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3 December 2016

# Woodhall's Weekly

## Nonfarm payrolls still show signs of weakness

- **Twitchy market at home**
- **US nonfarm payrolls data – negative wage growth**
- **UK and US economic growth impress but what about us?**

### Overview

It was another crazy week on the ASX 200. On Tuesday, Vocus (which I held) crashed around 25% on a profit downgrade and took TPG (another I hold) went part-way with it as collateral damage. Bellamy's – and other China facing stocks (which thankfully I don't hold) – took an even bigger beating on Friday on new regulations in China. A lot of market darlings now look in trouble. The market was down -1.1% on the week in line with a number of major markets around the world.

It is an era when the market is taking unusually harsh action in the face of bad or even just ordinary news. I sold VOC during the day on Tuesday just before the bottom of its market. My new position is to consider bailing out if a stock falls behind the benchmark by 20% or more. In a little study I did on my recommended portfolios, I found only one stock from a number would have rebounded within a reasonable time after such a fall.

I had previously split my 'recommended allocation' in Telcos last October between TPG and VOC rather than sell my TPG and buy only VOC (see the rebalance section at the end of this report). So the impact wasn't too major on my overall performance. TPG is struggling but so many analysts are still talking this stock up. I'm sticking with it.

I also took the opportunity to spend almost four times as much as the VOC proceeds on buying a

CBA play by drawing down some more cash. I normally hold CBA so it was a natural stock to buy. Its consensus recommendation is only 3.0 but that's fine for a big bank. I have been a strong believer of holding just CBA and WBC from the big four but I sold down CBA a while ago when the stats went against that play.

I was also spurred on by the upgrade in Financials' forecasts I reported last week. I then wrote, "This upgrade [of Financials' expected returns] could be revised back down in the days ahead. Occasionally gremlins creep into the broker forecast download I rely on. But this looks like a reasonable upgrade because of the global influence of increasing interest rates and the 'Trump effect'." Well it wasn't. You can't win them all! On Thursday 1<sup>st</sup> December, my forecasts were revised back to about the numbers from the week before because of changes to the broker forecasts of earnings.

Given the momentum in the market – particularly Financials – I shall hold on to CBA until a new direction becomes evident. These things happen! The dividend looks pretty safe and the capital losses of recent times might have been arrested. After all, I also wrote last week that, "I still have a little left in my war chest but I have no well-defined plan to use it. It is the sort of market when one needs to move decisively, quickly and strategically." I have less in my war chest now! I am still looking on the fringe for opportunities.

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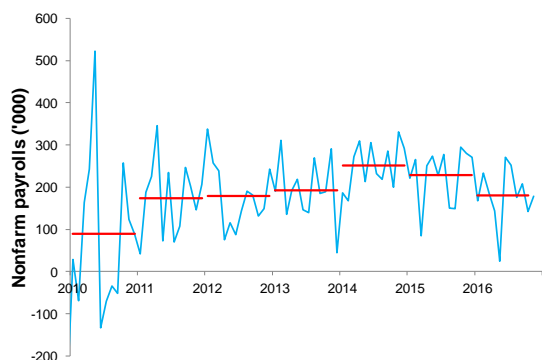
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Oil prices surged +17% on the OPEC deal announcement over the week. It took the oil stocks with them and my big gains on Santos wiped out my losses on Vocus, and then some. Hooray for diversification! If VOC hadn't tanked my outperformance stat would have jumped right up there.

US Nonfarm payrolls came in at +178,000, which is up from +142,000 the month before. Unemployment fell to a nine year low at 4.6% from 4.9% the month before but wage growth was negative.

The Fed is priced in to hike this month at about a 98% chance after these numbers 'dropped'. But when I look at the chart below that shows the monthly data along with the monthly averages for each calendar year I still see a problem.

**Chart of the Week: US nonfarm payrolls and annual averages**



The average for 2016 (y-t-d) is about the same as in 2011, 2012 and 2013 when there were no hikes and analysts were worried about the state of the economy. Of course less new jobs are needed the lower is the unemployment rate.

But negative wage growth is not consistent with capacity constraints in the labour market. Part-time employment proportions have been rising for 'non-economic' reasons. That is being interpreted on Bloomberg TV as people preferring part-time work rather than not being able to find full-time (for 'economic reasons'). My take is that some people are going part-time rather than not working at all because their partner is not earning enough!

Mohamed El-Erian and Bill Gross, who together ran PIMCO for years before exiting in recent times, were interviewed separately on Bloomberg TV this morning. Both talked up the chance of rate hikes and El-Erian specifically laid down one hike this month and two next year.

I think it is too soon to go yet because of the nfp data and there may be repercussions if they go as

expected. The Trump effect will not take hold next year – it is too soon.

Both UK and US growth figures were revised up – both to around 3%. Our GDP data comes out on Wednesday and there is an excellent chance it will be negative – which is far from excellent. Although our full-time employment growth has also been negative, it looks like being only a blip if we do indeed get a negative result. I'm not thinking recession at all. More likely growth will be a weak read next week and for quarters to come.

The RBA board will be in a quandary given the timing of the read – GDP comes out the day after the board meeting. They don't get a sneaky preview! But they do know what the market expects. I'll pencil in a cut for Tuesday. It's a lonely place.

