1st October 2011

Woodhall's Wrap

Ron Bewley PhD, FASSA

The Big Picture

September matched August with its intensity of volatility across equity markets. The US downgrade took a backstage role while European decision making - or lack thereof - was in the spotlight. With all of the anticipation the media could muster, we found out on the last day of the month that the German parliamentary vote was, in fact, a landslide 85% in favour of fixing up the European stabilisation fund - an equivalent of TARP in the post-Lehman action in the US. The move is grinding its way slowly towards setting up a fund to buy the sovereign debt that no one wants and issue something with a lot more security. It is also no surprise to learn that after the vote, the media reported it was a near certainty - not what I heard from them even the day before!

Despite the increased risks in September, the gold price took a $300 beating from its high of $1,927. While the gold price could go anywhere in the near term, its heightened volatility must surely take the shine off gold as being a safe haven. Most other commodity prices came off sharply as some called for a global recession. But China remains strong. Naturally, the doomsayers question their data. Having GDP growth that remains firmly above 9% does not help their cause.

But there are problems at home. Unemployment data released at the beginning of the month inched up again and is now only half a percent below the peak made during the GFC when interest rates were seven notches below the current level of 4.75%! Whether the RBA will or will not change rates up or down is no longer the question. They need to act quickly to restore consumer confidence - even if it only drops rates by 0.25%.

Our dollar has fallen from over $US1.10 just a short while ago to bounce around under parity in a wide range by the end of the month. This fall is good for lots of the economy - and is related to commodity prices - but it is also related to the notion that our rates don't look like going up anytime soon. Imagine what a rate cut might do? Maybe even under 90 cents and then our economy really can get going again. Which brings me to the National Accounts released in early September. Growth seemed strong at 1.2% but, on the back of a -0.9% for the flood-affected Q1, it left Q2 2011 at about the same level as Q4 2010! Not a pretty picture.

On the bright side, US data released on September 29th was not bad at all. Both labour force data and GDP revisions beat estimates. The US market rallied on the news - then lost steam - then bounced back. And a thought for the day. In the 100 years or so before Greece joined the EU, and after it became the nation it now is, Greece defaulted on its debt on average every other year. Can we be surprised if the Greeks don't like the idea of altering their behaviour to address the issue now. Why didn't the EU see this coming years and years ago?

Woodhall Investment Research Pty Ltd (ABN 17 141 486 160)

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.

Contact: ron.bewley@woodhall.com.au

Asset Classes

Australian Equities

Australian equities were not immune from the volatility caused by overseas events. Perhaps surprisingly, we had the best day since 2008 near the end of September but the worst week - the week before. With commodity prices falling and talk of a global recession, small miners in particular were hurt badly. Using any standard measure of pricing - such as price to earnings - lots of companies are at levels we saw at the bottom of the market in March 2009 - and yet companies are currently cashed up this time. Woodside Petroleum was valued by the market at much less than its assets. This market has the making of a 2009-like rally once it gets going.

Brokers did revise down their forecasts for earnings and dividends during August to the extent that we now think fundamentals can produce 10%+ gains over the coming 12 months to October 2012. That is down 4% from our previous estimates but still 3% above an average number. With our underpricing of the market at about 15%, the two results combined - underpricing plus fundamentals - give a possibility of 25% over the next 12 months. Of course all sorts of events could intervene but the end-of-the-world-as-we-know-it scenario hasn't reached company outlooks nor broker forecasts - but you can read about Armageddon in the press.

Foreign Equities

The relationship between US and Australian equities we have been following for two years seems that it might have broken down in the last few days of September. When both exchanges are measured in the same currency - say $US - there was an extremely high relationship between the two markets despite big swings up and down in the dollar.

With the last fall in the $A to sub-par, our market did not correct in $US - at least not yet. If this break is only temporary, we have about 10% catch up to make on the S&P500. Nice if we can get it.

The Federal Reserve's Bernanke brought back the 'Twist' - which is a play on bonds that is designed to bring down rates at the long end - but it didn't thrill equities' investors. The market fell. It didn't work when they tried it in the early 60's when the once-popular dance it was named after also vanished into insignificance.

Bonds

With Greek two-year bonds yielding 70%pa during September, you kind of think investors aren't really expecting to get all of their money back. The problem is, enacting a default or ejecting Greece from the Euro could have major impacts across the globe if all the bits and pieces are not sorted out first. The German vote at the end of September was the first step in insulating Europe from Greek financial woes.

Interest Rates

With JP Morgan still going for the next move in rates as up and Westpac still for going for four cuts in 12 months, there is no consensus on what will happen next. The ECB is now regretting its recent 0.5% hike and will probably soon reverse that and then some. We will look very silly if we keep rates on hold or, God-forbid, increase them, if it later turns out that our economy is falling to join the rest of the world.

Confidence is everything at the moment and consumers world-wide are feeling battered and bruised. A cut of one notch for us could hardly set off inflation but think of the relief and cheer it would bring to those living in Struggle Street.

Currency

Our dollar certainly came down with a thump in September and could well fall lower. If rates come down a little, our dollar could return to the $0.80 - $0.95 range that served us well before the silly season started. Of course, if the fall is sustained, the retail and other businesses that closed because they couldn't compete with the internet will not re-open. Shoppers might live to regret not supporting their local suppliers - back to higher prices and fewer bricks and mortar stores in which to browse. Of course policies could have been put in place to prevent the migration to the net as we discussed last year.

Oil

Oil fell with the rest - briefly to below $80. A lot of commodities' price volatility was caused by margin calls but a slowing of the global economy could since $100 again a thing of the past - until the next boom.

Gold

Gold again broke through $1,900 in September but it didn't take much to send it scurrying back to below $1,600. Anyone who bought gold for safety at the top of the market must surely feel bruised now - even its price eventually retraces to $1,900. The problem with all speculations is that there is a tendency for everyone to rush for the same exit at the same time.

Regional Analysis

Australia

The lower speed part of the economy will soon be going backwards if something like a rate cut is not done soon. With commodity prices softening in September, the faster speed part should not stall but it won't be able to carry the nation. The problem we face is not knowing what a predicted slowdown in the US and Europe will do to China demand. Waiting to find out does not seem to be the best solution.

China

Amazingly, China was reported to be slowing down when the HSBC PMI figure for China came in at under 50 for the third month in a row. If only they had read the HSBC report rather than just the headline they would have found out HSBC said that the reading was consistent with a mammoth 9% growth.

U.S.A.

The outcome of the much-awaited extended FOMC meeting for the Federal Reserve failed to excite anyone. Thankfully, Europe was centre stage so most forgot to interpret what this means. President Obama's $450m jobs program speech didn't resonate either, particularly as it got a cool reception from the Republicans.

Despite all the talk of the US economy slowing down, recessions and the like, the data are far from showing that. It is true they are not getting much better with unemployment stubbornly above 9%. But growth is well above 1%pa and that is not negative.

Europe

Angela Merkel, the German Chancellor, has her back against the wall as her party lost 6 out of 7 recent elections due to their stance on a united Europe. The Socialist party is gaining ground in the French upper house - and they are not too keen on bailing out the Greeks. The question is, can the European governments put in place what is needed before popular opinion brings in policies that could seriously damage Europe?

Rest of World

New Zealand got downgraded one notch by Fitch on the last day of September. At least they are doing well in The Rugby World Cup.

Great Britain won the Road Race World Cycling Championship for the first time since 1965 - one year before England last won the (soccer) World Cup. The London Olympics may help their economy. At least the riots were quelled quickly. It seems that rioters on government benefits quickly lost them. Now that is a deterrent!