11 February 2017

Woodhall's Weekly

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Trump trumps market

- **Tax tweet fires up market**
- **RBA on hold but no clue**
- **Aussie economy still struggling**

Overview

Note: Regular readers might wish to learn that we have rearranged the appendices, updated the glossary and added a new section for identifying 'key people'. The triggers for the geared strategy have also been updated as at January 1st 2017. Various other tables and charts have been renumbered.

Important: We have two new papers posted on the 'Market Updates' page. The first, 'The Year Ahead' was posted on January 1st 2017 and it will not be updated. It can, therefore, be used as a benchmark going forward. Similarly, the second, 'Investment Strategy', contains our reaction to those forecasts for our decisions for the year ahead. It too will not be updated.

As the situation warrants, two more papers will posted in the same section to comment on successes, failures and revisions. In this manner we offer a truly accountable set of analysis, forecasts and projections!

Just when markets were losing steam, Trump tweeted that tax cuts were still on the agenda – and there will be news on them in the next few weeks. Markets got fired up.

We charged above 5,700 yesterday and 6,000 now looks closer. But another day, another tweet could change that.

The S&P 500 charged through 2,300 and it stuck overnight to close at a record high of 2,316. Exuberance in each market is minimal so we see no pricing constraint on further growth. Fear, Disorder and volatility are all in the sweet spot so we are happy to be fully invested at this point in time.

It so happened that our SMSF portfolio (see later) outperformed by +0.5% in one day – Friday. That makes an outperformance of +1.1% since the last rebalance at the beginning of October last year.

The RBA and other central banks were on hold this week. A while back, almost nobody except us and Macquarie were predicting rate cuts in 2017. Last week Fairfax reported a survey of 27 economists and that view is for no change during 2017. But calls for a cut started to gain momentum over the week.

Our Retail Sales growth was pathetic at -0.1% when +0.3% was expected. What is holding the RBA back? We don't know but we hope it doesn't leave it too late.

At least Turnbull had some fire in his belly with his blistering attack on Shorten. It's unfortunate that people have to resort to such language but the government desperately needs to assert itself.

OPEC has managed to pull off 90% compliance on the recent supply decisions – that's a very good number. Oil prices are flat on the week. Iron ore prices are up +2.9%.

The Brexit bill passed the Commons' vote for the second time. So it is now off to the Lords.

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Market expectations

Our start-of-year 2017 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 report the FY17 forecasts in Table 1b that were made last June 30th.

Table 1a: ASX 200 range forecasts 2017

Forecast	Forecast origin		
CY16	30-Dec-2016	3-Feb-2017	10-Feb-2017
Low	5,350	5,350	5,400
High	6,300	6,300	6,300
End	6,000	6,000	6,000
Fair value	5,600	5,700	5,700
Exuberance	1.5%	-1.1%	0.5%
ASX 200	5,666	5,622	5,721

Table 1b: ASX 200 range forecasts FY2017

Forecast	Forecast origin		
FY '17	30-Jun-2016	3-Feb-2017	10-Feb-2017
Low	5,100	5,400	5,500
High	6,350	6,000	6,050
End	6,150	5,800	5,850
Fair value	5,350	5,700	5,700
Exuberance	-2.1%	-1.1%	0.5%
ASX 200	5,233	5,622	5,721

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.

The eoy forecast for 2017 (left-hand column in Table 1a) was 6,000 with a forecast high of 6,300 and a forecast low under normal volatility of 5,350. The 'high-volatility' forecast low was 4,950. [See the IOZ:IVV:IHVV section for the decision rules surrounding these low and high forecasts.]

The updated eoy 2017 forecast (Table 1a, last column) is 6,000. Fair value is a tick higher at 5,700. The updated eofy forecast in Table 1b is up at 5,850.

Chart 1a: Graphical representation of Table 1a

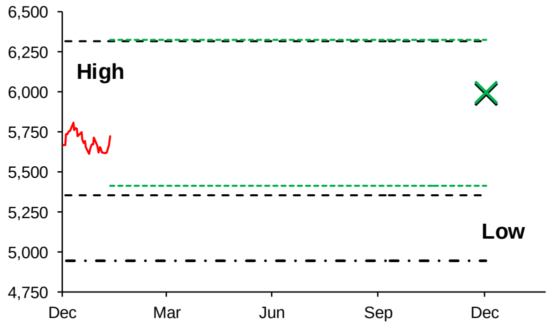
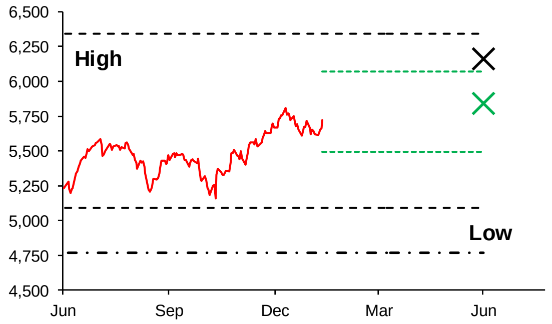


Chart 1b: Graphical representation of Table 1b



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 eoy 2017 – and our FY17 – forecasts for the S&P 500 are given in Tables 2a and 2b. 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 publish around 10am on a Saturday.

