16 March 2013

Woodhall's Weekly

Ron Bewley PhD, FASSA

China's data out last Saturday gave a hint of weakness with soft retail and industrial production numbers. The big question is whether these data were affected by the Lunar New year holidays. On the other hand, there were cracking US retail sales (+1.1%) and US jobs data +236,000 (when only 165,000 non farm-payrolls jobs were expected). US unemployment dropped to 7.7% from 7.9%.Surprisingly US consumer confidence slipped at the end of the week. At home, we all had to take second glance at the 71,500 increase in employment (against an expected 10,000) on Thursday.

Our market had a 60 point sell off on Thursday – possibly because the jobs data might mean we actually are at the bottom of the interest rate cycle – but the roar back yesterday was on the back of the highest volume traded since before Christmas. We finished the week down by 3 points and exuberance slipped from 5.4% to 4.8% over the week (Chart 5) as the fundamentals are lifting.

The Materials sector can't win a trick at the moment – now underpriced by -7.1% (Chart 6) – but brokers upgraded forecasts for the likes of RIO, Bradken and Atlas iron. What we are finding difficult to understand is the massive over-pricing in Discretionary (+12.0%) and Staples (15.3%) that we have estimated. With cash rates as they are and dividends for Financials, Property, Telcos and Utilities yielding 5.5% or more, overpricing in those sectors is understandable and possibly justified. However, the forward yield on Discretionary is only 2.7% and on Staples 4.2%. And with Health at a yield of 2.3% we are really concerned that the bubble in these three sectors might soon pop.

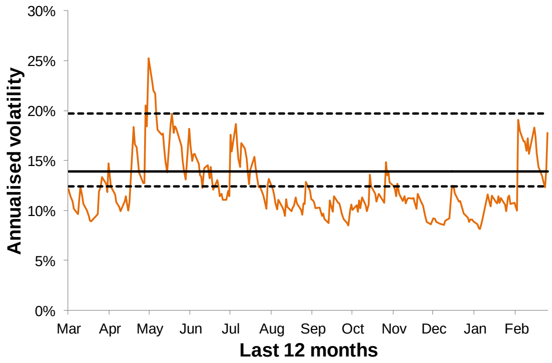
Volatility (Chart 1) unsurprisingly jumped up with all of the action on Thursday and Friday but our Fear Index (Chart 2) dropped to the bottom of the normal range – the VIX fell to 11.3% which is low by pre-GFC standards.

The *Financial Review* ran an article during the week about revisions to the end-of-year forecast for the ASX 200.We started the year with a forecast of 5,100 compared to the *Fin's* report of 4,550 for a group of forecasters. Those forecasters have now pencilled in 4,700 while our forecast has crept up to 5,350. From Chart 4, we can see our rolling 12-month-ahead forecast has been stable at just over 12%. It is our way of calculating the fundamental (as part of exuberance calculation) that has let consolidated gains in the market lift our target. It now so happens that our forecast for the e-o-y is close the 5,400 we called on January 1 from our long-term mispricing model. Time will tell!

In the short run, the market seems contained by the 6% exuberance trigger (Chart 5) and guided by the dividend yield convergence of Financials, Property, Telcos and Utilities. The sideways action for the market is expected for a little while longer.

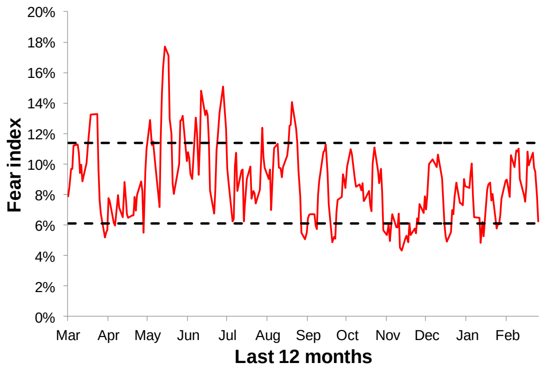
Woodhall Investment Research Pty Ltd. (ABN 17 141 486 160); www.woodhall.com.au

