

STRATEGY OBSERVATIONS

HEURISTIC INVESTMENT SYSTEMS
Generating Intelligence for Investment Decision Makers



26 AUGUST 2014

Market Extremes

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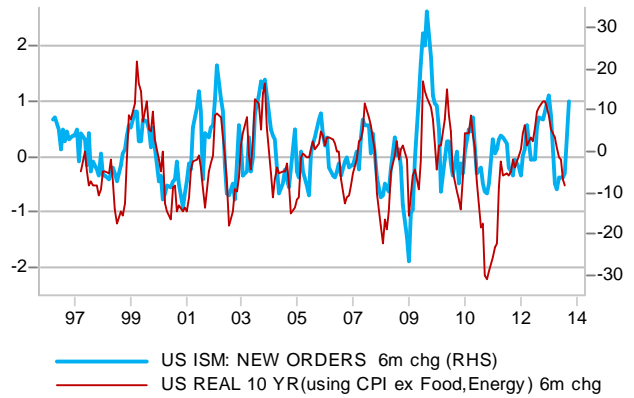
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DIVERGENCE & EXTREMES IN BOND MARKETS

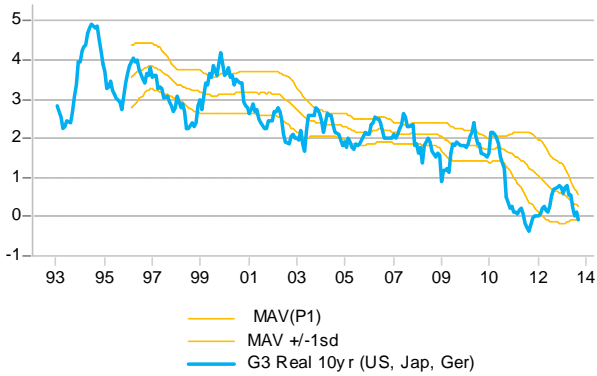
- Bond yields have sharply diverged from activity indicators such as the US ISM index and measures of G3 momentum (although less so).
- Nominal yields in the US are in line with 1940-50's levels.
- G3 real 10 year yields are back into negative territory. (using core G7 CPI)
- German bunds now sub-1%, taking the spread against US 10yr treasuries to almost record lows (near -1.5%)

US 10YR & US ISM NEW ORDERS



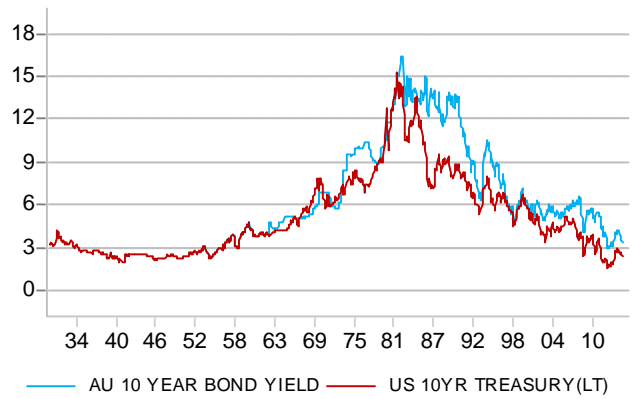
Source: ISM, IRESS

G3 Real 10 year yield



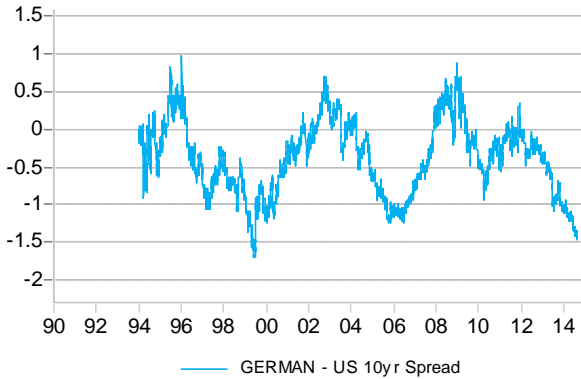
Source: US Fed, IRESS, HIS est., using proxy updates

10 YEAR BONDS



Source: IRESS, using proxy updates

German - US 10yr Spread



Source: IRESS

GERMAN 10 YR BOND

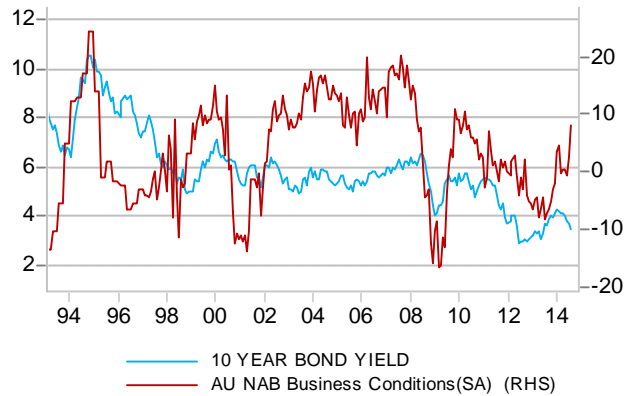


Source: IRESS

AUSTRALIAN BONDS DIVERGING

- Similarly, Australian 10 year bond yields have diverged from key macro indicators such as NAB business conditions (4-year highs).

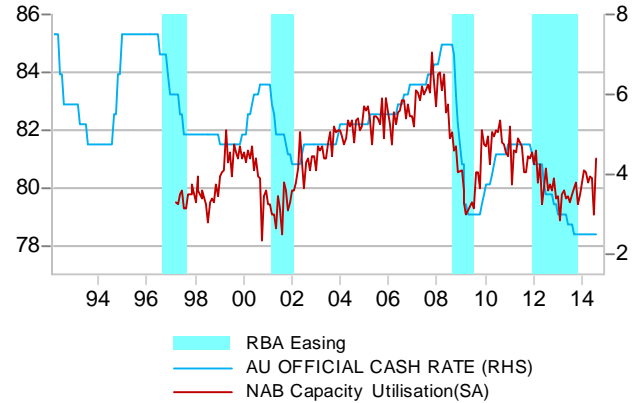
Aust 10yr Bond & NAB Business Conditions



Source: NAB, IRESS

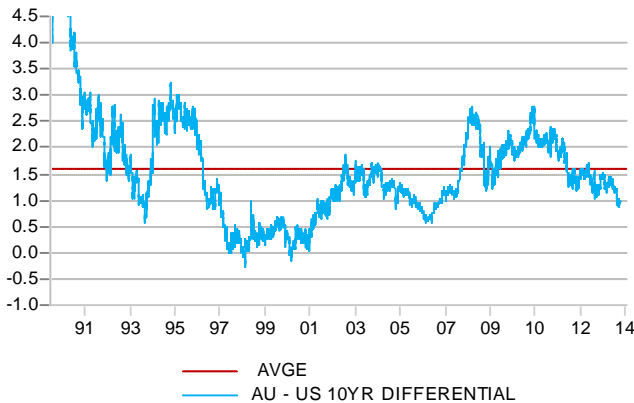
- The recent lift in the NAB capuse indicator (if sustained above 81) would suggest the cash rate is biased upwards....ie. Rising capuse and above 81 tends to be associated with an eventual rise in the cash rate.
- Technically, Australian 10 year bonds are overbought.
- In terms of the 10 year spread to US 10 year bonds, Australian bonds are back to 2006-07 levels.

