9 January 2021

Woodhall's Weekly

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- **Democrats take US Senate**
- **US nonfarm payrolls disappoint**
- **China-Australia trade war risks**

Overview

It was slightly surprising (to us and others) that the Democrats took both seats in the Georgia run-off elections on January 5th. The Dems now control both Houses. That means Biden will find it easier to move his agenda forward. But, as always, presidents don't always get their way given the checks and balances in the US voting system.

Over and above what we were thinking before the run-off, we now think there will be a much bigger fiscal stimulus and no change in Fed policy. Markets should like that! We also think that the US currency might weaken as a result. We chose to enter the market to deploy some of our 'emergency' cash holding (from our November 2nd 2020 sales). We think asset allocation (AA) decisions will dominate our thinking in 2021. We have replaced the former direct-equities section with a new section based on our actual AA decisions and the one following on our model portfolios.

Trump supporters stormed the Capitol in scenes reminiscent of the French Revolution at the Bastille. We did allow for such a possible backlash in our cash reserves. The only good thing about that riot was that it was largely contained and we think that might now be it. Of course, we have no expertise in the area, but we have to make financial decisions.

Biden does have a big tax agenda but we think Congress will dilute and delay it somewhat because of the negative impact it would have on economic growth. Therefore, we think the main emphasis on Wall Street will be very positive from the stimulus. And from here it could be 'bad news is good news' for additional stimulus.

Not only are hospitals very stretched in California and some other states, the new strains of COVID-19 are likely to make matters much worse.

It is largely unknown how the virus will react to vaccinations. Therefore, there is now more downside risk than upside. There have been many reported instances of distribution problems. The roll-out has been much slower than expected.

In Australia, we are now told that half of the population might be vaccinated by mid-2021. A few months ago, many were factoring in a big surge in vaccinations at the start of 2021! There is still a long way to go.

US nonfarm payrolls came in under expectations but the market rallied. The market expected 50k new jobs but they lost 140k! The unemployment rate was unchanged at 6.7%. Much of the job losses were in the obvious sectors but some strength appeared elsewhere

While iron ore prices have surged, Australian exports to China of other commodities and goods are being held up. This trade war must lower our expectations for economic growth in 2021. We see no end in sight. Indeed, with iron ore exports critical to our growth, might China stockpile a little and then cease importing for a while? While most of the news this week was good there are still plenty of skeletons in the cupboard.

Market expectations

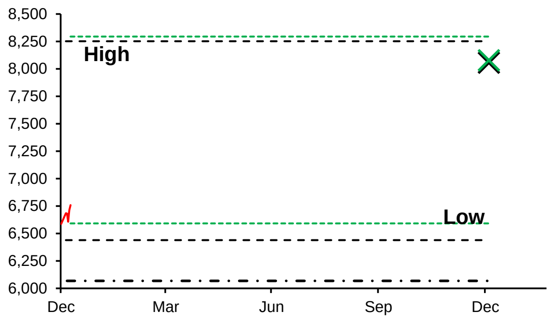
Our start-of-year 2021 eoy forecasts for the ASX 200 are given in Table 1 (left column) together with the latest calculations (right column) and last week's (middle column) for comparison. Chart 1 includes a trace of the index to compare with the forecast highs and lows.

Table 1: ASX 200 range forecasts for 2021

Forecast	Forecast origin		
CY21	**31-Dec-2020**	**1-Jan-2021**	**8-Jan-2021**
Low	6,450	6,450	6,600
High	8,250	8,250	8,300
End	8,050	8,050	8,100
Fair value	6,500	6,500	6,550
Exuberance	1.2%	1.0%	3.0%
ASX 200	6,587	6,587	6,758

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 2021 (left-hand column in Table 1) was 8,050 with a forecast high of 8,250 and a forecast low under normal volatility of 6,450. The 'high-volatility' forecast low was 6,050. The updated eoy 2021 forecast (Table 1, last column) is 8,010. Fair value is 6,550.

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.

