

**18/12/2009.**

**MARKET UPDATE – “Mum are we there yet?”**

When I was asked to put together a brief note reflecting on 2008 and looking ahead to 2009, my initial inclination for the reflection piece was to say "Rule it off and move on". After more thoughtful consideration I am not sure I want to change my view...

I could of course rabbit on about the sub prime crisis, the poorly executed TARP program in the US, how Australia is relatively better off, and how most investors have suffered a huge capital loss, but now equity valuations in Australia are looking extremely cheap. But you know all that, so what would be the point?

2009 and beyond

When looking out into an uncertain future, bizarrely what springs to mind are long road trips from a few years ago when my wife and I took our two much younger sons on holiday. No its not the continual replays of Wiggles CDs that drove me to distraction I recall. Its that quintessential question that every parent (although mostly Mum's for some reason) get asked on such a trip.

Are we there yet?

When it comes to the Australian equity market, unfortunately I have to say my answer would be "no, but we are very close". And then I would add "but once you get past the confession season in February 2009, the Australian equity market could be in for a substantial rally". Don't get me wrong, unemployment still has a long way to rise and maybe Australia will have a recession, but that doesn't mean equity markets can't rise.

Why do I say that? A few reasons.

Firstly, the equity market here is very cheap historically based on various measures including one year forward P/E's, equity yield / bond yield ratios, etc. In other words, your pay back period for an equity investment is shorter than the historical norm and you are getting paid a higher yield. On average the market is trading on a forward P/E of under 10x and there are individual stocks trading as low as 3-4x. I am sure you have all seen the charts.

The bears amongst you will no doubt say "Ah yes, but have analysts reduced their earnings sufficiently to capture the bleak economic outlook in 2009?" Well, if history is any guide, almost certainly not. If I put on my old economics hat for a minute, consensus earnings for the equity market are what we would definitely put in the category of a "lagging indicator". Its a bit like the RBA being hung up about inflation in May when it was pretty obvious the world economy was looking more than a little shaky,,, Even allowing for some further downward revision in earnings though, Australian equities still look cheap.

On top of this let's not forget the massive amount of stimulus that the authorities have and will continue to push into the economy. The \$10.4 billion spending package and the 3 per cent reduction in interest rates was just the beginning. How much more needs to be done here? Probably on Government spending we will see about double what has been announced so far. On interest rates, maybe another 1 per cent or so. But the point is, Australia has both the willingness and the scope to do a great deal more if required. Unlike the US we don't have a cash rate at zero and we have been running budget surpluses not deficits for the last 10 years.

Why is February such a key date? Because once most of the bad earnings news is out the analysts will roll their company models forward to include 2010, which by any measure is likely to be better than what we have just been through. We know financial markets anticipate outcomes, so this brighter outlook will get priced in during 2009. What does the upside look like? I have seen forecasts as bullish as plus 40 per cent. While on the high side it is feasible, especially when you consider its not enough to return the index to peak levels.

Many companies out there have leveraged up in the good times and much of the concern reflected in today's prices has to do with scepticism around the ability of these companies to re-finance their debt when it falls due. Again though, things are likely to look better on this front in 2009 as the global impact of central bank measures begin to gain traction. Even in these dark times, solid companies with real cashflows have been able to re-finance debt (albeit at high interest rates). As the liquidity squeeze eases, so does this concern, and equity prices will be quick to reflect the reduction in risk.

Its easy for emotion to dominate in the tough times and some of you may be doubting the investment strategies that you have developed for clients over many years. One thing I can say from my 20 odd years in markets is the fundamental principles of investing don't change. I hate using well worn cliches, but superannuation is a long term investment and I doubt you will see cheaper equity prices in the next 10 years. To paraphrase Warren Buffet, when hamburgers get cheaper you buy more of them. What is so different about shares?

Enjoy Christmas with your families.

Here's to a better 2009!

**Matthew Drennan**  
**Director of Investments**

**ZURICH**