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Woodhall's Wrap

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The Big Picture

September turned out to be a bumper month for good news but the budget situation in the US over the last few days made the short-term future a little uncertain. Our election turned out to be sufficiently decisive to allow business and consumers to be confident enough to lock in decisions after three years of a minority government. Importantly, the new government is playing its hand cool, calm and collected. The Westpac consumer confidence index surveyed over the election weekend jumped up +4.7%.

Almost every major statistic coming out of China beat expectations and looked strong. Both the official and the HSBC flash PMIs that measure manufacturing performance beat the 50 cut-off between deteriorating and improving conditions and they beat expectations that were already positive. HSBC increased its forecast for China GDP for 2013 from 7.4% to 7.7% last week. We never lowered our expectations below the government plan of 7.5%. The next PMI number, out today, came in at 51.1 – well above 50 but short of expectations. The planned slow-down is over and stronger growth is building.

Japan not only won its bid to host the 2020 Olympics that should come with a nice stimulus from the associated building program and tourism, it delivered another great GDP growth figure of +3.8% to back up a similar result for quarter 1.

Europe too is settling down. Angela Merkel got her best support in her third successive German election to back her approach to guiding Europe back to growth. The latest PMI figures for Europe looked to be on the right track.

Over the weekend the United Nations Security Council came up with a resolution that seemingly is a workable way to deal with the Syrian chemical weapons situation. Hopefully that takes intervention by the US off the agenda.

World stock markets – including Australia – had great Septembers – at least until the last day. So why is the US spoiling the party? There are four major things going on in the US and all four are being handled badly. Obama politicised the nomination for the next Federal Reserve Chairman to take over from the end of January and the consequent indecision caused some market volatility because of the differing views of front running candidates. The winding back of stimulus in the US – known as tapering – was widely expected to have started in September and markets felt duped when it didn't happen. It looks like tapering might not start until 2014 because the US economy is not strong enough yet.

It seems Republicans did not learn anything from the 2011 debt ceiling negotiations. The ceiling must be lifted by October 17th or the US could start to default on its debt that has already been accumulated. A related but separate issue is the government (partial) shutdown that started today. In both cases the Republicans want to build a reduction in the funding of 'Obamacare' (Affordable Care Act) into the negotiations. Now Obamacare is not part of the package – it is just that the Republicans don't like it and will seemingly stop at little to gain leverage. Now there were a few short shutdowns in the '90s so another wouldn't be the end of the world – but why? The ceiling is a big issue and will undoubtedly be resolved after every other avenue has been considered (to paraphrase Winston Churchill). Obama doesn't want to compromise because he went to the people in the last election based on Obamacare and the Republicans got a thumping. It should all just be a bad memory by Thanksgiving Day.

Asset Classes

Australian Equities

The ASX 200 had its third consecutive positive monthly return (+1.6%) in September as the index made a five year high. Financials played a big role in September's gain but we now have that sector overpriced and its expected dividend yield seems to be near a floor of 5.5%. So we see little or no growth in that sector in the next 12 months but, of course, the big banks should continue to pay very handsome fully-franked dividends. Property, Telcos and Utilities may also not reap much of a capital gain. But the future for Energy, Materials and – to some extent – Industrials looks quite bright – largely on the back of the improving situation in China.

Our end-of-year forecast for the ASX 200 is still around 5,300 but we see more chance of upside risk than downside. We believe that the market is overpriced by 1%. Our long-run pricing model for the e-o-y has fair value for the index at 5,550 but it might be June before we get there.

There are two things that could change our view. Resources companies and brokers may start to raise their earnings expectations as more and more positive data on China come through. Also, it appears that household deleveraging of credit card and other personal debt (not housing) looks set to end giving some stimulus to non-resource related companies

Foreign Equities

World equities put in a stellar September at 4.8% and the S&P 500 almost matched it despite the last day sell-off. We have the S&P 500 more or less fairly priced and our capital-gains-forecast for the next 12 months is 11%. As a result we see better prospects in the US than Australia in the near term

Bonds

10 year US Treasuries yield jumped from 1.7% to 2.9% in double time on talk of tapering but have now retreated back to 2.6%. Fitch's one-year probabilities of default fell even further during September reflecting a safer environment for investors.

