

What's driven the recent rally in shares? Is it sustainable?

Oliver's insights



Key points

- Shares have had strong gains over the last month driven by better than expected economic data and policy stimulus going into overdrive.
- It's too early to say for sure that the share bear market is over and the road will likely remain rough, but there are some positive signs, including evidence economic stimulus is gaining traction, which may be consistent with a cyclical improvement in shares getting underway.

Introduction

From their early March lows, global and Australian share markets have had gains of 20% or so. In fact Asian shares are up around 50% from their October low last year. What's driven it and is it sustainable?

It's been a big bad bear

When it comes to bear markets this one has been particularly bad. The table below compares top to bottom falls in all bear markets in Australian shares since 1900.

Bear markets in Australian shares since 1900

Share bear market in Aust shares	Mths to low	% fall	Mths after low to make new high	% gain in first 12 months after low
Jun 14-Dec16	30	-22	37	+10
Jul 29-Aug 31	25	-46	38	+33
Mar 37-Apr 42	61	-32	43	+30
May 51-Dec 52	19	-34	62	+8
Sep 60-Nov 60	2	-23	33	+12
Feb 64-Jun 65	16	-20	25	+9
Jan 70-Nov 71	22	-39	94	+52
Jan 73-Sep 74	20	-59	59	+51
Nov 80-Jul 82	32	-41	17	+39
Sep 87-Nov 87	2	-50	75	+35
Aug 89-Jan 91	15	-32	30	+39
Feb 94-Feb 95	12	-22	20	+25
Mar 02-Mar 03	12	-22	15	+27
Avg from 1900	21	-34	42	+28
Avg from 1950	15	-34	43	+30
Nov 07- ?	16 ?	-55 ?	?	?

Based on the All Ords. I have defined a bear market as a 20% or greater fall in shares that is not fully reversed within 12 months. Source: Bloomberg, AMP Capital Investors

Since 1900, bear markets in Australian shares lasted an average 21 months with an average top to bottom fall of

34%. The bear market since 2007 has now gone 16 months but is far worse in magnitude than the average bear market; its 55% top to bottom fall is second only to the 1973-74 bear market which saw shares fall 59%. Interestingly, the top to bottom fall in Australian shares has been a bit less than in most major markets. This would appear to reflect the faster and bigger policy response in Australia, the sharp fall in the \$A which has provided a boost for trade-exposed Australian companies and the better relative functioning of the Australian banking system.

Top to bottom falls in major share markets

Share market	Decline from 2007 bull market high to recent low
Asian shares, ex Japan	-61%
Japan	-61%
Europe	-62%
US	-57%
Australia	-55%

Source: Bloomberg, AMP Capital Investors

Drivers of the rally from early March

The sharp rally in shares since early March has been 'driven' by a combination of factors, including:

- A string of better than expected economic data ranging from US to Chinese business conditions and from Australian housing finance to UK mortgage approvals.
- Government policy stimulus going into overdrive with near zero interest rates and quantitative easing in several countries, massive fiscal stimulus packages, firmer moves to buy toxic debt in the US, a massive increase in funding for the IMF and a firm commitment from the G20 leaders summit in favour of free trade.
- The relaxation of US 'mark to market' accounting regulations that contributed to the crisis, essentially allowing the valuation of assets at prices consistent with an orderly sale, as opposed to at fire sale prices.

Is it sustainable?

Bear markets often have good countertrend rallies and this may be just one of them. For example, in the 1929 to 1932 bear market US shares fell 86% over nearly three years but there were six rallies along the way ranging between 13% and 47%. Ignoring the latest rally, since peaking in October 2007, US shares have had two rallies ranging from 12% to 24% and Australian shares have had two rallies ranging between 12% and 17%. While the latest rally has been the strongest in the bear market so far, given the ongoing problems in banks and the worst global recession in over 70 years, there is good reason for suspicion that the latest

rally is just another bear market bounce. That said, there are several grounds for cautious optimism.

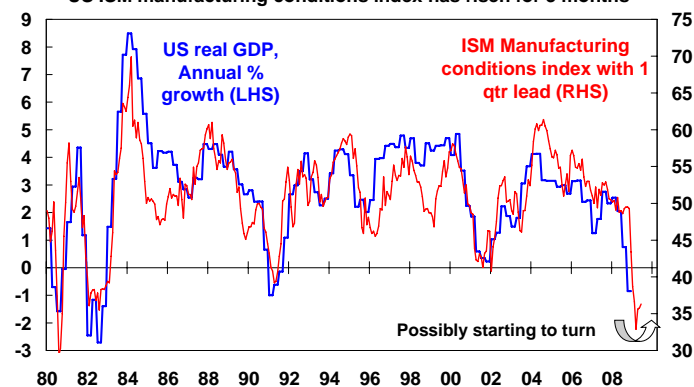
Firstly, investor sentiment reached levels of bearishness normally associated with major bear market bottoms. For example, at the low four weeks ago a record 70% of surveyed individual investors described themselves as bearish. Despite the rally from early March investor sentiment is still bearish and the consensus is that it has just been another bear market rally. This is a positive sign from a contrarian perspective.