NAB Capacity Utilisation & Cash rates



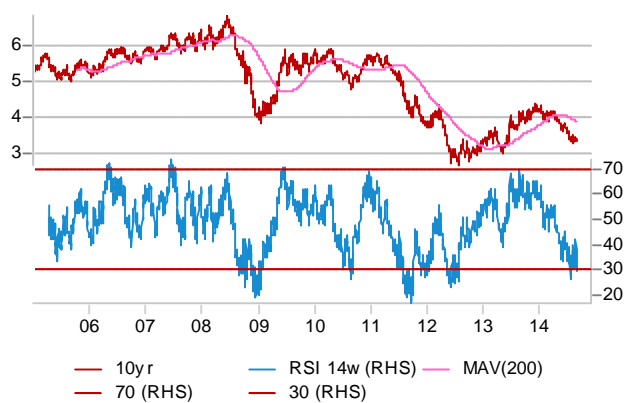
Source: NAB

AU-US 10YR SPREAD



Source: RBA, ABS, IRESS

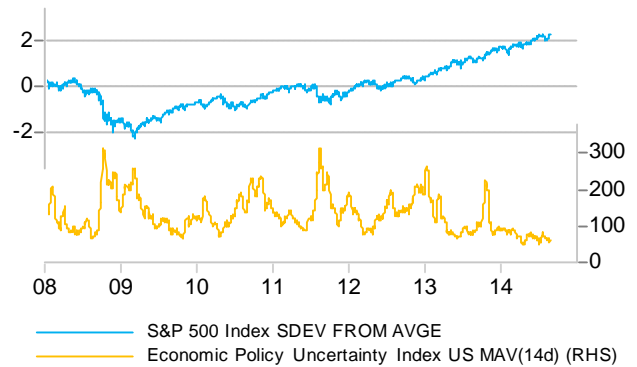
10-Year Bond & (RSI(14w))



STRESS, UNCERTAINTY & VOLATILITY

- The economic policy uncertainty index for the US is now at the lowest levels since 2007.

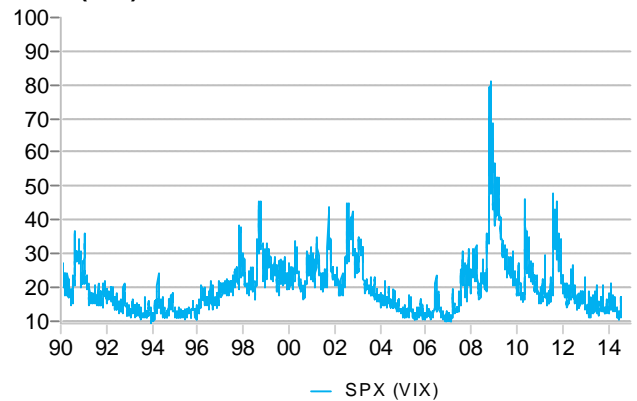
S&P 500 Index & Economic Policy Uncertainty Index for US



Source: St Louis Fed

- Although the VIX has lifted recently, it is near the mid-2000 and early 1990's levels.

SPX (VIX)



Source: CBOE

- The ST Louis Fed Stress indicator is near extreme lows.

St. Louis Financial Stress Index

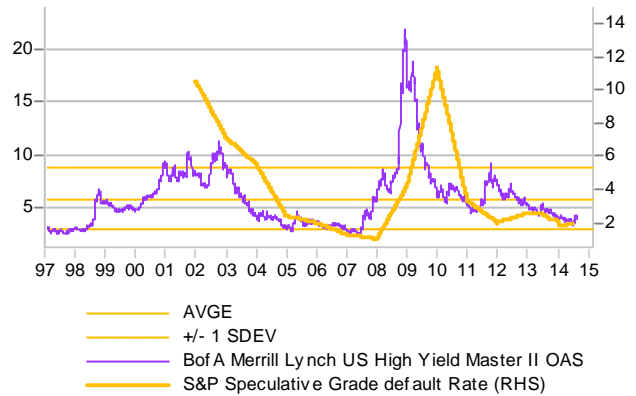


Source: St Louis Fed

US HIGH YIELD

- High yield spreads have recovered a little after the sell-off from 340 bps to 430 bps. They are above the lows of around 250 bps reached in 2007 and 1997 but broadly consistent with low default rates.

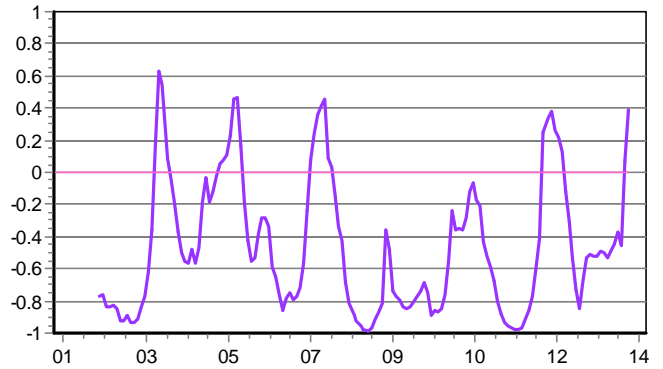
US High Yield spreads & Default rates



Source: St Louis Fed, BoA, S&P

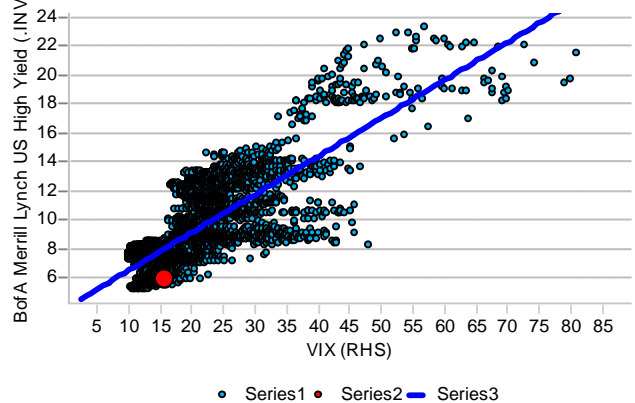
- Over the past 12 months high yield spreads have become quite highly correlated with changes in 10 year yields.
- Declining bond yields have been associated with narrowing spreads.

US 10 yr & BofA Merrill Lynch US HYld Master II OAS Rolling CORRELATION over 12 Months



- In absolute yield terms high yield appears to be relatively expensive despite the relatively low VIX.

US High Yield level & VIX

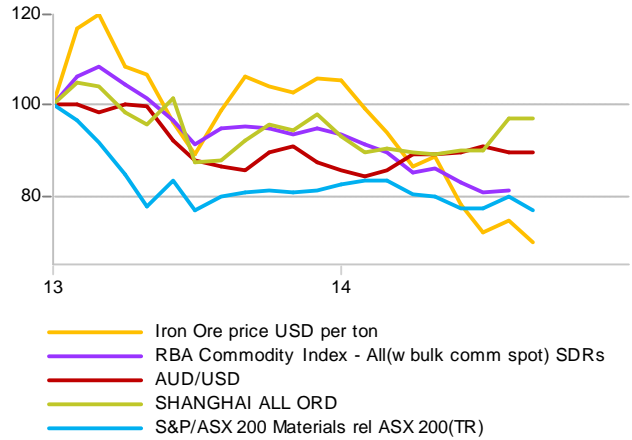


$$\text{BofA Merrill Lynch US High Yield (.INV)} = 0.26 * \text{VIX (RHS)} + 3.9 \quad (R^2 = .61)$$

IRON ORE, CHINA, BUSINESS CONDITIONS

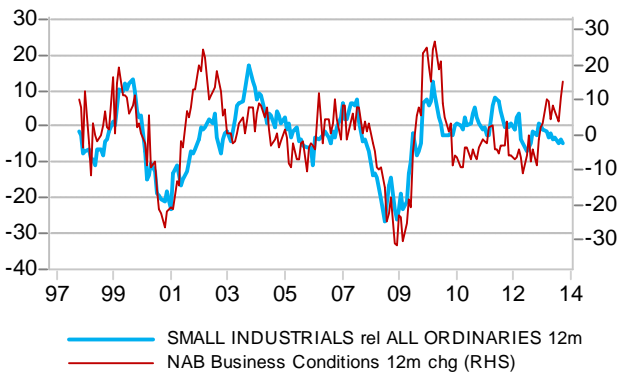
- While the Chinese equity market has risen and the AUD has been relatively stable, the iron ore price has continued to slide (after a brief respite) and the mining sector has followed.
- For a few months the direction of the Chinese economy (as measured by the China Market PMI) and iron ore prices had diverged.
- A considerable divergence has opened up between the NAB business conditions index and the relative performance of small industrial stocks.
- Likewise NAB business confidence has diverged from consumer confidence.
- Within the NAB survey, confidence in the construction and retail sectors has improved relative to mining and manufacturing.

