30 July 2016

Woodhall's Weekly

Ron Bewley PhD, FASSA

Bumper July

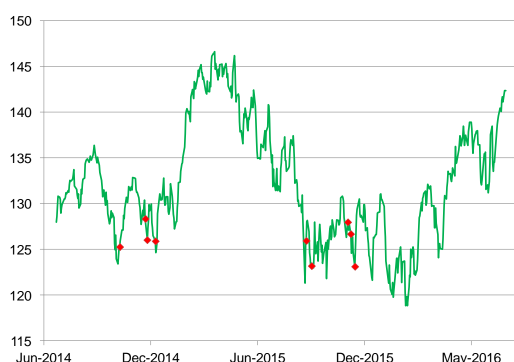
- **ASX 200 up +6.3% in July**
- **Inflation still low in Oz**
- **Mixed GDP reads overseas**

Overview

It's hard not to feel happy when our market posts a big gain like it did in July – up +6.3% for the month and the third weekly positive return just came in.

When I produced the chart below for the first time during the week I was close to manic. My geared strategy discussed later in this report was not looking as good as I felt it should. I had indeed been buying on the dips here and in Wall Street through ETFs but my capital gains seemed puny.

Chart: IOZ buy points – IOZ accumulation index



I worked out that my ETF lost nearly -4% against the benchmark but it made up most of that in extra yield. Hence the massive difference between the accumulation-index chart for the IOZ ETF's accumulation index and the ASX 200 price index in Chart 7.

The red dots which show my buying on the dips given by the signals discussed in the next section now seem to have proven to have been useful.

Of course I must take out interest payments and add in franking credits to get the full picture – but I am getting there.

But the best bit is that I have the ASX 200 finishing FY17 comfortably above 6,000. I might have to start selling before then if the 'high' forecast of 6,150 is indeed reached (Table 1a) for 2016. But with the 'high' for FY17 at 6,350 it will be a while before I have done anything more than take a little off the table.

Back the macro data! Our CPI came in at about expectations. That is +0.5% for the headline number and +0.4% for both the trimmed mean and the weighted mean. At 1% for the year, the RBA is in no danger if it cuts on Tuesday as many (including me) expect. But the chance of a cut on Tuesday fell from 70% to 55% after the CPI read.

The Fed, of course, didn't move after its FOMC meeting on Thursday. It hinted that September is a 'live' meeting but nobody listens – especially after their latest GDP data. Not only did it make a big miss for Q2 – only +1.2% (annualised) against an expected +2.5% but Q1 was revised down from +1.1% to +0.8%.

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But Britain pulled one out of the bag with a +0.6% for the quarter (not annualised) against an expected +0.4%. Europe's growth was less than impressive and Brazil is diving headlong into a big recession. Venezuela is reportedly using force labour on farms and Japan fell short of the hype when the BoJ didn't do much on monetary stimulus after kicking in nearly $US300bn in fiscal stimulus.

The nonfarm payrolls in a few days will give us a better read on the state of the USA economy after the bumper read at the start of July. But my take is that talk of crises is subsiding and a bottom may be forming in world growth. I feel positive for markets while I watch from 'home' in the North of England.

I can't wait to get a take on Brexit from the industrial north – and even more for a pint (or two) of Timothy Taylor's Landlord plus a few scotch eggs, black pudding and British pork sausages (yes, they are different). And both my geared portfolio and SMSF seem in good shape.

My son (with his wife and two boys) is coming over to meet my brother for a few days. That will be three Drs Bewley and two smashing little Bewley boys.

Please remember that I'll still be posting while I am away but at the later time of Saturday evening Sydney time.

Market expectations

My start-of-year 2016 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 1 includes a trace of the index to compare with the forecasts highs and lows. And we now add the new FY17 forecasts in Table 1b.

