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Off to the races!

Key points

- Although the labour market was reported to have been stabilising this month, we have some concerns when we delve deeper into the data.
- There is a strong case for the RBA having already cut rates. The issue should not be about guessing what the RBA will do. Rather it should be what they should have done.
- While Woodhall's capital gains forecasts for the ASX 200 remain at above average rates - at 9.5% - some sectors are not expected to do well: Consumer Discretionary, Financials, Property Trusts and Utilities. The resource boom is expected to continue at a solid rate taking part of the Industrials sector with it (Mining Services), and the defensive sectors of Consumer Staples, Health and Telcos are expected to continue on a moderate growth path.
- While the market was lurching its way through September and October, the week to week changes in the ASX 200 were much less volatile than during the GFC - and not much worse than we experienced during 1990 - 2003.
- The future of the market hinges on the deliberations in Europe and the G-20 scheduled for October 23rd and November 3rd and 4th. If these deliberations satisfy markets, and the RBA cuts rates, then it really could be "off to the races" for the market on Melbourne Cup Day. If not ....

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Unemployment

The market's initial reaction to the release of the labour force data on 13th October (for the month of September) was that the increase in employment was "twice as good as expected" at +20,400 and the unemployment rate had fallen from 5.3% to 5.2%.

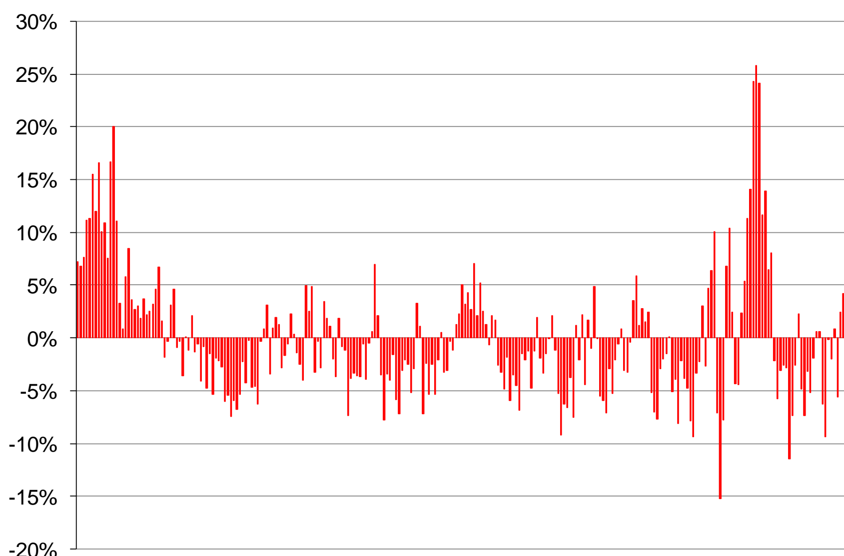
I don't want to be picky but that is not how to read the results from the labour market survey. The Australian Bureau of Statistics (ABS) deservedly has an excellent reputation for compiling statistics in a timely and cost-effective manner. And it would help if people read their interpretation of the results!

The ABS only surveys about 29,000 households to determine the state of the labour market. That corresponds to about 1 in 300 civilians being sampled. As a result, the headline data are subject to a degree of sampling error. It clearly matters which 1 in 300 persons is sampled. The ABS published a table summarising the magnitude of this sampling error. In the case of employment, the best estimate of an increase in employment from August to September was 20,400 but the ABS estimates that there is a 1 in 20 chance that the true number, if the whole population of Australia had been surveyed, is outside the range of -34,400 and +75,200. Anything from a massive fall to a massive increase! In other words, the month to month changes are so rubbery - which is why the ABS also publishes "trend estimates" which removes some of this variation. The trend estimate was for an increase of 0 and not 20,400 - yes, that is zero. So why did the market get excited and change its collective mind about the prospect of a rate cut?

When it comes to the unemployment rate, the ABS (seasonally adjusted) estimates went from 5.3% to 5.2% - a fall as commonly reported? No! Because the numbers are only given to 1 decimal place in the printed report - there is a rounding error when month-to-month differences are taken. The ABS reported that the change as 0.0 - yes, that is zero again. The tolerance for that number is -0.2% to +0.2%. In other words we don't have much of a clue what is going on from month to month. The ABS "trend estimates" reveal that there was an <u>increase</u> of 0.1% and not a <u>decrease</u> in unemployment as generally discussed in the media!

