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The bulls aren't quitting

By Martin Roth

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The local equity market seems to get higher by the week. Is a correction looming? Is it time for investors to be reducing their holdings, perhaps even to "sell in May and go away"?

Certainly, if you look for them, the portents for a short-term correction are there. There is the gravity-defying Chinese market, approaching bubble territory, with the benchmark Shanghai index up over 40 per cent this year, having more than doubled in 2006.

There is a slowing US economy and a looming crisis in the \$US1.2 trillion sub-prime (low credit rating) home lending market.

Domestically our share prices have, arguably, been appreciating ahead of earnings growth potential.

"People are saying that valuations are stretched," says Stuart Cartledge, the director of Phoenix Portfolios. "I find it difficult to mount an argument against that."

Or in the words of Marcus Padley, author of the Marcus Today sharemarket newsletter: "We have a reasonably tight balloon and any prick can burst it."

Leanne Pan, the portfolio manager at Prime Value Asset Management, says: "The market is pretty high up there. We now tend to be on the conservative side in managing our funds."

"There's been a fabulous book in Australian equities for several years but it's now looking long in the tooth," says James Holt, a senior investment specialist with Zurich Financial Services Australia. "There are no outstandingly cheap sectors."

But whatever happens in the short term, it is not easy to find professionals willing to forecast a sustained correction. Most see continuing long-term gains. The reasons are simple - a buoyant domestic (and global) economy and an incredible inflow of funds.

In the words of Michael Heffernan, a senior client adviser and strategist at Austock Securities: "People run around and look for reasons to be maudlin. And it's true that we've galloped a bit fast. But I still see a 10 to 15 per cent rise this year."



Quietly confident ... Michael Heffernan of Austock Securities.

Photo: *Paul Rovere*

"Underpinning it is a robust economy. Profits are rising and when that happens the market has to perform. The two don't disconnect. So I see a reasonable rise but it won't be as high as the past three years. The economy has slowed a little. But I think we're in for a good year."

Those rising profits mean the market price-to-earnings ratio remains at its long-term average of some 14 to 15 times, despite the recent run-up in share prices. However, part of this is due to the recent good performance of low-P/E resources stocks. Some industrial stocks are on high P/Es. This is at a time when many international stocks are relatively cheap.

Holt says: "Usually the Australian market trades at a discount to world markets. Now we are about equal. So international equities are looking relatively better value, especially with the currency in our favour."

"International equities have seen their P/Es fall and are now cheaper than for many years. For example, we have Foster's on more than 20 times but many global wine or beer companies are 13 or 14 times. CSL or Symbion Health are on higher P/Es than companies such as GlaxoSmithKline or Pfizer."

But Padley argues that "something else is going on – Australia is breaking from the pack, because of resources. Some forecasts are that China could grow at 8 per cent a year for the next decade".

Ivor Ries, the head of research at E.L. & C. Baillieu Stockbroking, agrees. "We don't think it's the top of the market, with just one caveat – that China keeps chugging along. Right now it is growing at 11 per cent a year. It has a huge dragthrough effect on the Australian market. As long as the locomotive keeps chugging along, the caboose will be dragged behind."

The other factor that sustains the market is, of course, the fabulous liquidity boom. Huge superannuation inflows will be joined this year by the Government Future Fund and merger and acquisition activity – including the new private equity binge – to create enormous demand for equities.

By some estimates, more than \$50 billion in new money could hit the market this year. "Looking at supply and demand, there's a lot of demand," says Dean Fergie, the executive director of Opis Capital.

"If you're a pure economist, that's another feather in the cap of the Australian market. I'm not an optimist all the time but it's hard to mount a credible argument for a big fall in the next few years."

He also notes that "market breathers and corrections come but so far the recovery has always been fast. Buying dips has been rewarding, although not as profitable as just staying in and riding out the fall."

Nevertheless, a liquidity boom cannot last forever. And when it ends the pain can be severe. The Japanese market – driven higher and higher during the 1980s on a wall of money, but now trading well below its 1989 high price – is testament to that.

It is a similar case with resources. "The cycle will end at some point," Holt says. "A slowdown in the global economy will have a quick impact on the bottom line of mining companies. Can every investor get off the boat at the same time?"

So what should an investor do in such a market, where – if the experts are to be believed – the potential seems good for a few more years, yet where many stocks are trading near their alltime highs? Firstly, are there stocks to avoid?

Property trusts have been superlative performers. Ries argues they are now priced too high. "Traditionally

they trade with yields that are at a premium over long bonds. Now they're below long bonds. The market is saying Australian property is less risky than Australian Commonwealth bonds. I don't think so."

And Heffernan sounds a warning about the retail sector. "The economy is slowing somewhat. [Fashion retailer] Noni B released a forecast recently of flat earnings growth. That could be a bit of a harbinger. I'd tread cautiously with retail."

And the stocks to buy? "Financial services is a no-brainer for the next decade," Fergie says.

"We like [fund management companies] HFA Holdings and MFS."

Others agree on the strong potential of financial stocks. Ries recommends financial data supplier Iress Market Technology. "It's a fantastic business, with great potential from the acquisition of the VisiPlan [financial software] business."

Finally, Heffernan extols the virtues of shares in the Australian Stock Exchange. "It's the monopoly goliath of the market. It now has annual turnover of about \$1.2 trillion. It's absolutely phenomenal. And more money keeps pouring through the door."

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