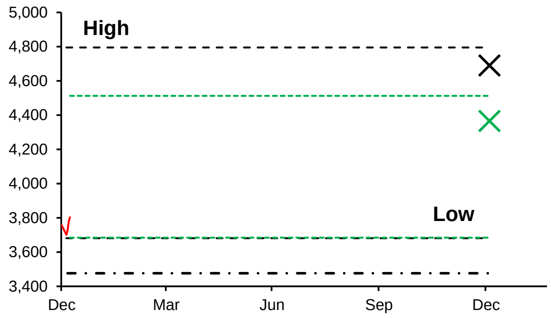
Our eoy 2021 forecasts for the S&P 500 are given in Table 2. Because overnight data are not available to us until the afternoon, the latest data for Wall Street will usually be presented for the day before the ASX 200 in this *Weekly* that we try to post at around 10am on a Saturday.

Table 2: S&P 500 range forecasts for 2021

Forecast	Forecast origin		
CY21	**31-Dec-2020**	**31-Dec-2020**	**7-Jan-2021**
Low	3,680	3,680	3,680
High	4,800	4,800	4,510
End	4,690	4,690	4,370
Fair value	3,610	3,600	3,660
Exuberance	4.1%	4.1%	3.8%
S&P 500	3,756	3,756	3,804

Note: see notes for Table 1.

Chart 2: Graphical representation of Table 2



Note: see notes to Chart 1.

Our original forecast for eoy 2021 was 4,690 with a high of 4,800 and a low of 3,680. The 'high-volatility' low was 3,480. The updated eo6 forecast for the S&P 500 is 4,370. Fair value is 3,660

Market stats

Our market volatility index (Chart A-1 to be found in the Chart Appendix) is above average at 17.0%. Our Fear Index (Chart A-2) is in the zone at 7.7%. The VIX stands above average at 21.6. Our Disorder index (Chart A-3) is above the zone at 1.2%.

Our updated 12-month capital gains forecast (Chart A-4) is +23.8%. The market is a little expensive at +3.0% (Chart A-5). So that leaves the adjusted rolling 12-month capital gains' forecast at +20.1%. The comparable 12-month adjusted capital gains forecast for the S&P 500 stands at about +15.1%.

Sector pricing (Chart A-6) is such that the Materials (+17.0%) and Energy (+9.9%) sectors are in the danger zone. Financials (+3.9%) and IT (+3.6%) are significantly overpriced. All other sectors are inexpensive or cheap.

SMSF Asset Allocation

We started reporting the direct domestic equities components of our SMSF from its inception on June 25th 2014. On November 2nd we deviated from the algorithmic approach because we wanted a cash reserve to see us through the US elections (and any backlash); the fallout from COVID-19; and the China-Australia trade war.

We held about 16% of the AA in cash from November 2nd 2020 to January 7th 2021.

On the announcement of the Georgia run-off elections as a double win for the Democrats on January 7th 2021, we immediately deployed a large portion of our cash reserve to take advantage of what we perceived to be the 'new future'. We may/will deploy more cash when there is more certainty about the fallout form COVID-19 and the China-Australia trade war.

Each month we also compute a fresh allocation between the ASX 200 and the S&P 500. We only use the optimised weights as a guide because of the cost of trading and possible CGT events.

We had been running about a 50:50 split between direct domestic equities and international ETFs. The sharp change in the weights in Table 3 for the start of 2021 optimisation are shown in Table 3.

Table 3: International Allocation Optimisation based on Woodhall forecasts 31st Dec 2020

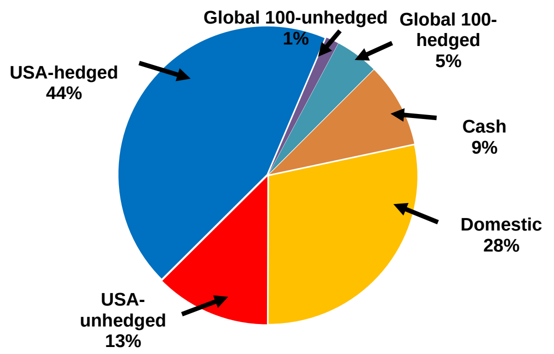
Index	Weights	Returns	Vol.
ASX 200	35.0%	27.4%	15.2%
S&P 500	65.0%	31.4%	12.1%
Portfolio	100.0%	30.0%	9.8%

Along with our optimisation procedure, we note that the US Democrats now hold both houses and so Biden will find it easier to pass bills. Most people, including us, seemed to have been expecting a split Congress.

