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SIRA VIEWS

China Bust

Yesterday the Chinese stock market fell nearly ten per cent. This was in reaction to moves by the government to reduce speculative trading and control fraud. However, it could have been anything that caused the market to react, because it was showing all the signs of what Alan Greenspan, former Chairman of the US Federal Reserve Bank, used to call irrational exuberance. For example, there was a recent report that a million new share trade accounts were being opened each week. And the market is up 140% in 12 months! Over the same period, our own market has risen just 23%.

In the past, big movements in the Chinese stock market have often been ignored by the world's major markets. However, the fall in China coincided with a report that US durable goods orders had fallen 8% in the month of January. Yet if you strip out aircraft orders – always very volatile month-to-month, because airlines tend to order a lot of aircraft in one hit – the fall was only 3.1%, after a gain of 2.8% in the previous month.

During "soft landings" (when the economy slows but doesn't go into recession), markets are often buffeted day to day and week to week by contradictory news flows. This indicator is up a little, that one down, and markets react accordingly. By contrast, during recessions, all the news is bad, and in strong upturns, at least in their early phases, all the news is good. (In the later phases of strong upturns, the news turns more diverse, because inflation starts to rise) We are at present in a stage where economic growth in the United States, and across the world, is mixed. So we will continue to get statistics some days that the markets like, and statistics other days that cause the markets to fall.

The big question is whether this is the beginning of a major bear market.

We don't believe it is.

Rising inflation is very bad for share markets. So is recession. (And so, often, is war.) But inflation is under control, though the measure that excludes "volatile items" (like the petrol price, for example) is stable rather than declining.

In This Issue

Special points of interest:

- *This is a correction, not the beginning of a bear market*
- *It will likely last several weeks*
- *The market could fall a further few percent before recovering*

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Market Update:
Nigel Purchase

And we don't expect a recession over the next year. True, growth will slow, but overall it's likely to remain positive, here and overseas. So on both these fronts, the risks to our share market are low. There is a risk that war could flare up against Iran. The share markets would not like that at all. Yet our assessment is that this possibility, for a United States already very stretched by the war in Iraq, is low -- but it can't be ruled out.

At the same time, valuations in Australia are not expensive. The price/earnings (P/E) ratio is currently 14.8, at the low end of the range for the last few years. If it were higher, towards the top end on the range, say 16.5, which is the point where markets have frequently corrected over the past few years, we'd be much more concerned.

The probability is that this is a normal market correction.

Since the current bull market began in March 2003, there have been 4 corrections as outlined in the table below.

The average fall was 6.4%. We expect a correction of similar size this time.

We believe that the market will, after this correction, continue to trend higher, though the market weakness could last several weeks. As usual, we are watching events closely, and will let you know if we change our minds.

Timing	Begin	End	% fall
Oct/Nov 03	3305.3	3175.7	3.9
March/May 05	4255.8	3940.5	7.4
Oct 05	4591.5	4340.5	5.6
May/June 06	5285.5	4830.8	8.6

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

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