



## Market rally – has it come too far?

The Australian sharemarket has rallied strongly since its lowest point in March this year. In this Point of View, AXA's Chief Investment Officer Mark Dutton looks at what's behind the rally to help assess its sustainability over the longer-term.

### The Australian sharemarket



Source: Bloomberg, All Ordinaries Index, data from 1 February 2007 to 15 September 2009

### A rally from the bottom always looks bigger than a fall from the top

A rally from the bottom of the market can create a false signal that markets have rallied too far and too fast, so it's worth being clear on the numbers. We are not even half way back yet.

After reaching an historic high of 6854 on 1 November 2007, the Australian All Ordinaries Index fell by 55 per cent to its lowest point of 3112 on 6 March 2009.

From this low point to the present level of 4541, the index has risen by 46 per cent. But the current level is still 34 per cent lower than its November 2007 high.

In other words, the rally has only recovered a little more than one third of the decline. The Australian sharemarket still needs to rally another 51 per cent from current levels to return to its previous high.<sup>1</sup>

#### *In brief*

- The current market rally is coming off a low base – the Australian sharemarket still needs to rally 51 per cent to return to its previous November 2007 high.
- So far the market recovery has passed through two stages: a change in risk assessment, followed by a second phase which began to price in recovery potential.
- Valuations for the Australian sharemarket are currently still cheap using forward earnings if companies continue to experience stronger earnings.

<sup>1</sup> Current level is taken as of 15 September 2009



## Phase 1 – disaster to just plain difficult

We are progressing through a series of phases in what can amount to an extended recovery. The first phase of market recovery, from March to July, came as it became increasingly apparent that policy measures were proving to be effective at stabilising the global financial and economic system. During this period, the risk outlook changed from 'disaster' to just plain 'difficult'.

While the outlook at this stage was not highly positive, the relative change and cheap valuations were enough to justify the relative increase in the sharemarket valuations.

## Phase 2 – pricing in recovery potential

The second phase of the rally, from July to now, reflects an increased willingness to price in a recovery in company earnings. During this period, confidence was boosted by the positive mid year reporting season as well as the emergence of stronger than expected economic data.

Profit results which deviate from consensus expectations are often referred to as earnings surprises. The August reporting season revealed 44 per cent positive surprises, 38 per cent on target and 18 per cent negative surprises. In other words, more than 80 per cent of companies met or exceeded expectations.

These positive trends were needed to support the view that an earnings recovery has commenced, and have subsequently led to an upward revision of analysts' forecasts for 2010.

Better than expected economic growth and business investment data also helped validate sharemarket performance.

## How sustainable is the market rally?

Looking at Australian equity valuations, the market rally has pushed the forward price to earnings ratio (p/e ratio) just past its longer-term historical average, suggesting that the Australian sharemarket is trading at around fair value.

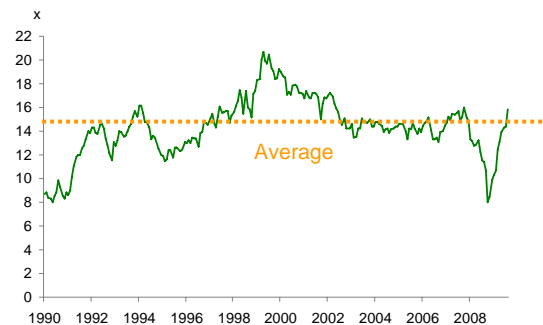
For example, figure 2 shows the Australian sharemarket p/e ratio on a 12 month forward consensus earnings is at almost 16 times

expected earnings, which is not too far from its longer-term historical average.

On this view, while the market no longer looks 'cheap', it is important to note that we are currently working with below average profit levels and depressed asset values.

Providing earning fundamentals continue to improve, the market still represents good value at today's levels.

**Figure 2: Australian sharemarket 12 month forward p/e ratio**

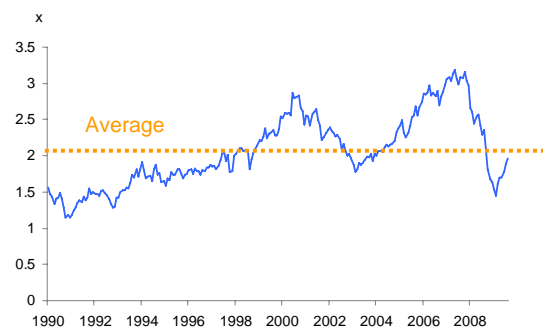


Source: AllianceBernstein, IBES, MSCI, Datastream, Deutsche Bank. MSCI Australia price to earnings ratio on consensus 12 month ahead expected earnings. Data from January 1990 to August 2009

The Australian sharemarket indicates fair value on other measures, such as price to book ratio (p/b ratio) and historical dividend yield.

Figure 3 below shows p/b ratio is reverting back towards its longer-term average.

**Figure 3: Australian sharemarket p/b ratio**

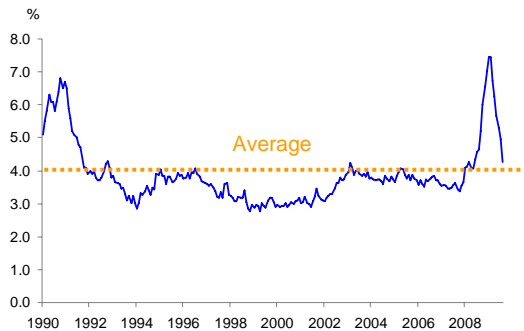


Source: AllianceBernstein, MSCI, Datastream, Deutsche Bank. MSCI Australia price to book ratio. Data from January 1990 to August 2009



Figure 4 below reveals that while the dividend yield has fallen a long way, its current level is consistent with longer-term historical trends.

**Figure 4: Australian sharemarket historical dividend yield**



Source: AllianceBernstein, IBES, MSCI, Datastream, Deutsche Bank. MSCI Australia trailing dividend yield. Data from January 1990 to August 2009

At current levels, dividend yields including franking credits represent an attractive source of return, especially when compared with current low levels of interest rates.

### What this means for investors

The Australian sharemarket has plenty of ground to make up to get back to previous highs.

However, in the next phase of the recovery, there is likely to be more divergence of individual stock returns, as those companies which fail to meet expectations are punished, and those with strong profit growth are favoured by the market.

In this phase, we can expect to see a continuation of recent trends. Consumer, business and investor confidence is likely to continue to increase as the global economy moves nearer to exiting recession.

However, investors will need to be cautious of becoming overly optimistic in the short term. The underlying fundamental issues of too much global debt (leverage) still remain and need to be unwound.

Having said this, the Australian sharemarket still offers high return potential even if recovery significantly slows down.

For example, if it takes another three years for the Australian sharemarket to return to its previous high, this equates to an annual average return of 14.7 per cent (plus dividends).

Over an even longer time frame of seven years, this equates to a healthy average annual return of 6 per cent (plus dividends).

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