VOLATILTIY AND CONFIDENCE

Confidence is what drives the markets, our overall general investment and our spending habits.

Elsewhere and particularly in Australia today, it is reported that Business Confidence is high, however this is not reflected in conversations I've had with small business owners and taxi drivers. What is a consistent theme though is how much Mining and Exploration determines the spending habits and the confidence of investors in Australia and specifically WA. When you see the empty offices in West Perth and the small crowds in restaurants and bars, it reflects just how much local business rely on the Mining sector for the trickle down benefit.

VOLATILITY GRAPH — A-VIX

S&P/ASX 200 v Volatility Index (pts)

SOURCE: S&P

ASX P/E RATIO & DIV YIELD SERIES Source: ASX Research

Index	Price/Earnings ratio series Jun 27	Jun 20	Jun 13	Dividend Yield series Jun 27	Jun 20	Jun 13
All Ordinaries	17.32	17.44	17.43	4.19	4.16	4.15
S&P/ASX 20	17.49	17.66	17.77	4.83	4.79	4.76
S&P/ASX 50	17.43	17.58	17.65	4.44	4.40	4.38
S&P/ASX 100	17.73	17.87	17.89	4.28	4.25	4.24
S&P/ASX 200	17.58	17.71	17.71	4.22	4.19	4.18
S&P/ASX 300	17.45	17.57	17.58	4.22	4.18	4.18
S&P/ASX Midcap 50	19.60	19.64	19.41	3.41	3.40	3.44
S&P/ASX Small Ords	15.39	15.44	15.35	3.66	3.62	3.64
Consumer Discretionary	18.25	18.38	18.05	3.74	3.71	3.78
Consumer Staples	48.98	48.76	48.59	3.57	3.55	3.52
Energy	21.20	21.59	22.19	2.58	2.53	2.46
Financials	15.64	15.78	15.80	5.54	5.49	5.49
Financial-x-A-REIT	15.64	15.78	15.80	5.54	5.49	5.49
Health Care	30.88	30.49	29.96	1.70	1.72	1.75
Industrials	17.27	17.39	17.29	4.37	4.33	4.35
Info Technology	27.53	29.10	28.19	2.65	2.54	2.47
Materials	18.87	18.96	19.38	3.07	3.05	2.98
A-REIT	8.74	9.05	9.01	4.86	4.64	4.64
Telecommunications	10.64	10.69	10.55	6.45	6.43	6.50
Utilities	39.28	39.75	39.37	3.97	3.91	3.95

NOTE: Dividend Yield series includes companies making losses but paying dividends.

You will see in the article included above, cut from the Financial Review, that the highest Price earnings ratio(P/E Ratio) sectors are the Consumer staples, Healthcare and Utilities all being safe harbor sectors when investors retreat from cyclical and riskier sectors. High PE ratios traditionally infer how many years it will take to recover your money if all the funds after tax were distributed to the shareholders. Of course dividend paying companies do not always distribute all their funds, it can range anywhere from less than 50% of funds to as much as 80%, or in some cases even more.

High dividend yields do not always reflect the best managed companies as sometimes high dividend yields are a result of high distribution of the funds earned after tax, and either means manipulation of the high dividends to attract buyers into the shares, or they are not retaining sufficient capital for ongoing growth. Some companies have been known to go into debt to meet the dividend payments and keep their share price up. As a rough guide on companies that pay fully Franked dividends, is if you add approx 40% onto the cash dividend, it'll give you an estimate of your Gross dividend earnings on that particular company's shares. The Franking credit of course is offset against whatever tax rate you pay.

The current PE's of 17 are also a bit on the high side, based on market history, but of course high PE's can also reflect high future earnings and investors are at times happy to pay the higher premium for those particular shares. This leads us to believe that the sectors such as Consumer staples, Healthcare and Utilities might be considered as trading in the top of their range.

In regards to the Volatility Index(VIX) graph, or commonly referred to as the Fear index, included on the front page, it's used to gauge whether the market is trading too high and is fearful of a market correction, or at the other end of the scale, it's believed there is no or little risk of a market correction. In fact, the index is calculated on the number of call and put options on the S&P/ASX 200 at a particular date. As you can see from the chart, the two indexes cross over in periods of volatility and then reverse again as conditions change. You will also note that it has been some time since they've crossed over. May and October are traditionally bad months.

In June last year the chart shows the spread was quite high with the ASX 200 at 5,150 and the VIX at 24. Now you could expect these two indexes at some stage to reverse and cross over again, however you would require an event to reverse the ASX 200 to around the 5500 mark and the VIX to rise to about 16(of course they could both overshoot these levels depending on the catalyst for the reversal). At the moment, the chart indicates there is little to no fear(the VIX is low) of an expected event for a correction and the indexes are pushing on even after Fridays pull back to 5,721, finalizing the May/June Tax sell off periods. You have also now got July and August ahead of us which are traditionally good months to look forward to.

At some stage the Fund Managers and Professional investors will start to slowly rotate out of the overpriced sectors, take profits and move into the unloved sectors to get ahead of the curve and retail traders. Although it may not yet be obvious, big money is being raised by the large mining companies from Fund Managers and Superannuation funds, especially in the Gold sector. This is usually the beginning of the cycle and it will eventually trickle down to the smaller retail traders, not usually buyers of large high cost stocks, as they follow the headlines. This cycle repeats about every 7-10 years and hasn't failed to produce since the 60's.

The cycle is what some call a Business cycle, others may it call it an interest rate cycle or even a Political cycle. Politicians screw up countries economics by overspending our taxes to buy votes and stay in power. The Central Banks then move interest rate to adjust for the havoc created by new Political policies (Central Banks always overshoot in both directions), then the investors adjust to the interest rate cycles, everyone panics and hence we have booms and busts. As usual, it's always the investors and citizens who get hurt, not the Politicians and/or Bureaucrats.

The debt ridden countries are mostly countries run by Generals (African Countries), Dictators (Venezuela) and socialists (such as countries in the European Union). Some just inherit the consequences of previous socialist inclined leaders like Australia.

It’s the citizens of these countries that will eventually pay the price, as each of these countries central banks increase interest rates. Governments currently calculate core inflation to be quite low but we certainly see the additional costs in our daily shopping.

One good thing going for the World at the moment is the low Oil price and low inflation(as per Government calculated numbers) and hence extra spending money in the hands of the consumer, especially in the USA. Governments usually exclude Fuel and Food out of their inflation numbers as being too volatile.

If inflation comes roaring back Gold is the place to be. If all the countries and their leaders screw up their economies, as expected, and start printing more funny money Gold is the place to be. If we have a major confrontation between the USA and China and/or North Korea, Gold is the place to be. Any one of these scenarios may be the catalyst for that reversal of the VIX and ASX 200 with Gold being the beneficiary.

For those who are holding stocks in various sectors that are earning dividend incomes that suit your needs and are happy to ride through these cycles, you really don’t need to worry. However, bear in mind if you do sell and hope to buy back later at a lower price you automatically become a trader and must bear the cost of the transactions, the Capital Gains tax whether it is 100%, 50% or less. Some Super funds depending on the beneficiary’s age and the value of the fund may not pay tax at all.

So, in essence you can sell, sit tight or buy into a sector that is likely to be on the upside in a cycle reversal in the relatively near future.

When the big boys run in the exploration and mining sector, the juniors will not be far behind.

Our recent recommendation for Green Cross (GXL) at $5.59, which a few clients took up, has done pretty nicely with recent trades up to $6.19. A Johnny come lately Broker on Sunday is recommending the stock as a buy up to $8.50.