W IR

1st October 2014

Woodhall's Wrap

Ron Bewley PhD, FASSA

September wasn't a pretty month

- **Our jobs data were good but our confidence wasn't**
- **Our stock market sold off more than most**
- **China data were unusually patchy but the US data were strong**

The Big Picture

September was a month of mixed news and markets did not react well. Our ASX 200 index reacted worse than most falling -5.9% over the month. The World Index only fell -2.9% and Wall Street's S&P 500 was down just -1.6%.

Since the conflicts in the Ukraine, Iraq, Syria and now Hong Kong should not have a particular impact on Australia's market we must look elsewhere to assess what caused our market to fall so hard.

Our jobs data were rather good. Unemployment fell from 6.4% back to 6.1%; +14,300 full-time new jobs and a massive +121,000 new part-time jobs were created. There are statistical explanations for the extreme part-time jobs number so this jump is not expected to be the start of something really big.

Consumer and business confidence did slip back to the level of a couple of months ago but the mining tax was repealed. The budget blow out to $48bn was largely expected. We think the three big reasons for our market's tumble were the following.

First, our dollar has depreciated quite strongly. While that might help our industry and its profits in the long-run, foreigners – who account for about 43% of investments in the ASX 200 – are seemingly exiting our market as they take any hit on our dollar as a loss in their returns when they convert their funds back into their own currencies.

Secondly, some China data were a bit weak and iron-ore prices fell over 10% in September. That hurt our resources sector.

However, the official Purchasing Managers Index (PMI) for manufacturing is the statistic most analysts watch for as an overall read on the China economy. Today that statistic came in at 51.1 which is indicative of a stable growth path and counters the poor Industrial Output read in the middle of September.

Thirdly, the Reserve Bank of Australia (RBA) is thinking about putting more controls on home loan providers to prevent the forming of a housing price bubble. That hurt our financials' sector.

Some stocks that operate in, or export to, the US did well. The net result is that all of the gains on the ASX 200 over 2014 before September were given back during last month. But we still get to keep the dividends that average around 4.7% plus franking credits.

The US has been posting some very good results. Their new home sales increased by +18%

General Advice Warning: This note has been prepared without taking account of the objectives, financial situation or needs of any particular individual. Any individual should, before acting on the information in this note, consider the appropriateness of the information, having regard to the individual's objectives, financial situation and needs and, if necessary, seek appropriate professional advice. Past returns are no guarantee of future performance.

(annualised) and economic growth for quarter two was revised up from +4.2% to a very strong +4.6%. The downside accompanying this economic strength is that there is growing speculation that the US Federal Reserve might start to increase its official interest rate to counteract the economic growth.

The Fed came out and repeated that rates will stay low for a 'considerable time' but there is now talk that rates will start to rise quickly after that point. It is this speculation that is hurting our high-yielding sectors adding to the downward pressure from the RBA on our financials' sector.

Importantly, stock market volatility at home and abroad has remained reasonably low. The markets are not panicking. Our best assessment is that this sell-off is controlled and temporary. At the beginning of this financial year we forecast the index to end at 5,900 (for June 30th next year) – about 11.5% higher than it closed at the end of September. We had a forecast floor of 5,150 and a ceiling of 6,200 to account for the volatility that we expected during the financial year. In other words, we are still very much on track from our position we stated three months ago.

Asset Classes

Australian Equities

The market sold off more or less right across the board – except, possibly, for Healthcare, which only fell -0.9%.

While it is normal for resource stocks to bounce up and down, it is less usual for the high-yield sectors (Financials, Property, Telcos and Utilities) to take such a hit.

New buyers in these yield stocks will possibly now expect higher yields but those who bought earlier in the year could have made a paper loss bigger than their gain in yield!

Importantly, we have found that the underlying estimates of company earnings we analyse are becoming increasingly favourable. That means we believe that much of the current sell-off is temporary.

Long-term investors might want to not chase potential bargains – or bale out – at this point. Every indication so far is that September was well in the range of normal behaviour – albeit a bad month.

Foreign Equities

The S&P 500 kept on a brave face during September. It reached an all-time high of 2,011 in mid-September but the index retreated during the Fed-fuelled rumours of rate hikes.