Our original forecast for eoy 2017 was 2,680 with a high of 2,750 and a low of 2,180. The 'high-volatility' low was 2,050.

The updated eoy forecast for the S&P 500 has since slipped to 2,570. Fair value is steady at 2,300.

The eofy forecast update in Table 2b is down at 2,420. The high forecast is 2,490 and the low under normal volatility is 2,240.

[Please note it has just been recognized that the previous week's data is not being picked up properly for the S&P 500 – please ignore for now]

Table 2a: S&P 500 range forecasts 2017

Forecast	Forecast origin		
CY16	30-Dec-2016	2-Feb-2017	9-Feb-2017
Low	2,180	2,220	2,230
High	2,750	2,710	2,660
End	2,680	2,640	2,570
Fair value	2,250	2,300	2,300
Exuberance	-1.2%	-0.6%	0.3%
S&P 500	2,239	2,281	2,308

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

Forecast	Forecast origin		
FY '17	30-Jun-2016	2-Feb-2017	9-Feb-2017
Low	2,050	2,230	2,240
High	2,610	2,500	2,490
End	2,530	2,430	2,420
Fair value	2,100	2,300	2,300
Exuberance	-0.8%	-0.6%	0.3%
S&P 500	2,099	2,281	2,308

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 2a: Graphical representation of Table 2a

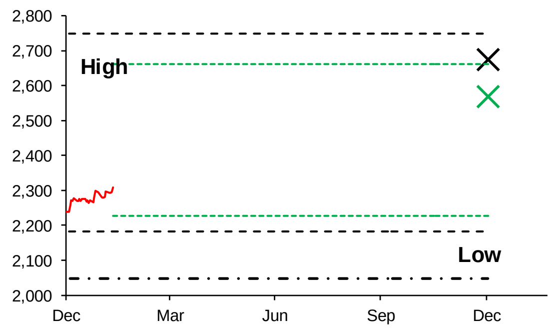
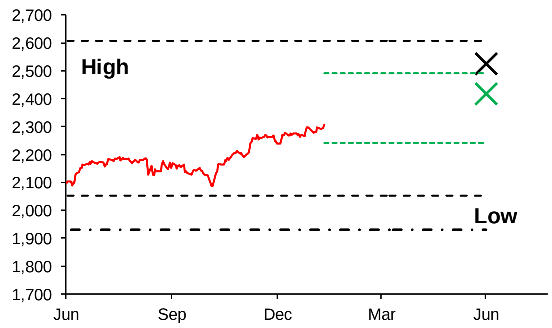


Chart 2b: Graphical representation of Table 2b



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

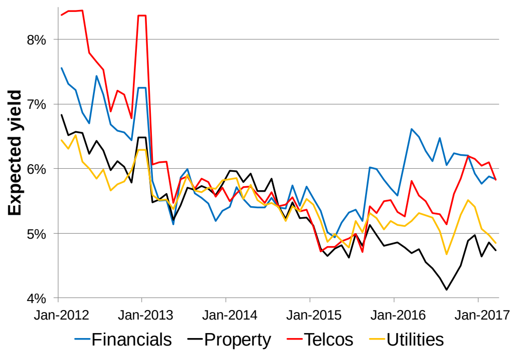
Our market volatility index (Chart A-1 to be found in the Chart Appendix) continues to be below normal levels at 11.3%. Our Fear Index (Chart A-2) is back in the zone at 10.3%. The VIX stands at 10.8%, still almost a 10 year low! Our Disorder index (Chart A-3) is in the zone at 0.8%. Conditions remain very reasonable for rebalancing.

Our 12-month capital gains forecast (Chart A-4) is steady at +6.0%. The market is over-priced at +0.5% (Chart A-5). So that leaves the adjusted 12-month capital gains' forecast at +5.5%. The comparable 12-month adjusted capital gains forecast for the S&P 500 stands at about +12%.

Sector pricing (Chart A-6) is such that Utilities (+6.6%) is in the danger zone. However, AGL had a great week on solid news so we think the brokers will reset their forecasts in the near future that will erode the over-pricing. Financials (+2.9%), Health (+1.5%) and Staples (+1.1%) are only moderately over-priced. All other sectors are under-priced.

As can be noted from Dividend Compression (Chart 3), the co-movement we observed for about three years from January 2012 broke down. They are starting to get back together – but only slowly.