Although most people find statistics totally boring and/or difficult, gaining a basic understanding would at least stop some people jumping at shadows. For my read on the state of play I focused on male unemployment - because it is typically more sensitive to change when macro conditions change - and rates of change three months apart to reduce the impact of sampling variation. By so doing - in Chart 1 - I can better see signals coming through.

Chart 1: The rate of change of male unemployment 1990-2011



Source: Woodhall Investment Research, Thomson Reuters Datastream

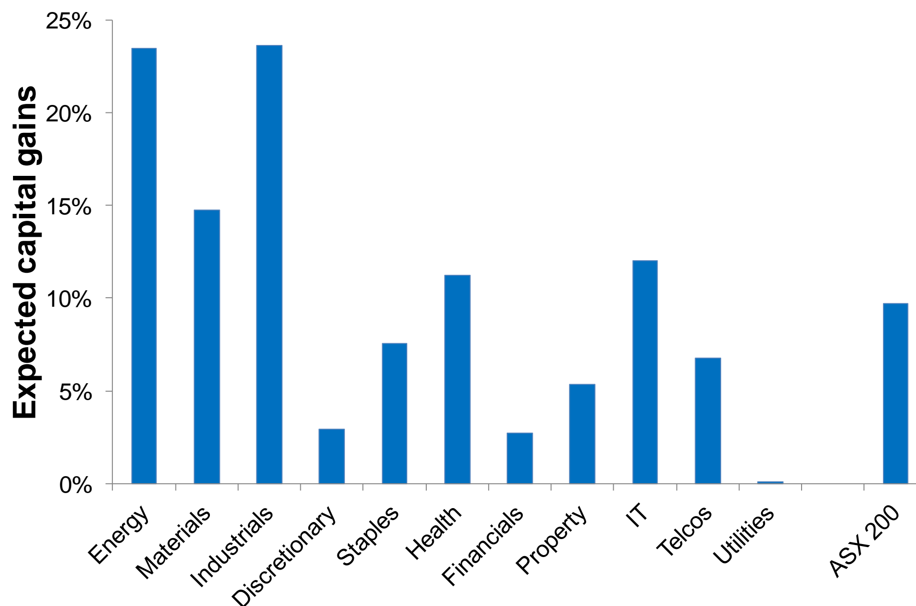
What now becomes clear to me is that the data for the last two months is worse than any other time in the last 22 years except for "the recession we had to have" and the GFC. Importantly, when unemployment was taking off on those two previous occasions, interest rates were already falling -

not flat for 12 months as we have now. There was a good case for a drop in rates at the October RBA meeting. It is far too soon to panic about recessions in Australia as the mining boom still supports us - as it did during the GFC - but the RBA should lift its activity level sooner rather than later. The RBA has a twin mandate: that of price stability and full employment. The RBA seems to be missing the signs on the full employment half of its mission.

Market Expectations

Woodhall bases its forecasts on broker forecasts of dividends and earnings - please see the Quant Quarterly on www.woodhall.com.au for details. Woodhall's current forecasts for 12-months ahead capital gains are shown in Chart 2 for the market and its 11 major sectors.

Chart 2: 12-month-ahead forecasts for the ASX 200



Source: Woodhall Investment Research, Thomson Reuters Datastream

Depending on the chosen historical period, different past performances can be estimated. Most market opinion seems to be that a reasonable historical average is about 7% for the ASX 200. While there is no reason why this average is a reasonable guide to future growth, it is the standard benchmark. Our forecast of 9.5% puts the next 12 months as possibly being a little better than this benchmark. That's not bad in such an uncertain world.

When this market forecast is split up across sectors, a stark contrast emerges. Forecasts of over 20% for Energy and Industrials (helped by Mining Services) and 15% for Materials (including mining stocks) stand out when compared to the home-based sectors of Consumer Discretionary (Harvey Norman, David Jones, etc), Utilities (e.g. AGL), Financials (mainly the big four banks) and Property Trusts. Three defensive sectors (Health, Consumer Staples and Telcos) are in the middle of the pack.

In my opinion, this polarisation of expectations is the result of the two-speed economy and the high interest rates that support the dollar at unreasonable levels and stunt growth through high costs of borrowing.