Given our GDP release on Wednesday, the RBA meeting on Tuesday and the Fed mid-December meeting along with our Labour force data, it's going to be a busy fortnight ahead.

I'll be looking for opportunities to deploy the last of my war-chest over this next couple of weeks. I don't plan on holding cash going into 2017 (except for transactional buffers, of course)

**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 1a includes a trace of the index to compare with the forecasts highs and lows. And we add the FY17 forecasts in Table 1b.

**Table 1a: ASX 200 range forecasts 2016**

Forecast	Forecast origin		
	31-Dec-2015	25-Nov-2016	2-Dec-2016
<b>CY16</b>			
<b>Low</b>	5,100	5,400	5,350
<b>High</b>	6,150	5,700	5,550
<b>End</b>	5,850	5,600	5,500
<b>Fair value</b>	5,350	5,500	5,500
<b>Exuberance</b>	-0.7%	-0.1%	-1.1%
<b>ASX 200</b>	5,296	5,508	5,444

**Table 1b: ASX 200 range forecasts FY2017**

Forecast	Forecast origin		
	30-Jun-2016	25-Nov-2016	2-Dec-2016
<b>FY '17</b>			
<b>Low</b>	5,100	5,350	5,250
<b>High</b>	6,350	6,200	5,950
<b>End</b>	6,150	6,050	5,750
<b>Fair value</b>	5,350	5,500	5,500
<b>Exuberance</b>	-2.1%	-0.1%	-1.1%
<b>ASX 200</b>	5,233	5,508	5,444

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 eoy forecast for June 30<sup>th</sup> 2017 (left-hand column in Table 1b) was 6,150 with a forecast high of 6,350 and a forecast low under normal volatility of 5,100. The 'high-volatility' forecast low was 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) slipped back to 5,500. Fair value is still 5,500 which is well above where we started 2016 (5,350).

The eoy forecast jumped back to 5,750 the week after a major reversal to the Financials broker earnings forecasts. The SPI is up +21 pts for Monday.

Chart 1a: Graphical representation of Table 1a

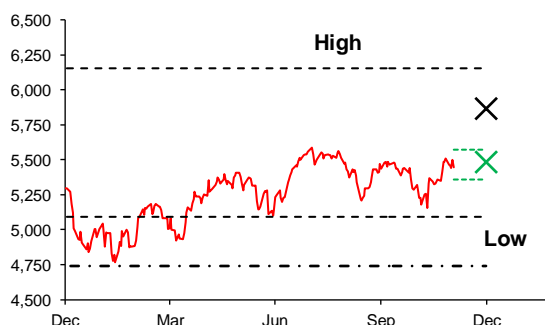
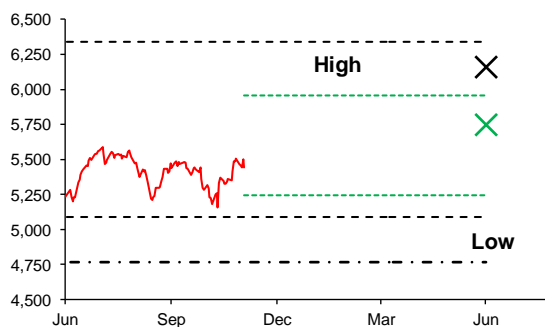


Chart 1b: Graphical representation of Table 1b



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. Indeed, this week (because of Thanksgiving) the data are based on the Wednesday close.

The eoy forecast for the S&P 500 slipped back to 2,220. Fair value is also 2,220.

The eoy forecast update in Table 2b is 2,430. The high forecast is 2,490 and the low under normal volatility is 2,140.

Table 2a: S&P 500 range forecasts 2016

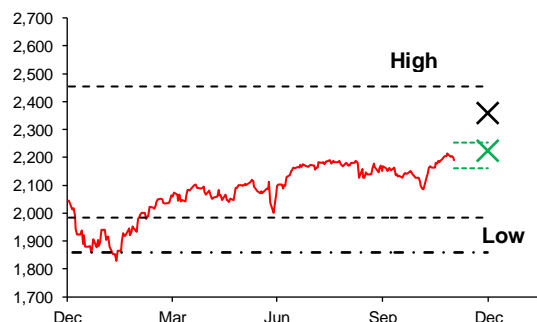
Forecast	Forecast origin		
	31-Dec-2015	24-Nov-2016	1-Dec-2016
Low	1,980	2,170	2,160
High	2,450	2,280	2,250
End	2,360	2,250	2,220
Fair value	2,100	2,250	2,200
Exuberance	-3.3%	-0.9%	-1.5%
ASX 200	2,044	2,205	2,191

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

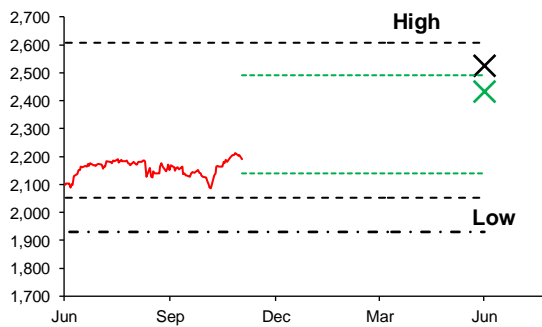
Forecast	Forecast origin		
	30-Jun-2016	24-Nov-2016	1-Dec-2016
FY '17			
Low	2,050	2,150	2,140
High	2,610	2,510	2,490
End	2,530	2,450	2,430
Fair value	2,100	2,250	2,200
Exuberance	-0.8%	-0.9%	-1.5%
ASX 200	2,099	2,205	2,191

