



Market recovery – where to next?

Global sharemarkets have rebounded strongly over the course of this year. In this Point of View AXA's Chief Investment Officer Mark Dutton looks at what the next phase of the rally is likely to entail.

In brief

- The current recovery cycle, while more pronounced, is following historical trends.
- After-shocks, such as the Dubai World debt problems will continue to ripple through the global financial system, but most will not represent a new systemic risk.
- The market recovery is transitioning to a new phase in which company earnings will drive returns, rather than a broad market revaluation.
- This next phase will be more difficult than the first, but still has considerable upside potential.

It's different, but it's not

Doomsday has been avoided. Not only is the market recovery well underway, it is actually following a rather 'normal' recovery pattern.

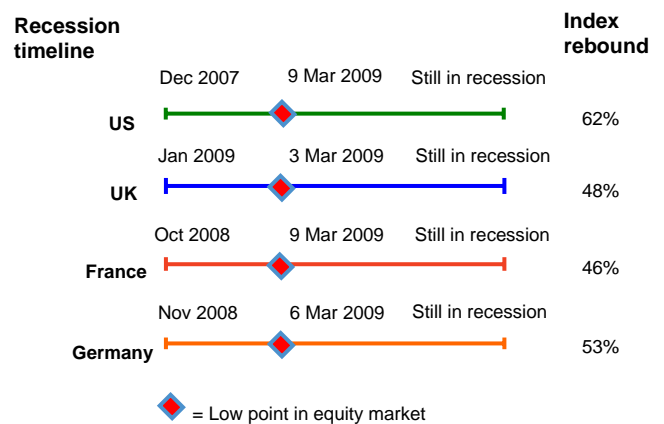
History shows us that during periods of immense disruption, investment markets tend to rally ahead of economic recovery.

The current recovery cycle has proved to be no exception. Figure 1 shows that the turning point for equities occurred relatively early in the economic downturn and sharemarkets in major economies that haven't convincingly emerged from recession, such as the US, are up by as much as 62 per cent.

This early mover trend is part of the reason that a very bad year of investment returns are more often than not followed by a period of very good returns.

Figure 2 shows that while the downturn of 2008 was more pronounced than any other, the market correction of 2009 is following a typical recovery pattern that has occurred over the past century.

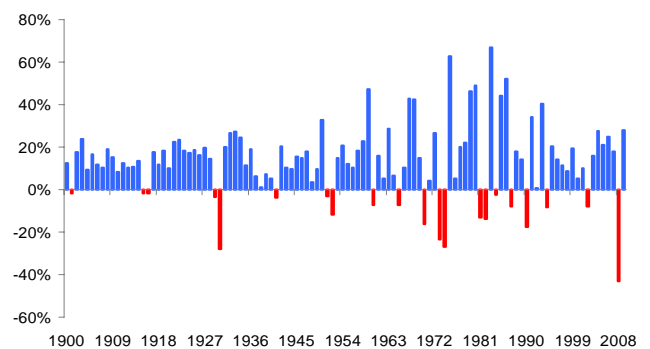
Figure 1: Investment markets move early



Source: Bloomberg, AXA. Indices: S&P500, FTSE100, CAC, DAX. Data through to 30 November 2009

Figure 2: A typical recovery pattern

The Australian sharemarket



Source: Bloomberg, AXA. All Ordinaries Index Data from 1900 to 30 November 2009

Risk on, risk off

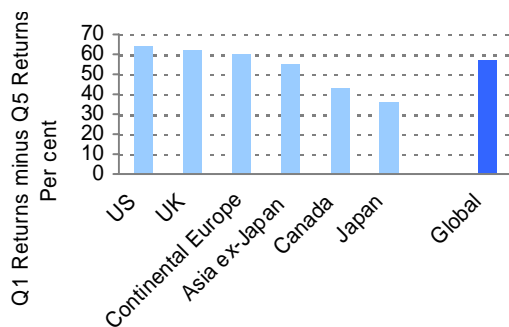
A more unusual aspect of our current recovery is its 'risk on, risk off' nature. During the height of the Global Financial Crisis (GFC) almost all markets fell simultaneously as investors sought to exit any form of risk.



Yet the first phase of the rally – from March to September – was driven by riskier stocks. Depressed markets meant that valuations were very cheap, which boosted returns to the most volatile stocks in every region of the world as shown by figure 3 below.

Figure 3: Very high returns to the most volatile stocks

Performance of highest minus lowest quintiles of stocks based on volatility



*Portfolios rebalanced once per month. Data from March–September 2009. Source: AllianceBernstein

We are now transitioning to a new phase of the recovery, which is likely to involve a shift from ‘macro to micro’, where it will become increasingly hard for a company’s share price to rise simply because the market is rising.

During this next stage of recovery, after-shocks such as the Dubai World debt concerns will continue to ripple through the global financial system, but most will not represent a new systemic risk.

Earnings now need to do the heavy lifting

Generally speaking, sharemarkets are trading at reasonable valuations – they are no longer cheap relative to the current expected level of earnings growth.

This means that for sharemarkets to rise further, company earnings need to increase more than currently expected.

The good news is that earning revisions are starting to turn positive, which is a typical occurrence during this stage of the recovery cycle.

What does this mean for investors?

The first stage of the market recovery saw global sharemarkets rise spectacularly, almost without a pause. This is typical of the first stage of a market rally, but not the next.

During this next phase, research will become increasingly important. Winners will include companies that deliver solid earnings improvements, while stocks that disappoint on this front will be punished.

This next stage will encompass difficulties, but offers strong return potential.

Emergency measures will continue to be wound back – the Reserve Bank of Australia’s (RBA) recent rate rise is another example of this occurring – as global economic markets are turning around.

Over the longer term sharemarkets tend to track economic growth and company earnings and both of these factors are on the upswing.

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