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AMP capital INVESTORS

Is the cyclical recovery in shares over?

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 is too early to say that the pull-back is over and 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 price to earnings (PE) driven rally to one which is dependent on earnings growth. This could lead to more constrained returns going forward.

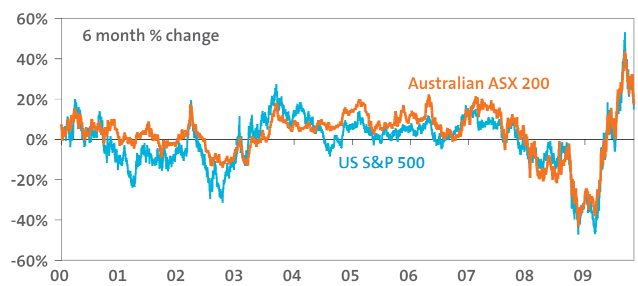
Shares, commodities and the Australian dollar (A$) fall

It seems ironic that just when the US economy is starting to grow and governments are revising their growth forecasts upwards, share markets are starting to look a little shaky. However, after the 50% plus gains since the lows of March, share markets have fallen over the past two weeks 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 A$. 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 strongly 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 pull-back. The rise of September quarter gross domestic product (GDP) in the US was certainly good news. However, 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 of shares traded in the last week it seems there is some conviction behind the pullback which in turn warns that it could still have a little further to go.

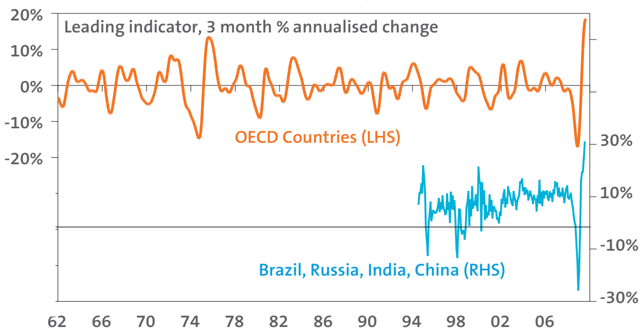
Cyclical bull market still intact with further to go

While it is 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, and 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 that are collated by the Organisation for Economic Cooperation and Development (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.

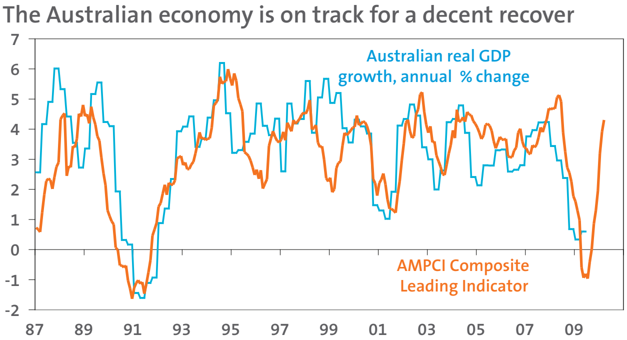
OECD leading indicators of global growth



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 looks like it will be extended. Similarly the leading economic indicator for Australia is indicating approximately 4% economic growth through 2010.

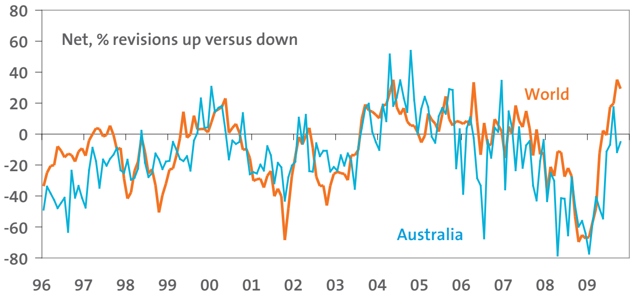
The Australian economy is on track for a decent recover



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 is likely the positive earnings revision cycle has further to run as the economic recovery continues.

Still early days in terms of upgrades to earnings expectations



Source: Thomson Financial, AMP Capital Investors

Furthermore, 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).

Additionally, 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 instance, 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
Avg from 1894	-33	45	150	75
Avg from 1950	-33	41	132	48
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 pull-back. Through the 2003 to 2007 bull market, US shares had six corrections of between 5% and 10% and Australian shares had five corrections of between 6% and 12%. However, after each pullback shares resumed the rising trend. We can also observe that corrections often occur around the September/October period, but the period from November through to 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 PE multiples to more normal PE levels; Phase 2 - earnings driven growth; and Phase 3 – exuberance as PEs rise to unsustainable extremes. With PE multiples having recovered from very low levels back to longer term averages, it is 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 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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