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 2a: Graphical representation of Table 2a



**Chart 2b: Graphical representation of Table 2b**



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 to be found in the Chart Appendix) is just above normal levels at 14.2%. Our Fear Index (Chart A-2) is in the zone at 7.7%. The VIX stands at 14.1%. Our Disorder index (Chart A-3) is a little high at 1.1% as the Telco and Staples downgrades swept through the market. Conditions are quite reasonable – outside of those smaller stocks that are being buffeted about.

Our 12-month capital gains forecast (Chart A-4) came back to 8.7% after the reversal to earnings forecasts in the Financials' sector. The market is below pricing at -1.1% (Chart A-5). So that leaves the adjusted 12-month capital gains' forecast at +9.9%. The comparable 12-month adjusted capital gains forecast for the S&P 500 stands at about +20%.

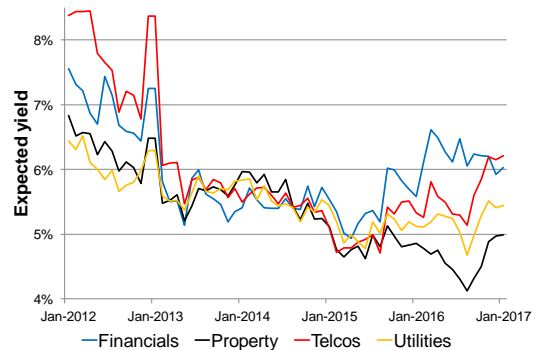
Sector pricing (Chart A-6) is such that Materials (+0.6%) and Financials (+2.6%) are the only ones in positive territory. Last week I wrote that, "The former looks a bit much to jump in now but, with the re-rating of Financials' forecasts and an exuberance of +2.7%, it isn't much of a deterrent for me." There was a strong pull-back in the Materials stocks that eroded the high over-pricing.

In the US (see the weekly publication on the same "Market Updates" page), Financials are precariously over-priced at +12.6%. If Trump delivers this pricing is less of an issue. US Industrials are close to the 6% overpricing warning signal at +5.7%.

As can be noted from Dividend Compression (Chart 3), the co-movement we observed for about three years from January 2012 broke down. But there has

been an interesting move in the last few weeks. They are starting to get back together – but only slowly.

**Chart 3: Dividend Compression**

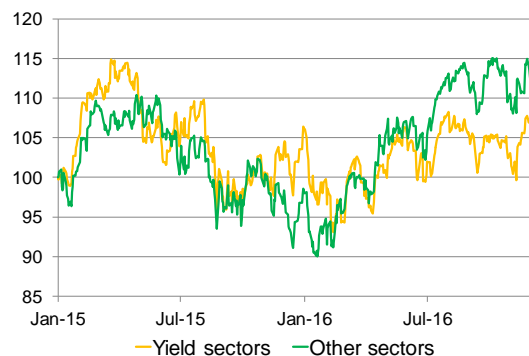


The expected yield for Financials is 6.0% (plus franking credits) and 4.6% for the ASX 200.

The yield play definitely waned during 2016. 'Other' sectors are beating the 'high yield' sector total returns (including dividends) by +13.1% y-t-d which is down from 15.2% last week. The return on high-yield sectors is above par at +1.5% (including dividends) this year while 'other' has gained +14.6%.

Chart 4 shows another 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.

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

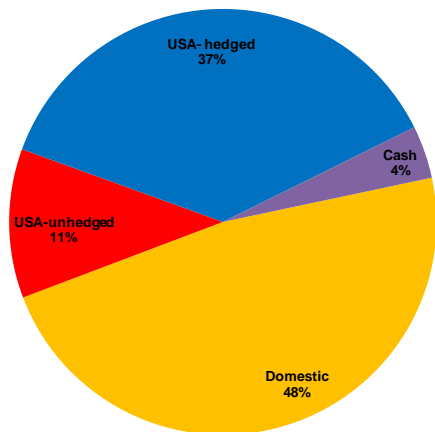


**SMSF Share Portfolio**

I last rebalanced my domestic share portfolio in my SMSF in the week of October 3<sup>rd</sup>, 2016. It is 100% High Conviction by my definition. I will keep my narrative on the rebalance in the section just before the Chart Appendix until the next rebalance.

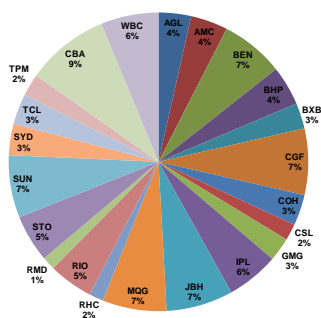
As discussed in the overview, I sold VOC and bought CBA during the week. This reduced my cash allocation as I show in the special chart.

