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Woodhall's Wrap

Markets starting to heal after a tough August

**China stock market crashes, but ...
China reacts positively
US economic growth very, very strong**

The Big Picture

After a great July in markets, many stomachs understandably churned as fingers were pointed at China's stock market during August.

We listened to and watched well-dressed people with sincere faces likening the China stock market falls to the Lehman Brothers collapse in 2008. Nothing could be further from the truth. Lehman's was a massive investment bank and the main problem was that no one knew who held the complex web of Lehman's massive debt – so credit markets locked up.

China is transitioning from a poorly run Communist country to a world powerhouse – while remaining Communist. That is a difficult task but China has been doing tremendously well. The China authorities know that every good capitalist country has a well-functioning stock market to allow for secondary trading in companies.

The so-called Shanghai Composite Index is a measure of a China market in its infancy. Unlike, say, Australia, there is very little institutional investing there. In Australia, we have the likes of BT, Colonial First State and many, many other

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sophisticated investment houses researching and trading in the relevant companies. We even have a substantial overseas investment in our market.

The Composite is dominated by mum and dad investors. The vast majority of mums and dads do not invest in the market and those that do mostly rely on property and gold for their main investments.

So a year or so ago, China encouraged more activity in the Composite and provided cheap loans for margin lending to promote involvement. The market rose more than 150% in less than a year so, even after the recent falls, the capital gain over the last 12 months has been mammoth! But, anyway, share market activity has little to do with economic activity in China.

So when global investors caught up with the obvious overselling of mature markets, the China market continued to fall while mature markets surged from the bottom. Of course China did some good work in adjusting monetary policy that helped matters but – basically – our market was simply oversold.

A few other events disturbed thinking at the same time – the China dock explosions and deaths; the

Bangkok bombings and deaths; ruminations in the US as to when the Fed will eventually hike rates; etc, etc.

It is often the case that when a lot of adverse news bombards markets, people sell first and ask questions later. Of course, these are the times when professional traders can make a killing.

While all of this was noise going on, the USA reported some spectacular growth data and reasonable labour market data. Our labour market data were also just fine.

So, in the next few weeks we expect markets to start to look far more settled and growing. And investors might even be looking for a Santa rally.

But one thing is bothering me. There are almost constant news reports on the BBC of immigrants flooding into Europe from Africa and the Middle East. While some people are genuinely fleeing war and oppression, lots being interviewed just want a better economic life. While it would be great to accommodate all of these people in Europe, there are obviously even more people who will follow as 'family' and/or other illegal immigrants to the point where European standards of living would fall measurably. The problem must be solved – and soon.

Asset Classes

Australian Equities

Our market suffered a major downturn in August losing -8.6% on the month. However, most other major international markets took a similar hit and our market started a recovery at the end of the month.

The Energy and Industrials sectors took much of the brunt of the fall on our market and no sector was spared. We have fair value for our market to be 5,750 making the end-of-August level of 5,207 quite underpriced.

Reporting season in August was not strong enough to dominate market movements but more than half of the companies that reported beat consensus estimates – which is about normal.

Foreign Equities

The VIX index – which is a measure of volatility many use as a 'fear' index for Wall Street – spiked a week before the end of the month but it too started to settle by the end of August.

Most major overseas markets are down on the year-to-date by around -4% to -5%. Since we have these markets also underpriced, we see most markets to be up over calendar year 2015.

Bonds and Interest Rates

As September approached, more and more analysts were coming to the view that September is too early for the Fed to raise rates in the US. Fed member William Dudley has all but ruled out September. October is less likely since there is no scheduled press conference to follow the Fed meeting.

We maintain our view that the first hike could be as late as 2016 as there is little to gain by going earlier. We also think it is quite likely that the first hike might be less than the traditional 0.25%.

China cut rates by 0.25% for the fifth time since November last year. It also cut the amount that banks have to hold against their lending.

The Reserve Bank of Australia (RBA) kept rates on hold in August and again on September 1. Perhaps the recent gyrations in markets might force its hand soon. We think one more cut is still possible this year.

Other Assets

Iron ore prices seem to have stabilised at moderate levels. Oil prices, that were plummeting, surged +10% in one day near the end of August. Oil prices rose a massive +27% in a three-day fight back. Russia and OPEC countries must be hurting but oil importing countries are benefitting from lower prices.

The Aussie dollar continued to be volatile. It started the year well into the 80s but is now in the very low 70s.

Regional Analysis

Australia

Australian employment improved by a solid +38,500 new jobs. Unemployment came in at 6.3% but, importantly, the official trend measure is still stable at 6.1%. The 6.3% number is most likely higher through statistical sampling errors.

The RBA left rates unchanged in August and at the start of September.

Various economic statistics continue to be mixed. It seems the political process is stuck in a rut and that is not helping the economy grow.

China

The China “perma-bears” had a field day when the Shanghai Composite index went into freefall again. But, as always, the authorities came to the rescue.

They devalued their currency, cut rates, reduced capital requirements for the banks, injected money into the system and deregulated pension holdings. Quite a lot for one month but that is why we are confident China will continue to manage its economy well.

On the real side of the China economy, the Purchasing Managers’ Index for Manufacturing slipped below the key 50 level to come in at a three-year low of 49.7. Of course, the latest rate cut has not yet had a chance to work through but it is worth continuing to watch activity in the world’s second largest economy.

China now has built an array of man-made islands in the South China Seas – complete with military installations. Clearly China not only wants to keep a hold over any oil and gas explorations in the region but it also wants to have a strategic hold over shipping activity in the Singapore Straits.

USA

The Federal Reserve may be in a quandary as what to do about rate hikes but the economy is in no doubt that it is booming. With Q2 growth at +3.7% it looks a no brainer for the first hike soon but the Fed might not want to rock the boat with all of the market volatility that went on in August.

US jobs were a little soft this month – just +215,000 new jobs when recent averages have been more like 240,000. But unemployment is still steady at a low 5.3%.

We still think caution will prevail and a very small cut later this year or at the start of next will be the go. We doubt whether it will have much effect on us.

Europe

European news is dominated about how the EU can deal with the immigration issue. People smugglers are taking so many would-be immigrants to places that just can’t cope with the influx. Sadly, tragedies abound as smugglers push the limits.

The Greek Prime Minister, Alexis Tsipras, called a snap election. A caretaker PM is now in place but the election will be soon. Since one third of his party did not vote with him in the bailout negotiations, the snap election is an attempt to rid his party of that element and leave a functioning parliament in its place. That will further stabilise the European economies.

In the UK, the race for the leadership of the Labour Party is taking on pantomime proportions. The claim by Labour is that non-Labour people have been signing up to vote for the leadership so that the outsiders can elect someone that has no chance of ever becoming Prime Minister! Given the rise in the Scottish National Party after last year’s referendum, it is possible the current structure means that Labour has little chance anyway in the near future.

Rest of the World

Russia’s GDP came in at -4.6% on the back of the slump in oil prices and the Ukraine-related sanctions. Other oil exporting countries like Venezuela and Saudi Arabia are also feeling it.

Venezuela and Colombia are having their immigration difficulties too but Venezuela is just shipping illegal immigrants back in droves.