11 March 2017

Woodhall's Weekly

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If Yellen doesn't hike ...

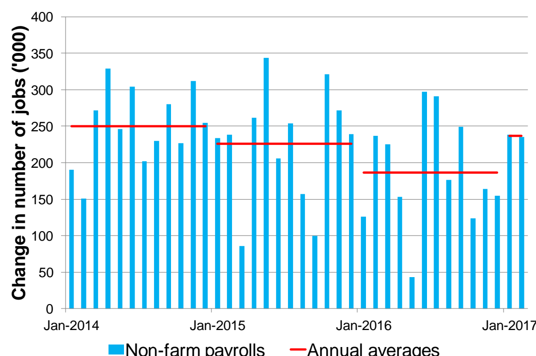
- **Is the nfp number right for a hike?**
- **RBA on hold at 1.5%**
- **No bubble in property prices**

Overview

Over this last week, markets have all but turned a March 15th Fed possible hike decision into a definite rate hike. Given that, the Fed might as well please the market, but should it? If it doesn't we shudder to think what might happen in markets.

The nonfarm payrolls came in last night at +235,000 – a good number by anybody's standards – as can be noted from the Chart of the Week. On top of that, the unemployment rate fell a notch to 4.7% but wage growth came in at 2.8% for the third month in a row. Not exactly great but good enough.

Chart of the Week: US nonfarm payrolls



There were some promising moves in the participation rate. Folk who didn't finish high school are starting to come back to the workforce but those who graduated from high school are yet to follow suit.

While not perfect, recent jobs data are about as good as they are going to get anytime soon. A hike on Thursday morning will take the pressure off the Fed for months to come. But if Trump doesn't put some rubber on the road quickly enough, the Fed might have to shift into reverse gear before the end of 2017.

At home, the RBA kept rates on hold at 1.5%. Blind Freddy can see that we need a rate cut. Two false arguments are being set against that view:-

Some say the switch from a mining boom to the new economy is going smoothly. Have they not noticed that, over the last 12 months or so, that commodity prices have rallied very hard. We are riding 'China Boom II: The Last Chance' very hard indeed – as we should. Dr Phil Lowe (RBA Governor) is believed to have been booked to play the villain. The producers are having trouble casting the part of the hero. Could this be a job for Arnie?

The second reason is related to property prices. I remember writing many reports, giving many presentations and press conferences on the topic in 2003-2005. The same arguments were then being put as now. I rejected the bubble merchants then and do so again now.

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I even made the front page of the Sydney Morning Herald on the topic over a decade ago arguing that it is normal for prices to rise hard for a few years and then plateau for 4 – 7 years (or maybe even 10).

We got the plateau and then another ‘step’ up in recent years. Nobody remembers the last time around (or where they in junior school at the time?).

A bubble is only a bubble if the price of an asset has been bid up above a sustainable level. It has nothing to do with whether prices are high – or fair – or out of the reach of youngsters.

I don’t think that anyone I know – even at my age and regardless of career paths – expects to be able to buy a house with a garden in central London or New York. So why should youngsters expect more than that in Sydney or Melbourne? Australia is coming of age – and with that comes exclusivity of prime locations. There is a queue more than a mile long (or is it 1.6 km) ready to buy any house with a garden in central Sydney/Melbourne. A bubble can only be a bubble when there is no queue of buyers at around that price.

When one delves into house prices in submarkets – by geography, size, or price – queue lengths vary a lot. Some house or unit prices may go down – but not the whole market in Sydney or Melbourne.

That means our banks deservedly look in good shape. Their home loan books are largely in good shape. The Senate Committee doesn’t like it. But it seems more that they don’t like successful people.

I watched most of the proceedings and they reminded me of bully-boy tactics. In our view, many members of the committee put points of view (or silly questions) when they knew the CEO could not respond by putting them in their places because of possible media backlash – that’s how bullies work.

Getting back to macro data – at least we got a positive Retail Sales number (+0.4%) but last months’ number was a miserable -0.1%. So don’t get excited just yet!

China Boom II will probably be much smaller than the previous boom – but it buys us some breathing space. We have our January employment figures due on Thursday – just after the Fed decision. We’re guessing full-time employment will again underwhelm us.

China puts out its Retail Sales, Production and Investment data just before Thursday’s big data day. We expect a very good set of numbers. Given that no sales data were released last month, because of the Lunar New Year, this is a big update.