Table 1a: ASX 200 range forecasts 2016

Forecast	Forecast origin		
Cal '16	1-Jan-2016	22-Jul-2016	29-Jul-2016
Low	5,100	5,350	5,400
High	6,150	5,950	6,050
End	5,850	5,750	5,800
Fair value	5,350	5,400	5,400
Exuberance	-0.7%	2.2%	2.8%
ASX 200	5,296	5,498	5,562

Table 1b: ASX 200 range forecasts FY2017

Forecast	Forecast origin		
FY '17	1-Jul-2016	22-Jul-2016	29-Jul-2016
Low	5,100	5,300	5,350
High	6,350	6,300	6,400
End	6,150	6,050	6,100
Fair value	5,350	5,400	5,400
Exuberance	-2.1%	2.2%	2.8%
ASX 200	5,233	5,498	5,562

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 to 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 date to the end-of-year and the greater is any mispricing.

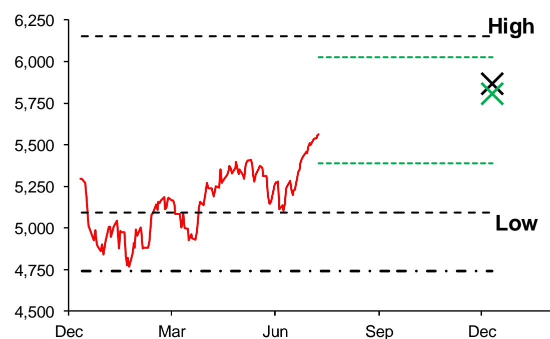
The original eofy forecast for June 30th 2017 (left-hand column in Table 1b) is 6,150 with a forecast high of 6,350 and a forecast low under normal volatility of 5,100. The 'high-volatility' forecast low is 4,785. See the IOZ:IVV:IHVV section for the decision rules surrounding these low and high forecasts.

The e-o-y 2016 forecast (Table 1a) improved over the last week to 5,800 from 5,750. Fair value is steady at 5,400 above where we started 2016.

The eofy forecasts also improved over the week. 6,400 is a possible high before mid-2017 and we could finish comfortable above 6,000 – by 100 points.

The index is well above the buy signal of 5,100 ('Low' Jul 1 forecast in Table 1b) but well short of the sell signal. The SPI is up +17 pts for Monday.

Chart 1: Graphical representation of Table 1a



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 updated 2016 – and our FY17 – forecasts for the S&P 500 are given in Tables 2a and 2b. Because overnight data are not available to me 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.

The eoy forecast was steady at 2,330 over the week which is almost back to our forecast made on Jan 1 but that does not take into account overnight action. The data will drop in mid-afternoon today. The S&P 500 is above buy territory on the IOZ:IVV strategy.

The eofy forecast update in Table 2b is also steady – at 2,530. The high forecast is up to 2,620 and the low under normal volatility is 2,110.

Table 2a: S&P 500 range forecasts 2016

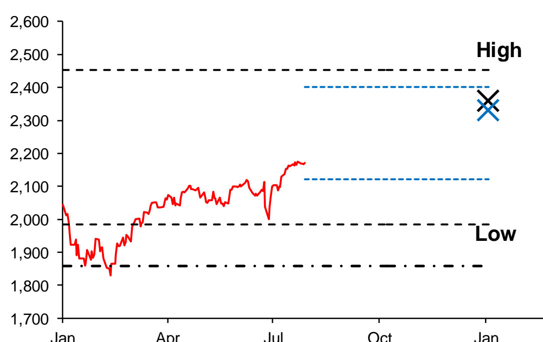
Forecast Cal '16	Forecast origin 1-Jan-2016	21-Jul-2016	28-Jul-2016
Low	1,980	2,120	2,120
High	2,450	2,400	2,400
End	2,360	2,330	2,330
Fair value	2,100	2,140	2,140
Exuberance	-3.3%	1.4%	1.2%
S&P500	2,044	2,165	2,170

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

Forecast FY '17	Forecast origin 1-Jul-2016	21-Jul-2016	28-Jul-2016
Low	2,050	2,110	2,120
High	2,610	2,610	2,620
End	2,530	2,530	2,530
Fair value	2,100	2,140	2,140
Exuberance	-0.8%	1.4%	1.2%
S&P500	2,099	2,165	2,170

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 to 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 date to the end-of-year and the greater is any mispricing.

