New York Securities Pty Ltd

Monthly Newsletter – July 2014

Market Dysfunction

The market continues to tread water waiting for either help to arrive to lift its spirits or finally succumb to exhaustion and slowly sink to the bottom of the ocean floor. The good news is if history has anything to do with it the next 4 months could very well produce the best gains we will see all year. Looking back over the last 5 years from 2009, if you had purchased an index based portfolio at the end of June and sold at the end of October, it would have yielded you a 42.35% return, an average increase of 8.47%. This includes a 7% decline during the same period in 2011, caused by concerns over European sovereign debt contagion, downgrading of US's credit rating and concerns over US's slow economic growth.

After studying a number of forward looking indicators to determine if there is any reason to change our view on where we believe the market is heading, as indicated by the rising bearish wedge in black, we ended up scratching our heads and throwing a vast number of them in the bin. The problem with many of these indicators is they were not developed for periods of dysfunction where central banks around the world control the stock markets, bond markets and currencies, like they do today with their cheap money. As a consequence predictive behaviour is no longer influencing markets to the same degree as it did in the past, instead investors are developing a fearless attitude toward potential risk events preferring to maintain long positions because quite simply the dysfunction gives them no other alternative to make their cash work. This is one explanation why we hardly saw any asset repricing occur during the May and June period.

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Market Expectations

The following chart reflects the S&P/ASX200 **XVI** index against the S&P/ASX200 **XJO**. The Australian S&P/ASX200 XVI index was developed in 2007 shortly after global markets began to implode. Primarily the "fear index" is used as an indicator of investor sentiment and market expectations, measuring market perceived volatility (in either direction). The XVI index at relatively high levels implies market sentiment is uncertain and a large change in the S&P/ASX 200 over the next 30 days is expected. Conversely a relatively low XVI index value implies a greater level of confidence among investors who expect very little change in the S&P/ASX 200 over the next 30 days. As you will observe in the chart below the XJO and XVI have an inverse relationship. For example the events of late October 2008 (GFC) reflected high levels of expected volatility (63% annualized) and with it great uncertainty amongst investors.

Today we find the XVI index at the lowest level seen since the introduction of the XVI in 2007 (Red circle). If we go by recent surveys of consumer and business confidence (within Australia) one could argue we find ourselves at this point not because investors are confident but rather investors are simply ignoring risk. Ignoring risk may certainly push the index higher, but the further it rises the less rational investors are becoming. This adds an extra element of risk which we are not comfortable with and so we maintain one must remain diligent and not get drawn into the divergence between price and value. In other words don't allocate all your resources to a dysfunctional market because you fear you're missing out as prices float up on weak volume. Instead allocate a higher percentage of cash to your portfolio where possible until evidence supports its worth allocating more of your hard earned cash to the market.

Possible Scenarios to play out in July

If we use the XVI level of 11.5% as indicated in the chart above, we can determine the markets expected change (in either direction) in the S&P/ASX 200 XJO level over the next 30 days.

Calculating the expected change…………

The current index volatility level is 11.5% (annualized rate), so to convert this to a 1 month period (30 days) we multiply the 11.5% by $\sqrt{1/12}$ which results in a standard deviation percentage of 3.32%. Given the current index level is 5395.7 we can then use the monthly percentage to determine the markets expectation of change in the S&P/ASX 200 XJO index level during July;

High – XJO of <u>5575</u> index points (To the upside + 3.32%)

Mid Range – XJO of <u>5396</u> index points

Low – XJO of <u>5217</u> index points (To the downside -3.32%)

The market seems eerily indifferent to the July/August period ahead of us when ASX listed companies (depending on their fiscal period) are due to release their **Quarterly**, **Half Yearly** or **Preliminary Final Reports**. Could the market be asleep at the wheel? After all, it would be frivolous to think the current low level of volatility is sustainable. Since investors have become accustomed to the higher yield on offer in equity markets and a strong belief growth in dividend payments will continue, in the short term the greater risk applies to the downside on any negative earnings surprise. If this scenario plays out be ready to take opportunities in the market place, otherwise enjoy any upside to your current portfolio and consider taking some profit along the journey to improve your cash position. Lastly, be sure to remember the market dysfunction, which has kept yields low among other asset classes will continue to be a major theme until central banks become less involved, so any sell off is likely to be short lived.

Performance of Key Indices

Equities	*Close*	*Change (M)*	*Change % (M)*
All Ordinaries	**5382**	**-91.80**	**-1.68%**
S&P/ASX200	**5395.7**	**-96.80**	**-1.76%**
Dow Jones (US)	**16826.60**	**+109.43**	**+0.65%**
NASDAQ	**4408.18**	**+165.56**	**+3.90%**
S&P500	**1960.23**	**+36.66**	**+1.91%**
FTSE 100 Index	**6743.94**	**-100.57**	**-1.47%**
Nikkei 225 (Japan)	**15162.10**	**+529.72**	**+3.62%**
10-year bond rate (US)	**2.53%**	**+0.0006%**	**-2.25%**

Upcoming RBA Events

Reserve Bank Board Meeting – 1st July
Minutes of the RBA meeting – 15th July

ABS releases March

International Trade in Goods and Services (May) – 2nd July
Building Approvals (May) – 3rd July
Retail Trade (May) – 3rd July
Labour Force (June) – 10th July
Housing Finance (May) – 11th July
Lending Finance (May) – 14th July
Consumer Price Index (June) – 23rd July

Upcoming US Economic Releases

ISM Manufacturing Index – 1st July
US Employment Situation (June) – 3rd July
FOMC Meeting announcement– 9th July
Retail Sales – 15th July
Producer Price Index – 16th July
Housing Starts – 17th July
Consumer Price Index – 22nd July
Existing Home Sales – 22nd July
New Home Sales – 24th July
Durable Goods Orders– 25th July
GDP – 30th July
Jobless Claims – Weekly Basis