We think Democrats will launch a much bigger stimulus package to offset the COVID-19 fallout. This change in policy might also make the US dollar weaker relative to our dollar. As a result, we wished to increase out (currency) hedging ratio.

We bought a significant portion of IHVV (Blackrock's currency-hedged exposure to the S&P 500) to accompany our existing holding and our existing holding of IVV (the unhedged version). We did not change our direct equities exposure nor our exposure to large (top-100) global ETFs, IOO, and IHOO, being the hedged version of Blackrock's IOO. The new AA is shown in Figure 3 for the rebalancing date.

Figure 3: AA at close of 7th January 2021



Our hedge ratio stood at just over 75% at the start of this January 7th 2021 regime. Excluding cash, the domestic/international split was about 30%. We left a little room to deploy more cash in direct domestic equities if the China situation is resolved giving us the preferred 35:65 split or international ETFs if the COVID situation improves (or both).

We will not change this section until there is a major deliberate change in our AA. We will however add a log of comments from hereon in.

9/1/2021 Start of log

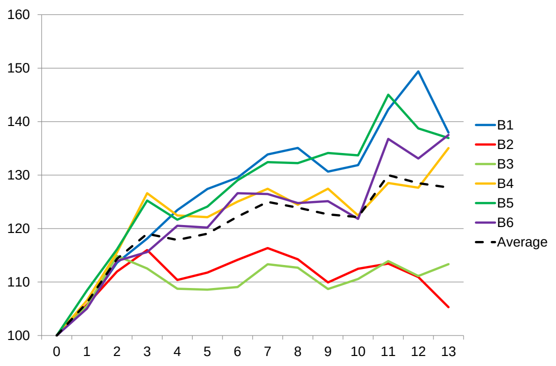
US nonfarm payrolls missed expectations but market rallied. Bad news is good news over stimulus?

Model portfolios

For the last six years or so we have reported on our model direct domestic equity portfolios. However, in practice we did sometimes deviate from the rules a little (as we reported). The following results are derived from a strict adherence to the rules.

We found that rebalancing on the first trading day of the month and then six months later, etc, was preferred. A six-month holding period gives time for the recommendations to kick in but not so long as to get stale.

Figure 4: Model portfolio relative performance

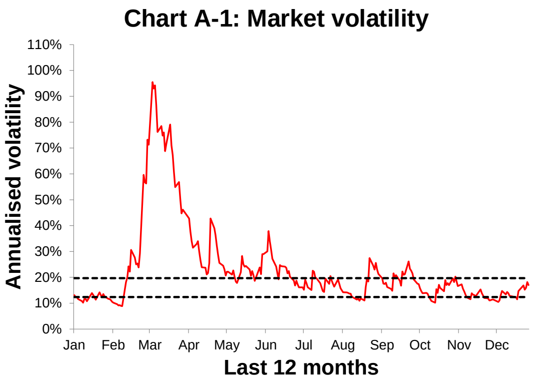


The B1 portfolios start in February 2014 and rebalance in August 2014, etc. B2 portfolios start one month later in March 2014, etc. The B6 portfolio starts in July 2014 etc. The numeral on the x-axis refers to the number of 6-monthly rebalances.

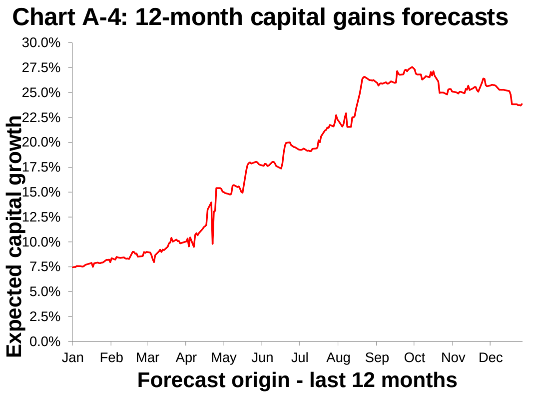
Since February and August are the focus of reporting seasons on the ASX 200 we note starting at or just before reporting season commences is preferable. Starting a month or two late (B2 and B3) produced the poorest performance.