Last weeks’ China inflation data were really promising. The PPI producer index posted the biggest inflation in nine years and the consumer version was just fine.

Trump has split his repeal of Obamacare into three parts. The first is an executive order which has already been made. The next two require votes which might not easily be found. So if Obamacare is meant to be done and dusted before the tax cuts etc, we think we are still looking at June before we get any real clear line of sight on the upcoming stimulus package.

The EC re-elected its president, Tusk, and Draghi kept the ECB rate on hold – and he signalled that the next move is up – even if it is quite a while away. Europe is back on its feet – if not yet quite moving along at above jogging pace.

This coming week will test markets. It will take at least a week before we have enough information to set a new course. In between there is likely to be some tame volatility hiding in the wings. We think March will be a good month despite a mixed start.

Our statistics show an uplift in our ASX 200 capital gains forecast such that out end of 2017 forecast has lifted from our Jan 1 forecast of 6,000 to 6,050.

It also seems that the high-yield play is coming back in force and some rebalancing of our SMSF portfolio should be made when the next model portfolio is manufactured on April 1st.

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-Mar-2017	10-Mar-2017
Low	5,350	5,450	5,500
High	6,300	6,300	6,350
End	6,000	6,000	6,050
Fair value	5,600	5,750	5,750
Exuberance	1.5%	-0.3%	0.3%
ASX 200	5,666	5,730	5,776

Table 1b: ASX 200 range forecasts FY2017

Forecast	Forecast origin		
FY '17	30-Jun-2016	3-Mar-2017	10-Mar-2017
Low	5,100	5,500	5,550
High	6,350	6,050	6,050
End	6,150	5,850	5,850
Fair value	5,350	5,750	5,750
Exuberance	-2.1%	-0.3%	0.3%
ASX 200	5,233	5,730	5,776

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) has risen to 6,050 – higher than the forecast at the start of the year! Fair value is steady at 5,750. The updated eofy forecast in Table 1b is steady at 5,850.

Chart 1a: Graphical representation of Table 1a

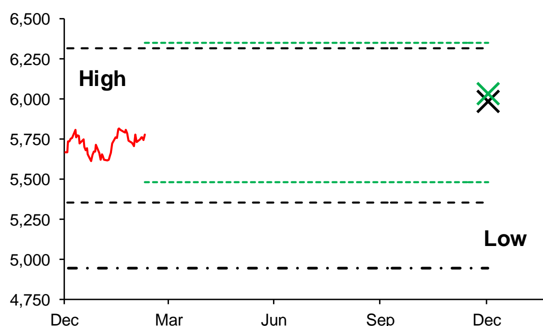
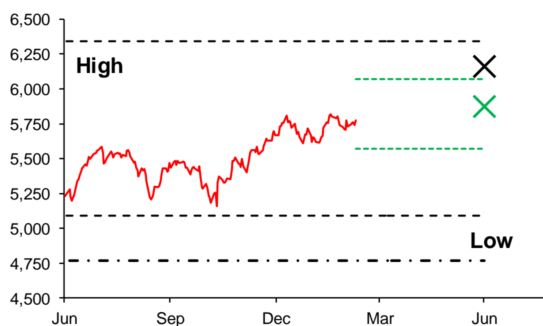


Chart 1b: Graphical representation of Table 1b



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 is steady at 2,590. Fair value is also steady at 2,350.

The eofy forecast update in Table 2b slipped back to 2,450. The high forecast is 2,520 and the low under normal volatility is 2,300.

Table 2a: S&P 500 range forecasts 2017

Forecast	Forecast origin		
CY16	30-Dec-2016	2-Mar-2017	9-Mar-2017
Low	2,180	2,290	2,280
High	2,750	2,690	2,690
End	2,680	2,590	2,590
Fair value	2,250	2,350	2,350
Exuberance	-1.2%	1.8%	0.6%
S&P 500	2,239	2,382	2,365

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

Forecast	Forecast origin		
FY '17	30-Jun-2016	2-Mar-2017	9-Mar-2017
Low	2,050	2,310	2,300
High	2,610	2,530	2,520
End	2,530	2,460	2,450
Fair value	2,100	2,350	2,350
Exuberance	-0.8%	1.8%	0.6%
S&P 500	2,099	2,382	2,365

