

## Is the cyclical recovery in shares over?



### Oliver's insights

#### Key points

- Shares and other listed growth assets have hit an air pocket in the last two weeks – with most share markets having fallen around 5 to 7%.
- It's too early to say that pull back is over, but we doubt the cyclical bull market in shares and other listed growth assets that started in March is over.
- However, it is likely that shares are transitioning from a PE driven rally to one which is more dependent on earnings growth. This could lead to more constrained returns going forward.

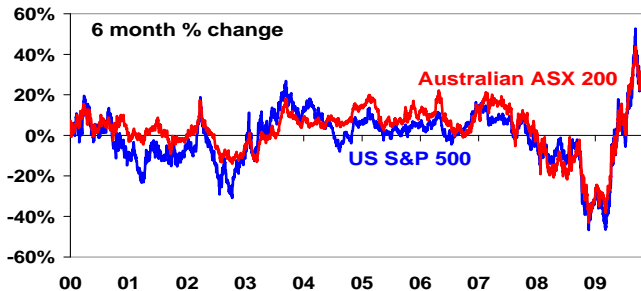
#### Shares, commodities and the \$A fall

It seems ironic that just when the US economy is starting to grow & governments are revising up their growth forecasts, share markets have got the wobbles again. But after 50% plus gains since March lows, share markets have fallen over the past two weeks or so on the back of renewed worries about the strength and durability of the economic recovery, notably in the US. This has flowed through to other growth oriented listed assets – eg, commodities and the Australian dollar. Does this mean the share market recovery is over and the bear market is now set to resume?

#### Shares were due for a correction

The first thing to note is that shares have risen hard and fast since March. As the next chart shows the six month rate of change in share markets reached an extreme.

Equity market gains reached an extreme and became vulnerable to a correction



Source: Bloomberg, AMP Capital Investors

While the strength of the rebound partly reflected the steepness of the falls last year, sharp gains in shares over short periods often leave them vulnerable to a pullback. The September quarter GDP rise in the US was certainly good news but recent consumer confidence and housing data has been a bit soft and worries have returned

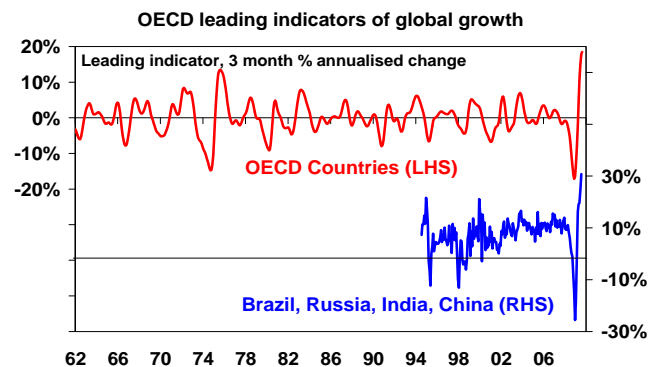
regarding US and European banks. With down days seeing quite high volume in the last week or so it seems there is a bit of conviction behind the pullback which in turn warns that it could still have a bit further to go.

#### Cyclical bull market still intact with further to go

While it's too early to say the correction is over our assessment is that the cyclical recovery in shares has further to go. In other words, we are seeing a correction in a still rising trend, & not the resumption of the bear market.

#### Firstly, the global economic recovery remains on track.

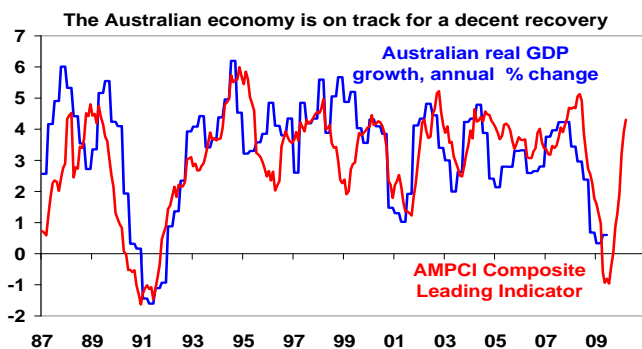
This is illustrated in the next chart which shows leading economic indicators put together by the OECD – these are combinations of indicators such as economic confidence and building approvals, which lead future economic activity by about six months. They have rebounded very strongly for both OECD and developing countries.



