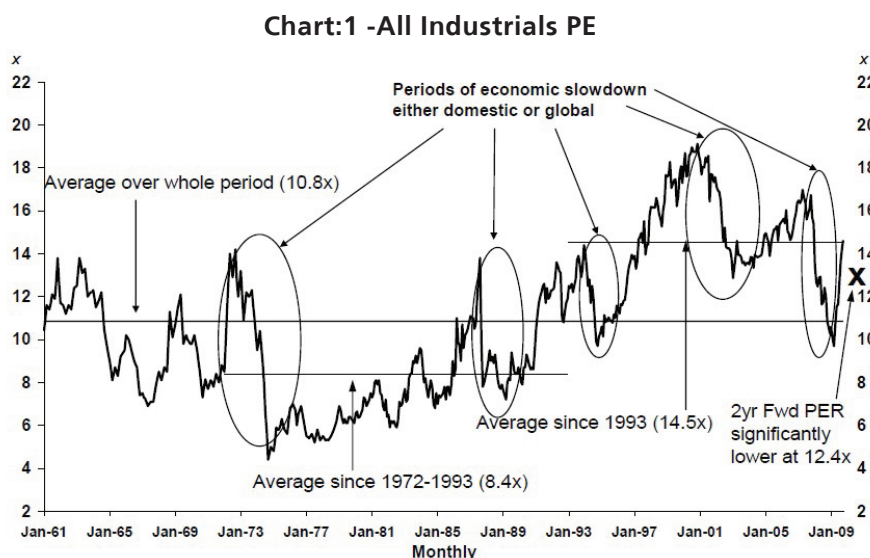


Climbing the wall of worry

An old Wall Street proverb says that a rising stock market in the face of negative uncertainty is “climbing a wall of worry”. Whilst the extent of the current equity market rally has been particularly pleasing, we are now entering into a stage of the market cycle where earnings and earnings growth will be required to sustain the upward momentum. It is the presence, or otherwise, of continued profit growth that will determine the durability of the current rally.

Chart 1 below illustrates the average valuation of the industrials market since 1961, and suggests that even though the market has risen sharply since March 2009, the 2 year forward PE remains relatively low; at 12.4x.



Source: IRESS, Macquarie Research, September 2009, (All Industrials PE)

Investor behaviour and expectations tend to be heavily clouded by recent experience. The excessive share price falls of the past 18 months have ingrained a high level of conservatism in the earnings expectations of market participants, as seen below. Consensus anticipates EPS growth in FY10 of only 0.6% (which itself has been recently revised upwards from -1.0%). Longer term consensus expects a strong earnings bounceback in FY11 of 24%. From a price perspective, this values the Australian stock market at a PE multiple of 13.2x (on FY11 earnings) - certainly good value within a historical context - but a near term FY10 P/E ratio of 16.3x.

30 September 2009	2010 FY (F)	2011 FY (F)
EPS GROWTH	0.6%	24.0%
PE	16.3x	13.2x
Yield	3.9%	4.6%

Ausbil broker panel consensus for the market which includes the resources and industrials sector.

We are of the view that the longer term confidence will start to be brought forward as GDP growth recovers ahead of expectations. This will result in the 2010 FY EPS growth figure being further upgraded (and a corresponding fall in the market P/E), further supporting share prices and sustaining the current rally for some time yet.

The above investor behaviour is also evident at a sector level. We continue to find investors' expectations far too conservative in a variety of key sectors, and therefore significant opportunities remain. We believe that the Banks, Media, Diversified Financials and Retailing sectors are still suffering from lingering negativity, but are likely to enjoy continued strong revisions as this negativity dissipates.

Whilst it would not surprise us to see some market consolidation in the short term, this is normal for a rising market. However, as investor confidence continues to grow and the earnings upgrade trend continues, the fair market value of today will become good value tomorrow.