Chart 3: Dividend Compression



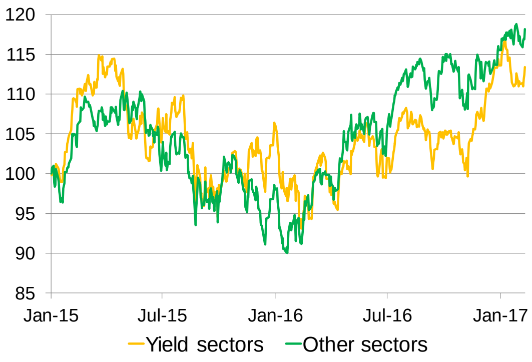
The yield play definitely waned during 2016 but there was a big comeback which can best be seen from Table 3. Yield lost -2.3% over the month but gained +4.2% over three months. High-yield sectors' returns lagged by -8.1% over the last 12 months. Recent results are very mixed. There is no current established trend but the December bubble in Financials seems to have burst taking the pressure off the relationship.

Table 3: Yield play - total returns

	Sector		
Period	**Yield**	**Other**	**Difference**
1 year	20.2%	28.3%	-8.1%
6 months	6.8%	4.1%	2.7%
3 months	9.2%	5.0%	4.2%
1 month	-2.0%	0.3%	-2.3%

Chart 4 shows another interesting angle on the yield play. The yield sector lost relative to 'other' around the end of 2015 but the two lines got back together in February and broke free again at the end of June. The yellow line was almost back up to the green line but it lost sharply in the last few weeks until the sell-off in Financials was reversed.

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

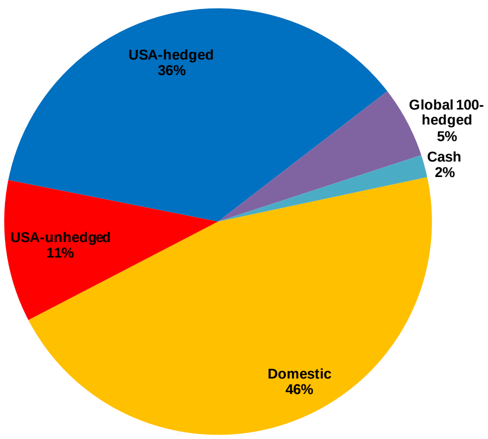


SMSF Share Portfolio

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

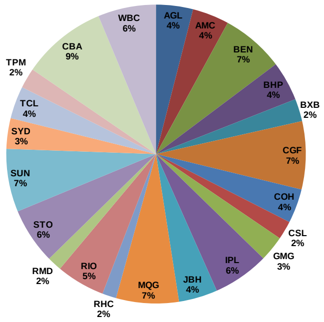
The current allocation pie chart is shown in Chart 5. The Santos offer has now been incorporated in the charts and tables.

Chart 5: Asset allocation on SMSF



There are currently 22 stocks in my direct equity portfolio. My current holdings are given in Chart 6.

Chart 6: Current holdings



The performance of my domestic equities in my SMSF portfolio – including the impact of the March 5th 2015, the November 2nd 2015 and the October 3rd 2016 rebalances (and the Nov 29 mini-rebalance) – against the ASX 200 since late June 2014 is shown in Table 4. That corresponds to an outperformance of +3.3% pa (annualised) since inception. After all of the turbulence of recent times the portfolio is still returning +10.1 % pa for over two and a half years.

Table 4: Total returns from SMSF (domestic equities)

Period	Portfolio	ASX 200	Alpha
Since inception	10.1%	6.7%	3.3%
2 years	5.0%	4.2%	0.9%
1 year	26.7%	23.9%	2.8%
6 months	4.4%	6.1%	-1.7%
3 months	7.7%	7.2%	0.5%

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

In Table 4 I also show that the recent 6-months underperformance (-1.7%), which includes the period just before the October rebalance, has pulled down the return since inception.

In Tables 5 and 6 I show more detail on the recent activity to better understand how the rebalance is going. Since the rebalance, my SMSF has performed above benchmark at +1.1%. We believe the underperformance over the last 6 months has been arrested if not turned around.

Table 5: Recent total returns from SMSF (domestic equities)

Period	Portfolio	ASX 200	Alpha
Since Oct rebal	6.5%	5.4%	1.1%
2 months	3.3%	3.1%	0.2%
1 month	-0.3%	-0.9%	0.6%

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

In Table 6 I show the performance of the individual stocks since the last rebalance. High P/E stocks are generally being sold-off on the slightest bad news – even if that news related to a different company in the same sector.