Source: Bloomberg, AMP Capital investors

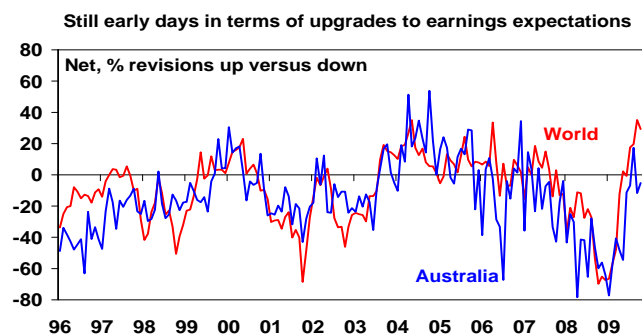
While recent consumer confidence and housing data in the US has been a bit soft, there is a danger in reading too much into this. Consumer confidence is taking its lead from the rising unemployment rate – which is normally the last economic indicator to start improving after a downturn. In any case, recent retail sales figures have been showing signs of improvement. Moreover, several leading employment indicators in the US including jobless claims have been improving and suggest that employment will start to grow again early next year. Finally, housing indicators have been distorted by buyers trying to get in ahead of the scheduled expiry of the first home buyer tax credit which in any case looks like it will be extended.

Similarly our leading economic indicator for Australia is pointing to 4% or so economic growth through 2010.



Source: AMP Capital Investors

**Secondly, analysts' earnings estimates are starting to be revised up worldwide**, and with global operating earnings down 35% from their 2007 peak it's likely the positive earnings revision cycle has further to run as economic recovery comes through.



Source: Thomson Financial, AMP Capital Investors

**Thirdly, interest rates are still extremely low making shares relatively attractive for investors.** Even in Australia where interest rates have started to gradually increase they are still at generational lows. For example, the return on cash is just 3.5% versus a 5.6% dividend yield (once franking credits are allowed for).

**Fourthly, there remains considerable scepticism about the sustainability and strength of the global economic recovery and hence the recovery in share markets.** For example, at an investment conference in New York last month run by the Bank Credit Analyst only 40% of attendees said they were overweight shares and nearly 70% did not believe that a multi-year bull market was underway. Reflecting this sort of scepticism there is still a lot of cash sitting on the sidelines. For example, Australian superannuation funds are still reportedly overweight cash. This is healthy because it means there are still plenty of funds that can push shares higher.

**It would be unusual for a cyclical recovery in shares to end when leading economic indicators are still rising, earnings are still recovering from depressed levels, interest rates are so low and so many investors are still sitting in cash.** As such, our assessment is that it is still early days in the cyclical recovery. Since 1950 the typical cyclical bull market in Australian shares lasted four years and saw average gains of 132%. This is longer if data back to 1894 is included. This time around we have only seen a gain of 56% over seven months – so if history is any guide there is still a lot further to go.

## Cyclical bull markets in Australian shares

Cyclical share bull market in Aust shares (All Ords price index)	Prior bear market % fall	Months after low to make new high	Total bull market, % gain	Duration in months
Mar 1894-Jun 14	-36	112	253	243
Dec 1916-Jul 29	-22	37	196	15
Aug 31-Mar 37	-46	38	168	68
Apr 42-May 51	-32	43	175	109
Dec 52-Sep 60	-34	62	146	93
Nov 60-Feb 64	-23	33	42	39
Jun 65-Jan 70	-20	25	120	55
Nov 71-Jan 73	-39	94	57	14
Sep 74-Aug 76	-59	59	101	23
Nov 76- Nov 80	-23	21	173	48
Jul 82—Sep 87	-41	17	421	62
Nov 87-Aug 89	-50	75	55	21
Jan 91-Feb 94	-32	30	94	37
Feb 95-Mar 02	-22	20	89	85
Mar 03-Nov 07	-22	15	156	56
<b>Avg from 1894</b>	<b>-33</b>	<b>45</b>	<b>150</b>	<b>75</b>
<b>Avg from 1950</b>	<b>-33</b>	<b>41</b>	<b>132</b>	<b>48</b>
Mar 09- ?	-55 ?	? ?	56 ?	7 ?

Source: Bloomberg, AMP Capital Investors

## Corrections are normal

It is normal for share markets to get ahead of themselves every so often and then have a pullback. Through the 2003 to 2007 bull market, US shares had six corrections between 5% and 10% and Australian shares had five corrections between 6% and 12%. But after each pullback shares resumed the rising trend. It is also worth observing that corrections often occur around the September/October period but the period from November through May, which we have now entered, is normally strong.

## Concluding comments

Share bull markets normally have three phases: Phase 1 - recovery as shares go from dirt-cheap panic-driven price to earnings multiples to more normal PE levels; Phase 2 - earnings driven growth; and Phase 3 – exuberance as PEs rise to unsustainable extremes. With price to earnings multiples having recovered from very low levels back to longer term averages it's likely that Phase 1 has now largely run its course and that the recent weakness in share markets represents a transition to a more earnings driven phase. This would probably mean we should expect the pace of share market gains to slow going forward.

However, with the economic and profit recovery likely to have further to go, interest rates remaining low, and plenty of cash still sitting on the sidelines our assessment is that it is too early to conclude that the cyclical bull market in shares is over.

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