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Woodhall's Wrap

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The Big Picture

As the year 2012 drew to a close, we could reflect on some exhausting political debates in Australia, Europe and the US. However, many stock markets finished the year well above where they started. If we include dividends, our market rose by about 20% in one year! Those sitting in cash saw their yields slashed as the RBA cut rates time after time to a low of 3% - the same as the emergency low setting during the GFC.

The so-called fiscal cliff debate in the US caused some increases in concern during the last few days of 2012 but, in comparison to other political squabbles, markets were largely taking it on the chin. While it might take a few days, or even weeks, to sort out the solution to the automatic tax hikes and spending cuts, whatever is agreed upon can probably be backdated and we can all soldier on. Standard & Poors, the agency that downgraded US debt in 2011, claims it is not worried about the outcome of the current cliff debate.

In our opinion, 2013 is shaping up to be the year we finally shake off the effects of the GFC. The controlled China slowdown bottomed in August 2012 and is set for growth of about 8.5% in 2013 - according to the IMF *and* the World Bank. Iron ore prices recovered back to $140 a ton after a brief dip below $90. Fortescue reactivated its expansion plans for the Pilbara. Those who followed the hard landing for China and the end of the mining boom push missed out on some great buying opportunities.

Europe is in surprisingly good shape too. Of course it continues to flirt with recession but Mario Draghi, President of the ECB since mid 2012, seems to have made a profound effect on both governments and markets. It seems quite likely that any debt crises in the future will be much better handled than before Draghi's tenure started - to the extent markets in the rest of the world can now grow without the unnecessary corrections that have characterised the last few years.

The US has two strong Quantitative Easing packages in place that can buy time for the US to consolidate its growth path. They do have a massive debt level to deal with over coming years but, in the short run, we expect promising conditions in the US, OK in Europe, and really good in China. So, barring any major natural disasters or military conflicts, Australia is the only problem facing Australia.

With our government finally abandoning its misguided target of a budget surplus by June 30 - and an election due this year - there might be a few more stimulus crumbs thrown about to pump-prime our economy. Rates may well be cut again to try and reign in our dollar but, in our opinion, rate cuts would do more harm to savers than good to borrowers. But if rates do continue to fall - and some expect several cuts this year, cash from deposits will be forced into dividend-paying equities.

We have our market currently a little overpriced and with expected capital gains of over 12% for 2013. That means we expect the ASX 200 to break though the 5,000 level - and stay there this time?

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Asset Classes

Australian Equities

Santa Claus delivered his rally making a capital gain for the year of 14.6% - and if dividends are included - a total return of near 20%. December's gains were led by the Materials and Industrials sectors as investors realised that the hard landing for China had well and truly been averted. For the year as a whole, though, it was Health and Telcos that led the charge - both over 40% capital gains!

Given the composition of sectoral growth over the year, it seems reasonable to deduce that some investors were switching from cash to defensive stocks and/or stocks that paid good dividends. As we have Health and Telcos very - indeed precariously - overpriced, future capital gains might be hard to come by in these sectors and corrections in these sectors is quite possible. Materials posted less than 2% capital gain over the year and Energy went backwards - the only sector so to do.

Our indicators for market stability - our fear, volatility and disorder indexes - are all in pretty good shape - despite the unease over the US fiscal cliff. We take that to mean that this rally can continue and, should a negative shock come our way, the market will probably deal with it in a orderly fashion.

Our current forecast for 2013 - based on broker forecasts of dividends and earnings - is for a capital gain of over 12% but, with the market being overpriced by about 2%, our forecast for the end of 2013 is for the ASX 200 to be at about 5,100. Our alternative long-run cyclical forecasting model is even more optimistic with 5,400 not being out of the question. Sectoral and market forecasts and estimates of mispricing are updated each week in our *Woodhall Weekly* publication posted on our website.

Foreign Equities

The S&P 500, the FTSE and the DAX could not keep pace with our market during December. The fiscal cliff weighed more heavily on those markets than it did on ours. The VIX fear index - a measure of implied volatility from options on the S&P 500 - jumped up sharply at the end of December but to a level that was much lower than during the European debt crisis and the GFC.

Our broker-based forecast for capital gains in 2013 for the S&P 500 is just under 11% and we have that market underpriced by over 2%. That means there could be a big 'pop' on that market when (if?) the fiscal-cliff 'patch' is enacted and a figure in the high 1,500's for the end of 2013 is reasonable. Even 1,600 seems possible!