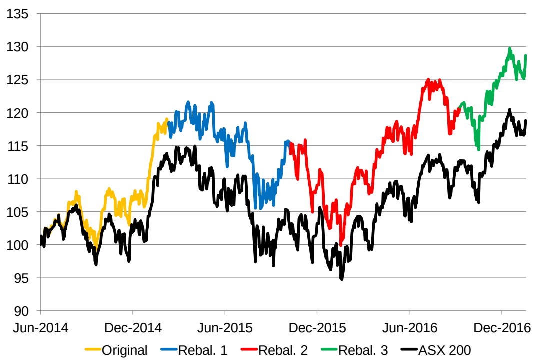
Table 6: Individual stock total returns

	AGL	AMC	BEN	BHP	BXB	CBA	CGF	COH
Return	32.6%	-4.8%	14.7%	11.7%	-13.1%	6.6%	13.0%	-4.8%
Alpha	27.0%	-10.4%	9.1%	6.1%	-18.7%	1.0%	7.4%	-10.4%
	CSL	**GMG**	**IPL**	**JBH**	**MQG**	**RHC**	**RIO**	**RMD**
Return	8.1%	5.0%	32.8%	-1.7%	3.4%	-12.1%	28.9%	8.2%
Alpha	2.5%	-0.6%	27.2%	-7.3%	-2.2%	-17.7%	23.3%	2.6%
	STO	**SUN**	**SYD**	**TCL**	**TPM**	**WBC**		**ASX 200**
Return	0.3%	6.3%	-4.2%	3.7%	-17.4%	9.3%		5.6%
Alpha	-5.3%	0.7%	-9.8%	-1.9%	-23.0%	3.7%		0.4%

Note: Since October 7th 2016 (except CBA which is from 29th November 216). Returns include dividends. The 'alpha' under ASX 200 is for the portfolio for the same period.

The returns chart (Chart 7) 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 7: SMSF and ASX 200 total returns



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

Table 7 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 7: Price and current broker forecasts

Percentage change over week								
Price	Target Price	Consensus Rec.	Sector	Stock	Price	Target	Rec	T/P - 1
-1.0%	-2.0%	-3.0%	Energy	SANTOS	3.91	3.46	2.75	-11.5%
2.7%	1.1%	-0.1%	Materals	AMCOR	14.55	12.24	2.46	-15.9%
-1.2%	5.7%	2.7%		BHP BILLITON	25.88	21.67	2.71	-16.3%
1.6%	4.2%	-2.0%		INCITEC PIVOT	3.74	3.50	2.36	-6.4%
2.2%	8.8%	1.2%		RIO TINTO	65.95	53.90	2.53	-18.3%
1.0%	-5.7%	-3.2%	Industrials	BRAMBLES	10.55	9.55	2.54	-9.5%
4.8%	0.0%	3.0%		SYDNEY AIRPORT	6.17	7.06	2.39	14.3%
5.1%	0.9%	0.0%		TRANSURBAN GROUP	10.95	11.86	2.43	8.3%
3.6%	0.0%	-3.4%	Discretionary	JB HI-FI	28.47	30.12	2.46	5.8%
4.3%	0.8%	-0.1%	Health	COCHLEAR	134.04	127.50	3.18	-4.9%
1.8%	3.5%	3.3%		CSL	114.37	86.96	2.42	-24.0%
2.3%	0.0%	-0.1%		RAMSAY HEALTH CARE	69.88	78.35	2.33	12.1%
4.6%	4.9%	-3.3%		RESMED CDI.	9.15	7.22	2.27	-21.1%
1.1%	1.3%	-11.9%	Financials	BENDIGO & ADELAIDE BANK	12.63	11.30	3.62	-10.5%
5.7%	-0.9%	-1.2%		CHALLENGER	11.53	10.92	2.60	-5.3%
1.5%	2.7%	-6.7%		COMMONWEALTH BK.OF AUS.	82.90	80.55	3.20	-2.8%
1.9%	6.0%	0.0%		MACQUARIE GROUP	85.09	89.00	2.43	4.6%
1.4%	1.1%	-2.1%		SUNCORP GROUP	13.33	14.00	2.43	5.0%
2.6%	1.2%	-5.3%		WESTPAC BANKING	32.73	33.40	2.60	2.0%
4.6%	0.5%	-0.2%	Property	GOODMAN GROUP	7.25	7.54	2.46	4.0%
7.1%	-1.5%	-2.4%	Telcos	TPG TELECOM	6.64	9.65	2.42	45.3%
5.2%	13.2%	-3.2%	Utilities	AGL ENERGY	24.68	23.80	2.39	-3.6%

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: BEN, CBA, and COH. I argue in the rebalancing section (just after the Chart Appendix) for COH. For a yield-stock like BEN, I am getting a little worried by a 3.62 but it is nicely outperforming the benchmark in Table 6 (up +9.1% in about three months). I am thinking that much of the downward revision is due to the strong rally it has enjoyed. I have this stock on watch.

I was happy to buy CBA as a big, sturdy dividend play at 3.00 with some capital gains' prospects. It's already made some nice gains (+6.6% in nearly two months!) from Table 6 and the downgrade to 3.20 is even less relevant for a big bank.