Chart 1: Market volatility



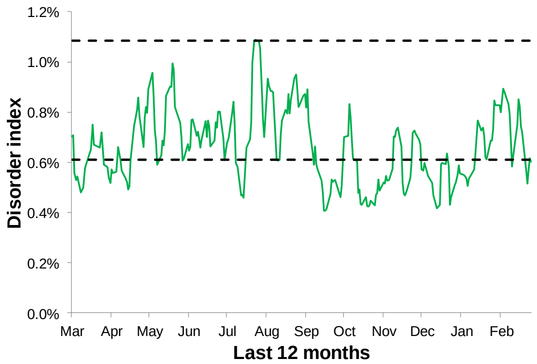
Notes: The solid black line depicts the average volatility since January 2010; the lower dotted line depicts the average volatility pre the GFC; the higher dotted line depicts the average level of volatility during the GFC - up to December 2009. The brown line is a daily estimate of the ASX 200 index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

Chart 2: Fear index



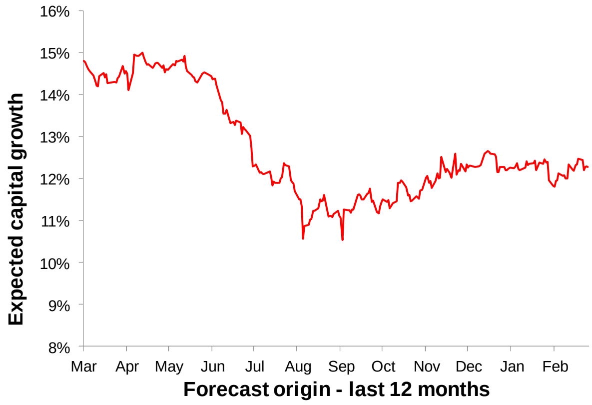
Notes: The fear index is a measure of 'excess' volatility denoting behaviour outside the open/close values each day. The two dotted lines depict the band in which the fear index resided before the GFC in two thirds of days. Extended periods below the lower dotted line might indicate complacency. Extended 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 3: Disorder index



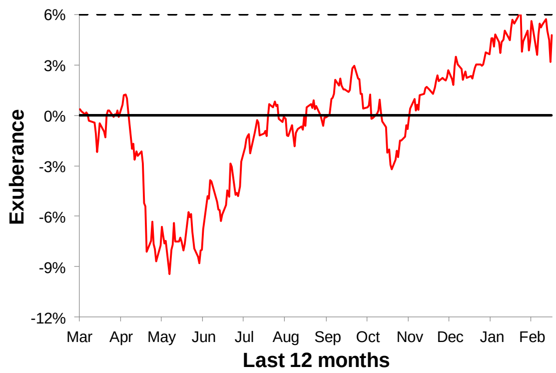
Notes: The disorder index measures the degree to which the 11 sectors' daily returns move in harmony. The two dotted lines depict the band in which the disorder index resided before the GFC in two thirds of days. Extended periods below the lower dotted line might indicate belief that there is little 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 4: 12-month-ahead capital gains forecasts



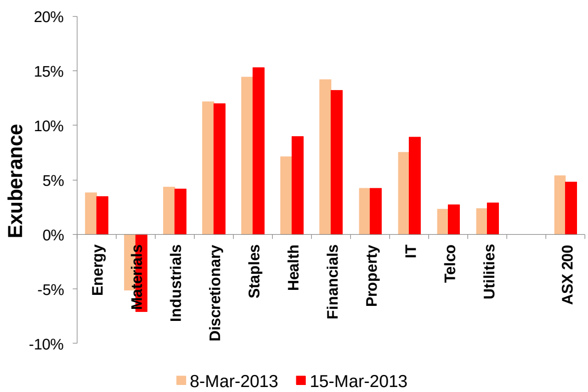
Notes: Each business day we update our estimates for capital gains on the ASX 200 for the following 12 months. For example, the left-most estimate on the vertical axis is a forecast for the 12 months concluding today. The right hand estimate is for the 12 months from today.

Chart 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 an extended period for the market to move sideways for an extended period.

Chart 6: Sector exuberance



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