Chart 2: Graphical representation of Table 2a



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.

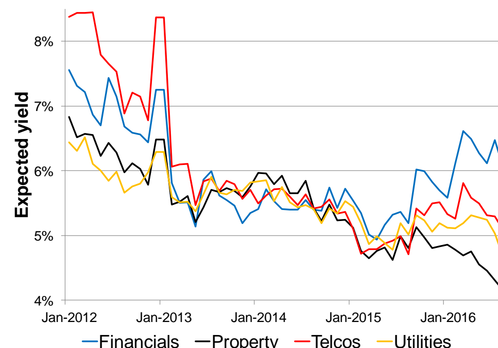
Market stats

Our market volatility index (Chart A-1 found in the Chart Appendix) is down to 8.9% which is well below average even for good times. Our Fear Index (Chart A-2) is normal at 9.7%. The VIX is below normal at 11.9%. Our Disorder index (Chart A-3) is at the bottom of the normal range. As a result, conditions are very good for rebalancing but care should be taken because four sectors are in possible correction territory.

Our 12-month capital gains forecast (Chart A-4) lost nearly 1% point to +13.6%, largely on the back of a lower forecast for Financials. The market is above fair pricing at +2.8% (Chart A-5) but not uncomfortably so. So that leaves the adjusted 12-month capital gains' forecast at +10.4%. The comparable 12-month adjusted capital gains forecast for the S&P 500 stands at about +18%.

The Discretionary, Health, Property and Utilities sectors are in correction territory (or a prolonged sideways movement) (Chart A-6) and Industrials is only just short of the 6% trigger at +5.2%. Only one sector is cheap – Energy at -5.5% probably because of the small beating oil prices faced over the week.

Chart 3: Dividend Compression



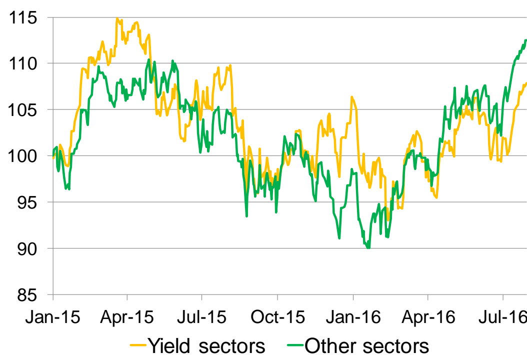
As can be noted from Dividend Compression (Chart 3), the co-movement we observed for about three years from January 2012 has broken down. The expected yield for Financials is 6.1% plus franking credits and 4.3% for the ASX 200. Property is getting close to 4% yield. Given these stocks do not usually provide franking credits, they seem very over-bought – particularly since the exuberance statistic is at a worryingly large +9.2%!

The yield play definitely waned during 2016. 'Other' sectors are beating the 'high yield' sector total returns by +13.1% y-t-d. High yield sectors at last are up on the year at 1.8% this year while 'other' has gained +14.9%. Yield seekers have been

paying the price. Big dividends are not much use if the capital losses offset them!

But Chart 4 shows a more interesting picture. The yield sector lost relative to 'other' around the end of 2015 but the two lines got back together in February but broke free again at the end of June. However, in the last week or two, yield has been trying to stay in line!

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

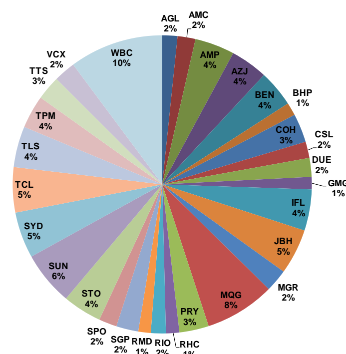


SMSF Share Portfolio

I last rebalanced my SMSF on November 2, 2015. I combined my new Yield Conviction portfolio with a High Conviction portfolio in about equal proportions. The notion behind the strategy is to note that I believed the pure yield play might be soon over. This 50:50 strategy is, in essence, an each-way bet which I intend to keep for the medium term given my sectoral analyses.