I've included Table 8 to show the real action in my rebalance over the first few months using actual buy and sell prices – and yesterday's closing prices. Those stocks I sold would have gained +2.0% over the near three months had I not sold – while the buys gained +9.6% when the ETFs (excluding IHOO) are included! That's about a +7.6% benefit from not having sat on my hands in about four months!

Table 8: Analysis of returns since rebalancing

Code	Date	Price change	Code	Date	Price change
Sell all			**Buy all**		
VCX	3/10/2016	-9.5%	**BXB**	4/10/2016	-12.2%
SPO	3/10/2016	-11.9%	**CGF**	4/10/2016	11.9%
TTS	3/10/2016	13.1%	**IPL**	4/10/2016	32.6%
PRY	3/10/2016	-1.3%	**VOC - SOLD 29/11/2016**		-25.7%
AMP	3/10/2016	-1.9%	**CBA**	29/11/2016	6.0%
DUE	3/10/2016	13.2%	**Total**		**6.3%**
IFL	3/10/2016	4.0%			
AZJ	4/10/2016	11.8%	**Buy more**		
MGR	4/10/2016	-3.6%	**AGL**	4/10/2016	30.8%
SGP	4/10/2016	-4.5%	**AMC**	4/10/2016	-3.3%
Total		**1.6%**	**BHP**	4/10/2016	13.8%
			GMG	4/10/2016	0.4%
Sell some			**RIO**	4/10/2016	26.3%
TCL	3/10/2016	-2.6%	**Total**		**13.9%**
MQG	3/10/2016	3.3%			
WBC	3/10/2016	8.7%	**ETFs:**	various	
SYD	3/10/2016	-10.8%	**IHVV**	around	**11.5%**
Total		**3.2%**	**IOZ**	election	
Sell total		**2.0%**	**Buy total**		**9.6%**

Note: The VOC price change is up to the sale price I got on 29th November, 2016 when I sold at 4.52.

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 July 1 2017:*

Buy IOZ at 5,350 from Table 1a (up to maximum levels determined by risk assessments) and start to sell at 6,300 for new investments. If the ASX 200 *falls to 4,950 (high-volatility low) it might be prudent to exit the strategy until clarity emerges and then buy back in at (well) above 4,950 but below 5,350.*

Buy IVV:IHVV at 2,180 (up to maximum levels determined by risk assessments from Table 2a) and sell at 2,750 for new investments. If the S&P 500 falls to 2,050 (high-volatility low) it might be prudent to exit the strategy until clarity emerges and then buy back in at (well) above 2,050 but below 2,180.

For old investments start to take profits (lightly) at 2,610 (the FY17 forecast high in Table 2b) and more aggressively at 2,750 from Table 2a.

The difference between the price index for the ASX 200 in Chart 7 and the IOZ accumulation index in Chart 11 is more than stunning. IOZ has not kept pace with its price index benchmark but it has so with its accumulation index benchmark.

Charts 7 to 10 are based on the price indexes as this is the metric where the signals are being made.

The strategy has been returning +11.8% pa since inception (Table 9) (including dividends). The IVV-IHVV leg is up +13.0% pa. The IOZ part of the strategy is up +10.7% pa. The table below shows that I am now 64% hedged in the Wall Street component. The domestic share of the portfolio is 49%.

Table 9: Total returns on IOZ:IVV strategy

10-Feb-2017	Inc divs.	Current allocation	
ETF	**IRR pa**	**Total**	**USA**
IOZ	10.7%	49%	
IVV+IHVV	13.0%	51%	100%
IVV	10.3%		36%
IHVV	18.8%		64%
Total	11.8%	100%	
Indexes		**Alpha pa**	
ASX 200	6.9%	3.8%	
S&P 500	8.4%	1.8%	
S&P 500 ($A)	10.6%	8.2%	

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 9 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 8 to 12 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 (etc), 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. 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 8: IOZ buy points - ASX 200

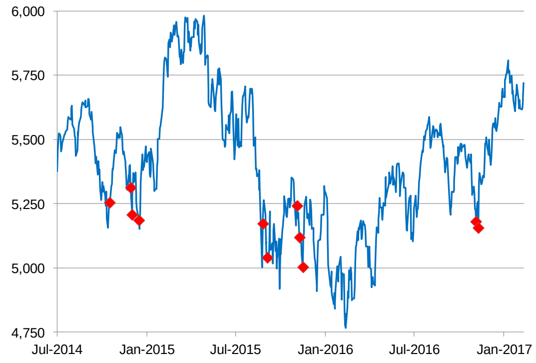


Chart 9: Buys - S&P 500 ($US; i.e. unhedged)