The VIX volatility index – often called the fear index – remained below long-term averages during nearly all of September. Their market sell-off in September was so different from ours. While we fell -5.9%, the S&P 500 only fell -1.6%.

But we should not kid ourselves. When the US returns to normal rates of economic growth, normal interest rates, normal unemployment and wages, then the straight line growth that this market has experienced over the last period will not continue. What comes next is too hard to predict yet but a balanced portfolio should see us through. Markets tend to cycle around trend growth.

Bonds

Bill Gross, the founder of the world's largest bond fund left PIMCO to go to a much smaller competitor. That, and the fact that PIMCO is being investigated by the US regulator, might cause some short-term volatility in bonds.

Interest Rates

Our official interest rate continues to be on hold with little likelihood of change any time soon. If the RBA tried to cut rates, there might be even more upward pressure on house prices. Unless the RBA can find separate curbs on home lending, rates are unlikely to go down. With unemployment at 6.1%, there is no way the RBA can yet raise rates.

We think it is reasonable to form the view that our rates will not change until at least the middle of 2015 – and then they will go up.

Other Assets

Iron ore prices fell further over September. There is speculation that China is trying to manipulate the market. Whether or not that is the case, iron ore prices tend to go through a cycle accompanying periodic restocking.

Gold, Oil and the Australian dollar all fell sharply in September – in the region of -5%.

Regional Analysis

Australia

The bad unemployment reading we reported to you at the start of September turned out, as we then argued, to have been a statistical aberration. In effect, the labour market hasn't changed much in months – once the statistical noise is removed.

Both the NAB business confidence and the Westpac consumer confidence indexes fell back to the levels of the previous month. Disposable income (after taxes, etc) has been flat for two years after inflation and population are taken into account. People want more and more to feel happy.

China

China's Purchasing Managers' Index (PMI) for manufacturing came in on the 1st September at 51.1 which was well above the '50' that divides expansion from contraction. Today, the new PMI was also 51.1 so that China is on a stable growth path.

Iron ore prices have fallen below $80 / tonne which means a number of small miners will now be making losses. BHP, RIO and Fortescue are safe at these prices.

China Industrial Output came in at the lowest level in five years. This figure rattled our market but the latest PMI should negate much of the impact of that Industrial Output number.

China's inflation rate slowed leaving room for stimulus but the government is seemingly reluctant to turn on the taps yet.

USA

Nonfarm payrolls (employment) came in at a modest 142,000 but the August data (a summer holiday month) are typically revised upwards by an average 55,000. Their unemployment rate fell from 6.2% to 6.1% - the same as ours!

The housing and economic growth data were very strong. The US recovery is very much underway. The Fed has stated that they are prepared to be a bit slow in raising rates so that they do not risk the chance of making the economy splutter.

The consensus seems to be that US rates will not start to rise until mid-2015 but then there might be as many as five small increases in the following 12 months. It is this conjecture which has unsettled markets.

Europe

Greece at last expects positive economic growth in the third quarter. Spain's economy is showing signs of life after having made some serious cuts to wages under the European austerity programme.

The European Central Bank cut rates again. ECB President Draghi is considering implementing a stimulus programme in the fashion of Prime Minister Abe of Japan but there are constitutional issues owing to the structure of the EU.

After a good first quarter, Germany's economic growth is waning along with its business and consumer confidence. The whole European Union is struggling with how to implement stimulus across nations with a common currency but different governments and budgets.

Rest of the World

The Ukraine-Russia crisis continues to cause problems for all. The latest twist is that Russia is considering retaliating by freezing some foreign assets. That Putin might still take part in the G-20 summit is encouraging in that a solution might be found for the crisis.

The coalition of 40 or more countries against ISIS in Iraq and Syria is good in that more moderate groups from that region are participating along with the usual Western players. In effect, the air strikes have been from a United Nations force.

We have no expertise in predicting how these crises will play out. They could be resolved quickly or they could blow out of current proportions. Therefore it is not clear that typical investors can do anything different to position themselves to allow for this type of uncertainty. Diversification still rules.

Tear gas has just been used to disperse protesters in Hong Kong. But again there is little investors can do to position for whatever developments might occur on that front.