**Special chart: Asset allocation on SMSF**



There are currently 22 stocks in my direct equity portfolio. 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 5<sup>th</sup> 2015, the November 2<sup>nd</sup> 2015 and the October 3<sup>rd</sup> 2016 rebalances (and the Nov 29 mini-rebalance) – against the ASX 200 since late June 2014 is shown in Table 3a. That corresponds to an outperformance of +3.5% pa (annualised) since inception. After all of the turbulence of recent times the portfolio is still returning +8.6% pa for nearly two and a half years in a broadly sideways market (excluding dividends).

In Table 3a I show that the recent 3-months underperformance (-1.5%) has pulled down the return since inception.

**Table 3a: Total returns from SMSF**

Period	Portfolio	ASX 200	Alpha
Since inception	8.6%	5.0%	3.5%
2 years	7.2%	5.8%	1.4%
1 year	8.1%	8.8%	-0.7%
6 months	5.5%	5.4%	0.2%
3 months	0.9%	2.4%	-1.5%

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

In Table 3b I show far more detail on the recent activity to better understand how the rebalance is going. Over the last two months, my SMSF has performed above benchmark at +1.1% and all shorter periods now show slight outperformance. Most of the damage causing the 3-month figure was done in the latter stages of September before my rebalance.

**Table 3b: Recent total returns from SMSF**

Period	Portfolio	ASX 200	Alpha
Since Oct rebal	1.2%	0.1%	1.1%
2 month	1.2%	0.1%	1.1%
1 month	5.3%	4.8%	0.5%
1 week	-0.8%	-1.2%	0.3%
1 day	-0.9%	-1.0%	0.2%

Note: Since June 25th 2014. Returns include dividends.

In Table 4 I show the performance of the individual stocks. COH, RHC and TPM have been left behind and are under my close scrutiny. TPM left that list last week but it got caught up with VOC this week.

**Table 4: Individual stock total returns**

	AGL	AMC	BEN	BHP	BXB	CBA	CGF	COH
Return	12.3%	-7.8%	11.5%	7.7%	-4.9%	1.1%	5.7%	-17.2%
Alpha	12.1%	-8.1%	11.3%	7.4%	-5.1%	0.8%	5.5%	-17.5%
	CSL	GMG	IPL	JBH	MQG	RHC	RIO	RMD
Return	-7.6%	-6.6%	19.0%	-6.4%	1.4%	-13.5%	12.5%	-5.8%
Alpha	-7.8%	-6.9%	18.8%	-6.6%	1.2%	-13.8%	12.3%	-6.0%
	STO	SUN	SYD	TCL	TPM	WBC	ASX 200	
Return	12.1%	1.9%	-7.4%	-6.1%	-13.3%	3.5%	0.3%	
Alpha	11.8%	1.7%	-7.7%	-6.3%	-13.6%	3.2%	0.4%	

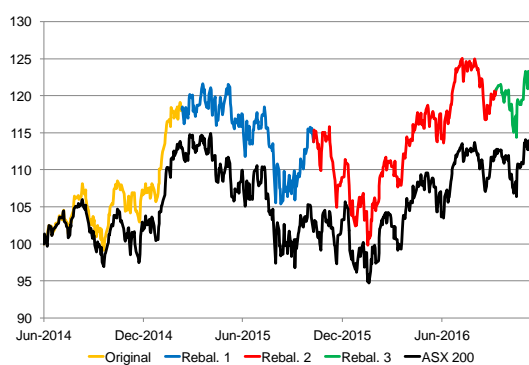
Note: Since October 7<sup>th</sup> 2016 (except CBA which is from 29<sup>th</sup> November 2016). Returns include dividends. The 'alpha' under ASX 200 is for the portfolio for the same period.

The whole Healthcare space has been re-rated in the pre- and post-presidential election space.

The returns chart (Chart 6) shows the recent performance 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. That's when the yield play took a big hit.



Chart 6: SMSF and ASX 200 total returns



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

Table 5 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.