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

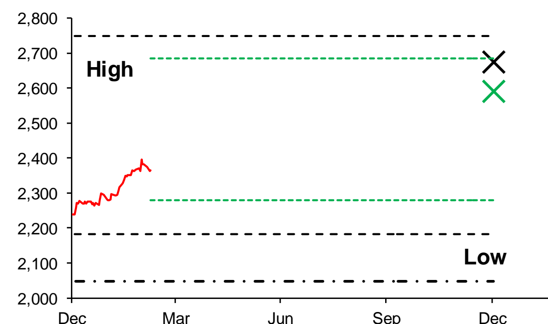
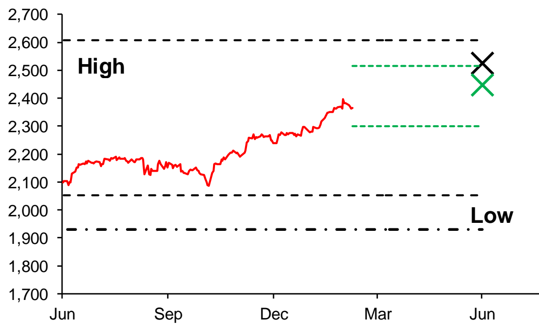


Chart 2b: Graphical representation of Table 2b



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.

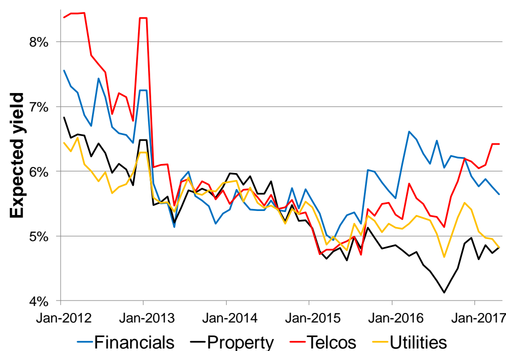
Market stats

Our market volatility index (Chart A-1 to be found in the Chart Appendix) is below average at 10.3%. Our Fear Index (Chart A-2) is in the zone at 8.8%. The VIX stands at a low 11.7%. Our Disorder index (Chart A-3) is in the zone at 0.7%. Conditions are very calm considering we are going into a busy week.

Our 12-month capital gains forecast (Chart A-4) climbed to +5.9%. The market is fairly priced at +0.3% (Chart A-5). So that leaves the adjusted 12-month capital gains' forecast at +5.6%. 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 Financials (+5.2%) and Utilities (+5.1%) are just under the danger zone. Staples (+3.9%) and Health (+3.6%) are also quite a bit over-priced. All other sectors are moderately priced or under-priced.

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 broke down. They are starting to get back together – but only slowly. However, recent price falls in Telcos have put upward pressure on expected yields.

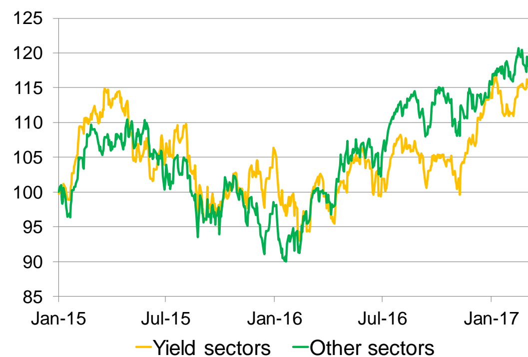
The yield play definitely waned during 2016 but there was a big comeback which can best be seen from Table 3. Yield gained strongly over 1, 3 and 6 months but it is down -2.7% over 12 months. Recent results have been mixed but a new trend is emerging. High yield may be back.

Table 3: Yield play - total returns

	Sector		
Period	**Yield**	**Other**	**Difference**
1 year	15.9%	18.6%	-2.7%
6 months	13.6%	7.3%	6.3%
3 months	6.1%	4.3%	1.8%
1 month	5.0%	1.6%	3.4%

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 is almost back up to the green line.

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

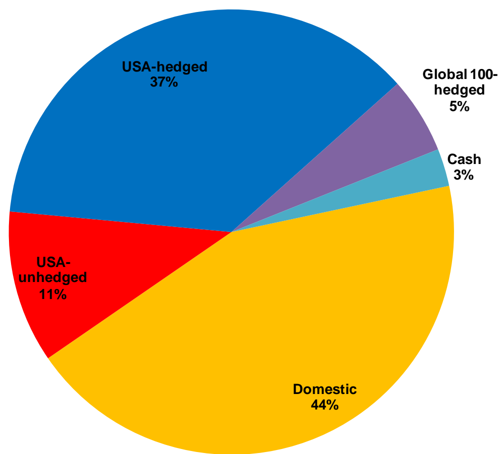


SMSF Share Portfolio

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.

