

What's driven the recent rally in shares? Is it sustainable?



Key points

- Shares have had strong gains over the last month driven by better than expected economic data and policy stimulus going into overdrive.
- It is too early to say for sure that the share bear market is over. The road will likely remain rough, but there are some positive signs, including evidence that economic stimulus is gaining traction, which may be consistent with a cyclical improvement in shares getting underway.

Introduction

From their early March lows, global and Australian share markets have had gains of 20% or so, while Asian shares are up around 50% from their October low. What has driven this and is it sustainable?

It's been a big bad bear

In terms of bear markets, the current one has been particularly bad. The table below compares top to bottom falls in all bear markets in Australian shares since 1900.

Bear markets in Australian shares since 1900

Share bear market (Aus shares)	Months to low	% fall	Months after low to make new high	% gain in first 12 months after low
Jun 14-Dec16	30	-22	37	+10
Jul 29-Aug 31	25	-46	38	+33
Mar 37-Apr 42	61	-32	43	+30
May 51-Dec 52	19	-34	62	+8
Sep 60-Nov 60	2	-23	33	+12
Feb 64-Jun 65	16	-20	25	+9
Jan 70-Nov 71	22	-39	94	+52
Jan 73-Sep 74	20	-59	59	+51
Nov 80-Jul 82	32	-41	17	+39
Aug 87-Nov 87	2	-50	75	+35
Aug 89-Jan 91	15	-32	30	+39

Share bear market (Aus shares)	Months to low	% fall	Months after low to make new high	% gain in first 12 months after low
Feb 94-Feb 95	12	-22	20	+25
Mar 02-Mar 03	12	-22	15	+27
Avg from 1900	21	-34	42	+28
Avg from 1950	15	-34	43	+30
Nov 07- ?	16 ?	-55 ?	?	?

Based on the All Ords. I have defined a bear market as a 20% or greater fall in shares that is not fully reversed within 12 months. Source: Bloomberg, AMP Capital Investors

Since 1900, bear markets in Australian shares have lasted an average of 21 months with an average top to bottom fall of 34%. The bear market since 2007 has now gone 16 months but is far worse in magnitude than average; its 55% top to bottom fall is second only to the 1973-74 bear market when shares fell 59%. The top to bottom fall in Australian shares has been slightly less than in most major markets. This appears to reflect the faster and bigger policy response in Australia, the sharp fall in the A\$ (which has helped trade-exposed Australian companies) and the better relative functioning of the Australian banking system.

Top to bottom falls in major share markets

Share market	Decline from 2007 bull market high to recent low
Asian shares ex Japan	-61%
Japan	-61%
Europe	-62%
US	-57%
Australia	-55%

Source: Bloomberg, AMP Capital Investors

Drivers of the rally from early March

The rally in shares since early March has been driven by:

- A series of better than expected economic data, ranging from US and Chinese business conditions to Australian housing finance to UK mortgage approvals
- Policy stimulus going into overdrive with near zero interest rates and quantitative easing in several countries, massive fiscal stimulus packages, firmer moves to buy toxic debt in the US, increased IMF funding and G20 commitment in favour of free trade
- The relaxation of US 'mark-to-market' accounting regulations allowing the valuation of assets at prices consistent with an orderly sale, rather than fire sale prices

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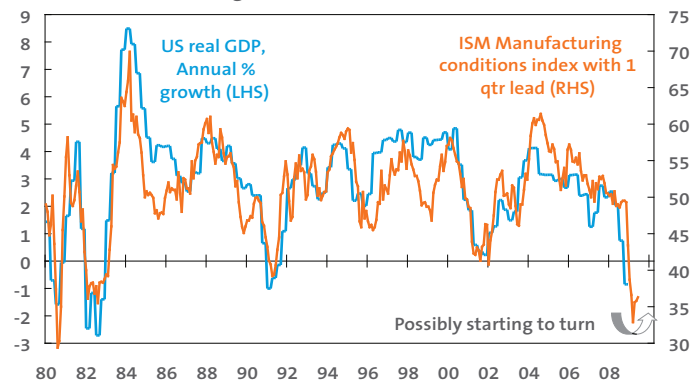
Is it sustainable?

