

Is the current rally sustainable?

With the bear market appearing to have bottomed on March 6th, the Australian equity market has sprung back 43% (to the end of August). Still significantly below its 2007 peak, the primary question is whether this represents a market back to fair value, that has run ahead of itself or is still looking attractive.

The rebound experienced in the past few months appears to indicate that investors had become excessively pessimistic through the downturn; illustrated in chart 2 by the market's price earnings ratio (P/E) contracting to multiples not seen in over two decades. Also highlighted is the degree to which the equity market has 'corrected its excessive pessimism', with the P/E expanding back to a more 'average' level.

The August reporting season confirmed this reversal in market sentiment with company profits generally beating pessimistic expectations – sometimes considerably. The level of pessimism was highlighted by companies who, despite reporting a fall in profits, experienced significant share price rises following their results announcement. In addition, the announcement of proportionally more company profit upgrades than downgrades, compared to expectations reflected a more positive outlook for businesses than was feared only a few months before.

We expect businesses that worked diligently to reduce costs and increase efficiency through the economic downturn will harvest the benefits from any uplift in economic conditions, as increased revenue flows directly to the bottom line. Improvements in margins and overall profitability will spur additional earnings upgrades, which in the light of an 'average' P/E, leads us to believe that the market is certainly not overvalued at these levels. Rather, as suggested earlier, the recent bounce appears to have merely corrected the excessive pessimism that gripped the market through the latter stages of the downturn.

Markets generally do not move up in a straight line and there is no reason to think it will be any different this time. The risk remains that the economy and profits do not grow, however, this scenario seems less likely. As a result, we remain confident that the Australian equity market remains an attractive investment, as confidence continues to filter through both earnings and sentiment.

Chart 1



Source: IRESS

Chart 2



Source: IBESS, UBS