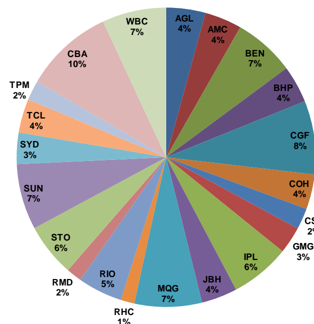
The current allocation pie chart is shown in Chart 5.

Chart 5: Asset allocation on SMSF



There are currently 21 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 +2.5% p.a. (annualised) since inception. After all of the turbulence of recent times the portfolio is still returning +9.8% p.a. for over two and a half years.

Table 4: Total returns from SMSF (domestic equities)

Period	Portfolio	ASX 200	Alpha
Since inception	9.8%	7.4%	2.5%
2 years	4.9%	4.5%	0.4%
1 year	16.7%	17.1%	-0.4%
6 months	6.2%	9.6%	-3.5%
3 months	3.6%	5.3%	-1.7%

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 (-3.5%), 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 slipped below benchmark at -0.9%.

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

Period	Portfolio	ASX 200	Alpha
Since Oct rebal	6.8%	7.6%	-0.9%
2 months	-0.6%	0.6%	-1.2%
1 month	2.0%	3.4%	-1.4%

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	37.2%	-5.9%	11.6%	2.8%	**Sold**	11.3%	19.0%	-5.6%
Alpha	29.3%	-13.7%	3.7%	-5.0%	**21/2/17**	3.4%	11.2%	-13.5%

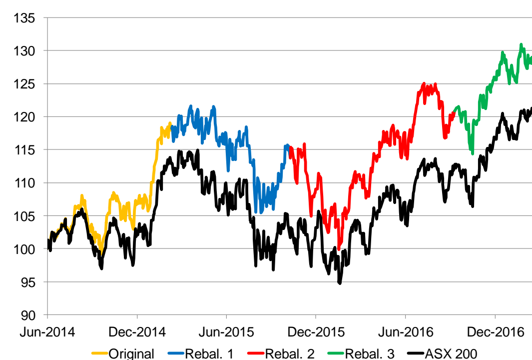
	CSL	GMG	IPL	JBH	MQG	RHC	RIO	RMD
Return	19.2%	7.7%	37.7%	-9.1%	8.6%	-16.2%	15.6%	11.1%
Alpha	11.3%	-0.1%	29.9%	-17.0%	0.7%	-24.1%	7.7%	3.3%

	STO	SUN	SYD	TCL	TPM	WBC		ASX 200
Return	-7.9%	10.5%	-4.6%	5.0%	-20.8%	17.8%		7.9%
Alpha	-15.8%	2.7%	-12.5%	-2.9%	-28.6%	10.0%		-1.6%