Bear markets often have good countertrend rallies and this may be just one of them. For example, in the 1929 to 1932 bear market, US shares fell 86% over three years but there were six rallies along the way, ranging between 13% and 47%. Ignoring the latest rally, since peaking in October 2007, US shares have had two rallies ranging from 12% to 24% and Australian shares have had two rallies ranging from 12% to 17%. While the latest rally has been the strongest in the bear market so far, there is good reason to suspect that the latest rally is just another bear market bounce given ongoing bank problems and the global recession. That said, there are several reasons for cautious optimism.

First, investor sentiment reached levels of bearishness normally associated with major bear market bottoms. For example, at the low four weeks ago, a record 70% of surveyed individual investors described themselves as bearish. Despite the rally from early March, investor sentiment remains bearish and the consensus is that it has just been another bear market rally. Second, shares remain very cheap from a long-term perspective offering much higher cash flow yields than cash or bonds.¹ Finally, and most importantly, the global policy response to the crisis appears to be gaining some traction:

- Money market lending spreads have returned to levels seen prior to Lehman Brothers' collapse in September and credit spreads have stabilised
- Business conditions indicators globally seem to be stabilising and are improving in some cases. This is clear in the US ISM manufacturing survey which is up for three consecutive months

US ISM manufacturing conditions index has risen for 3 months



Source: Thomson Financial, AMP Capital Investors

- Housing related indicators for sales and finance in the US and UK are showing some signs of bottoming
- Chinese exports and industrial production remain weak, however business conditions surveys have improved, as have data for loan growth, fixed asset investment, retail sales, car sales and electricity production
- In Australia, lower interest rates and stimulus payments to households appear to be stabilising consumer sentiment and retail spending and boosting some housing indicators
- Various other financial markets have confirmed the rally in shares since early March with commodity prices breaking higher, growth-oriented currencies such as the A\$ on the rise, and so-called 'safe-haven' currencies such as the yen and US\$ weakening. Bond yields have also stopped falling.

In terms of growth-related indicators, it appears the world is going through an inflection point with the rate of decline moderating. This is consistent with growth starting to improve from later this year or through 2010. The US share market normally leads the trough in economic activity by about six months. If economic conditions improve from later this year, this would be consistent

1. This was discussed in 'Share market earnings and dividends', Oliver's Insights, March.

with shares bottoming in the first half 2009. While labour market indicators are still deteriorating and likely have further to go, it is notable that unemployment is a lagging indicator. In Australia, the average lag from a bottom in shares following a bear market to a peak in the unemployment rate is twelve and a half months.

Shares normally lead the peak in unemployment around recessions (Australian shares, All Ordinaries)

Australian recessions	Associated bear market in shares	Peak in Aust u/e rate	Share market low versus u/e peak. Months before (+)
Early 1930s	Jul 29-Aug 31	Jun 32	+10
Early 1950s	May 51-Dec 52	Jun 53	+6
Early 1960s	Sep 60-Nov 60	Sep 61	+10
Mid 1960s	Feb 64-Jun 65	Sep 67	+15
Early 1970s	Jan 70-Nov 71	Sep 72	+10
Mid 1970s	Jan 73-Sep 74	Dec 75	+15
Early 1980s	Nov 80-Jul 82	Jul 83	+12
Early 1990s	Aug 89-Jan 91	Dec 92	+23
Average			+12.5

The table only shows those episodes where a recession was associated with a bear market in shares. Source: Bloomberg, Thomson Financial, AMP Capital Investors

But expect a bumpy ride

There is good reason to expect the rally in shares has further to go and there is a reasonable chance we may have seen the lows. However, the ride will be bumpy. Problems in the banking sector remain; the recession is still with us; house prices have more downside; and more earnings downgrades are likely. After 20% or so gains over four weeks, shares are due for a bit of a pause and this now seems to be underway. Also, after rallying into mid-year, shares are likely to experience their normal seasonal weakness in the September quarter. To be more confident we have entered a new cyclical upswing in shares, we would look for any pullbacks in shares to bottom above their March lows, credit spreads to narrow, the fall in US house prices to slow, success in removing banks' toxic debts, and business and consumer confidence to trend higher.

Finally, while the cyclical outlook for shares looks slightly more promising, medium-term economic growth in developed equity markets will be constrained by the unwinding of high debt levels; tighter credit conditions in the long term; the need to unwind budget deficits once recovery occurs; and the increasing role of government in the economy. This is a separate topic but highlights the relative attractiveness of Asian and emerging markets which are not constrained by high debt levels and these trends factors.

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