

## A new bull market in shares?



### Key points

- > Shares are overbought and vulnerable to a correction. February is often a soft month and current risks regarding Italy, Spain, the US budget and earnings results in Australia may constrain markets in the very short term.
- > However, the rising trend in share markets since late 2011, reasonable valuations, improving global economic news and easy monetary conditions suggests shares have likely entered a new cyclical bull market.

### Introduction

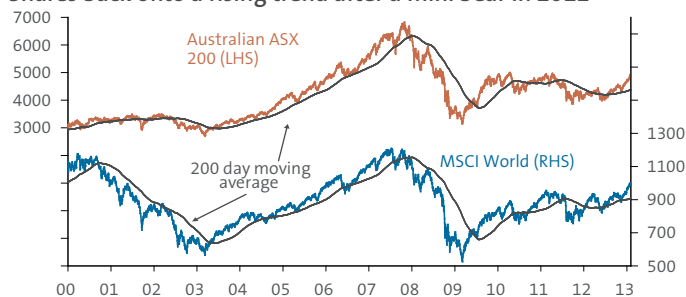
Since the height of the European public debt crisis in September/October 2011, global share markets are up 32% and Australian shares are up 26%. With the global outlook looking brighter, inflows into share markets seemingly starting to pick up and shares accelerating to the upside over the past few months, an obvious question is whether we have commenced a new bull market? This note focuses on cyclical bull markets, associated with three to five-year economic cycles rather than whether we are in a long term bull market which can run for a decade or two.

### Rising highs and rising lows

Trying to define a cyclical bull market in shares is always difficult. My preferred definition is that a cyclical bull market is seen as a pattern of higher highs and higher lows spread over months/years until it's interrupted by a bear market (which is a 20% fall that takes more than a year to reverse).

While shares rallied nicely coming out of the GFC, this was cut short in 2011 by the euro-zone crisis and worries about a double-dip recession in the US triggering 20% plus falls from early 2011 highs to lows in September/October 2011, resulting in a new bear market. Since then, share markets have been tracing out a rising trend indicative of a new bull market. The 200-day moving average of share prices, which is a good guide to the underlying trend, is clearly rising. What's more, market volatility seems to be settling down. This can be seen in the chart below. The breadth of the rally over the past year – in terms of sectors and stocks participating – is also consistent with it being a bull market.

### Shares back onto a rising trend after a mini bear in 2011



### Fundamental drivers

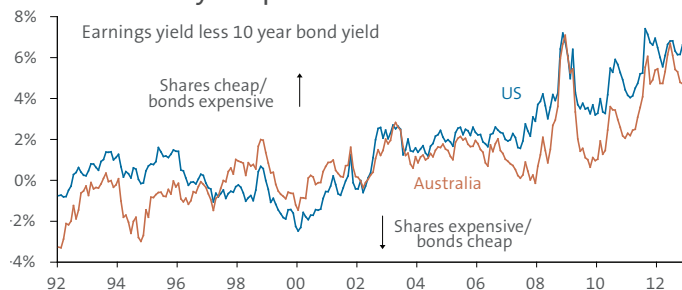
But what about fundamental drivers. Is it sustainable? A typical cyclical bull market goes through three phases.

- > **Phase 1** is driven by an unwinding of very cheap valuations helped by very easy monetary conditions but with receding downside risks, causing some investors to snap up undervalued shares. This is the phase where shares climb a "wall of worry".
- > **Phase 2** is driven by strengthening profits.
- > **Phase 3** sees euphoria with investors not only saying they are bullish but backing it up, pushing cash flows into shares to extreme levels. This is despite shares becoming expensive and central banks starting to raise interest rates to combat rising inflationary pressure.

Right now we are probably nearing the end of Phase 1:

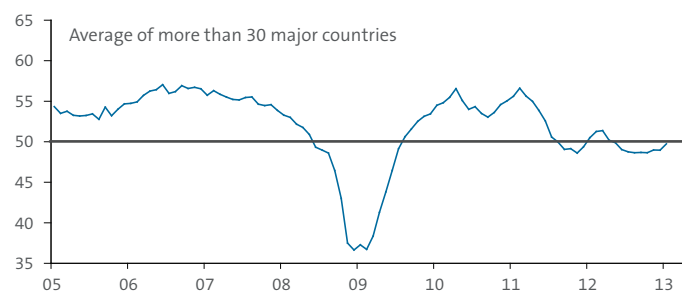
- > The rally in shares has reflected valuations becoming less cheap as global risk has receded. But while shares are no longer dirt cheap, they are not expensive either. Price to earnings ratios are up but only to reasonable levels of around 13.4 times in Australia, 13 times in the US and 12.4 times for global shares. In Europe and Asia they are still around 10 to 11 times. The gap between earnings yields and bond yields, a proxy for the excess return shares offer relative to bonds, remains extreme.

### Shares remain very cheap relative to bonds



- > While we are yet to see the sort of earnings growth upswing associated with a typical second phase of a cyclical bull market, the upswing in global business conditions (evidenced through improvements in various manufacturing conditions indices) now starting to occur suggests this is likely to become apparent over the next six to 12 months.