Table 5: Price and current broker forecasts

Percentage change over week			Sector	Stock	Price	Target	Rec	T/P - 1
Price	Target	Consensus						
-4.3%	-3.0%	-0.1%	Energy	SANTOS	4.37	3.47	2.71	-20.5%
-5.2%	-7.9%	-0.1%	Materials	AMCOR	14.20	11.94	2.46	-15.9%
-5.6%	-2.3%	-3.4%	Materials	BHP BILLITON	25.02	16.46	2.95	-34.2%
5.0%	0.0%	-0.2%	Materials	INCITEC PIVOT	3.37	3.37	2.21	0.0%
-6.0%	3.4%	-3.8%	Materials	RIO TINTO	58.04	45.88	2.75	-20.8%
-4.0%	-4.9%	3.1%	Industrials	BRAMBLES	11.61	10.00	2.46	-13.9%
-1.9%	0.0%	-0.2%	Industrials	SYDNEY AIRPORT	6.12	7.24	2.39	18.3%
-3.8%	0.0%	-2.9%	Industrials	TRANSURBAN GROUP	10.01	12.00	2.43	19.9%
2.2%	0.0%	0.9%	Discretionary	JB HI-FI	27.10	29.54	2.67	-9.0%
-1.4%	2.3%	-0.4%	Health	COCHLEAR	116.97	126.15	3.18	7.8%
-1.2%	-2.7%	-1.8%	Health	CSL	98.08	81.47	2.55	-16.9%
-2.6%	0.5%	2.0%	Health	RAMSAY HEALTH CARE	69.00	80.19	2.33	16.2%
0.9%	-3.1%	-1.4%	Health	RESMED CDI	8.01	6.64	2.20	-17.1%
3.3%	1.7%	0.1%	Financials	BENDIGO & ADELAIDE BANK	12.28	10.50	3.08	-14.5%
0.8%	0.0%	0.0%	Financials	CHALLENGER	10.88	10.58	2.57	-2.8%
0.6%	0.0%	0.0%	Financials	COMMONWEALTH BK OF AUS.	78.60	76.15	3.00	-3.1%
0.6%	0.0%	0.0%	Financials	MACQUARIE GROUP	84.23	83.98	2.43	-0.3%
1.8%	0.0%	0.0%	Financials	SUNCORP GROUP	12.78	13.55	2.43	6.0%
-0.6%	0.0%	0.1%	Financials	WESTPAC BANKING	31.34	32.50	2.44	3.7%
-1.5%	0.0%	-0.2%	Property	GOODMAN GROUP	6.49	7.47	2.46	15.1%
-6.4%	-3.8%	-2.2%	Telecom	TPG TELECOM	6.97	10.20	2.38	-46.3%
0.6%	1.7%	0.0%	Utilities	AGL ENERGY	21.03	20.85	2.23	-0.9%

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.

There are only three stocks with a recommendation at 3.0 or worse: CBA, COH and BEN. I argue in the rebalancing section (just before the Chart Appendix) for COH. For a yield stock like BEN, I am not worried by a 'hold' of 3.08 and it is nicely outperforming the benchmark. As I wrote in the introduction, I was happy to buy CBA as a big, sturdy dividend play at 3.0 with some capital gains prospects.

I've included a special table below to show the real action in my rebalance over the first few weeks using actual buy and sell prices – and yesterday's closing prices. Those stocks I sold would have lost -3.5% over the two months had I not sold – while the buys gained +4.1% when the ETFs are included! That's about a +7.5% benefit from not having sat on my hands in two months.

Special Table: Analysis of rebalancing

Code	Date	Price change	Code	Date	Price change
<b>Sell all</b>					
VXC	3/10/2016	-11.4%	BXB	4/10/2016	-3.3%
SPO	3/10/2016	-15.6%	CGF	4/10/2016	5.6%
TTS	3/10/2016	12.8%	IPL	4/10/2016	19.5%
PRY	3/10/2016	-8.0%	VOC - SOLD		-25.7%
AMP	3/10/2016	-12.8%	CBA	29/11/2016	0.5%
DUE	3/10/2016	-6.0%	<b>Total</b>		<b>1.5%</b>
IFL	3/10/2016	-0.3%	<b>Buy more</b>		
AZJ	4/10/2016	6.7%	AGL	4/10/2016	11.4%
MGR	4/10/2016	-9.1%	AMC	4/10/2016	-5.7%
SGP	4/10/2016	-9.8%	BHP	4/10/2016	10.0%
<b>Total</b>		<b>-4.7%</b>	GMG	4/10/2016	-10.1%
<b>Sell some</b>					
TCL	3/10/2016	-10.9%	RIO	4/10/2016	11.2%
MQG	3/10/2016	2.3%	<b>Total</b>		<b>4.1%</b>
WBC	3/10/2016	4.1%	ETFs:	various	
SYD	3/10/2016	-11.6%	IHVV	around	6.6%
<b>Total</b>		<b>-0.4%</b>	IOZ	election	
<b>Sell total</b>		<b>-3.5%</b>	<b>Buy total</b>		<b>4.1%</b>

Note: The Voc price change is up to the sale price I got on Nov 29.

## 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.

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.

The strategy has been returning +9.9% pa since inception (Table 6) (including dividends). The IVV-IHVV leg is up +11.5% pa. The IOZ part of the strategy is up +8.4% pa. The table below shows that I am now 63% hedged in the Wall Street

component. The domestic share of the portfolio is 49%.

**Table 6: Total returns on IOZ:IVV strategy**

2-Dec-2016	Inc divs.	Current allocation	
ETF	IRR pa	Total	USA
IOZ	8.4%	49%	
IVV+IHVV	11.5%	51%	100%
IVV	10.2%		37%
IHVV	14.7%		63%
<b>Total</b>	9.9%	100%	
Indexes	Alpha pa		
ASX 200	5.2%	3.2%	
S&P 500	6.7%	3.6%	
S&P 500 (\$A)	10.3%	4.4%	

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 6 so I can calculate any outperformance from the buying low – selling high strategy. Annualised outperformance is eroded in the long-run to zero unless fresh buys are made or a sell signal arrives.

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 77c and then down again, a fleet-of-foot trader might have better performed than my sit and wait philosophy. I don't have the energy or the predictive ability!

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.