Since the lines in the chart are the derived portfolio accumulation index versus the benchmark index, B1 has outperformed by about 38% (ratio 138) since inception. The average is just under 30% outperformance. The worst (B2) still outperformances but at just less than 10%. Of course, none of these performance statistics is annualised.

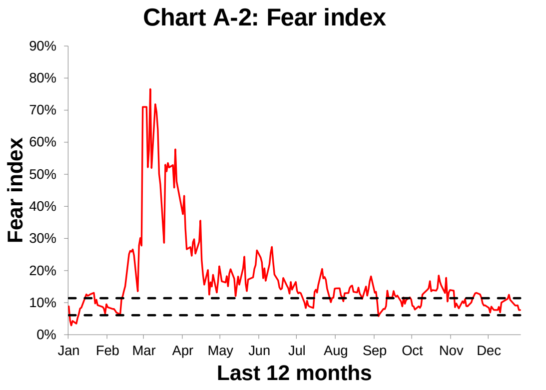
Chart Appendix



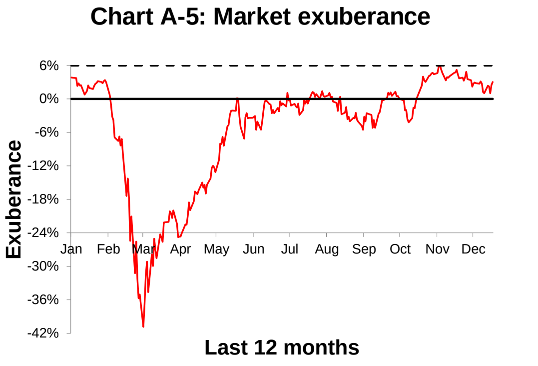
Notes; the lower dotted line depicts the average volatility pre the GFC; the higher dotted line depicts the average level of volatility during the GFC - up to December 2009. The red line is a daily estimate of the ASX 200 index volatility.



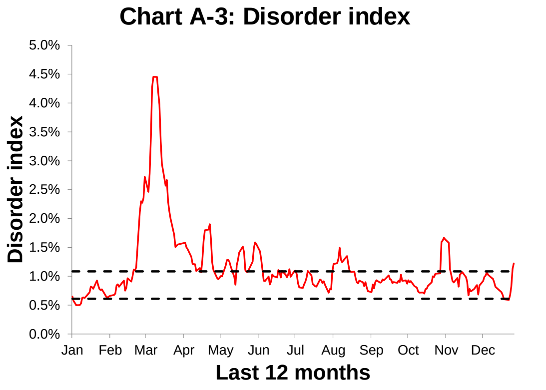
Notes: Each business day we update our estimates for capital gains on the ASX 200 for the following 12 months. For example, the left-most estimate on the vertical axis is a forecast for the 12 months concluding today. The right hand estimate is for the 12 months from today.



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.



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.



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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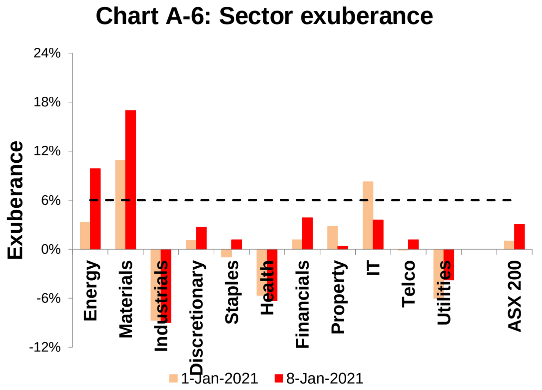

Notes: The estimates in this chart are based on the same notions as for Chart A-5. More detailed information on mispricing is contained in our companion weekly publication in the same section of our website

Glossary

Abenomics – Japan's former Prime Minister Shinzo Abe came to power early in 2013 and has brought a new economic style to managing that economy. PM Suga has vowed to continue the policies.

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 was finalised by the end of 2020 continue.

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. 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, Yoshihide Suga, since 16th September 2020; 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, Joe Biden, from January 20th 2021 (4-year term); Chair of the Federal Reserve Bank (**Fed**), Jerome "Jay" Powell, since 5th February 2018 (4-year term)