



SIRA VIEWS

The Year Ahead in the Stock Market

The level of the stock market is driven by three factors – company profits (or earnings), interest rates, and confidence. If profits rise, then share prices go up. If interest rates rise, then share prices go down.

In a period of very strong growth, profits can rise fast. But as inflation starts to pick up in the wake of the strong economy, interest rates can rise even faster. At 5%, a rise in rates to 7% is a 40% increase. Earnings have to go up by 40% for the market just to stay in the same place. Meanwhile, a sharp rise in interest rates will affect confidence. After all, a jump in interest rates by the Reserve Bank is designed to slow the economy – which means profits will fall. So even if earnings are rising strongly, investors may believe that the rise will be reversed later on, and sell their shares.

Equally, a very weak economy tends to be bad for share markets, at least initially, because profits slow or decline, and this slowdown can only be offset by a proportionate fall in interest rates.

The best environment for shares is one where the economy is growing modestly and interest rates are therefore unlikely to rise. Although this means that profit growth is moderate, it also means it's sustainable, and unlikely to be reversed. It looks very likely that this is the outlook for 2006. Company earnings are likely to grow by somewhere between 6 and 10%, though the total could be higher if commodity prices continue to rise strongly. The cash rate is unlikely to move much from its current level of 5.5%. If anything, the short- and medium-term pressure is for a slight easing: house prices are falling, housing starts are slowing, consumer spending is

slowing, and inflation is for the time being quiescent.

So for 2006, prospects are positive for shares – rising earnings and stable or slightly lower interest rates. This will translate into a rise in the market of 5 -10%, which suggests a total return of 10 to 15% if we include dividends and their attached franking credits. This seems low, but at 15%, a total return (with dividends reinvested in the market) will cause your capital to double in five years. At 10%, your capital will have risen 60% over the same period.



What could go wrong? Well, it is the nature of markets that disasters are always unexpected. What changed between Friday October 17th 1987 and Monday October 20th, when various markets round the world fell between 20 and 40% in a single day? Confidence. Nothing else. Yet 'expensive' markets (as in 1987 before the crash) are vulnerable to losses of confidence, while 'cheap' markets are not.

While our market is not bargain-basement cheap, it is far from expensive. As measured by the price-earnings ratio, the share market is priced at the low end of the range for the last 5 years, but towards the higher end over a longer period – though the measurement was distorted by the high inflation 70s and 80s, when PE's were low. This means that the market, while not invulnerable to unexpected shocks, is much less vulnerable that it was before the 1987 crash.

We believe that apart from cash holdings held for asset allocation reasons, clients should be fully invested in the market.

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Special points of interest:

- Profits up 6 - 10%
- Interest rates stable
- Market not expensive

*Market Update:
Nigel Purchase*