations. This percentage is usually high because people (in companies and analysts) like to set a low bar. But the normal beat rate (from memory) is about 70%. It's not surprising, therefore, that the S&P 500 got close to its all-time high after a March bear market. The NASDAQ kept on reaching new highs time and time again (32 of them this year alone). It breached 11,000 points for the first time.

The big (or is it mega?) tech stock prices led the way for both of these indexes. Indeed, a couple of them went almost vertical from mid-week.

Aussie retail sales for the month came in at another healthy number. In this case 2.7% for the month on month result.

It is hard to say whether or not the Dems and Republicans are any closer to getting a top-up COVID package in place. The $600 per week unemployment top up ended on July 31 so there are a lot of people struggling even more to get by. Both sides claim agreement on some items but, of course, they have to hold these back while negotiating the important deals.

But Wall Street didn't struggle on our Thursday night. After a (US) morning of going nowhere, the S&P 500 started a great rally into the close on the news that a relaxation of international travel restrictions was being considered. Imagine what would be the result if something actually happens!

The weekly initial jobless claims came in a bit lower at 1.19m after a spike of a couple of weeks broke the down-trend. There are around 33 million unemployed Americans (which presumably doesn't include the 'dreamers').

The nonfarm payrolls came in overnight slightly ahead of expectations.1,763,000 new jobs were reported and the unemployment rate fell to 10.2%.

Because macro data lost so much ground in Q2 due to the global policy induced shut-down, we are now seeing some big numbers in recovery. Germany exports was a very big beat and China exports also beat big time but largely on the back of medical supplies exports for COVID-19.

Our take on all that is going on is that macro data are starting to get very good but second, third and fourth waves could derail the markets. We have a 'feeling' (very touchy feely) that, broadly speaking, the world will get through the current resurgence much better than the first wave.

Victoria has gone into lock down again – at least in Melbourne and some related regions. ScoMo predicts that this lockdown of business and people may cost GDP in Q3 by as much as 2.5% points. Queensland is trying to lock out potential problems and NSW may have to wonder from where its food will come.

A lot of people must have been caught with their pants down over the S&P 500 rally to almost new highs. We hung in (based on our models) and indeed carried on with our normal investment strategy.

We did an extensive scheduled rebalance of our direct Australian equity portfolio on Monday in the February/August six monthly rebalance. sequence We present the stocks and weights in the following section.

Owing to the massive share price changes during the COVID-19-induced March down-turn and then recovery, we note major natural changes in sector weights over the February – August period. In particular, the February 3rd weight of Financials (37.87%) fell to 24.84% without user intervention. Furthermore, the Energy sector weight fell from 6.64% to 5.37%.

The Discretionary sector weight was roughly unchanged over the period. All other sector weights increased with the Health sector gaining the most ground from 14.19% to 20.17%.

Owing to these sector weight changes and the general increases in the expected risk-adjusted returns, the allocated number of stocks increased from 16 to 23 as is evident from comparing Portfolio tables 1 and 2.

The increased weight in Health up to August was sharply trimmed in the rebalance but the number of stocks was increased from two to three. It appears that RMD was excluded because of its strong returns (and assumed overpricing?) and it was replaced by SHL and RHC.

The number of stocks in Financials was increased from three to five. After a poor six months, VUK was exited. MQG and LLC were retained. WBC, SUN and NIB joined the sector's five-stock exposure.

Staples is now represented by three stocks (WOW, COL and A2M) after the underperforming TWE was exited. CWN and SGR were added to ALL for the Discretionary allocation.

The Industrials sector retained four stocks but three of them were changed; only AZJ was retained. In the IT sector, XRO and CPU were replaced by APT.

In Materials, AMC was replaced by RIO and NCM.

Portfolio rebalance

In the Portfolio table 1 we detail the initial weights of the February 2020 portfolio and the weights at the end after taking capital gains over the six months into account.

In Portfolio table 2, we detail the new weights for the August 2020 portfolio. We aggregate the individual stock weights into sector weights.

The number of stocks in each sector depends upon the market share of the sector in the portfolio (determined by optimisation) and the strength of the risk adjusted expected returns (Sharpe ratios).

The current portfolio weights do not explicitly depend upon the weights or number of stocks in the previous portfolio.