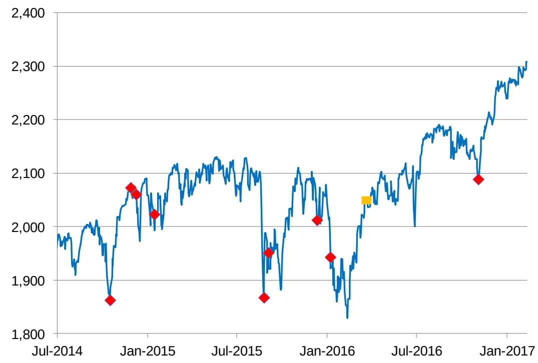


Chart 10: Buys S&P 500 ($A; i.e. hedged)

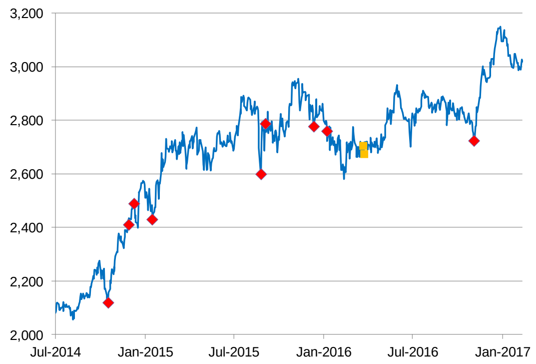


Chart 11: AUD hedging points

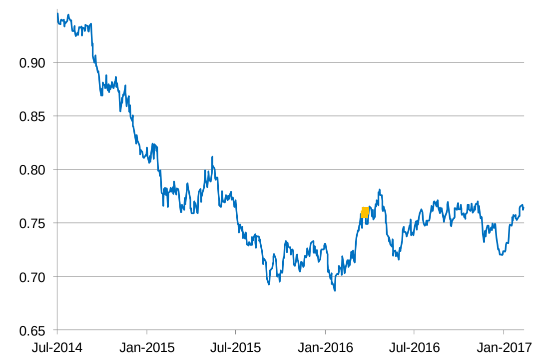
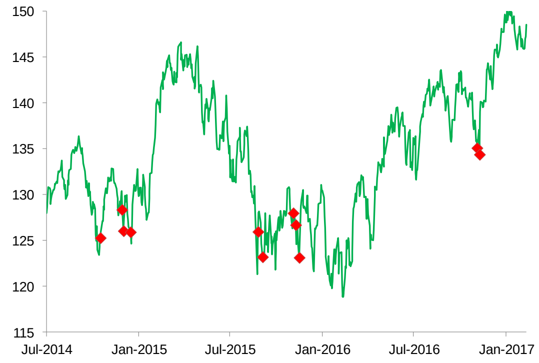


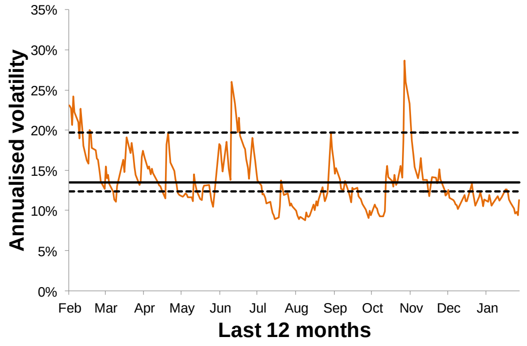
Chart 12: IOZ buys – IOZ accumulation index



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 dots in Charts 9 and 10 refer to either IVVV or IHVV or both. Hedging or not refers only to the underlying index.

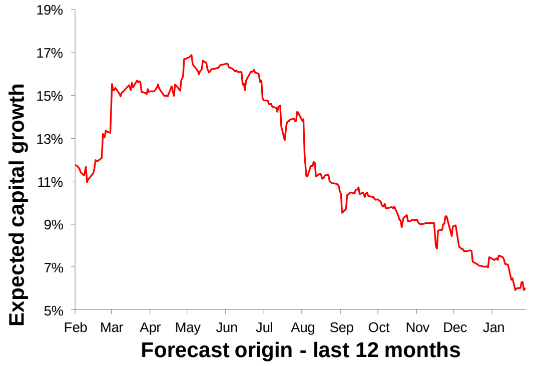
Chart Appendix

Chart A-1: Market volatility



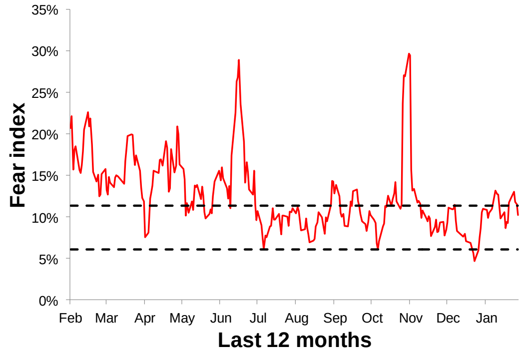
Notes: The solid black line depicts the average volatility since January 2010; the lower dotted line depicts the average volatility pre the GFC; the higher dotted line depicts the average level of volatility during the GFC - up to December 2009. The brown line is a daily estimate of the ASX 200 index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