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
-2.2%	-4.8%	0.0%	Energy	SANTOS	3.59	3.30	2.75	-8.1%
1.2%	-0.9%	0.0%	Materals	AMCOR	14.35	12.19	2.50	-15.0%
-6.6%	-2.4%	0.0%		BHP BILLITON	23.67	21.64	2.71	-8.6%
1.0%	0.0%	0.0%		INCITEC PIVOT	3.87	3.50	2.36	-9.6%
-3.2%	-0.4%	0.0%		RIO TINTO	58.97	54.19	2.53	-8.1%
-1.0%	-16.1%	0.0%	Industrials	BRAMBLES	9.22	7.71	2.83	-16.3%
2.2%	-2.0%	0.0%		SYDNEY AIRPORT	6.14	6.92	2.46	12.7%
0.2%	0.0%	0.0%		TRANSURBAN GROUP	11.05	11.98	2.39	8.4%
-0.8%	2.2%	0.0%	Discretionary	JB HI-FI	25.62	31.90	2.62	24.5%
1.8%	-1.8%	0.0%	Health	COCHLEAR	132.69	125.00	3.33	-5.8%
4.5%	2.3%	0.0%		CSL	125.91	94.08	2.08	-25.3%
-3.8%	-2.3%	0.0%		RAMSAY HEALTH CARE	66.55	76.55	2.33	15.0%
-1.5%	-1.3%	0.0%		RESMED CDI.	9.40	7.11	2.22	-24.4%
2.2%	0.0%	0.0%	Financials	BENDIGO & ADELAIDE BANK	11.94	11.51	3.71	-3.6%
2.6%	0.0%	0.0%		CHALLENGER	12.11	11.28	2.67	-6.9%
1.6%	1.1%	0.0%		COMMONWEALTH BK.OF AUS.	84.50	84.19	3.20	-0.4%
1.4%	0.0%	0.0%		MACQUARIE GROUP	88.95	89.00	2.43	0.1%
0.4%	0.7%	0.0%		SUNCORP GROUP	13.52	14.16	2.36	4.7%
3.5%	0.3%	0.0%		WESTPAC BANKING	35.13	33.50	2.60	-4.6%
-2.5%	1.6%	0.0%	Property	GOODMAN GROUP	7.42	7.68	2.55	3.5%
1.6%	0.0%	0.0%	Telcos	TPG TELECOM	6.37	9.65	2.58	51.5%
3.1%	0.0%	-3.6%	Utilities	AGL ENERGY	25.47	25.00	2.42	-1.8%

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.

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 worried by a '3.71' but it is nicely outperforming the benchmark in Table 6 (up +3.7% in about three months) even after the sell-off following its February report. 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 (+11.3% in about three months!) from Table 6 and the downgrade to 3.20 is even less relevant for a big bank.

Table 8: Analysis of returns since rebalancing

Code	Date	Price change
Sell all		
VCX	3/10/2016	-12.4%
SPO	3/10/2016	-29.1%
TTS	3/10/2016	16.6%
PRY	3/10/2016	-17.0%
AMP	3/10/2016	-4.9%
DUE	3/10/2016	11.2%
IFL	3/10/2016	-5.8%
AZJ	4/10/2016	13.8%
MGR	4/10/2016	-3.2%
SGP	4/10/2016	-1.9%
Total		**-2.8%**
Sell some		
TCL	3/10/2016	-1.7%
MQG	3/10/2016	8.0%
WBC	3/10/2016	16.7%
SYD	3/10/2016	-11.3%
Total		**8.2%**
Sell total		**0.2%**

Code	Date	Price change
Buy all		
BXB - SOLD 21/2/2017		-22.9%
CGF	4/10/2016	17.5%
IPL	4/10/2016	37.2%
VOC - SOLD 29/11/2016		-25.7%
CBA	29/11/2016	8.0%
Total		**8.1%**
Buy more		
AGL	4/10/2016	35.0%
AMC	4/10/2016	-4.7%
BHP	4/10/2016	4.0%
GMG	4/10/2016	2.8%
RIO	4/10/2016	12.9%
Total		**9.0%**
ETFs:	various	
IHVV	around	**14.5%**
IOZ	election	
Buy total		**11.0%**

Note: The VOC price change is up to the sale price I got on 29th November, 2016 when I sold at 4.52. The BXB price is up to when it was sold on 21st February, 2017.

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 +0.2% over the near three months had I not sold – while the buys gained an actual +11.0% when the ETFs (excluding IHOO) are included! That's about a +10.8% benefit from not having sat on my hands in about five 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 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 +13.2% p.a. since inception (Table 9) (including dividends). The IVV-IHVV leg is up +14.7% p.a.. The IOZ part of the strategy is up +11.7% p.a.. The table below shows that I am 64% hedged in the Wall Street component. The domestic share of the portfolio is 49%.

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.

Table 9: Total returns on IOZ:IVV strategy

10-Mar-2017	Inc divs.	Current allocation	
ETF	**IRR pa**	**Total**	**USA**
IOZ	11.7%	49%	
IVV+IHVV	14.7%	51%	100%
IVV	11.7%		36%
IHVV	20.9%		64%
Total	13.2%	100%	
Indexes		**Alpha pa**	
ASX 200	7.5%	4.1%	
S&P 500	9.2%	2.5%	
S&P 500 ($A)	12.3%	8.5%	