Interest Rates

Rates were on hold at 2.5% last month and stayed at that level when the RBA met today. The RBA certainly wants a lower dollar so that there is downward pressure on rates but the danger is that lower rates are causing people to pile into housing. With only one lever to control inflation, economic growth, the dollar and house prices staying put seems the way to go but markets are expecting another cut this year – most probably on Melbourne Cup Day.

Other Assets

Gold, silver and oil prices fell sharply in September but iron ore prices were stable and the copper price was slightly up. The dollar climbed from 89.5c to 93.2c via 95c. The iron ore and copper prices are good for our resource sector. Gold, silver and the dollar are reacting to tapering talk in the US.

Regional Analysis

Australia

Tony Abbott is taking a measured approach to managing our economy. But he will have his work cut out trying to get rid of the carbon tax and the mining tax as he doesn't have a majority in the Senate.

Consumer confidence is already on the rise but the economic drivers will take longer to pick up. Retail sales came in at +0.1% against an expected +0.4% at the start of the month but +0.4% today. GDP growth came in at +0.6% for a below-trend annual +2.6%. Unemployment is 5.8% which is the same as the peak during the GFC. It looks very likely that the rate will average more than 6% during 2014 but the Coalition is talking about a substantial infrastructure programme that would be stimulatory.

China

China started September with an official PMI (Purchasing Managers Index) of 51.0 against an expectation of 50.6 reaffirming renewed strength in China growth. This figure was then eclipsed by exports and imports as both increased 7% over the year. Iron imports in August were the third highest ever on record and at very nice prices for our miners. But then Industrial Production nearly made double figures at 9.9%. The HSBC flash PMI on the 23rd also beat with a 51.2 over an expected 50.9. And today, the official PMI inched forward to 51.1. All in all, China is on a charge and will carry Australia with it.

The third quarter came and went but iron prices held up over $130 / tonne when some thought there would be seasonal softness. Citi came in with a forecast of $115 for quarter 4.

U.S.A.

The US economy started the year with much promise but expectations are softening as data have been missing expectations. Nonfarm payrolls came in at 169,000 for August and the unemployment rate fell to 7.3% but on the back of weaker participation. Providing the partial government shutdown does not affect the publication of September's result on Friday, markets will be responding to the number as an indicator of impending tapering. It seems payrolls would have to beat 200,000 with an upward revision for August to kick tapering into gear before Christmas. Tapering seems far more likely to start next year.

However, Bernanke hands over the reins to a new Chairman at the end of January – probably Janet Yellen – after Larry Summers withdrew his nomination presumably on a lack of support from Congress. He might want to start the process before leaving his post to take the heat off his successor.

The next few days and weeks will put the government shutdown and debt ceiling deliberations into perspective. Almost certainly both will be resolved reasonably quickly but the delay will cause excess volatility such as that we saw starting yesterday.

Europe

Europe is gently on the mend but it is still on life support. The improvement in economic growth seems to have already had a positive effect on China exports. Politically, Italy is again going through some turbulence but Angel Merkel looks rock solid after her convincing victory in Germany's election last month.

That there rarely is any adverse news emanating from that part of the world is creating a greater sense of confidence around the world. All of the major economies seem to be doing reasonably well if not better.

Rest of World

What a difference a year makes as Prime Minister Abe changes the whole psyche. GDP growth at last has been very strong for the first two quarters of 2014, Japan will host the 2020 Olympic and, to cap it off, it just posted the best business confidence read in 5 years. As a result it will benefit from the infrastructure spend it will need, the tourism it will create and possibly a change in spirit from a 'two lost decades' economy to one leading the way – a little like the impact the London Olympics had on Great Britain.

It must be with great relief for Obama that the United Nations Security Council has brokered a deal over Syria. Obama was on a hiding to nothing if he turned to Congress or the people over a military strike in Syria. The US is losing its appetite to keep getting involved elsewhere but the President will find it hard to react to international incidents without having a military threat behind him.