

Signs of confidence starting to return



SIMON BONOUVRIE

At time of writing, the Australian share market has experienced several consecutive days of positive returns and market commentators are beginning to talk cautiously of a bear market rally.

At Platyplus, we are starting to think we have seen the low point in the market for the time being. Any rally could be quite substantial and our best-case scenario is a retracement of up to 50 per cent of the entire bear market, although this may take some time to play out.

Even if this particular rally lasts several days rather than several months or even several years – any of which is possible – it is inevitable at some point we will experience a sustained bear market rally. The only question is whether it is now or later this year. A useful exercise is to look at the 1987 stock market crash and the ensuing bear market. The index hit a low of 1149 in November 1987, falling 50 per cent from its high of 2312 in September 1987. The bear market continued to mid-1991, when the index ‘retest low’ was made at 1199 points.

However, during that period the market had a strong bear market rally, during which the index retraced about 55 per cent of the prior fall, rallying back to a high of 1786 points in September 1989.

Looking back on this period, we can describe it as a bear market that lasted three-and-a-half years, at which time the index had its secondary fall to 1199 points in 1991, retesting the 1987 low. But a key point is that this overall bear market contained a 55 per cent rally during the middle of that three-and-a-half-year period, providing a very good opportunity to profit on the long side.

It’s impossible to tell at these early stages whether we are seeing the start of a bear market rally or a new bull market campaign. Given the problems associated with the United States and European economies, we believe it is more likely to be a bear market rally than a bull market start.

However, looking at the bear market not just as pure index point movement but also in a time sense, there is every chance of very

strong index gains before the index falls back to a lower level.

The initial stages of the rally will almost certainly be accompanied by extreme pessimism and disbelief that the market is actually going up. This phenomenon is known as the market ‘climbing a wall of worry’. There is a substantial amount of bad news already factored into stock prices, so it is possible investors are happy to buy stocks for valuation reasons even though there is more bad news about the economy printed each day. History shows markets tend to rise for six to nine months before an improvement is seen in the underlying fundamentals of the economy.

Focus has been switching between the US and China in recent months as opinions change as to which one will lead Australia out of recession, and both economies are important drivers for Australia. However, the US economy heavily influences China, therefore our view is the US economy is probably more pivotal for the global economic growth picture. In terms of positive stock market sentiment, it is more crucial for the US economy to show signs of recovery, as global stock markets tend to follow the lead of the US market.

At Platyplus, we think the stocks leading the rally will be financials and consumer discretionary stocks. Both these sectors have led the downturn and both were targets of major short-selling campaigns, both in Australia and abroad.

It is interesting bank stocks (Commonwealth Bank of Australia and Westpac) did not make new price lows in March, even though the market as a whole made an extreme index low on 10 March, which is a sign of technical strength relative to the broader market. Instead, these banks made their extreme low in January.

Consumer discretionary stocks historically have been the best performing sector once the economy shows signs of exiting a recession. We think this time will be no different and we also believe the Australian consumer is more resilient than the ‘bear case’ being factored into prices of these stocks.

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There are some stocks that are proving to be a surprise and holding up well during a downturn, when conventional thinking suggests they would suffer. For example, Toll Holdings was one of a few companies to exhibit positive earnings growth this reporting season. Probably the main reason for this is that Toll has an extremely strong balance sheet and the company is continuing to focus on its growth strategy. We expect the company will make several bolt-on acquisitions in Asia in the next 12 to 24 months.

Overall, we believe the market will warm towards companies that, firstly, have a strong balance sheet; secondly, are able to demonstrate positive earnings growth in 2009; and thirdly, have the potential to grow earnings greater than 10 per cent once the economic cycle turns positive. Toll Holdings meets all these characteristics. Other stocks also meeting these characteristics include ASX, JB Hi-Fi, David Jones, Commonwealth Bank, Computershare, WorleyParsons, CSL, Westpac and Woolworths.

One of the most important sectors to monitor is banks. This was the sector to lead us into this bear market, therefore we also expect it to lead us out of the bear market. At the very least, banks need to stop declining before we will see a sustained rally in the market.

It is starting to seem extremely unlikely there will be any more major financial institutions in the US that will collapse (there could be the odd minor regional bank that collapses, but the major banks will not be allowed to collapse).

The US government has indicated it will support the US financial system at all costs and it is now widely recognised the Lehman Brothers collapse should not have been allowed to happen.

The US\$1 trillion Geithner plan (announced at the end of March) to rid banks of their toxic assets via a public-private investment program should provide more support to the health of bank balance sheets and hopefully encourage more liquidity into the market for housing-related debt. «

Columnist: Simon Bonouvrie, Platyplus Asset Management portfolio manager