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SIRA VIEWS

When Bad Is Good!

One of the things that non-financial observers find very odd about share markets is how they sometimes rapturously receive what appears to be bad news.

The market's behaviour over the last few weeks has been an interesting example of this. Data released in the US showed that the US economy was slowing sharply, from growth rates of 4% or above to less than half that. In Europe, Japan and China, monetary policy is being tightened, meaning that it is very likely that growth there will slow too (as indeed indicators in China already suggest). Yet world stock markets rallied. The Dow-Jones industrial average rose to new highs, and the Standard and Poors 500 index (the US equivalent of our All Ords) pushed through previous short-term peaks on the way towards its all time highs. In Australia, the All Ords and other broad indices also rose to all time highs.

Why has this happened, and where to from here?

The valuation of an individual share and the market as a whole is a result of many influences. The three most important are: interest rates, confidence, and earnings (profits).

At first sight, soaring earnings are good for share prices. But this is only true if you look at them in isolation. Often, soaring earnings happen because economic activity is strong. And if economic activity is strong, then there is a risk that interest rates will be raised, which is bad for share prices, because not only does it raise the discount rate we apply to shares, but it can also affect confidence adversely. Sometimes these factors, and the expectation of how they will move, overwhelm the positive influence of rising earnings, and markets fall, despite the "good news".

Our belief is that, here, in the US, and in the world as a whole, growth will slow, but – crucially – it also seems that there will not be a recession. This is good news, because it means that inflation will in time decline, interest rates will stop rising and may even drop, while profits are not significantly affected. In so-called "soft landings", earnings growth falls away, without turning negative. On the other hand, during recessions, earnings fall, often very sharply, and, just as important, confidence collapses. So in "soft landings", share markets tend to pause or undergo modest corrections before renewing their advance, while if there is a "hard landing", share markets slump.

The markets continue to believe that the benign environment of the last fifteen years (sustained growth, low inflation and stability, much of it the result of good central bank governance) will continue. Though this is the most likely outcome, it is by no means guaranteed. There is a new central banker at the helm of the world's most important central bank, The Federal Reserve Bank, and it is possible that he may stumble.

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Share markets likely to rise over 2007

Special points of interest:

- *Market risk on the upside*
- *World economy slowing*
- *World inflation has peaked*

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Market Update:
Nigel Purchase

All the same, our belief is that there will not be a "hard landing" this year. Economic growth will slow, and so will earnings growth, but they are neither of them likely to turn negative. And slowing growth and inflation mean that interest rates are close to their peak, here and globally.

Our optimism is reinforced by relatively low PE ratios in Australia (see chart below), even though these are somewhat distorted by resource stocks earnings. If the PE ratio rises back towards the level where it has frequently turned down over the last 7 years, the share market could rise another 30% from here. If the PE ratio rises back to the average of the last four years, the rise could be around 20%. A 10% rise in the US Standard and Poors 500 index will take it back to the previous high reached in March 2000, which chartists would say is now very likely. (Whether it will push through the previous high is another question.) It is unlikely that our market will rise by less than the increase on Wall St.

So it seems probable that, even ignoring moderate earnings growth over the next year, the All Ords will rise by between 10 and 30% from current levels. The balance of risk is on the upside, rather than the downside. Your portfolios have for some weeks been structured to take advantage of this projected market increase. We do not dismiss out of hand the risk of a recession. At this stage, our view is the risk of a "hard landing" is small. But in case it isn't, we will, as always, continue to review the markets, world economies and your portfolios and will advise you if any action is required.

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

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