Secondly, shares remain very cheap from a long term perspective offering much higher cash flow yields than cash or bonds.¹

Finally, and most importantly, the global policy response to the crisis appears to be getting some traction:

- Money market lending spreads have returned to levels prevailing prior to Lehman Brothers' collapse last September and credit spreads have stabilised.
- Business conditions indicators worldwide seem to be stabilising and in some cases improving. This is clearly shown in the ISM survey of manufacturing conditions in the US which is now up for three consecutive months.

US ISM manufacturing conditions index has risen for 3 months



Source: Thomson Financial, AMP Capital Investors

- Housing related indicators for sales and finance in the US and UK are showing some signs of bottoming.
- While Chinese exports and industrial production remain weak, Chinese business conditions surveys, loan growth, fixed asset investment, retail sales, car sales, electricity production & property data have all improved.
- In Australia lower interest rates and stimulus payments to households seem to have been successful in stabilising consumer sentiment, retail spending and in boosting some housing indicators.
- Various other financial markets have confirmed the rally since early March in shares with commodity prices breaking higher, growth oriented currencies such as the \$A on the rise, so-called 'safe-haven' currencies through the crisis such as the Yen and \$US weakening and bond yields having stopped falling.

In terms of growth related indicators it's looking as if the world is going through an inflection point with the rate of decline moderating. This is consistent with growth starting to improve from later this year or through 2010. Shares normally lead the trough in economic activity in the key direction setting US share market by about six months. So if these indicators are right in pointing to an improvement in

¹ This was discussed in some detail in "Share market earnings and dividends", *Oliver's Insights*, March 2009.

economic conditions from later this year then this would be consistent with shares bottoming in the first half of the year.

While labour market indicators are still deteriorating rapidly and likely have a lot further to go (with US unemployment likely to peak around 11% and Australian unemployment likely to peak around 9%) it's worth noting that unemployment is a lagging economic indicator. In Australia the average lag from a bottom in shares following a bear market to a peak in the unemployment has been twelve and a half years. See the table below.

Shares normally lead the peak in unemployment around recessions – Australian shares

Australian recessions	Associated bear market in shares	Peak in Aust unemployment rate	Share market low versus unemployment peak. Months before (+)
Early 1930s	Jul 29-Aug 31	June 32	+10
Early 1950s	May 51-Dec 52	June 53	+6
Early 1960s	Sep 60-Nov 60	Sep 61	+10
Mid 1960s	Feb 64-Jun 65	Sep 67	+15
Early 1970s	Jan 70-Nov 71	Sep 72	+10
Mid 1970s	Jan 73-Sep 74	Dec 75	+15
Early 1980s	Nov 80-Jul 82	Jul 83	+12
Early 1990s	Aug 89-Jan 91	Dec 92	+23
Average			+12.5

Only shows those episodes where a recession was associated with a bear market in shares and vice versa. Based on All Ords. Source: Bloomberg, Thomson Financial, AMP Capital Investors

But expect a bumpy ride

There is good reason to expect that the rally in shares has further to go and there is a reasonable chance that we may have seen the lows, but the ride is likely to be bumpy. The problems in banks remain immense, even if the rate of deterioration is slowing the recession is still with us and is very severe, house prices have more downside in the US, Europe and in Australia and further earnings downgrades are likely. In particular:

- After 20% or so gains over four weeks shares are due for a bit of a pause & this now seems to be underway.
- After rallying into mid year, shares are likely to experience their normal seasonal weakness in the September quarter.

To get more confident that we have entered a new cyclical upswing in shares we would look for any pullbacks in shares to bottom above their March lows, credit spreads to narrow further, the decline in US house prices to slow, US efforts to remove toxic debts from banks to be successful and business and consumer confidence to trend higher.

Finally, while the cyclical outlook for shares is looking a bit more promising, the combination of the unwinding of high debt levels which may take years to unfold, tighter credit conditions long term, the need to unwind budget deficits once recovery occurs & the increasing role of government in the economy will all constrain economic growth over the medium term in traditional developed country equity markets. This is a separate topic but highlights the relative attractiveness of Asian and other emerging markets that are not constrained by high debt levels and these trends.

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