Edition 21 – 29 July 2009
Shane Oliver, Head of Investment Strategy & Chief Economist

AMP capital INVESTORS

From bear to bull – the cyclical upswing in shares

Key points

- The evidence is continuing to accumulate that shares have embarked on a cyclical recovery.
- Further gains are likely: shares are cheap and the economic recovery will lead to an improvement in the profit outlook. There are still plenty of funds sitting on the sidelines and there is still a lot of healthy scepticism about the rally which is normally a good sign.
- Past cyclical upswings have seen Australian shares rise an average of 132% over an average of four years.

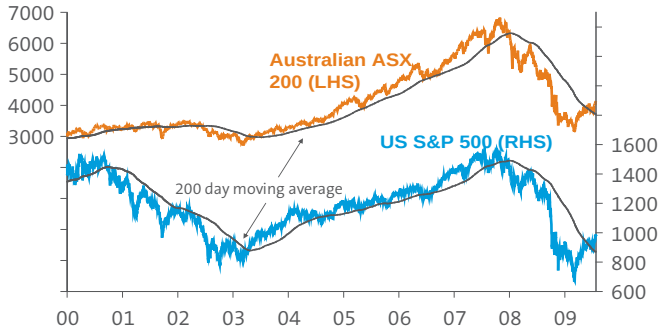
Introduction

After undergoing a bout of nervousness from mid-June into mid-July, shares have surged higher on improved economic indicators and a better than expected US profit reporting season indicating that further gains look likely. While we are of the view that the long-term picture for US, European and Japanese shares is constrained by high debt levels and the need to reverse policy stimulus, the longer-term picture is more positive in emerging markets and Australia. Also, as we saw during the 1970s in the US or over the last 20 years in Japan, a constrained or difficult long-term trend doesn't prevent sharp cyclical rebounds. [1]

Bottoming action

From a technical perspective, share markets appear to have built a good base over the past nine months.

US and Australian shares – appear to have built a base



Source: Bloomberg, AMP Capital Investors

1. See "Where are we in the short and long-term share cycles?" Oliver's Insights, June 2009.

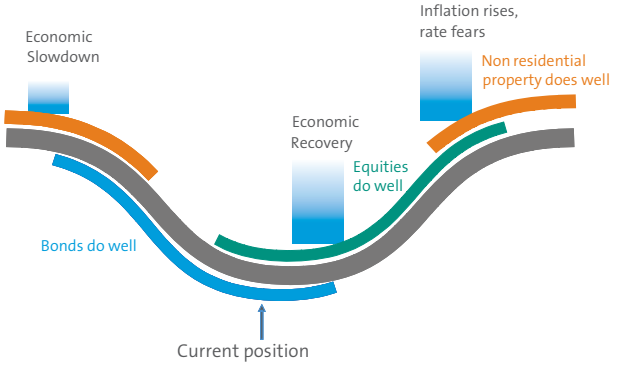
Markets fell sharply into November last year on very heavy volumes and in the midst of complete panic. While the bulls attempted a recovery into early January, it lacked any conviction. With economic data still being poor, the bears were able to gain the upper hand again into March.

However, the fall into March did not generate any follow through and when economic data failed to deliver on the feared depression shares took off. The churning up and down in a wide range late last year and early this year is indicative of past bottoms in share bear markets including that in 2002-2003 in the US. Since then, shares have started to trace out a pattern of higher highs and higher lows. Additionally, in a bear market, shares struggle to break above their trailing 200 day moving average, so the recent decisive break above 200 day moving averages is a positive sign.

A typical cyclical bull market

The typical short-term investment cycle lasts around three to five years and looks similar to the chart below.

The economic/investment cycle



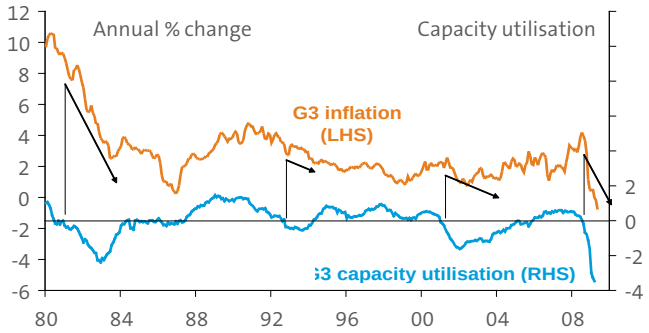
Source: AMP Capital Investors

During an economic slump, government bonds are attractive and eventually monetary and fiscal stimulus set the scene for the next economic recovery. Shares normally anticipate this and start to increase about six months before the economy bottoms. This is the period in the cycle where shares climb the classic 'wall of worry' as there is still uncertainty about whether there will be an economic recovery. This eventually gives way to a 'sweet spot' in the cycle where growth and profit expectations are recovering but inflation and interest rates are still low and stocks are cheap. This is usually a time when investors are still worried, but it is often the most prosperous time for shares. After a few years or so, inflation builds and interest rates rise to onerous levels, setting the scene for the start of the next cyclical downswing in shares and the economy.

Currently, it seems that shares are entering the classic 'sweet spot' as leading economic indicators are improving virtually everywhere. However, because there is excess capacity worldwide, inflationary pressures will remain low.

