

## From bear to bull – the cyclical upswing in shares



### Oliver's insights

#### Key points

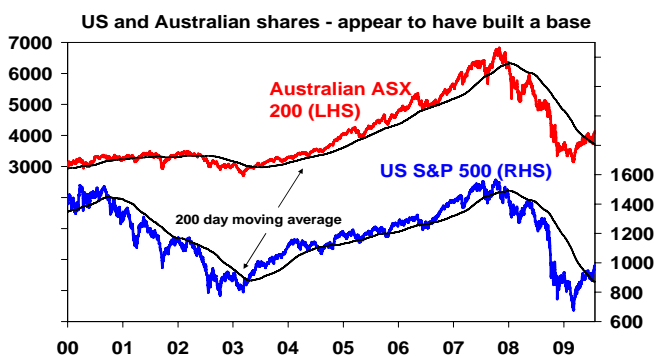
- The evidence is continuing to accumulate that shares have embarked on a cyclical recovery.
- Further gains are likely: shares are not expensive, economic recovery will lead to an improvement in the profit outlook, there are still plenty of funds sitting on the sidelines and there is still a lot of 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 since surged higher on better than expected economic indicators and a better than expected US profit reporting season. Further gains look likely. While we are of the view that the secular or 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 far more positive in emerging markets and Australia. Also, as we saw in 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.<sup>1</sup> This is what we have likely entered now.

#### Bottoming action

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



Source: Bloomberg, AMP Capital Investors

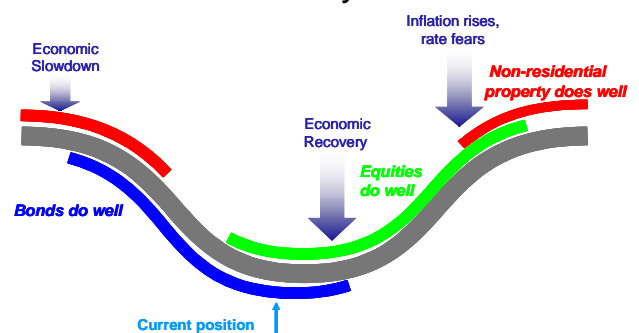
They fell sharply into November last year on very heavy volumes in the midst of complete panic. While the bulls attempted a refloat into early January it lacked any conviction with economic data still being poor only to see

the bears gain the upper hand again into March. However, the fall into March didn't generate any follow through and so 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 2002-03 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 like that shown in the next chart.

#### The economic/investment cycle



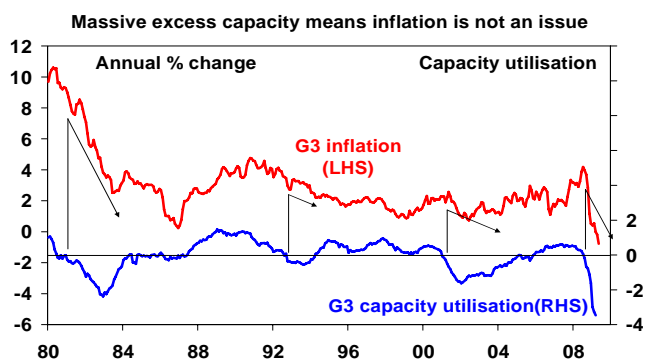
Source: AMP Capital Investors

During an economic slump, government bonds are the place to be, but eventually monetary and fiscal stimulus set the scene for the next economic recovery. Shares normally anticipate this and start to move up 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 much 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.

Right now it seems that shares are entering the classic "sweet spot". Leading economic indicators are improving virtually everywhere, but because there is so much excess capacity worldwide, inflationary pressures will remain very low. The next chart shows average inflation in the US, Japan and Europe versus a measure of capacity utilisation

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

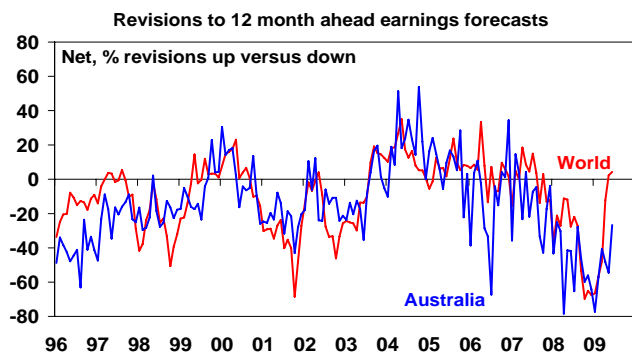
averaged across all three regions. Whenever capacity utilisation is below normal – zero on the right hand side axis – inflation has fallen. In other words with economic activity having fallen so far worldwide there is plenty of scope for recovery before inflationary pressures kick in.



Source: Thomson Financial, AMP Capital Investors

On top of this, while shares are no longer dirt 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.

And 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, and then when revenues don't fall as much as feared, profits start to surprise on the upside. This now appears to be what is happening in the US with 75% of June quarter results surprising on the upside (compared to a norm of about 59%) and the same is likely to occur in Australia with results likely to surprise on the upside over the month ahead.



Source: Thomson Financial, AMP Capital Investor

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 table below 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, which I have 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 Aust shares	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 ?	? ?	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 (column 3). 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 (column 4). And since 1950 the typical cyclical bull markets lasted four years (or by over 6 years if we go back to 1894) (column 5). The high level of household debt and need to reverse government stimulus suggests a more constrained and shorter cyclical upswing this time around. But against this, the severity of the bear market and historically easy monetary conditions still suggest plenty of upside over the next year or two.

### Conclusion

While 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 not expensive, economic recovery will lead to an improvement in the profit outlook, there is still plenty of funds sitting on the sidelines and there is still lots of healthy scepticism about the rally which is normally a good sign. There is a good chance that the US S&P 500 index will rise to between 1200 and 1250 over the next six to 12 months, a gain of 25% from current levels. 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%.

As time goes by, 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.

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