Chart A-4: 12-month capital gains forecasts



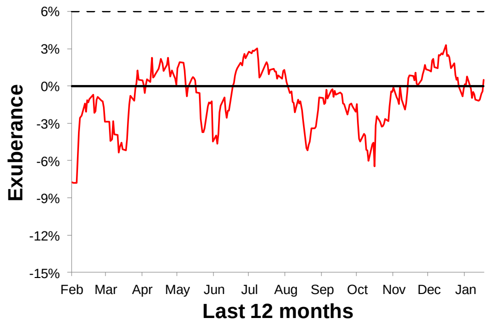
Notes: Each business day we update our estimates for capital gains on the ASX 200 for the following 12 months. For example, the left-most estimate on the vertical axis is a forecast for the 12 months concluding today. The right hand estimate is for the 12 months from today.

Chart A-2: Fear index



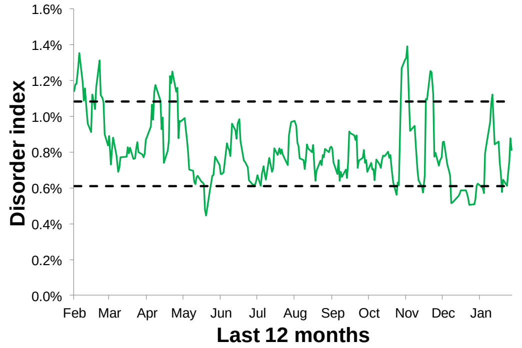
Notes: The fear index is a measure of 'excess' volatility denoting behaviour outside the open/close values each day. The two dotted lines depict the band in which the fear index resided before the GFC in two thirds of days. Extended periods below the lower dotted line might indicate complacency. Extended periods, or extreme values, of the index above the higher dotted line might indicate a propensity for the market to overreact in an irrational manner.

Chart A-5: Market exuberance



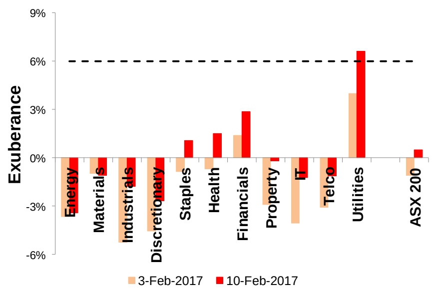
Notes: Exuberance is our measure of mispricing on the ASX 200. A value below the solid black line denotes the market is perceived to be cheap and above that line expensive. Experience suggests that exuberance above +6%, denoted by the dotted line, is an indicator of a potential correction of 6% to 10%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

Chart A-3: Disorder index



Notes: The disorder index measures the degree to which the 11 sectors' daily returns move in harmony. The two dotted lines depict the band in which the disorder index resided before the GFC in two thirds of days. Extended periods below the lower dotted line might indicate belief that there is little information to have different impacts on different sectors. Extended periods, or extreme values, of the index above the higher dotted line might indicate investors and traders are lurching from sector to sector in search of a new trend.

Chart A-6: Sector exuberance



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

Glossary

Abenomics – Japan's Prime Minister Shinzo Abe came to power early in 2013 and has brought a new economic style to managing that economy.

ASX forecasts - We have further supplemented our forecasting process for the ASX 200 by including not just a forecast of the peak (at some unspecified time during the year) but also the low. Thus, we now have an end point (e-o-y forecast) and a range for the whole year. Naturally, on a rising market the low is more likely to occur earlier in the year and the high nearer the end. Since we publish our forecasts to the nearest 50 points to reduce the sense of false accuracy a change of just a couple of points can kick the forecast over by 50 points at around the 25 and 75 marks.

Australian debt ceiling – Labor brought in a debt ceiling in mid 2008 of $75bn to self-impose some fiscal discipline during the onset of the GFC. Within seven months that ceiling was almost trebled to $200bn and it has since been raised to $300bn during Labor's term in office. Since before 2008 we had no debt ceiling that is equivalent to an infinite ceiling!!!

Bad debt, good debt – Whether one is referring a household or national debt, the classification implies the following. Good debt is expected to produce income or other returns in the future – such as from infrastructure spending or buying a principal place of residence. Bad debt is used to finance 'recurrent' expenditure such as pensions or family holidays.

Black Friday – This term is used for the Friday after Thanksgiving in the US to denote the start of the shopping season for the holidays. Black refers to the accounts going back into the black from increased sales – it is certainly not a negative term!

Brexit – on 23rd July 2016 Britain voted to leave the European Union. The process is expected to take at least two years and negotiations must take place to engineer a smooth transition.

CAIXIN (formerly HSBC) flash PMI – CAIXIN publishes an alternative to the official PMI for China. It is based on a survey of predominantly small to medium sized firms – unlike the official version. The number on the 1st of the month gets much less attention than the official but the preliminary, or 'flash', reading gets attention as a read a week or two before the official numbers.