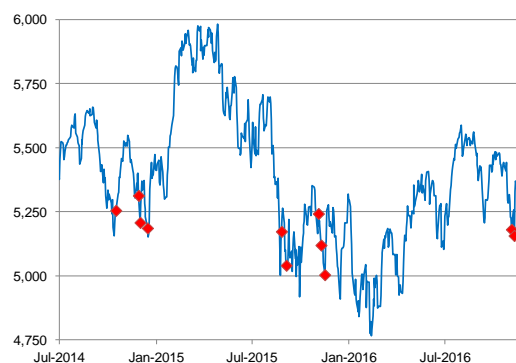
The basis of the strategy is to buy when the indexes (using ETFs) get very close to or cross the beginning of the year predicted low – and to sell when the indexes reach the predicted highs – as indicated in the 'Market Expectations' section. I do not use the weekly updated lows and highs for this purpose. These update statistics help me consider 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.

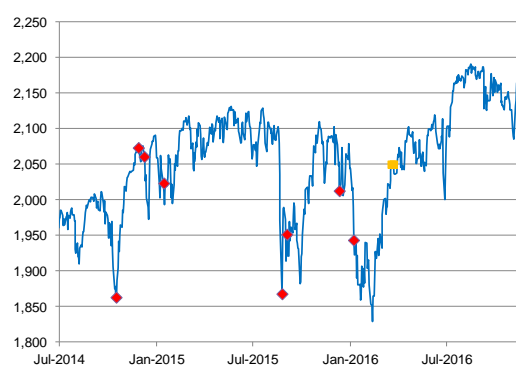
Note that the irr is a single annualised return to summarise all of the buys of the three ETFs and the current value including dividends when paid and not when the ETF went ex-div..

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).

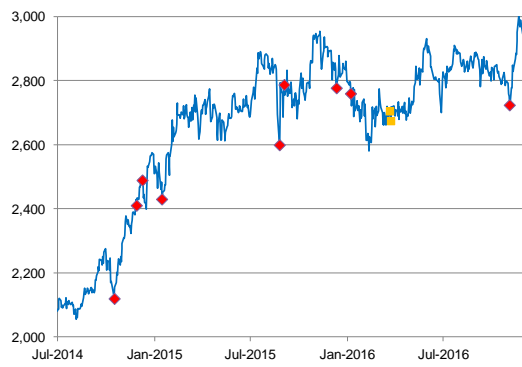
**Chart 7: IOZ buy points - ASX 200**



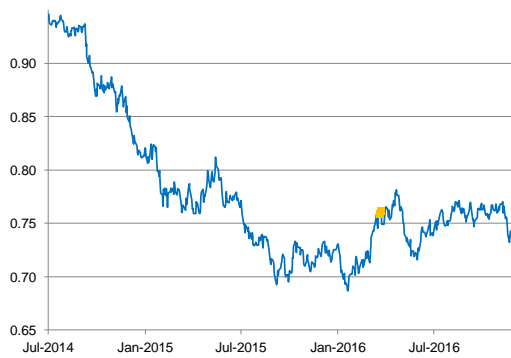
**Chart 8: IVV buy points - S&P 500 (\$US; hedged)**



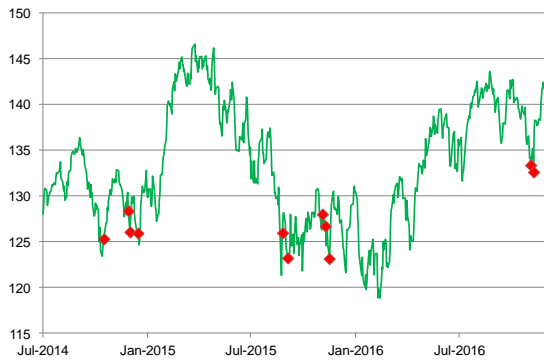
**Chart 9: IVV buy points S&P 500 (\$A; unhedged)**



**Chart 10: AUD hedging points**



**Chart 11: IOZ buys – IOZ 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.



## The October 2016 rebalance

After thinking about it for six months, I finally started the process of rebalancing on Monday, October 3<sup>rd</sup> – one month short of a year since the previous rebalance.

With the Monday being a holiday in NSW, I was particularly surprised by the strength of the market. I decided to do most of the 'sells' that afternoon and leave the buys to another day. In the table below, I show the new Conviction portfolio I had produced over the long weekend in my regular monthly update. The right panel shows my September 30<sup>th</sup> portfolio and weights.

**Table: The rebalancing proposition**

Conviction portfolio		Old portfolio	
Code	share	Code	share
AGL	3.50%	AGL	1.59%
ALL	7.24%	AMC	2.05%
AMC	4.66%	AMP	4.10%
BHP	4.25%	AZJ	3.82%
BOQ	6.49%	BEN	4.42%
BXB	3.13%	BHP	1.68%
CGF	7.28%	COH	3.47%
CSL	3.04%	CSL	1.67%
GMG	3.16%	DUE	2.00%
IPL	5.14%	GMG	1.36%
MQG	7.50%	IFL	4.50%
ORG	2.89%	JBH	5.78%
RHC	3.34%	MGR	2.60%
RIO	4.70%	MQG	8.78%
RMD	3.60%	PRY	3.24%
SUN	6.86%	RHC	1.53%
SYD	3.42%	RIO	1.77%
TCL	3.37%	RMD	1.30%
VOC	6.93%	SGP	2.37%
WBC	6.77%	SPO	1.83%
WPL	2.74%	STO	3.64%
		SUN	5.51%
		SYD	4.83%
		TCL	4.64%
		TLS	4.17%
		TPM	2.53%
		TTS	2.42%
		VCX	2.26%
		WBC	10.12%

I had a number of particular considerations to take into account. My old portfolio was a 50:50 blend of my Conviction and Hybrid Yield November 2015 portfolios. Since I decided to go 100% conviction this time around, there was going to be a lot of selling. I also wanted to hold about 20% cash – most unusual for me.

