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SIRA VIEWS

How Low Can It Go?

The All Ordinaries index has fallen from 5318.2 to 4939.4, a decline of 7.1%. The correction in March 05 was 8.2%, and the October correction was 6% (See the chart below) On this basis, if this is just a correction, and not the beginning of a major bear market, the market has fallen about as much as it will.

Using the price-earnings ratio as a valuation guide, in all corrections/bear markets over the last six years, the market has turned up when the P/E ratio has fallen to an average 14.51. Currently it is 15.09. This suggests the possibility of a further decline of about 4%. (Chart over) However, remember that on a longer term perspective, the P/E ratio is low, and is more likely to rise than fall over the next few months, which is consistent with at least a 10% market rise from here to the next peak, even if earnings (profits) weren't growing strongly.

The final indicator is "technical". If the market falls to the previous "support" level of around 4850 in February this year, a further decline of 2-4% will occur, after which the market should "bounce".

Taken together, these calculations suggest that the market is not far from the low point, provided that this is indeed a correction and not the beginning of a bear market.

So the key question becomes: is it likely that this is the beginning of a new bear market?

Our judgement is that it is not.

In This Issue

How much further has the market to fall?

Special points of interest:

- *Market not expensive*
- *Close to level where it will bounce*
- *Australian inflation contained for now*
- *US inflation key risk*

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Market Update:
Nigel Purchase

In the past major bear markets have happened for several reasons, often simultaneous. The first is that the market becomes too "expensive", i.e., the P/E ratio gets too high. This was the key cause of the 2002-2003 bear market. The market's P/E hit a high of 20.4 in March 2002. It fell to a low of 14.2 before rebounding. *As we pointed out above, the P/E ratio currently indicates that the market is far from expensive, and is in fact close to the point at which it has previously turned up.*

The 1987 bear market was also due mostly to excessive valuations.

Bear markets before that have occurred because of a combination of excessive valuations and economic factors. *Strongly* rising inflation is very damaging to share prices, because it means that interest rates are likely to rise as the Reserve Bank attempts to slow the economy. If inflation rises high enough, the Reserve Bank must raise rates so much it causes a recession (as in 1989/90, the "recession we had to have") which leads to a collapse in earnings (profits).

Even with the large jump in oil prices, Australian inflation is still relatively low. The most recent inflation data, for the March quarter, was 3.0%. Excluding the G.S.T. rise in 2000, inflation for the last decade has been about this level.

Inflation in Australia is well contained. The risk to the market from this area is not material.

The problem lies elsewhere. In the United States, "headline" inflation has been creeping up as their economy recovers from the 2001 recession and as the oil price has risen. The Federal Reserve Bank has indicated that interest rates are about right provided growth and inflation don't accelerate. So any sign of either causes share prices there to fall, and our stock market follows suit. Growth looks set to moderate as leading indicators are weakening. Inflation is likely to drift – not surge – higher. So even if the Fed does raise rates from here, the rise is likely to be small – at most 0.5% over the next six months, taking the Fed Funds rate from 5 to 5.5%. This will undoubtedly dampen the US stock market, but is not likely to be a cause of a major decline in share prices.

One day, there will undoubtedly come another bear market. Our judgement is that this is not the time. We may be wrong, and so, to reduce risk, we have diversified portfolios for our clients to include conservative shares which have not risen recently as resource shares have, but which will also not fall as much during a bear market. We continue to monitor your portfolios with an eye to short-term and longer-term risk and will advise you if we change our minds about the market.

As always, if you have any questions or concerns, please do not hesitate to contact us.

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