AUD, Iron ore, commodities & Global Cyclical



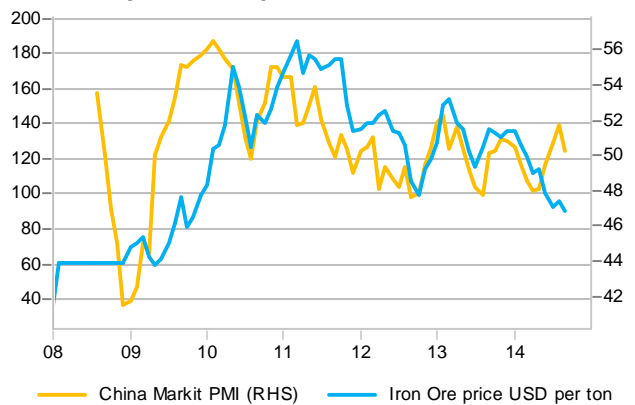
Source: IRESS, RBA, using proxy updates

Small Industrials rel ASX200 & NAB Business Conditions



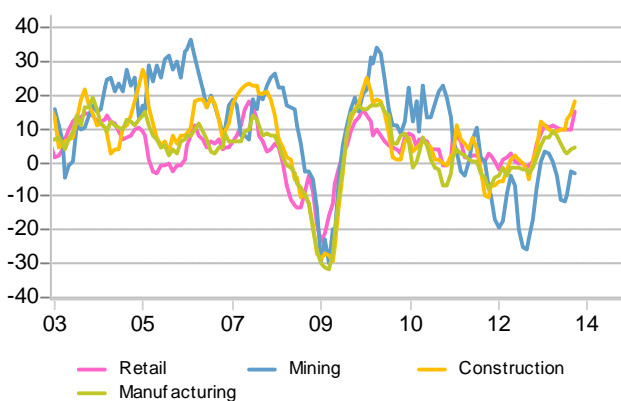
Source: NAB, IRESS

Iron Ore price USD per ton & China PMI



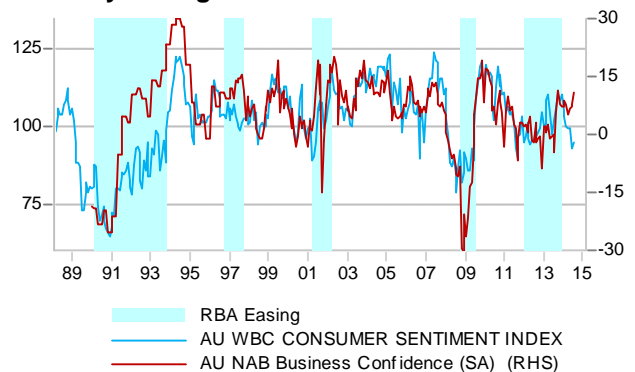
Source: China NBS, IMF

Business Confidence by sector (3MMA)



Source: NAB

Australia Business & Consumer confidence & Policy easing

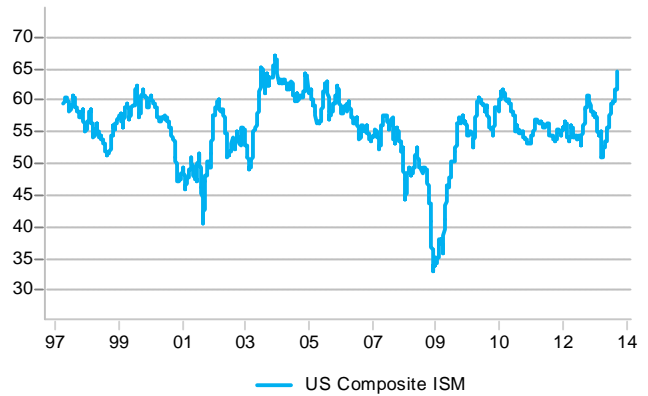


Source: NAB, WBC, RBA

US CYCLE

- A composite measure of the US ISM (70/30% weighting to services/manufacturing) has reached its highest level since 2003-04.

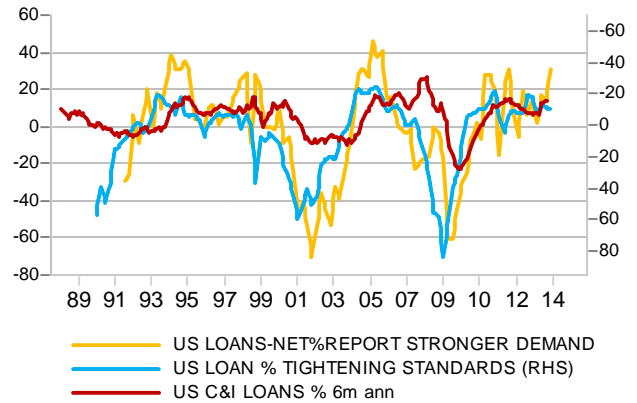
US ISM Composite Index level



Source: ISM

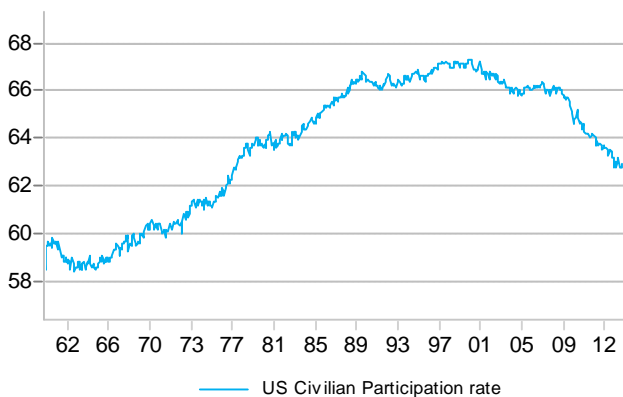
- The latest US Fed loan officer's survey showed that the diffusion index for those reporting stronger demand for loans rose to the highest level since pre-GFC.
- Initial claims for unemployment insurance are very close to previous cycle lows, yet consumer confidence (as measured by the US Conference Board), although improving, is still below 100.
- One of Fed chair Janet Yellen's favourite indicators suggesting considerable slack in the economy is the US participation rate which, at 62.9, is back to late 1970's levels.