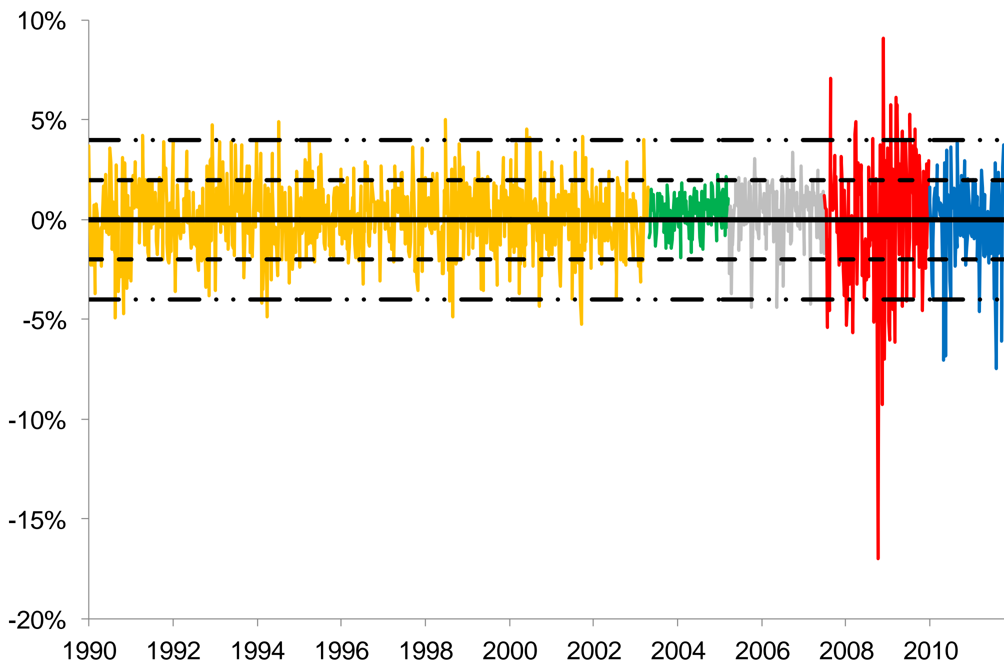
Volatility

I would not be surprised if most people do not have a good handle on what financial statisticians call volatility. Taxi drivers keep telling me markets never used to change as quickly as they do now. So in Chart 3 I show the weekly change (as a percentage) since the start of 1990. In separate, and quite sophisticated, analysis I have determined that there have been several separate regimes of volatility. I have colour-coded them for visual simplicity.

The first regime lasted from 1990 to March 2003. For about the first 14 years, the market often grew/fell outside ±2% (the inner dotted lines) in a week and sometimes the change was outside the range ±4% (the outer dotted lines). From March 2003 to March 2005, the market barely got outside the inner dotted lines and came nowhere near the outer. This period of quiet was at the start of the last big bull run.

Interestingly, from March 2005 to the lead up to the GFC in July 2007, the market often fell by more than 4% but never rose by that much. In other words, the grey regime was a hybrid of the green and gold regimes. This period was the time of exuberance bubbles being burst - possibly fuelled by contributions going into superannuation funds.

Chart 3: Weekly returns on the ASX 200



Source: Source: Woodhall Investment Research, Thomson Reuters Datastream

During the GFC - the red regime - the range of weekly returns magnified and - perhaps surprisingly for some - there were many weeks of good gains. Since January 2010, we have had yet another regime (blue). For much of 2010/11 variation was more in accord with the quiet green regime. Except for a few weeks, the blue resembles the grey.

This analysis is not predictive. But it does perhaps highlight how we have become overly sensitised to change. To me, this sensitivity (which elsewhere I measure as fear and dispersion - as we discuss in the Quant Quarterly) will slow down the healing process. The market can go up from here but maybe not as fast as it otherwise would have.

Where to from here?

Prediction is always hard and perhaps even more so at the moment. If Europe does not reach an acceptable conclusion on October 23rd, there will be serious ramifications for the market. If the meetings are successful, the underpricing we have estimated for the Australian and US markets could be eroded as markets climb - about 10% in Australia and 5% in the US - in the short run before the capital gains forecasts - of 9.5% for the market - take hold. But, perhaps, Australia is going to be more affected by the action, or inaction, of the RBA. The RBA next meets on Melbourne Cup Day. I have no observed skill in predicting what they will do but I do know what they should do! A 25 basis point cut to 4.5%, the dollar will fall, expectations will improve and it could be off to the races for the market. If not ....