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

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

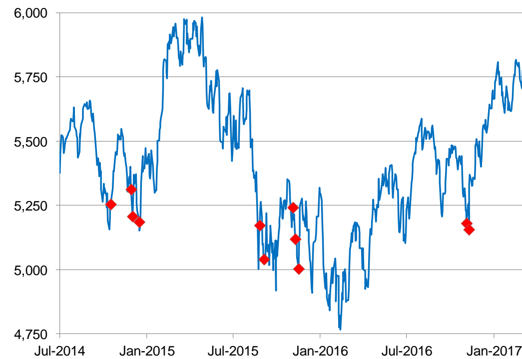


Chart 9: Buys - S&P 500 ($US; i.e. unhedged)

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

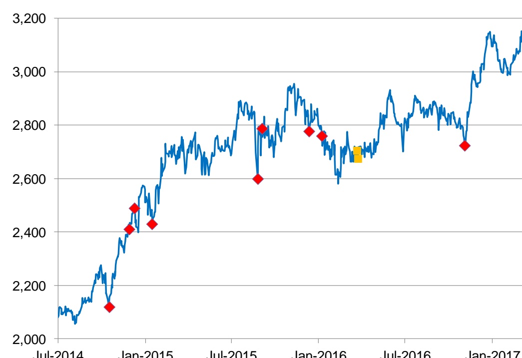


Chart 11: AUD hedging points

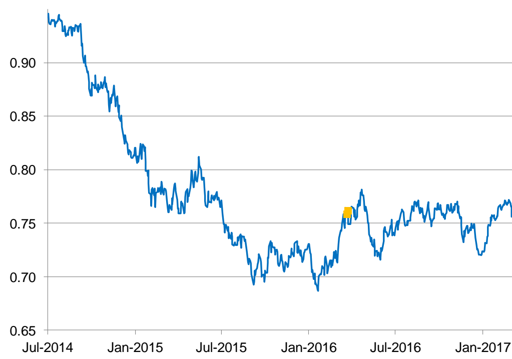
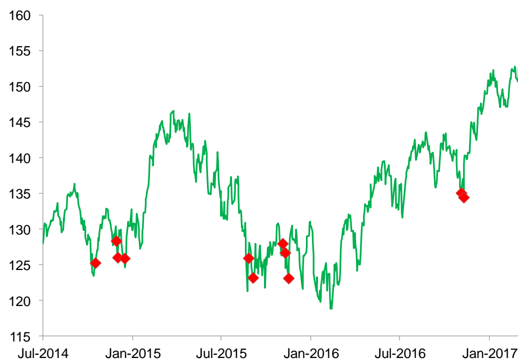


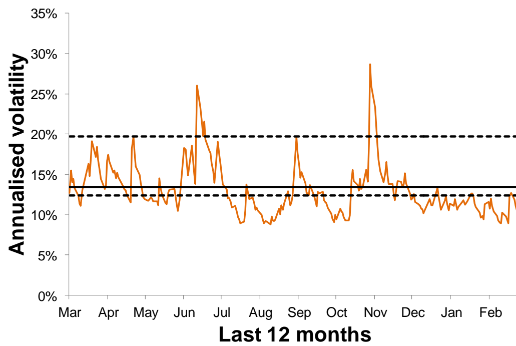
Chart 12: IOZ buys – IOZ accumulation index



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.

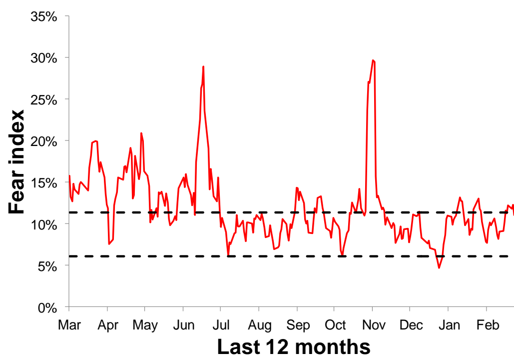
Chart Appendix

Chart A-1: Market volatility



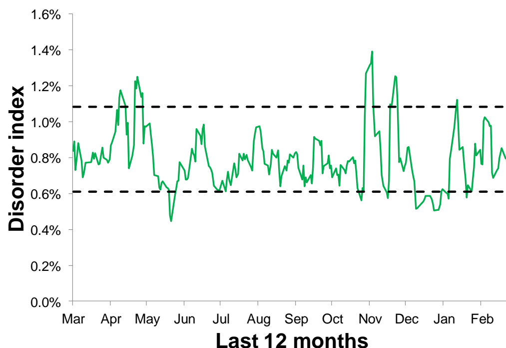
Notes: The solid black line depicts the average volatility since January 2010; the lower dotted line depicts the average volatility pre the GFC; the higher dotted line depicts the average level of volatility during the GFC - up to December 2009. The brown line is a daily estimate of the ASX 200 index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