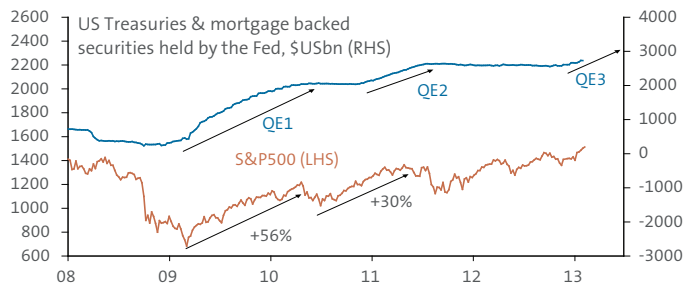
### Global manufacturing conditions indicators (PMIs) appear to have bottomed



- > Australia is lagging in this regard, reflecting much tighter monetary conditions in 2011 and the strong A\$. However, tentative signs that lower rates are getting traction is apparent in some housing and confidence readings. By the second half, the earnings outlook in Australia is likely to start looking healthier.

> And global monetary conditions remain easy, with near zero interest rates and open ended quantitative easing in the US, with Japan joining the fray more recently. Global monetary conditions are likely to remain easy until growth becomes a lot stronger and inflation fears loom. There is no sign of Phase 3 monetary tightening here.

### US quantitative easing and US Shares



Source: Bloomberg, AMP Capital

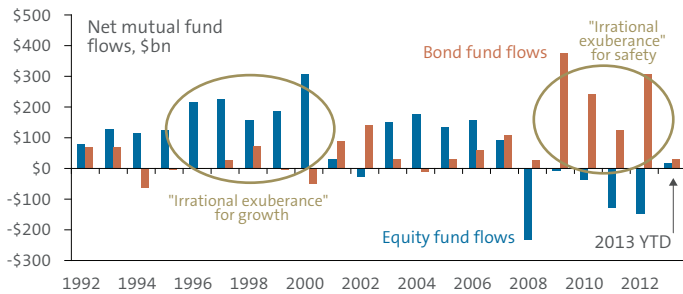
> Similarly, monetary conditions remain easy in Australia with cash rates around record lows and potentially more cuts are in prospect over the short term.

### Further to go

These indicators suggest the rally has further to go: shares are still not expensive, forward looking growth indicators are improving, pointing to an upturn in the global profit cycle and monetary conditions are likely to remain easy for some time.

What's more, investors may be starting to warm to equities again with inflows returning to equity mutual funds in the US and anecdotes suggesting the same may be starting to occur in Australia. This is likely to accelerate if the US share market breaks out to an all time high which is less than 4% away and Australian shares break through the 5000 level, which is less than 2% away. This proved to be a psychological barrier for the market in 2010 and 2011.

### Tentative signs US investors are returning to shares



Source: Bloomberg, AMP Capital

However, any inflows into equities are coming from a very low base. Given the outflows from equities over the last five years or so, it likely has a lot further to go. We are nowhere near the extremes in investor euphoria and equity market inflows normally seen in the final phase of an equity bull market.

### How long could it last?

The next table shows the record of cyclical bull markets in Australian shares since 1894. I have applied the definition that a cyclical bull market is a rising trend in shares that ends when shares have a 20% or greater fall that takes more than 12 months to be reversed.

### Cyclical bull markets in Australian shares since 1894

Cyclical share bull market in Aust shares, All Ords index	Prior bear market % fall	Months after low to make new high	Total bull market, % gain	Duration in months
Mar 1894-Jun 14	-36	112	253	243
Dec 1916-Jul 29	-22	37	196	151
Aug 31-Mar 37	-46	38	168	68
Apr 42-May 51	-32	43	175	109
Dec 52-Sep 60	-34	62	146	93
Nov 60-Feb 64	-23	33	42	39
Jun 65-Jan 70	-20	25	120	55
Nov 71-Jan 73	-39	94	57	14
Sep 74-Aug 76	-59	59	101	23
Nov 76- Nov 80	-23	21	173	48
Jul 82- Sep 87	-41	17	421	62
Nov 87-Aug 89	-50	75	55	21
Jan 91-Feb 94	-32	30	94	37
Feb 95-Mar 02	-22	20	89	85
Mar 03-Nov 07	-22	15	156	56
Mar 09-Apr 2011	-55	NA	63	25
<b>Avg from 1894</b>	<b>-35</b>	<b>45</b>	<b>144</b>	<b>71</b>
<b>Avg from 1950</b>	<b>-35</b>	<b>41</b>	<b>126</b>	<b>47</b>
Sep 2011-?	-22	?	26?	16?

Source: ASX, Bloomberg, AMP Capital

A typical cyclical bull market in the post WW2 period has seen shares rise 126% (column 4) and last nearly four years (column 5). So far, we are up just 26% spread over 16 months.

### Concluding comments

Having risen sharply since the last correction in November, shares are overbought technically and vulnerable to a correction. February is often a soft month for shares and several hurdles may constrain markets in the month ahead, including negotiations around US "sequester" spending cuts due to kick in on 1 March, Italian elections, corruption allegations regarding the Spanish Prime Minister and uncertainty around the earnings reporting season in Australia.

However, the trend in share markets is likely to remain up this year. The positive momentum seen in recent months in share markets is indicative of a bull market, during which corrections are usually short lived and mild. Share market valuations are still attractive. The global growth outlook is steadily improving which should result in better momentum for profits. Global monetary conditions are ultra easy and getting even easier. And shares are likely to benefit from investors switching out of low yielding cash and bonds. Australian shares will also benefit from Reserve Bank of Australia's rate cuts starting to drive a pick up in the key cyclical parts of the economy. So notwithstanding the usual bumps along the way, this all suggests that shares are still in the early stage of a cyclical bull market.

**Dr Shane Oliver**

**Head of Investment Strategy and Chief Economist  
AMP Capital**

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