China's shadow banking – In essence, the China government dictates what all banks must lend at and pay for deposits. As a result, if a potential borrower is deemed too risky at the prevailing rate, the banks refuse to lend (rather than increase borrowing rates as may happen here). The 'failed' borrower may then seek funding from the shadow banking system that is not so regulated.

FOMC – The Federal Open Market Committee determines monetary policy in the United States. It can be thought of as being similar to our Reserve Bank board.

GOP – stands for Grand Old Party which is an alternative name for the US Republican Party.

High-Yield Sectors: by this, we mean Financials, Property, Telcos and Utilities.

International Monetary Fund (IMF) – Managing Director, Christine Lagarde (French), since 28th June 2011. The IMF is charged with fostering global monetary cooperation.

ISM - Institute of Supply Management produces a 'PMI-like' number for the US economy. Like the PMI, 50 is the cut off between improving and worsening expectations.

Long-run mispricing – Our measure is based on analysing trends over more than a century of data. The average period of over- or under-pricing is about 18 months. That is, we do not expect the market to rapidly approach its fair value.

MYEFO (Mid-year economic and fiscal outcome) is a mid-year update on the Australian Budget situation – usually in December.

PMI – This acronym stands for Purchasing Managers Index. There is one for most countries and separate statistics for manufacturing and services. Manufacturing typically gets more attention. The official statistics are published in the first few days of each month – with China on the 1st. A reading less than 50 means the sector is decreasing in its growth rate – so If China growth slows from 8% to 7%, its PMI should be below 50. If the US speeds up from 2% to 2.5%, its PMI should be above 50. Note also the existence of the CAIXIN measure and its 'flash' or preliminary estimate.

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

Short-run mispricing – Our exuberance measure is our mispricing statistic reported in Chart 5. It is based on 12-month-ahead forecasts of the ASX 200. Please see the notes under Chart 5.

Tapering – It was the name given to the exit strategy from QE3. It is not a tightening monetary policy – just an increasingly less accommodative stimulus.

US non-farm payrolls data – are usually published on the first Friday of each month. They are generally considered to be the most reliable indicators for employment and unemployment in the US. Roughly speaking, a 200,000 increase in jobs is considered strong. Of course less new jobs are needed when the economy is running at full employment.

Key people

Australia – Prime Minister, Malcolm Turnbull, (Liberal) since 14th September 2015; Treasurer, Scott Morrison, since 21st September 2015; 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; President of the People's Bank of China (**POBC**) since December 2002.

Europe – President of the European Central Bank (**ECB**), Mario Draghi (Italian), since 1st November 2011; Chancellor of Germany, Dr Angela Merkel, since 22nd November 2005; President of France, Francois Hollande, since 15th May 2012; Prime Minister of Greece, Alexis Tsipras, since 21st September 2015.

Japan – Prime Minister, Shinzo Abe, since 26th December 2012; Emperor, Akihito, enthroned 12th November 1990; Governor of the Bank of Japan (**BoJ**), Haruhiko Kuroda, since 20th March 2013.

New Zealand – Prime Minister and Treasurer, Bill English, since 12th December 2016; Minster of Finance, Steven Joyce, since 20th December 2016; Governor of the Reserve Bank of New Zealand (**RBNZ**), Graeme Wheeler, since 26th September 2012.

United Kingdom – Prime Minister, Theresa May, since 11th July 2016; Chancellor of the Exchequer, Philip Hammond, since 13th July 2016; Governor of the Bank of England (**BoE**), Mark Carney (Canadian), since 1st July 2013.

United States of America – President, Donald Trump, from January 20th 2017 (4 year term); Chair of the Federal Reserve Bank (**Fed**), Dr Janet Yellen, since 3rd April 2014 (4 year term).

The October 2016 rebalance

After thinking about it for six months, I finally started the process of rebalancing on Monday, October 3rd – 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 30th 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 11th 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 30th to Oct 7th) 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.

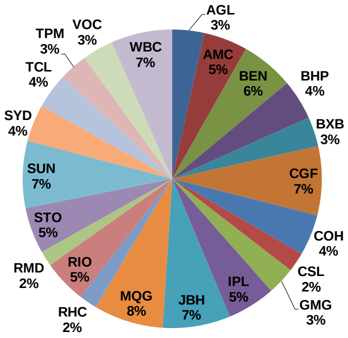
On Tuesday, the market fell so I bought all of my BXB, CGF, IPL and VOC. I topped up AGL, AMC, BHP, GMG, and RIO. I sold AZJ, MGR and SGP. That's 23 trades in two sessions!

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 7th 2016 is in the following pie chart.

Chart: New portfolio after rebalance



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

Table: Sector weights at October 7th 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%