US C&I LOANS & Loan Officers survey



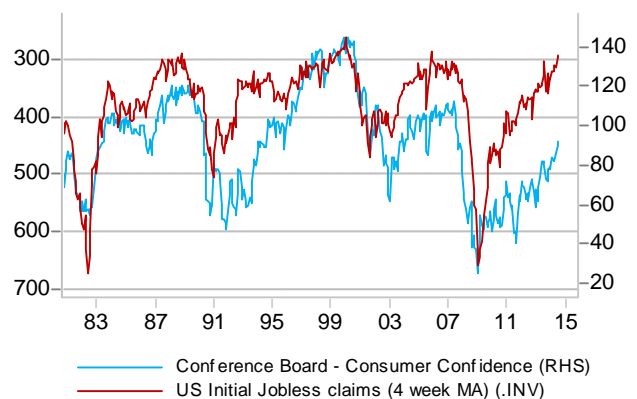
Source: ISM, US Fed

US Participation Rates



Source: BLS

US Consumer Confidence and jobs market

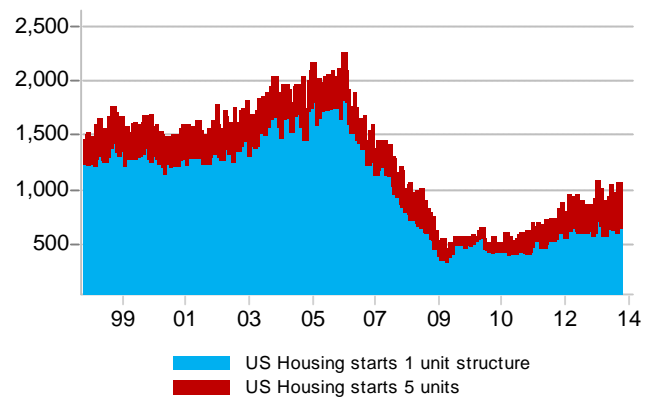


Source: Conference Board, Dept Labour

HOUSING

- The US housing recovery has been relatively disappointing. Although overall starts are rising, it is being driven by multi-family units which were up almost 50% yoy and now comprise almost 40% of starts compared with 15-20% prior to 2007.

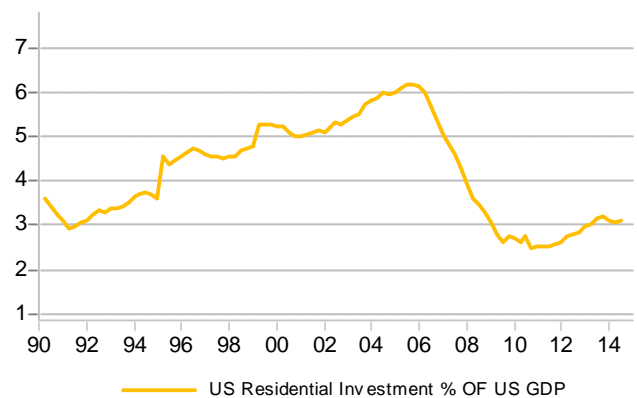
US Housing starts breakdown



Source: St Louis Fed

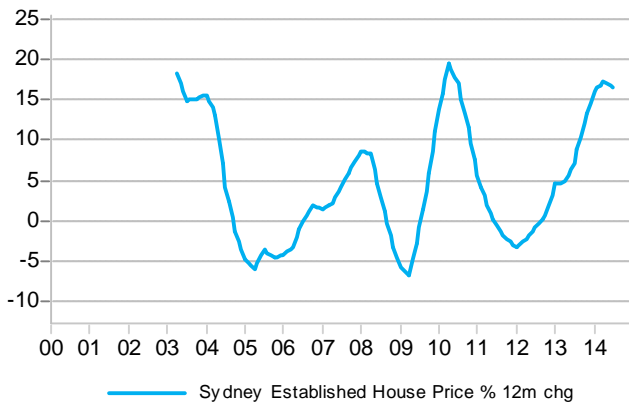
- US residential investment as a proportion of GDP is a lowly 3%.
- In the UK house prices are up more than 10% over the past 12 months.
- In Sydney house prices are more than 16% higher over the year.

US Residential Investment % of REAL GDP



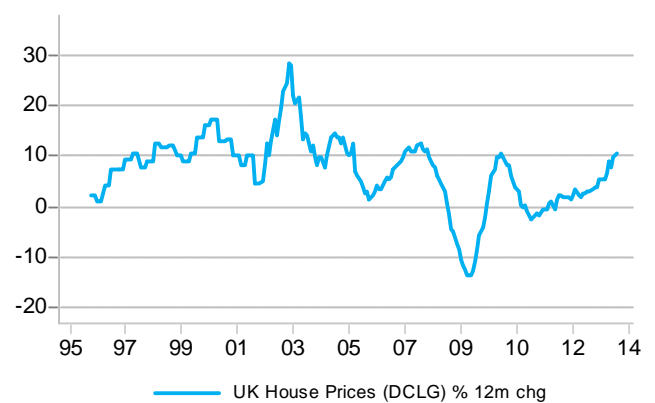
Source: BEA

Sydney Established House Price (% 12m chg)



Source: ABS

UK House Prices yoy%

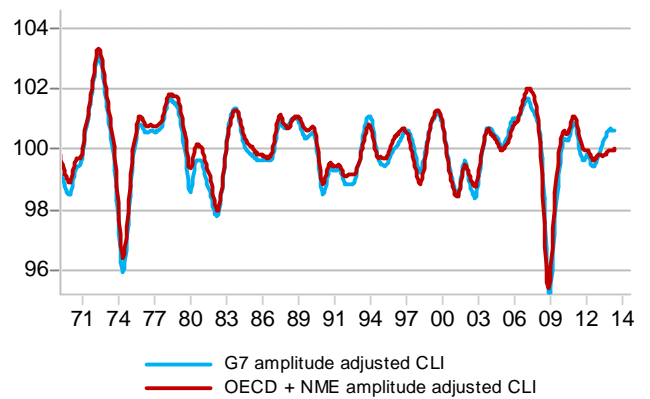


Source: ONS

EMERGING MARKETS

- The leading indicators for the OECD plus non-member economies (China, India, Brazil, Russia, South Africa, Indonesia) is showing the largest divergence recorded against the G7 leading indicator.

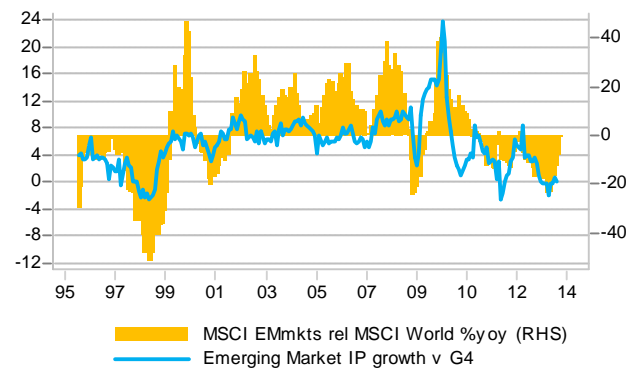
Leading Indicator for G7 & OECD plus BRICs



Source: OECD

- Relative industrial production growth between the emerging economies and the major four economies is close to record lows (late 1990's, 2011), although it has recovered since January.

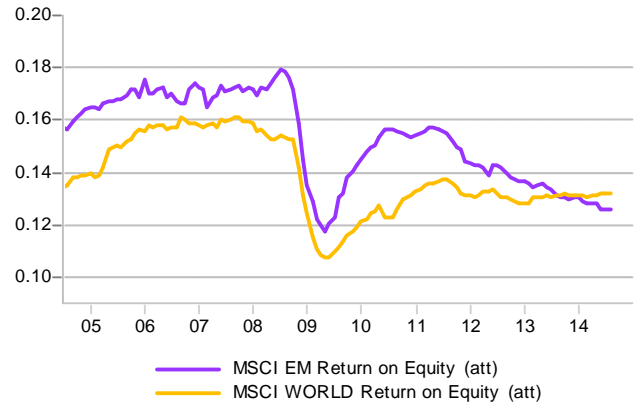
Emerging Market Output v OECD & relative performance



Source: OECD, MSCI

- Emerging market return on equity is now below that of developed markets.