There are 29 stocks. My current holdings are given in Chart 5.

Chart 5: Current holdings



The performance of my domestic equities in my SMSF portfolio – including the impact of the March 5th 2015 and the November 2nd rebalances – against the ASX 200 since late June 2014 is shown in Table 3. That corresponds to an outperformance of +5.0% (annualised). After all of the turbulence of recent times the portfolio is still returning +10.9% pa for more than two years.

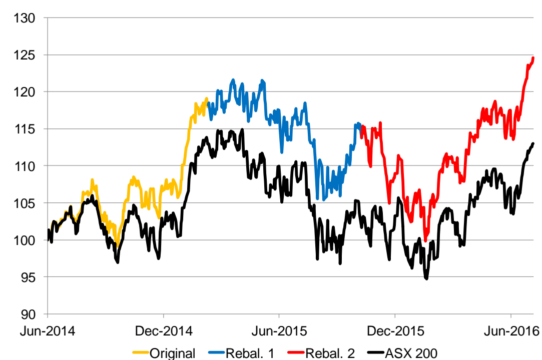
Table 3: Annualised returns from SMSF

	Portfolio	ASX 200	Alpha
Cap gains	5.4%	1.4%	4.0%
Tot rets	10.9%	6.0%	5.0%

Note: Since June 25th 2014

The returns chart (Chart 6) shows the recent outperformance 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.

Chart 6: SMSF and ASX 200 total returns



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

I am off to England for a month or so on Tuesday so I will rebalance after I get back near the end of the predicted 12-month lifespan of that portfolio. I will still be posting my Weeklies on Saturday mornings – just GMT not Sydney time.

Table 4 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.

AZJ took a big hit to its recommendation over the week but it is still hanging on at 3.0. With reporting season breathing down our necks, confession season is over and the reports will start to land in our in-boxes.

Confession season has been so quiet that maybe we are ready to make another charge up. Much is made about current earnings against those for the next quarter in the US or half-year at home. I use four years of earnings to construct my views – hence the difference between what I write and others may say elsewhere.

Table 4: Price and current broker forecasts

Sector	Stock	Price	Target	Rec	T/P - 1
Energy	SANTOS	4.39	5.10	2.54	16.2%
Materals	AMCOR	15.02	12.06	2.58	-19.7%
	BHP BILLITON	19.52	15.52	2.53	-20.5%
	RIO TINTO	49.56	40.82	2.44	-17.6%
Industrials	SPOTLESS GROUP HOLDINGS	1.20	1.37	2.25	14.6%
	AURIZON HOLDINGS	5.20	4.60	3.00	-11.5%
	SYDNEY AIRPORT	7.56	7.20	2.58	-4.8%
	TRANSURBAN GROUP	12.56	11.95	2.54	-4.9%
Discretionary	JB HI-FI	25.94	24.45	2.67	-5.7%
	TATTS GROUP	4.13	3.95	2.70	-4.4%
Health	COCHLEAR	132.73	109.27	3.17	-17.7%
	CSL	118.00	86.14	2.58	-27.0%
	PRIMARY HEALTH CARE	4.09	3.68	3.00	-10.0%
	RAMSAY HEALTH CARE	78.79	70.50	2.43	-10.5%
	RESMED CDI.	9.20	6.57	2.36	-28.6%
Financials	AMP	5.81	6.05	2.20	4.1%
	BENDIGO & ADELAIDE BANK	10.15	9.50	2.93	-6.4%
	IOOF HOLDINGS	9.04	8.75	2.67	-3.2%
	MACQUARIE GROUP	74.39	81.25	2.46	9.2%
	SUNCORP GROUP	13.43	13.42	2.39	-0.1%
	WESTPAC BANKING	31.09	32.18	2.47	3.5%
Property	GOODMAN GROUP	7.54	7.10	2.18	-5.8%
	MIRVAC GROUP	2.20	2.07	2.27	-5.9%
	STOCKLAND	5.04	4.60	2.00	-8.7%
	VICINITY CENTRES	3.46	3.18	3.09	-8.2%
Telcos	TELSTRA	5.77	5.75	3.13	-0.3%
	TPG TELECOM	12.83	11.40	2.38	-11.1%
Utilities	AGL ENERGY	20.58	19.90	2.82	-3.3%
	DUET GROUP	2.69	2.40	2.73	-10.8%

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.

