



Caution wise, but most signs remain positive

Columnist: Prasad Patkar, Platypus Asset Management portfolio manager

While it could turn out that the Australian share market's poor start to the year still has some way to run, overall the signs for 2010 are quite positive. We have now passed the peak of the half-yearly reporting season, which so far has been positive – unless there are unreported major upsets still to come, which seems very unlikely.

At the time of writing, there has been nothing bad enough to offset the generally good news coming out of company reports, and current market levels appear justified. Indeed, any future movement either up or down will depend more on the United States and Europe than what happens here.

With the global financial crisis (GFC) still fresh in the memories of investors, the sharp falls in equities earlier this year left many concerned. At one point the benchmark ASX 200 Index retreated nearly 400 points from its January high of 4951. Markets generally took a battering from a myriad of bad news, including weaker-than-expected US economic data, worries over China tightening monetary policy and concerns over sovereign debt defaults in Europe.

In Australia, things have improved significantly, although the valuation expansion phase that started last year is now over. We believe the market remains on track for a 25 per cent plus earnings recovery in the next 18 months and the stock market is more likely to end the calendar year higher than lower. This view is premised on the continued strength in the emerging economies and an ongoing recovery in the developed world, although we expect economic activity to remain sub-trend for some time.

One element investors must keep in mind is that policy decisions around the world will affect companies and sectors in varying degrees, making it very difficult – if not impossible – to find any easy gains.

In the US, high unemployment and poor consumer sentiment are still major issues, as is the current political gridlock in Washington. No-one should be surprised if additional fiscal measures are required.

In Europe, the situation is little better, particularly with Greece's current woes.

In Australia, while the index could fall as low as 4200 points at some time, and may remain range bound for some months, we remain cautiously optimistic the stock market will post a positive return for the full calendar year. Unlike the US and most of Europe, the recovery in the domestic economy is self-sustaining. Confidence levels remain high despite interest rate increases and the unemployment rate is declining.

However, one note of caution here is that the share prices of the majority of domestic stocks have now increased to a level where companies must deliver something worthwhile for investors, either in the reported numbers or the outlook commentary.

We are seeing earnings downgrades from even the strongest companies being punished by the market, something that didn't happen during the previous nine months or so, due to the amount of valuation support.

So while Australian company earnings are on track to rise 25 per cent in the next year and a half, which will support the market, from an individual company's earnings perspective, it will still need to convince investors the worst is truly over for its share price to go up or even hold at current levels.

The majority of companies remain reluctant to be too optimistic about the future, which in itself is not necessarily a bad thing.

Yet most companies have exceeded market expectations on dividend during the current reporting season, which perhaps is a more accurate reflection of the level of corporate confidence in the medium-term operating environment. In July last year, analysts were expecting the earnings per share for the Australian equity market to fall about 35 per cent from their financial year 2008 peak. It now appears the trough will be shallower, at less than 20 per cent, meaning earnings recovery has been sharper than what was anticipated only six months ago.

Investors that have been sitting on the sidelines do need to regain an appetite for

some risk and understand sensible risk and smart stock picking will be rewarded. In fact, corporate risk appetite is on the rise, as shown by the increased mergers and acquisitions activity globally in recent months.

Domestically, some sectors still appear to be in a good position. Currently things look rosy for the banks as their bad debt experience normalises, but the future does hold some challenges. They will need to hold more capital in the future, which explains their cautious approach to dividend payouts this reporting season, and the outlook beyond 2011 depends on how quickly credit growth recovers from its current deflated state. Ultimately the demand for credit needs to improve for the banks to achieve solid revenue growth.

High-quality retail businesses continue to trade well despite month-to-month volatility in sales. The sector is under-owned by domestic investors and represents one of the best opportunities in the market.

Overall, there are unlikely to be major trends affecting the Australian share market as a whole and investment decisions will need to be made on a company-by-company basis. The next few years will therefore demand greater skills from equity managers than were required in recent years, for example, in areas such as analysis, stock selection and portfolio construction.

Nevertheless, a major positive indicator we have seen at Platypus is that consumer, business and investor sentiment have all recovered in the past 12 months, notably in Australia but even in the countries enduring the most difficult circumstances. At the same time, equity markets remain 30-40 per cent below previous peaks, which implies to us that there is still a genuine opportunity for investors. The consolidation period we are in at the moment should ultimately resolve to the upside, which means 2010 is likely to be a good year to add to equities exposure, especially in the best-performing Organisation for Economic Co-operation and Development economy, Australia. «

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