The downside for the US market is the possibility that dividends and capital gains might be taxed at a higher rate after the conclusion of the fiscal-cliff negotiations. But with interest rates so low in the US, it is hard to imagine the market not shrugging off any tax hikes on stock market income and gains.

Bonds

The Fitch 1-year probability of default for Western Europe debt reached a low of 1.31% near the end of the year from a high of 4.05% during 2012. This is an excellent sign for European bond markets. The days of yields for Spain and Italy bonds flirting with the 'unsustainable' 7% are long gone. Spain is currently at 5.20% and Italy at 4.48% for 10-year bonds (Australia 10-year is 3.27%)

Interest Rates

The RBA again cut rates in December to 3% - making the cumulative current cutting regime to be 1.75% - and further cuts are predicted by many for 2013. However, the relaxation of the government's policy to bring home a budget surplus in 2012/13 has reduced the chances of further cuts. Sadly, monetary policy became largely ineffective during 2012 and perceived benefits from any cuts in 2013 seem misguided.

Currency

The $A peaked at $1.055 in December before retreating to the mid $1.03 - $1.04 range.

Oil

The price of WTI oil rose from a low of $85 at November 30 to end December to be back in the $90+ range. That is not enough to stifle growth in the US economy. The price of Brent oil was quite flat at around $110 during December.

Gold

The price of gold slipped from a high of $1,748 in November to finish the year fluctuating just above the mid $1,600 - $1,700 range.

Regional Analysis

Australia

Unemployment fell to 5.2% (for November) when 5.5% was expected by analysts. Full-time jobs fell by -4,200 but the gain in part-time employment was sufficient to post an aggregate gain of 13,900 jobs for total employment.

Perhaps the biggest economic or political event during 2012 in Australia was the 11th hour relegation of the pledge to return the budget to surplus by June 30. At a time when our economy is having mixed success, it was never a good idea to rush the return to surplus. It was only ever a political statement. With that target shelved, how far will the government now push stimulus? We are not aware of any plans so to do, but if they do - in time for the election - it could be off to the races for the market.

The outcome of the general election - necessary this coming year - could provide the stability for consumer and business confidence to grow. The last thing we need is another hung parliament to divert government. While the LNP coalition is well ahead in the polls, its leader is not. Is it possible to get two new leaders to contest the election? A strong leader of either persuasion could see major gains for our economy and market. More of the same and the struggle is likely to continue.

China

The official China PMI for manufacturing for the last six months came were 50.1, 49.2, 49.8, 50.2, 50.6 and now 51.5. With 50 being the cut-off between 'worse than' and 'better than' usual, the bottom of the engineered slow down almost certainly seems to have occurred in August.

Iron ore prices - which plummeted from the $130 - $140 range to sub $90 in September have since breached $140 from below! Some say that China manipulates these prices. Perhaps it is more proper to say that both sides negotiate terms by controlling demand and supply. Some iron ore stocks have bounced right back. RIO's price was higher at the end of the year rather than at the beginning despite all of the fuss.

While there is no doubt that China will want to further develop its consumer sector, it does not have to abandon its infrastructure development. The new government sworn in a month or two to go will certainly want to keep the whole growth story going - but at a sustainable rate. This is the first time in many, many years that economic growth and inflation expectations are where they have been wanted - not just by China - but also by the IMF and World Bank.

Of course, the rush to consumerism means opportunities for us to export more than just iron ore and coal. And with the US looking moderately strong - and Europe still breathing - China can find a home for its exports. Perhaps the biggest threat to stability is a social unrest that gets out of hand. There have been occasional murmurings that have been quickly stamped out - but that situation should be watched by smart investors.

U.S.A.

The US holiday shopping spree was muted this year and some other data were weak but there have been promising signs of recovery in housing - the sector that set off the GFC. The superstorm Sandy that hit the US east coast made it difficult to properly interpret data from November and December. With US unemployment down from double digits to 7.7%, their economy is on the mend - and the QE programs are now linked to an unemployment target of sub 6.5% - headway is possible after the fiscal-cliff debacle gets resolved.

As we have maintained all along, it seems impossible that no deal will be done forcing the economy eventually into recession. Some patch seems extremely likely and backdated reforms very possible. Recession is only used in the media to scare us!

Europe

Europe has been (thankfully) quiet over December. They are getting on with the job (at last).

Rest of World

Russia has banned US citizens from adopting Russian children in retaliation to some US sanctions. Really good standard of political debate. At least it makes other governments look better.