MSCI EM & WORLD Return on Equity

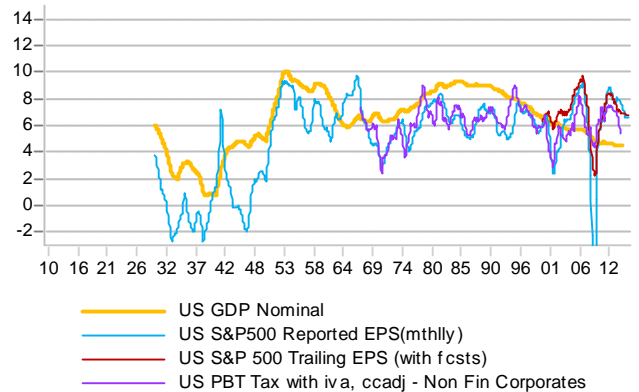


Source: IBES

US GROWTH, PRODUCTIVITY & EPS

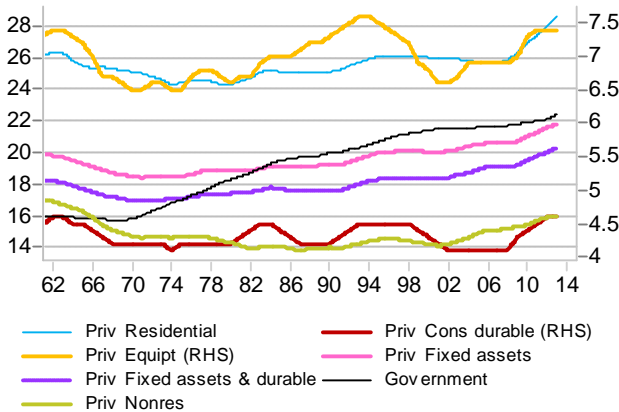
- The first chart shows the relationship between annualised 20 year nominal GDP growth and similar measures of EPS and profit growth. Since the early 2000's EPS and profit growth has generally exceeded trend GDP growth (which has slowed to 4-4.5%, the lowest since the 1940's). Should market valuations continue to assume long term EPS growth of around 6.5%?
- Although the age of the capital stock has risen and productivity growth has slowed, continued low wages growth (and low unit labour cost growth) has enabled US profit share to remain elevated (the latest drop in US NIPA profits partly reflects an end to bonus depreciation).

US Nominal GDP growth & EPS, Profit growth



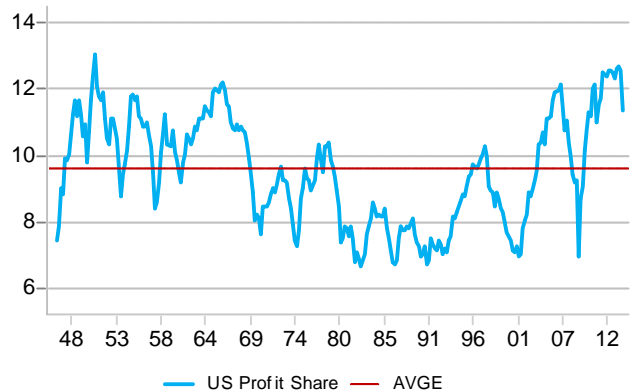
Source: BEA, IBES

US Age of Capital Stock



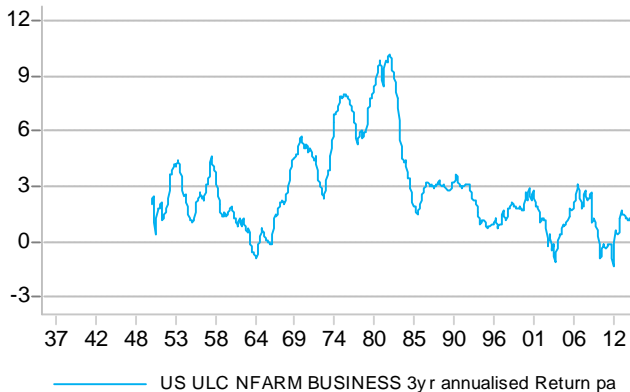
Source:BEA

US Profit Share



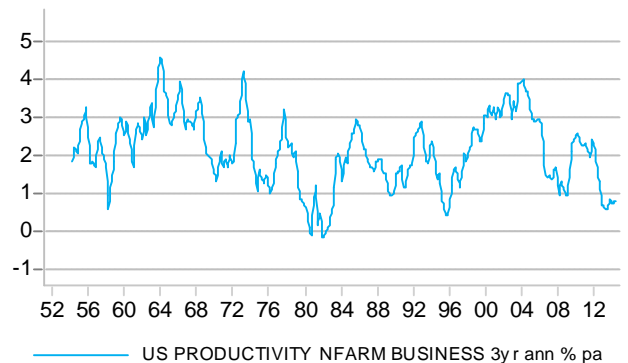
Source: BEA

US Unit labour cost Trend



Source: BEA, NBER

US PRODUCTIVITY NFARM BUSINESS (3yr annualised Return pa)

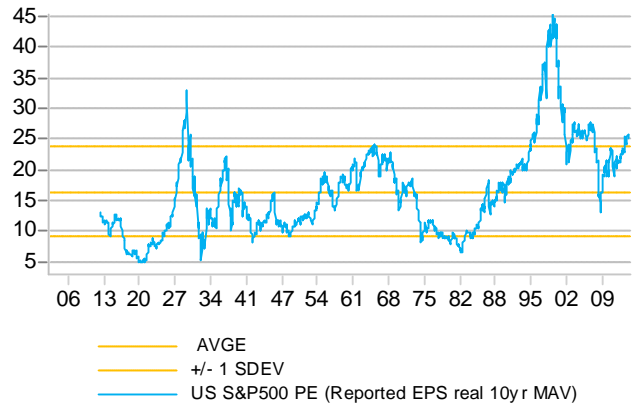


Source:US Bureau of Labour Statistics

EQUITY MARKET VALUATIONS

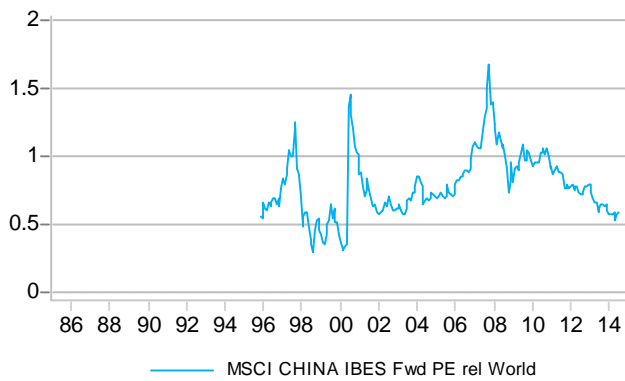
- The CAPE or Shiller PE for the US is around 26 times, more than 1 standard deviation above average,
- On a forward PE relative basis (IBES consensus) Japan, China and Eastern Europe appear “cheap”. NZ appears expensive.

US PE (real reported 10yr mav EPS)