Part of the reason for holding cash was to have a buffer going into the US Presidential elections next month – and part was because I want to invest in my High Octane portfolio. Since I have never invested in an octane portfolio before, I wanted a breather first. Octane – to me – requires quite a few stocks and an emphasis on market timing. More of that next week!

If I did not have a legacy portfolio, I possibly would have just bought the one in the left panel of the table. I chose to modify it because I have come to learn quite a bit about my existing stocks – so I made some substitutions – and it reduced transaction costs and effort.

I had already placed a request to sell all of my TLS in the buy-back offer. That transaction will not be completed until Tuesday 11<sup>th</sup> October. Since I do not yet know how many stocks they will buy, nor for how much, I decided to assume all will be sold and the proceeds will be added to the 20% cash – and I'll sort it all out

later. I also am in the hunt for some extra JBH following their capital raising that hasn't yet arrived.

I chose not to substitute ALL for JBH in my Discretionary holding as the conviction portfolio dictates. I got attached to JBH. Also ALL (gambling) always worries me because of the chance of changes to regulation – and I vividly remember when the stock plunged over 10 years ago when it lost just one big contract in South American.

While I am in stocks for the long-haul, it will take some time to assess whether it was a wise move not to switch. In the first week (from Sep 30<sup>th</sup> to Oct 7<sup>th</sup>) ALL was up +4.2% against -0.1% for JBH. Not enough to sting (too much) – but I can always change my mind later! I think it is fine to rebalance just one stock in such circumstances. ALL does have a very strong recommendation at 2.0 – but that doesn't allow for my perception of its risk.

I also chose not to substitute BOQ for BEN. Both are regional banks but I am also holding the Queensland-based SUN. A little 'regional' diversification! In the first week, BOQ was down -2.8% after a moderate report while BEN was up +2.2%. I'm happy with that and it cancels the ALL:JBH play. Moreover, BEN is about to offer a share purchase plan that might be attractive.

I refuse to sell my COH! I have done so well backing that one for years when it was very unloved by brokers. I bought several times under \$60 and sold most above \$80. With current prices over \$140, this last parcel is 'for the manager'. This meant I did not add to CSL, RHC and RMD as my model portfolio recommended. In the first week, COH was up +0.5% while the other three Health stocks are mixed: CSL (-0.6%), RHC (+1.1%) and RMD (+0.8%). Not much in it overall.

I also held on to STO. It is a bit of a risky stock but I like its chances against ORG and WPL. So no substitution there either. In the first week, STO was up +8.0% while the others were up a little less: ORG (+3.7%) and WPL (+4.3%). Got lucky there!

My final substitution was in the Telco space. My TLS will be sold soon – if only partially – and VOC was the putative substitute. TPM and VOC both took hammerings in recent times. I think the TPM fall was over-done on what didn't seem like a bad report. Therefore, I kept TPM and bought enough VOC to fill the Telco void once TLS has gone. That's about 50:50 TPM:VOC. When in doubt diversify more! VOC fell -10.0% while TPM fell -5.8%.

So, on Monday's rising tide I sold all of my holdings in AMP, DUE, IFL, PRY, SPO, TTS, VCX and the overweight part of MQG, SYD, TCL and WBC.

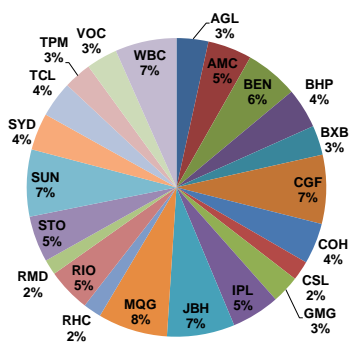
On Tuesday, the market fell so I bought all of my BXB, CGF, IPL and VOC. I topped up AGL, AMC, BHP, GMG, and RIO. I sold AZJ, MGR and SGP. That's 23 trades in two sessions!

I chose not to make some other trades as brokerage does not make small transactions economical – and the paperwork for tax records gets unnecessarily burdensome. I also took capital gains' calculations into account in a similar fashion.

Since I don't transact at closing prices, I wanted to evaluate my performance in making these transactions. As it happens, I sold 58% more than I bought – to generate my cash holding. The sells by the end of the week fell -0.8% while the 'buys' have fallen -0.3%. Not much in it – just a little bit ahead!

The new composition of my portfolio without the cash and TLS at the close on October 7<sup>th</sup> 2016 is in the following pie chart.

Chart: New portfolio after rebalance



percentage point increase in Utilities is small, it does represent a doubling of the exposure.