Portfolio table 1: Old portfolio

Code	Name	Sector	Feb	Aug	Feb	Aug
WPL	WOODSIDE PETROLEUM	ENERGY	6.64%	5.37%	6.64%	5.37%
BHP	BHP GROUP	MATERIALS	6.57%	8.69%	13.43%	17.56%
AMC	AMCOR CDI		6.87%	8.87%		
AZJ	AURIZON HOLDINGS	INDUSTRIALS	2.40%	2.83%	10.44%	12.11%
CWY	CLEANAWAY WASTE MANAGEMENT		2.91%	4.33%		
CIM	CIMIC GROUP		2.51%	2.71%		
RWC	RELIANCE WORLDWIDE		2.62%	2.23%		
ALL	ARISTOCRAT LEISURE	DISCRETIONARY	6.55%	6.76%	6.55%	6.76%
TWE	TREASURY WINE ESTATES	STAPLES	7.48%	8.85%	7.48%	8.85%
CSL	CSL	HEALTH	7.39%	9.11%	14.19%	20.17%
RMD	RESMED CDI.		6.80%	11.07%		
MQG	MACQUARIE GROUP	FINANCIALS	12.48%	10.86%	37.87%	24.84%
LLC	LENDLEASE GROUP STAPLED UNITS		13.53%	7.97%		
VUK	VIRGIN MONEY UK CDI		11.86%	6.01%		
XRO	XERO	IT	1.80%	2.66%	3.40%	4.33%
CPU	COMPUTERSHARE		1.60%	1.67%		

Portfolio table 2: New portfolio

Code	Name	Sector	Aug	Aug
WPL	WOODSIDE PETROLEUM	ENERGY	4.85%	4.85%
BHP	BHP GROUP	MATERIALS	5.90%	15.87%
RIO	RIO TINTO		5.13%	
NCM	NEWCREST MINING		4.84%	
BXB	BRAMBLES	INDUSTRIALS	2.44%	9.32%
AZJ	AURIZON HOLDINGS		2.81%	
SEK	SEEK		2.10%	
ALX	ATLAS ARTERIA STAPLED UNITS		1.97%	
ALL	ARISTOCRAT LEISURE	DISCRETIONARY	3.41%	9.09%
CWN	CROWN RESORTS		2.84%	
SGR	STAR ENTERTAINMENT GROUP		2.85%	
WOW	WOOLWORTHS GROUP	STAPLES	2.91%	8.57%
COL	COLES GROUP		2.96%	
A2M	THE A2 MILK COMPANY(ASX)		2.70%	
CSL	CSL	HEALTH	4.66%	13.08%
SHL	SONIC HEALTHCARE		4.44%	
RHC	RAMSAY HEALTH CARE		3.98%	
WBC	WESTPAC BANKING	FINANCIALS	6.26%	34.56%
MQG	MACQUARIE GROUP		7.60%	
SUN	SUNCORP GROUP		6.23%	
LLC	LENDLEASE GROUP STAPLED UNITS		8.00%	
NHF	NIB HOLDINGS		6.47%	
APT	AFTERPAY	IT	4.67%	4.67%

Market expectations

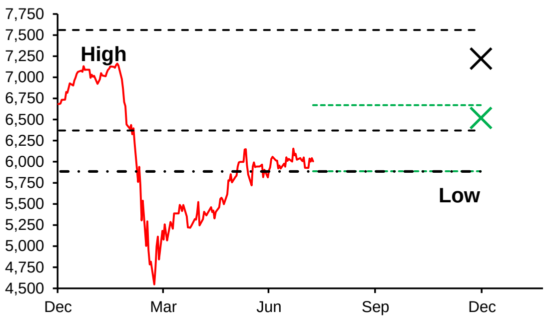
Our start-of-year 2020 eoy forecasts for the ASX 200 are given in Table 1 (left column) together with the latest calculations (right column) and last week's (middle column) for comparison. Chart 1 includes a trace of the index to compare with the forecast highs and lows.

Table 1: ASX 200 range forecasts for 2020

Forecast	Forecast origin		
CY20	**31-Dec-2019**	**31-Jul-2020**	**7-Aug-2020**
Low	6,350	5,800	5,900
High	7,550	6,650	6,650
End	7,200	6,500	6,500
Fair value	6,750	6,100	6,050
Exuberance	-1.3%	-2.9%	-0.8%
ASX 200	6,684	5,928	6,005

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 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.

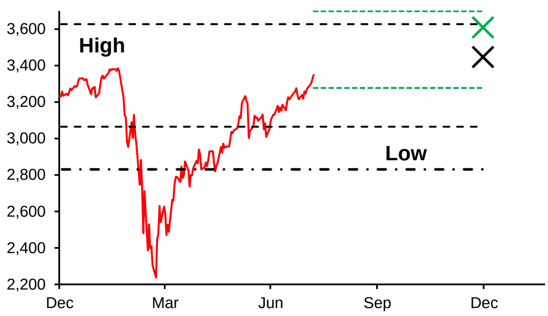
Our eoy 2020 forecasts for the S&P 500 are given in Table 2. Because overnight data are not available to us until the afternoon, the latest data for Wall Street will usually be presented for the day before the ASX 200 in this *Weekly* that we try to post at around 10am on a Saturday.