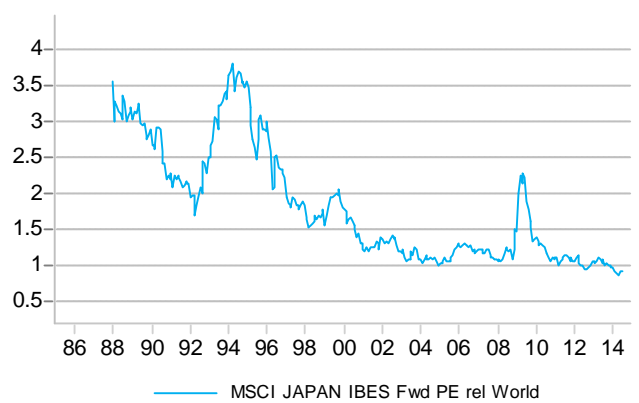
Source: IBES, Shiller

MSCI CHINA PE rel World

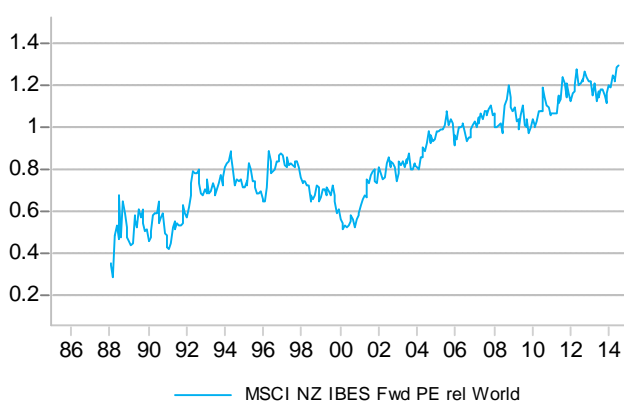


Source: IBES

MSCI JAPAN PE rel World

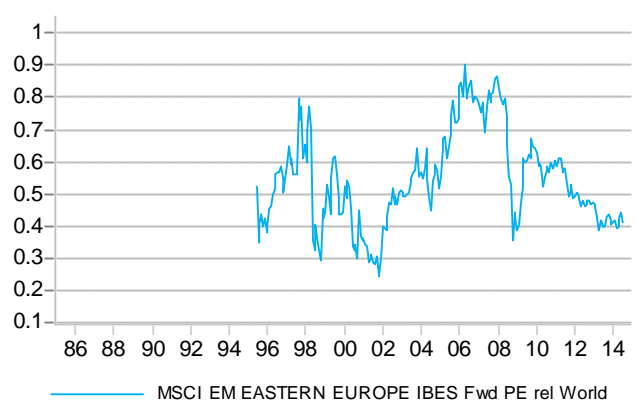


MSCI NZ PE rel World



Source: IBES

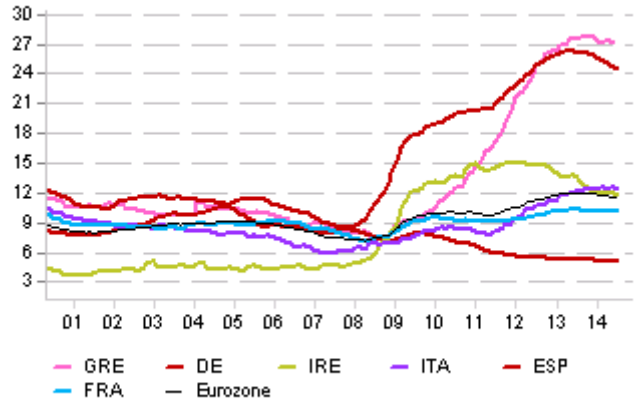
MSCI EM EASTERN EUROPE PE rel World



EUROPEAN ECONOMY

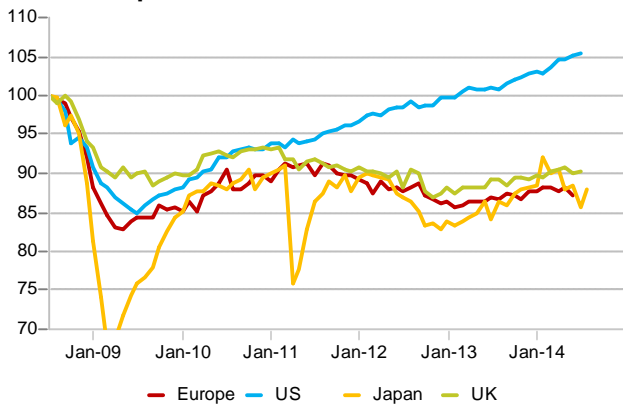
- Unemployment rates remain elevated in Greece and Spain and continue to trend higher in Italy.
- While industrial production in the US is more than 5% higher than it was in January 2008 production in Europe and Japan is more than 10% below January 2008 levels.
- Corporate loans outstanding in Ireland, Spain and Portugal continue to decline while motor vehicle registrations are recovering off extreme lows.
- EPS in Europe and the UK has lagged Japan and the US.

EU Unemployment Rates



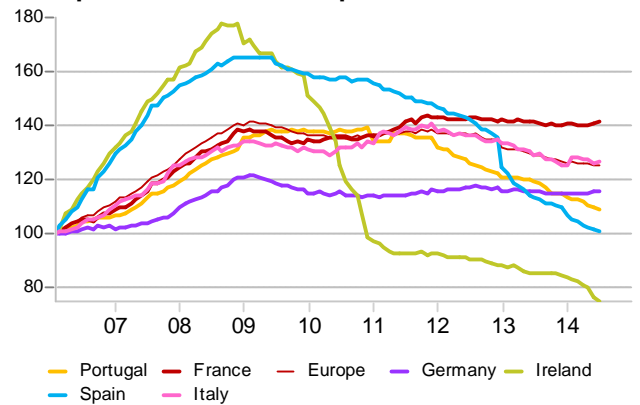
Source: ECB

Industrial production



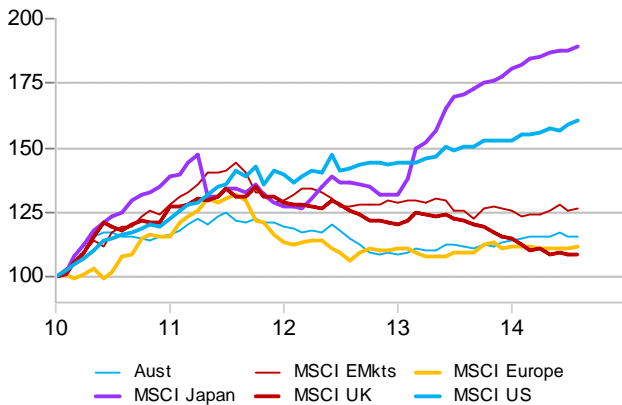
Source: ECB, Fed, METI

Europe Non-Financial corporations Loans



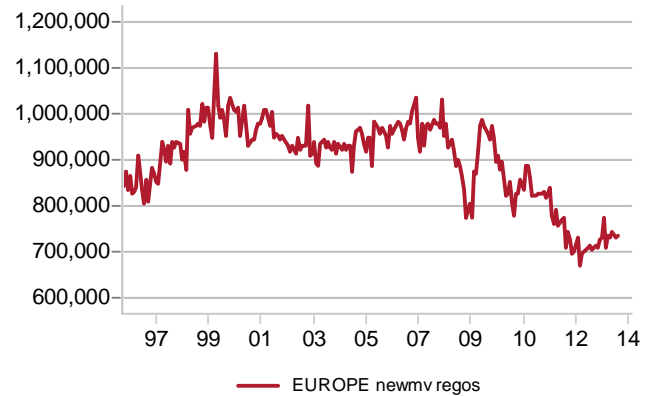
Source: ECB

Global EPS



Source: IBES

EUROPE MOTOR VEHICLE REGISTRATIONS

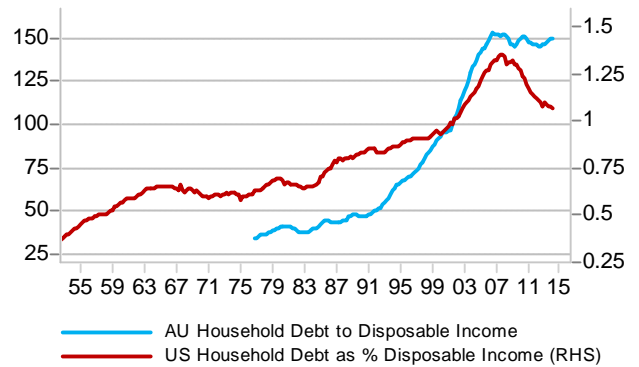


Source: ECB

AUST & US HOUSEHOLD DEBT, NET WORTH

- Australian household debt to disposable income ratio has flat-lined at around 150% since 2006 while for the US the ratio has declined from around 135% to just over 105%.