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 January 1 2017:*

Buy IOZ at 5,100 from Table 1b (up to maximum levels determined by risk assessments) and start to sell at 6,350 for new investments. If the ASX 200 falls to 4,785 it might be prudent to exit the strategy until clarity emerges and then buy back in at (well) above 4,785 and below 5,100.

For old investments start to take profits (lightly) at 6,150 (the 2016 forecast high in Table 1a) and more aggressively at 6,350.

Buy IVV:IHVV at 2,050 (up to maximum levels determined by risk assessments from Table 2b) and sell at 2,610 for new investments. If the S&P 500 falls to 1,930 it might be prudent to exit the strategy until clarity emerges and then buy back in at (well) above 1,930 and below 2,050.

For old investments start to take profits (lightly) at 2,450 (the 2016 forecast high in Table 2a) and more aggressively at 2,610.

Two weeks ago I pointed out that I had just discovered that Table 5 had been under-reporting the returns on the IOZ strategy. The calculations were correct but IOZ has not been keeping up with the index in capital-gains terms. The first trades should be about 5% higher! However, the accumulation index of IOZ has kept pace so higher yields have offset lower capital gains. I reported gains because the yield was designed to pay the margin loan interest.

I have now adjusted the table to reflect total returns and I have included a new Chart 11 at the end to show the buys in relation to the IOZ accumulation index. The difference between the price index for the ASX in Chart 7 and the IOZ accumulation index in Chart 11 is more than stunning. Charts 7 to 10 are still based on the price indexes as this is the metric where the signals are being made.

Franking credits on IOZ are not included. Of course, interest payments should be deducted if gearing is being used. I'll get ready to include interest soon!

The strategy is very much in positive territory at +10.9% pa since inception (Table 5) (now including dividends). The IVV-IHVV leg is up +12.0% pa. The IOZ part of the strategy now showing its true colours at +10.0% pa! The table below shows that I am now 60% hedged in the Wall Street component. The domestic share of the portfolio is 49%.

If I calculate the same IRRs in capital gains, the IOZ figure falls from 10.0% to 2.7%. That is close to 7.3% yield excluding franking credits! No negative gearing here.

Table 5: Total returns on IOZ:IVV strategy

29-Jul-2016	Inc divs.	Current allocation	
ETF	**IRR pa**	**Total**	**USA**
IOZ	10.0%	49%	
IVV+IHVV	12.0%	51%	100%
IVV	10.3%		40%
IHVV	19.4%		60%
Total	10.9%	100%	
Indexes		**Alpha pa**	
ASX 200	6.2%	3.7%	
S&P 500	6.9%	3.5%	
S&P 500 ($A)	10.4%	9.1%	

NB: IRR is the internal rate of return (pa) 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) starts on 22/12/2014 when IHVV first became available.

I have also included the benchmarks for each ETF in Table 5 so I can calculate any outperformance from the buying low – selling high strategy.

The Charts 7 to 11 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 76c, a fleet-of-foot trader might have better performed than my sit and wait philosophy.