Table 2: S&P 500 range forecasts for 020

Forecast	Forecast origin		
CY20	**31-Dec-2019**	**30-Jul-2020**	**6-Aug-2020**
Low	3,060	3,190	3,280
High	3,630	3,640	3,700
End	3,450	3,560	3,610
Fair value	3,100	3,190	3,220
Exuberance	4.0%	1.6%	4.1%
S&P 500	3,231	3,246	3,349

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 3,610. Fair value is 3,220

Market stats

Our market volatility index (Chart A-1 to be found in the Chart Appendix) is above average at 16.4%. Our Fear Index (Chart A-2) is above the zone at 14.4%. The VIX stands above average at 22.2. Our Disorder index (Chart A-3) is in the zone at 0.9%.

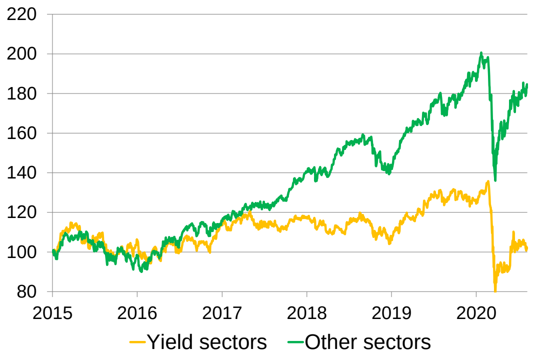
Our updated 12-month capital gains forecast (Chart A-4) is +21.8%. The market is cheap at -0.8% (Chart A-5). So that leaves the adjusted rolling 12-month capital gains' forecast at +22.8%. The comparable 12-month adjusted capital gains forecast for the S&P 500 stands at about +21%.

Sector pricing (Chart A-6) is such that Materials (+10.3%) is materially over-priced. IT (+5.7%) is expensive. The other sectors are moderately over-priced or 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 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 August 2020. We kept the style at 100% High Conviction. There are 23 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	9.4%	6.1%	3.2%
5 years	8.4%	6.3%	2.1%
3 years	9.1%	5.7%	3.4%
2 years	5.6%	1.8%	3.7%
1 year	-5.2%	-5.3%	0.1%
6 months	-19.1%	-13.5%	-5.6%
3 months	8.4%	11.7%	-3.3%

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 +3.2% p.a. (annualised) since inception. The portfolio has been returning +9.4% p.a.

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

We have no stocks beating the index by more than 10% since August 3rd 2020 and no stocks trailing by more than -10%.

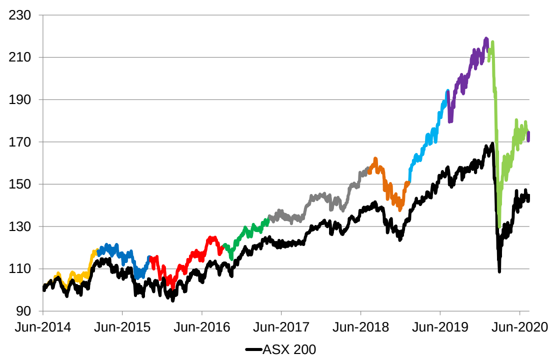
Table 4: Individual stock total returns

	A2M	ALL	ALX	APT	AZJ	BHP	BXB	COL
Return	-2.3%	7.3%	-4.2%	6.3%	2.1%	5.3%	-1.2%	-0.5%
Alpha	-3.6%	5.9%	-5.6%	4.9%	0.7%	3.9%	-2.6%	-1.9%
	CSL	**CWN**	**LLC**	**MQG**	**NCM**	**NHF**	**RHC**	**RIO**
Return	-1.1%	7.2%	0.5%	2.3%	1.2%	-0.7%	-0.3%	-0.5%
Alpha	-2.4%	5.8%	-0.8%	0.9%	-0.2%	-2.0%	-1.7%	-1.8%
	SEK	**SGR**	**SHL**	**SUN**	**WBC**	**WOW**	**WPL**	**ASX200**
Return	1.0%	10.0%	1.9%	0.7%	1.7%	-0.3%	1.6%	1.4%
Alpha	-0.4%	8.6%	0.6%	-0.7%	0.3%	-1.6%	0.2%	

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.