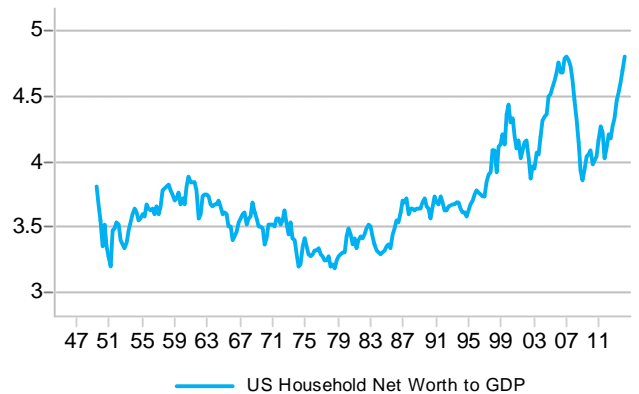
AUST & US HOUSEHOLD SECTOR DEBT % DISPOSABLE INCOME



Source: BEA, RBA

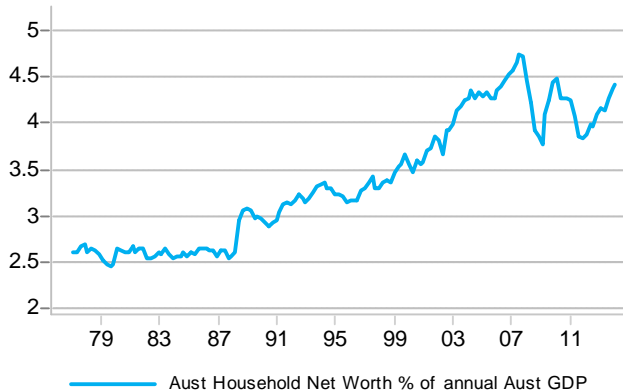
- US household net worth to GDP has climbed to a record 4.8 times from the low of under 4 times in 2009, driven by declining debt at the same time as rising asset prices (equities and housing). The strong rise in net worth to GDP since the mid-1990's reflects a number of factors including declining inflation and interest rates, ease of credit and deregulation and increased profit share all of which in turn have fuelled further credit growth and asset price inflation.
- Australia has also seen a recovery in household wealth although not to the same extent.
- Higher household net worth to disposable income has been associated with a reduced household savings rate although the relationship has not been as strong in this up-cycle.

US Household Net Worth to GDP



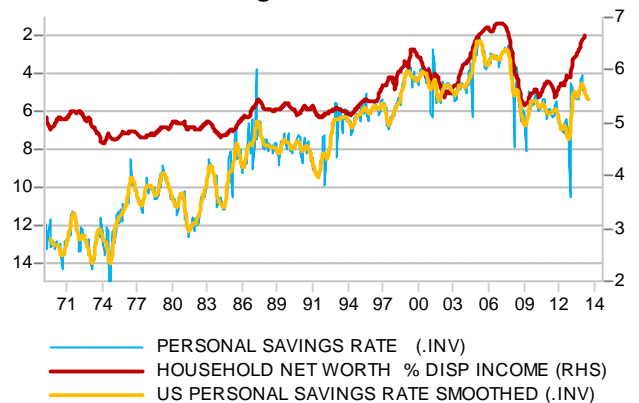
Source: US Fed. BEA

Aust Household Net Worth to GDP



Source: RBA, ABS, Heuristics

US Wealth & Savings

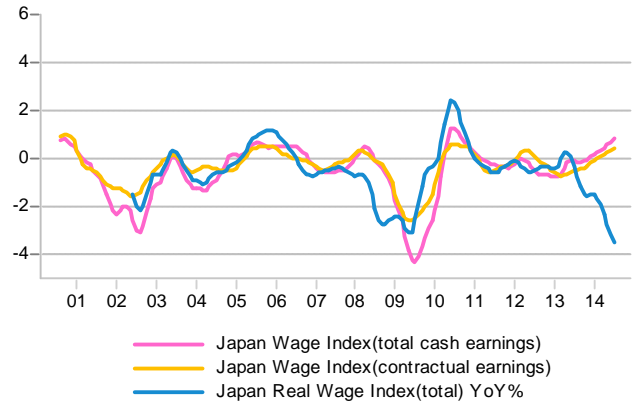


Source: BEA

WAGES & UNIT LABOUR COSTS

- Although nominal cash earnings in Japan are up close to 1% over the year to June and are close to 15 year highs, real wages are down 3.2%, lower than during the GFC.

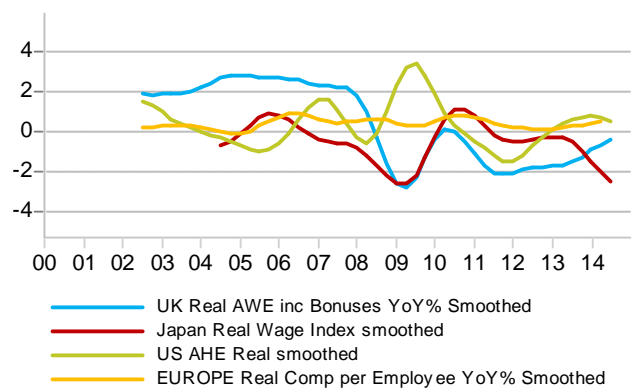
JAPAN Wage Costs



Source: Cabinet Office

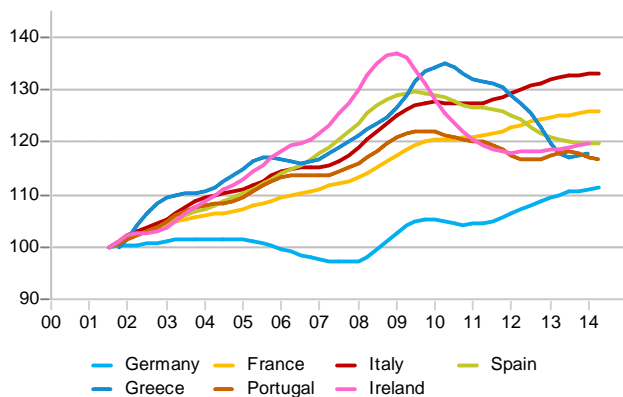
- Real compensation growth is also negative in the UK (and has been since 2008-09) and only slightly positive in the US and Europe.
- Australian real wages growth is also negative.
- Unit labour costs continue to rise in Italy and France (and Germany albeit from a lower level) while ULC's in Spain, Greece, Portugal and Ireland have all stabilised after sharp declines.

Real Wage Growth in US, Europe, Japan & the UK



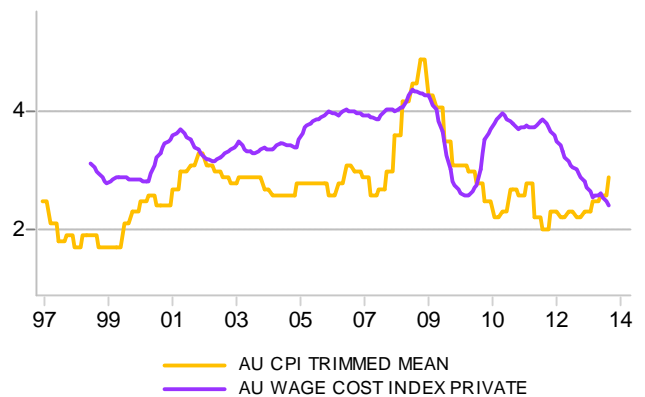
Source: BLS, ECB,ONS, BOJ

Europe Unit Labour Costs



Source:ECB

Australia Wages Growth

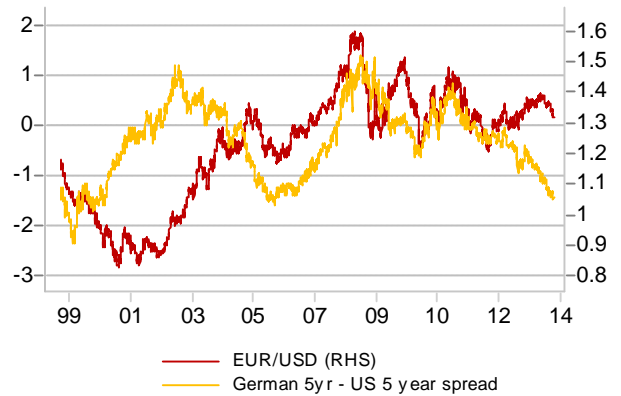


Source: ABS, NAB

CURRENCIES

- The spread between a 5 year German bond and the US 5 year is around -1.5%. The EUR-USD has weakened but not as much as may have been expected given the change in interest rate spreads.