Chart A-2: Fear index



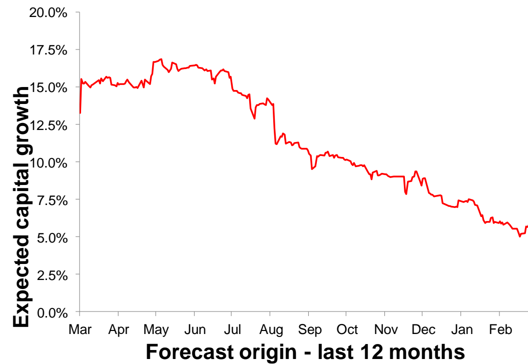
Notes: The fear index is a measure of 'excess' volatility denoting behaviour outside the open/close values each day. The two dotted lines depict the band in which the fear index resided before the GFC in two thirds of days. Extended periods below the lower dotted line might indicate complacency. Extended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



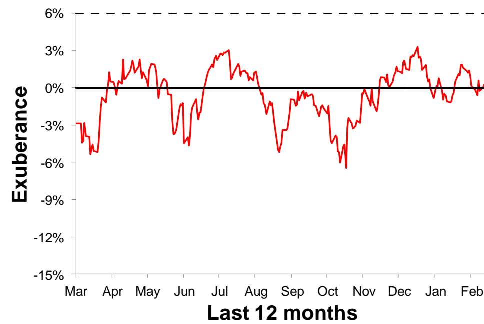
Notes: The disorder index measures the degree to which the 11 sectors' daily returns move in harmony. The two dotted lines depict the band in which the disorder index resided before the GFC in two thirds of days. Extended periods below the lower dotted line might indicate belief that there is little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



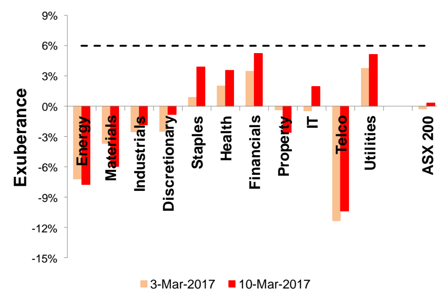
Notes: Each business day we update our estimates for capital gains on the ASX 200 for the following 12 months. For example, the left-most estimate on the vertical axis is a forecast for the 12 months concluding today. The right hand estimate is for the 12 months from today.

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!!!

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	
Code	**share**
AGL	3.50%
ALL	7.24%
AMC	4.66%
BHP	4.25%
BOQ	6.49%
BXB	3.13%
CGF	7.28%
CSL	3.04%
GMG	3.16%
IPL	5.14%
MQG	7.50%
ORG	2.89%
RHC	3.34%
RIO	4.70%
RMD	3.60%
SUN	6.86%
SYD	3.42%
TCL	3.37%
VOC	6.93%
WBC	6.77%
WPL	2.74%

Old portfolio	
Code	**share**
AGL	1.59%
AMC	2.05%
AMP	4.10%
AZJ	3.82%
BEN	4.42%
BHP	1.68%
COH	3.47%
CSL	1.67%
DUE	2.00%
GMG	1.36%
IFL	4.50%
JBH	5.78%
MGR	2.60%
MQG	8.78%
PRY	3.24%
RHC	1.53%
RIO	1.77%
RMD	1.30%
SGP	2.37%
SPO	1.83%
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.

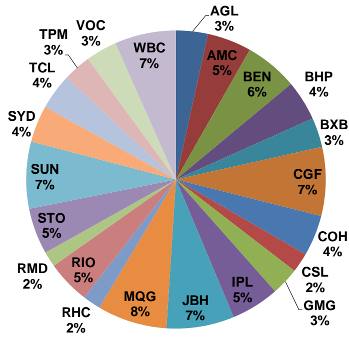
On Tuesday, the market fell so I bought all of my BXB, CGF, IPL and VOC. I topped up AGL, AMC, BHP, GMG, and RIO. I sold AZJ, MGR and SGP. That's 23 trades in two sessions!

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%