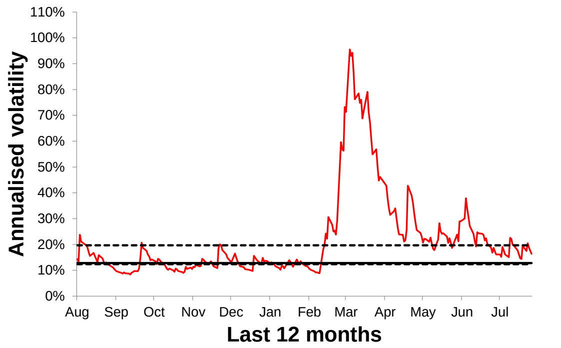
Chart 4: SMSF and ASX 200 total returns



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

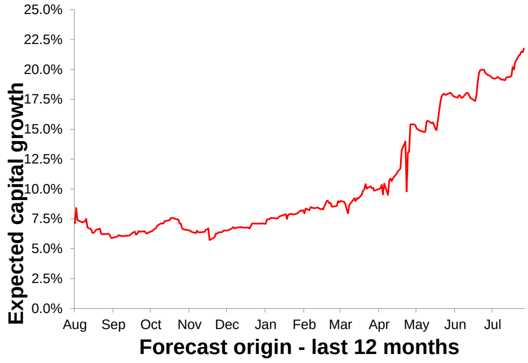
Chart Appendix

Chart A-1: Market volatility



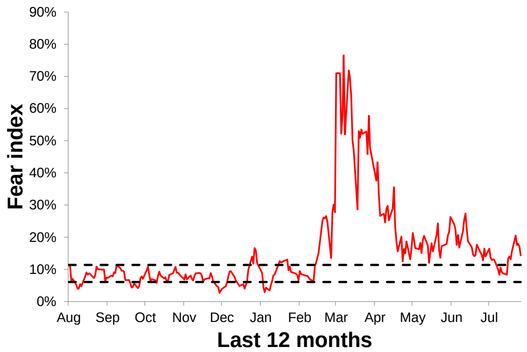
Notes: The solid black line depicts the average volatility since January 2010; the lower dotted line depicts the average volatility pre the GFC; the higher dotted line depicts the average level of volatility during the GFC - up to December 2009. The brown line is a daily estimate of the ASX 200 index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

Chart A-4: 12-month capital gains forecasts



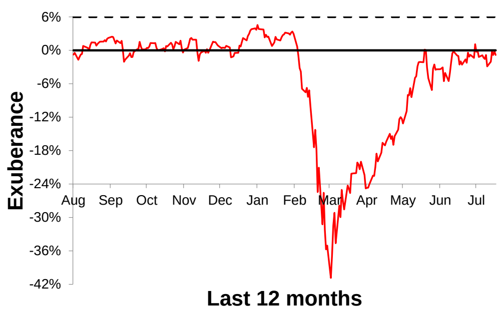
Notes: Each business day we update our estimates for capital gains on the ASX 200 for the following 12 months. For example, the left-most estimate on the vertical axis is a forecast for the 12 months concluding today. The right hand estimate is for the 12 months from today.

Chart A-2: Fear index



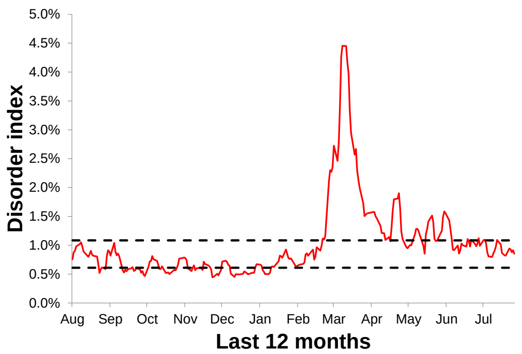
Notes: The fear index is a measure of 'excess' volatility denoting behaviour outside the open/close values each day. The two dotted lines depict the band in which the fear index resided before the GFC in two thirds of days. Extended periods below the lower dotted line might indicate complacency. Extended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

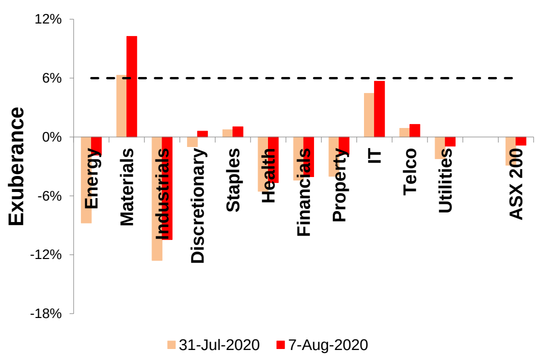
Chart A-3: Disorder index



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 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)