



PHILO CAPITAL ADVISERS

WEALTH 23

It's too early to call an end to bull market



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INVESTORS in Australian shares have been through a 20-20 experience. Last year, and again in the 10 months to the end of last month, returns on average — counting dividends but ignoring franking credits — have been 20 per cent. As someone who's always happy to champion the magic of compounding, let me remind readers the cumulative return over 22 months is 44 per cent.

Investors enjoying these gains had to hold on through a lot of negative comment. The US would slip back into recession, it was said. The eurozone would break up. "Deleveraging" (or debt reduction) would prevent the recoveries in rich countries' economies and sharemarkets. China's growth would fall below target. Commodity prices would tank. The profitability of the banks would be stymied by house prices collapsing.

When sentiment is excessively gloomy, as it was in the middle of last year, investors who take an optimistic (and counter-cyclical) view do well when the subsequent rebounds in confidence and share prices come through.

But that was then and this is now. Is it time for investors to prepare for an early end to the bull market in shares and pocket their profits? Let's start by considering what may happen in the US and here — to corporate earnings and to the valuations the markets will put on these prospective earnings.

US profits, on average, are at an all-time high. I see the year ahead as providing further, though sedate, growth in US corporate earnings, helped by growth in real GDP moving up from 2 per cent to 3 per cent and, for most listed companies, by cheaper energy costs thanks to

shale oil and gas. By contrast, corporate earnings in Australia have been flat to weak in the past two years, because of softer commodity prices and our strong dollar. With commodity prices gaining more support from growth in China than expected in recent months and with firms cutting costs, prospects are that earnings per share will increase, though much will depend on the exchange rate, and average dividends will rise modestly.

Market valuations of forecast earnings measured as the prospective price/earnings multiple (P/E) are likely to be influenced in the next 12 months by bond yields, the pace of liquidity generation by major central banks and investors' continuing hunt for yield.

Next year, the US Federal Reserve is likely to cut back its program of buying government bonds and mortgage debt. "The taper" seems likely to be a negative for US sharemarket valuations, both because bond yields will probably move higher and because there'll be less liquidity generation to spill over to sharemarkets. Fortunately for share investors, the Fed is likely to move on the taper only when there are unambiguously strong numbers on the US economy. And it expects to keep its cash rate near zero during 2014.

US shares are selling on a P/E of about 15 times. That's a bit above the average of recent years, but it's hard to identify any events with high probability that would soon cause a significant and sustained fall in this multiple. In Australia, the average prospective P/E is about 14 times.

It's easier to feel relaxed about the high P/E of the US market than about Australia's elevated P/E, at least while our currency remains strong. But there are good reasons to expect our market to continue to follow the US lead; and if, as expected, average earnings and dividends rise modestly, the market would have further support. It seems much too early to call the end of the bull market in shares — but investors should expect they will often hear such claims when, inevitably, the sharemarket next stumbles.

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