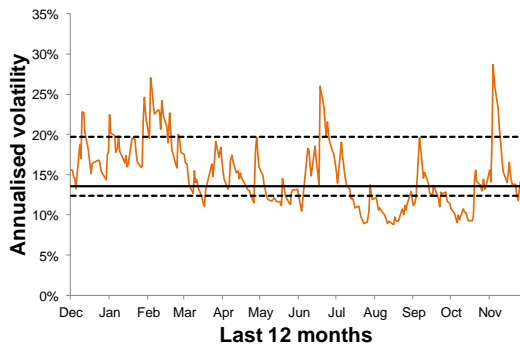
Table: Sector weights at October 7<sup>th</sup> 2016

Sector	New	Old	Change
Energy	5.0%	3.6%	1.3%
Materials	22.2%	9.3%	12.9%
Industrials	7.9%	11.3%	-3.4%
Discretionary	7.3%	8.2%	-0.9%
Health	10.1%	11.2%	-1.1%
Financials	34.6%	37.4%	-2.8%
Property	3.0%	10.6%	-7.6%
Telco	6.4%	6.4%	0.0%
Utilities	3.4%	1.6%	1.8%

The changes in sector weights are shown in the table below. The biggest change is the increase in exposure to Materials which was offset by falls in Industrials, Financials and Property. Although the

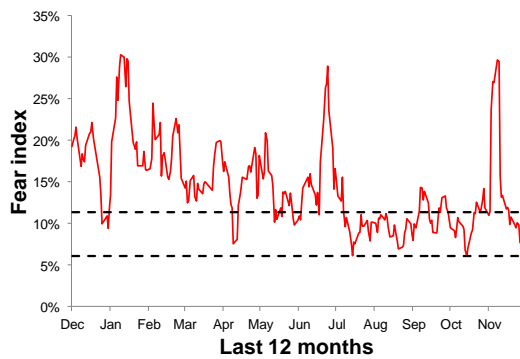
## Chart Appendix

**Chart A-1: Market volatility**



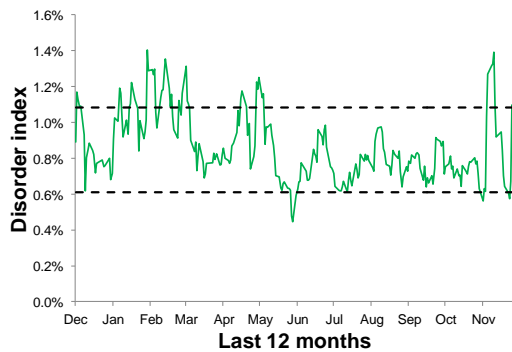
Notes: The solid black line depicts the average volatility since January 2010; the lower dotted line depicts the average volatility pre the GFC; the higher dotted line depicts the average level of volatility during the GFC - up to December 2009. The brown line is a daily estimate of the ASX 200 index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

**Chart A-2: Fear index**



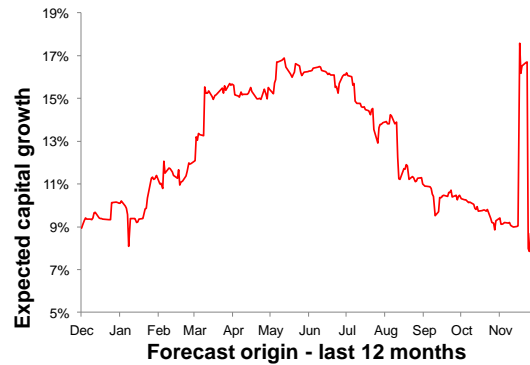
Notes: The fear index is a measure of 'excess' volatility denoting behaviour outside the open/close values each day. The two dotted lines depict the band in which the fear index resided before the GFC in two thirds of days. Extended periods below the lower dotted line might indicate complacency. Extended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



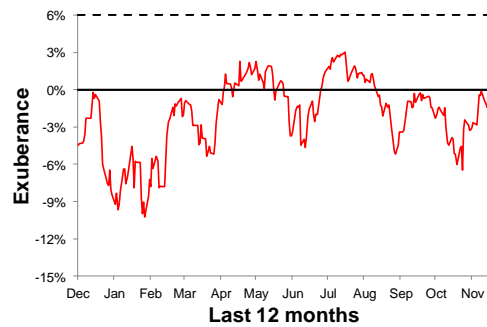
Notes: The disorder index measures the degree to which the 11 sectors' daily returns move in harmony. The two dotted lines depict the band in which the disorder index resided before the GFC in two thirds of days. Extended periods below the lower dotted line might indicate belief that there is little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



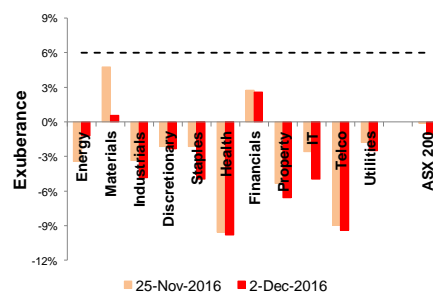
Notes: Each business day we update our estimates for capital gains on the ASX 200 for the following 12 months. For example, the left-most estimate on the vertical axis is a forecast for the 12 months concluding today. The right hand estimate is for the 12 months from today.

**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 1<sup>st</sup> 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 1<sup>st</sup>. 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. Of course less new jobs are needed when the economy is running at full employment.