The next chart shows average inflation in the US, Japan and Europe versus a measure of capacity utilisation averaged across all three regions. Whenever capacity utilisation is below normal – zero on the right hand side axis – inflation has fallen. In other words, with economic activity having fallen so far worldwide there is plenty of scope for a recovery before inflationary pressures kick in.

Massive excess capability means inflation is not an issue

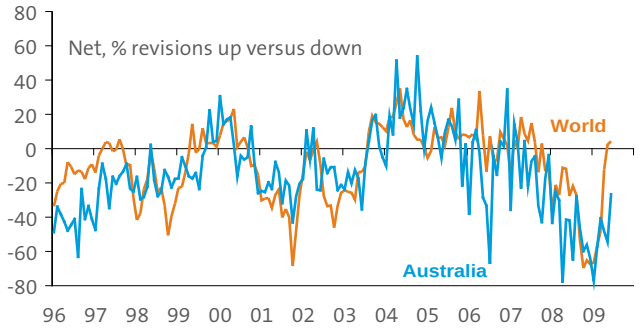


Source: Thomson Financial, AMP Capital Investors

On top of this, while shares are as cheap as they were back in March, they are not expensive either. Forward price to earnings multiples are around 15 times in the US and Australia which is in line with their long-term averages. However, in Australia, if trend earnings are used rather than the depressed level of consensus earnings then on the basis of a 15 times price-to-earnings multiple, fair value for the market is currently around 4600.

Finally, the earnings revision cycle is turning up in most countries as evident in the next chart. Typically, during an economic downturn companies start to factor in the worst and slash costs to compensate. When revenues don't fall as much as feared, profits start to surprise on the upside. This is now what appears to be happening in the US with 75% of June quarter results surprising on the upside (compared to a norm of about 59%). The same is likely to occur in Australia over the coming month.

Revisions to 12 month ahead earnings forecasts



Source: Thomson Financial, AMP Capital Investors

There is no doubt that the road ahead will be rough. However, the combination of improving economic indicators, an improving outlook for profits, reasonable valuations, low inflation and low interest rates is very positive for shares and suggests we are entering the 'sweet spot' in the investment cycle. With cash weightings still well above normal levels, this suggests there is plenty of scope for funds to come into the market and push shares higher.

How long do cyclical bull markets last?

If we have commenced a cyclical upswing, how long could it last? The next table shows the history of cyclical bull market in Australian shares. I have defined a cyclical bull market as a rising trend in shares that ends when shares have a bear market (defined as a 20% or greater fall that takes more than 12 months to be reversed).

Cyclical bull markets in Australian shares since 1894

Cyclical share bull market in Australian shares	Prior bear market % fall	Months after low to make new high	Total bull market, % gain	Duration in months
Mar 1894 – Jun 1814	-36	112	253	243
Dec 1916 – Jul 1929	-22	37	196	15
Aug 1931 – Mar 1937	-46	38	168	68
Apr 1942 – May 1951	-32	43	175	109
Dec 1952 – Sep 1960	-34	62	146	93
Nov 1960 – Feb 1964	-23	33	42	39
Jun 1965 – Jan 1970	-20	25	120	55
Nov 1971 – Jan 1973	-39	94	57	14
Sep 1974 – Aug 1976	-59	59	101	23
Nov 1976 – Nov 1980	-23	21	173	48
Jul 1982 – Sep 1987	-41	17	421	62
Nov 1987 – Aug 1989	-50	75	55	21
Jan 1991 – Feb 1994	-32	30	94	37
Feb 1995 – Mar 2002	-22	20	89	85
Mar 2003 – Nov 2007	-22	15	156	56
Avg from 1894	**-33**	**45**	**150**	**75**
Avg from 1950	**-33**	**41**	**132**	**48**
Mar 2009 – ?	-55 ?	?	33 ?	4 ?

Source: Bloomberg, AMP Capital Investors

The bad news is that on average it has taken around three and a half years to regain the prior high point once a bull market starts. The good news though is that a typical cyclical bull market has seen shares rise by 150% (the average since 1894) or by 132% if averaged from 1950. And since 1950, the typical cyclical bull markets lasted four years. The high level of household debt and the need to reverse government stimulus suggests a more constrained and shorter cyclical upswing this time around. However, against this, the severity of the bear market and historically easy monetary conditions still suggest plenty of upside over the coming years.

Conclusion

The longer term picture is likely to remain difficult in the US, shares have likely embarked on a new cyclical bull market that has further to go. Shares are inexpensive and the economic recovery will lead to an improvement in the profit outlook. There are still funds sitting on the sidelines and healthy levels of scepticism about the rally which is a good sign. There is also a good chance that the US S&P 500 index will gain appproximately 25% from current levels over the next 12 months. In this context, a rise to 5000 for the Australian share market by year-end is conceivable. The average cyclical bull market in Australian shares in the post-war period has lasted four years and seen a gain of 132%.

Going forward, investors will need to focus on a new set of signposts as to when the rally will peak. These are likely to include measures of capacity utilisation and inflation and the speed with which government stimulus is removed.

Dr Shane Oliver
Head of Investment Strategy and Chief Economist
AMP Capital Investors

Contact us

If you would like to know more about how AMP Capital can help you, please visit ampcapital.com.au, or contact:

AMP Capital's International Client Service Team at internationalCS@ampcapital.com