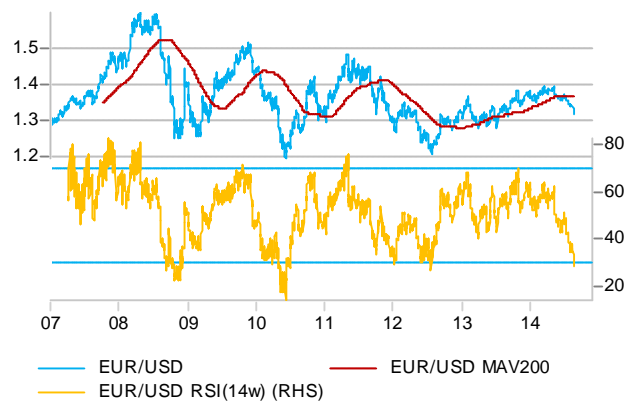
German - US 5yr Spread & EUR



Source: IRESS

- Despite this the EUR is looking slightly oversold at present.

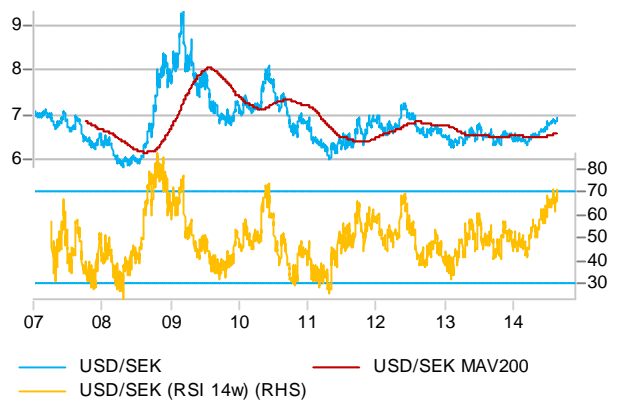
EUR-USD RSI



Source: IRESS

- The Swedish krona appears oversold against the USD. The SEK has suffered from low inflation and rate cuts.

USD-SEK RSI

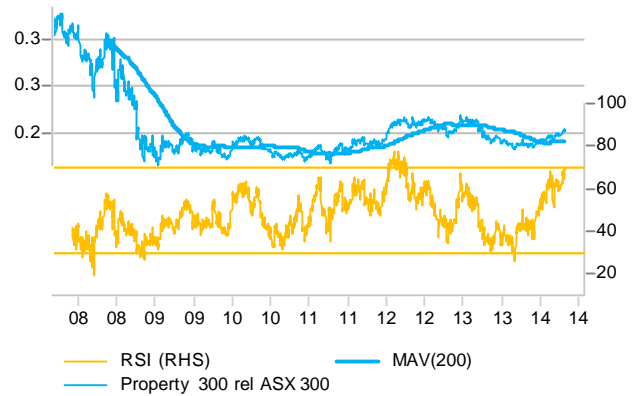


Source: IRESS

AUSTRALIAN SECTORS

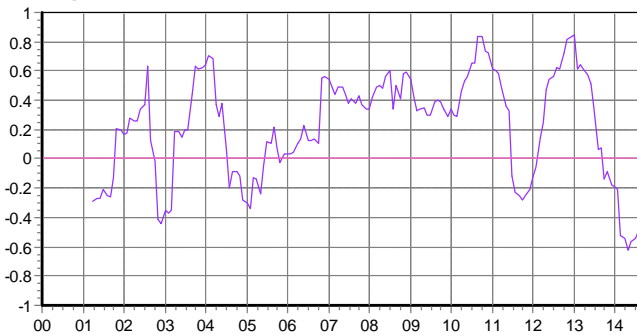
- REITs appear overbought, as do telco's.
- The rolling 12 month correlation between utilities, REIT's and monthly changes in bond yields is also at extremes.
- Australian building materials stocks relative to the market have had an unusually strong negative correlation with monthly changes in the US NAHB index over the past 12 months.

REITS rel Market RSI



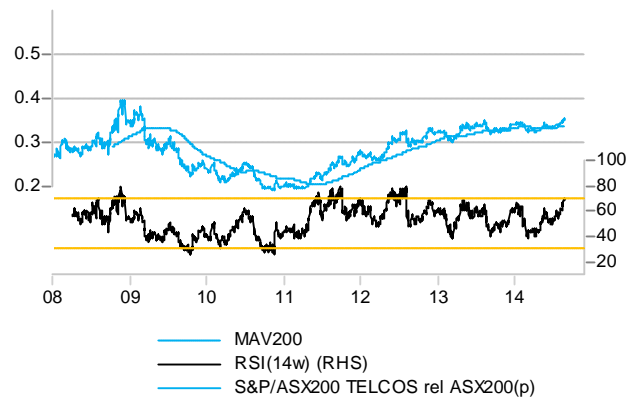
Source: IRESS

Aus Build Materials 1m Rel ret to ASX200 and US NAHB: Housing Market Index 1m chg Rolling CORRELATION over 12 Months from 1999 to 31/07/2014



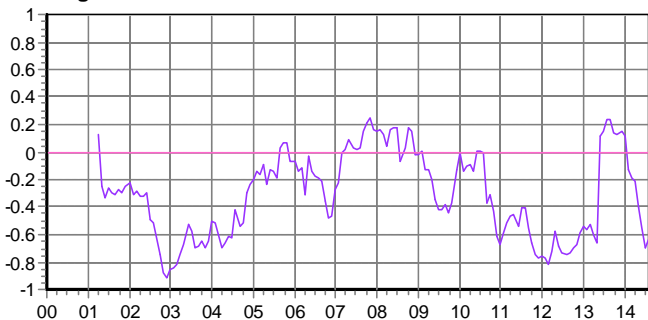
Source: IRESS, NAHB

Telcos rel Market



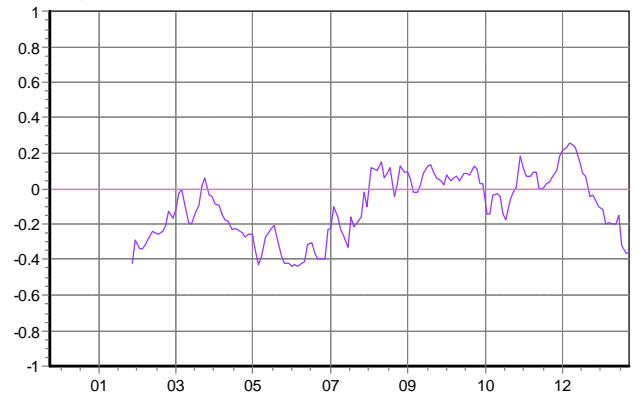
Source: IRESS

S&P/ASX 200 -Utilities rel ret ASX200 over 1m and AU 10 year 1 chg Rolling CORRELATION over 12m from 1999 to 31/07/2014



Source: IRESS

ASX Listed Prop Trust % 1m chg and AU 10 year 1m chg Rolling CORRELATION over 24m from 31/12/1999 to 31/07/2014



Source: IRESS

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