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. Indeed, my ASX forecasts have strengthened over the last 12 months. 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 if 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 7: IOZ buy points - ASX 200

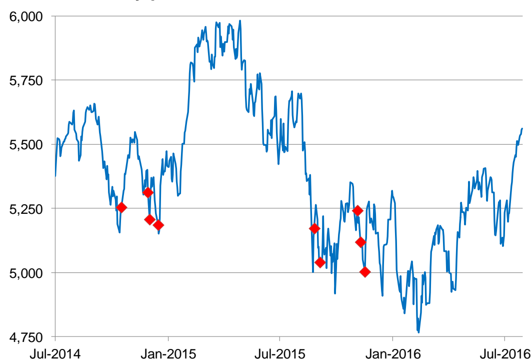


Chart 8: IVV buy points - S&P 500 ($US; hedged)

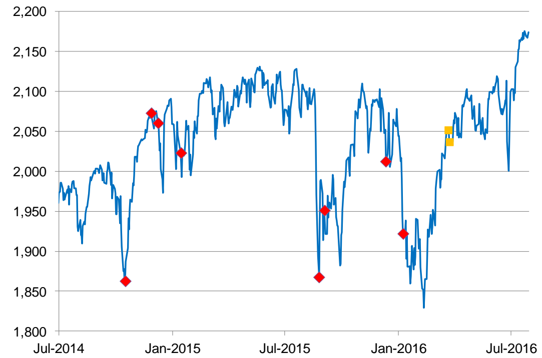


Chart 9: IVV buy points S&P 500 ($A; unhedged)

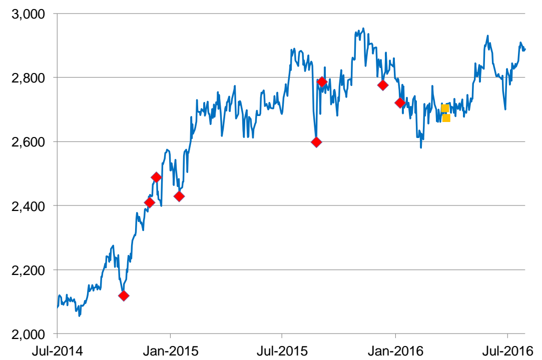


Chart 10: AUD hedging points

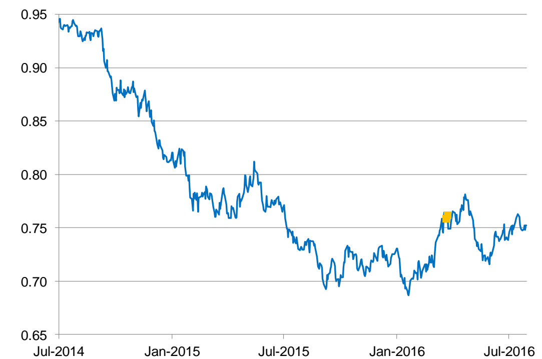
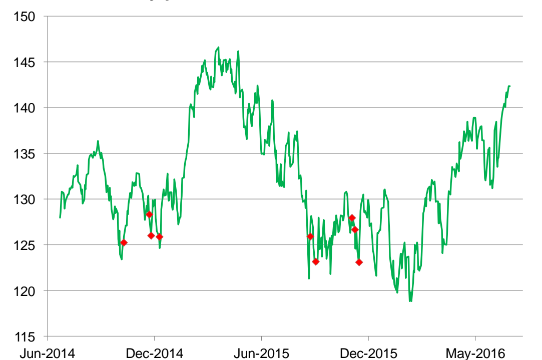


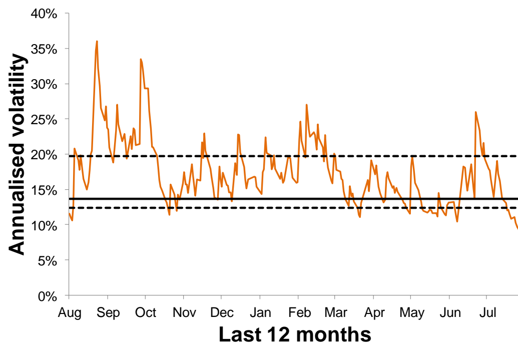
Chart 11: IOZ buy points – accumulation index



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.

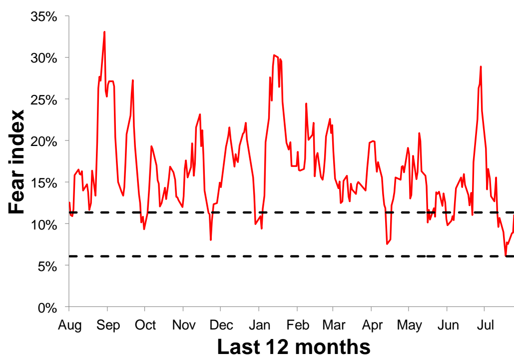
Chart Appendix

Chart A-1: Market volatility



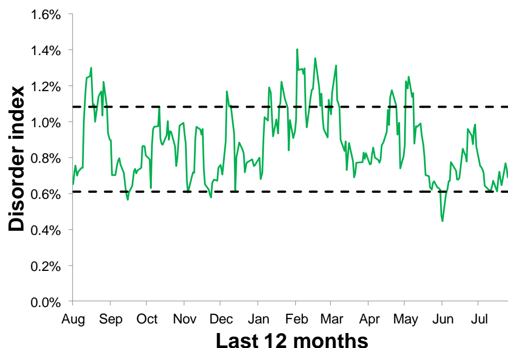
Notes: The solid black line depicts the average volatility since January 2010; the lower dotted line depicts the average volatility pre the GFC; the higher dotted line depicts the average level of volatility during the GFC - up to December 2009. The brown line is a daily estimate of the ASX 200 index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

Chart A-2: Fear index



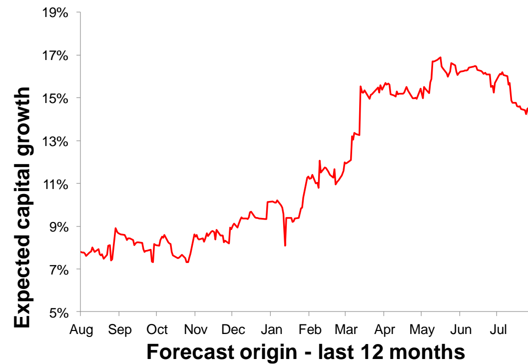
Notes: The fear index is a measure of 'excess' volatility denoting behaviour outside the open/close values each day. The two dotted lines depict the band in which the fear index resided before the GFC in two thirds of days. Extended periods below the lower dotted line might indicate complacency. Extended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



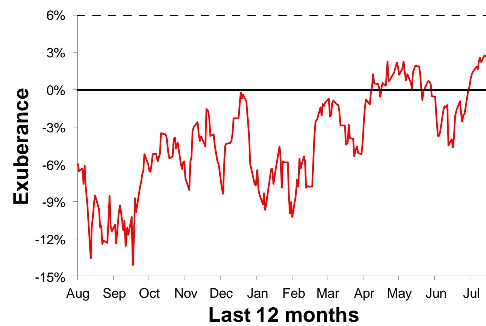
Notes: The disorder index measures the degree to which the 11 sectors' daily returns move in harmony. The two dotted lines depict the band in which the disorder index resided before the GFC in two thirds of days. Extended periods below the lower dotted line might indicate belief that there is little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



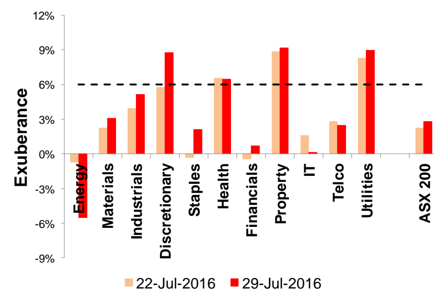
Notes: Each business day we update our estimates for capital gains on the ASX 200 for the following 12 months. For example, the left-most estimate on the vertical axis is a forecast for the 12 months concluding today. The right hand estimate is for the 12 months from today.

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!!!

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!

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.

It appears that any defaults in the shadow banking system would be covered by the Central Bank so there would not be the sort of contagion problems that arose in the US and Europe. However, a serious round of defaults in China would put a bit of a brake on growth.

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.

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 – This 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.

Short-run mispricing – This 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.

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 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.

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

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 – particularly in the context of the tapering discussions.