IML's review of the market for 2006 and our outlook for the year ahead - 04.01.2007

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Despite a mid-year correction that pulled it back by 10 per cent, the Australian share market racked up its fourth consecutive year of double-digit gains in 2006, with a return of 20 per cent.

The benchmark S&P/ASX 200 index ended the year at a record high of 5669.9 points, crowning another stellar year for equity investors, as continued commodity strength helped drive company profits higher and a wave of mergers and acquisitions (M&A) activity pushed share prices higher.

After returning 15 per cent in 2003, 28 per cent in 2004 and 23 per cent in 2005, the Australian share market has more than doubled since early 2003, when the commodities boom kicked off.

In accumulation terms, the S&P/ASX 200 index's 24 per cent gain in 2006 pushed its rise since February 2003 to 130 per cent.

In the US, share investors bounced back from a slumping housing market, record high oil prices earlier in the year and the Federal Reserve's two-year campaign of interest rate rises. After a commodities market-inspired correction mid-year, the US market recovered to send the Dow Jones Industrial Average past 12,000 points for the first time.

Investors in Australia and overseas were heartened by the pullback in the oil price in the latter half of the year. After briefly approaching US$80 a barrel in July, oil eased by more than 22 per cent to close the year at just above $61 a barrel, as the US hurricane season (and its threat to gasoline production) turned out to be a fizzer, and markets realised that global oil inventories were healthy.

With the imminent threat of triple-digit oil prices disappearing, global share markets were able to shrug off fears of inflation and consequent interest-rate rises. In short, 2006 continued what has been an outstanding period for share market investors.

From the point of view of an Australian investor, the simple reason for the share market's strength is: profits. Company profits could hardly have been better for Australian investors in the last three years. Australian stocks (the S&P/ASX 300 universe) boosted their profit on average by 20 per cent in 2005-06, following a 28 per cent rise in 2004-05 and 17.4 per cent the year before. With this strong earnings growth driving price/earnings (P/E) ratio expansion, the market has pushed strongly ahead.

Drivers of the Australian sharemarket

The major driver for the market's profit strength has been continued high commodity prices, which have substantially boosted the earnings of resources companies. The resources companies lifted their net profit by more than 60 per cent on average in 2005-06, following a 79 per cent profit surge in the 2005 financial year and a 43 per cent profit rise the year before.

Much of this profit bonanza has been driven by economic growth in China, but that growth is cooling. The "China Syndrome" is expected to continue to support commodity demand – and thus prices – but not at the exalted levels that have prevailed in recent years. Commodity price strength is resilient: a good example is the recent reported news that Brazilian iron ore miner CVRD and Chinese customer Baosteel have agreed to a price rise of 9.5 per cent for 2007. That was well above market consensus estimates for a 3–7 per cent rise, and is a positive development for Australian iron ore miners. But the extent of growth in commodity prices appears to be limited from here, with much of the "China Syndrome" well and truly priced in to the market, and indeed, the risk appearing to be very much to the downside for many commodities.

That situation has real ramifications for an Australian share market leveraged to ongoing high commodity prices. Over the last three years, the profit performance of the Australian market has run well above the long-term average, driven by strong resources earnings. According to research house Wren Research, profit growth for the S&P/ASX 300 stocks has averaged 19.1 per cent compound over the last three financial years, compared to the average of earnings growth since 1975, at 9.3 per cent a year. Wren Research expects the market's profit growth to fall to 7.9 per cent in the 2006-07 financial year, which would represent a seven-year low.

Earnings will come under pressure from slowing economic growth in the US, China and in Australia, which is likely to fall well short of the average of 3.7 per cent economic growth rate it has enjoyed over the last 15 years. In its mid-year Budget Review, the federal government lowered its 2006-07 economic growth forecast to 2.5 per cent.
As growth in both the US and China cools, this will place commodity prices under pressure. The global economy is unlikely to go into recession, but investors should be prepared for it to grow at a slower rate than it has shown in the past few years.

This external headwind should temper the growth that the Australian share market can deliver to investors in 2007, but the market enters the new year with a sound case for
positive momentum. Liquidity flows are very strong, with compulsory superannuation delivering about $460 million a week to the

market, the Future Fund commencing its investment over the year ahead and continued takeover/merger activity to be expected as the colossal amounts of money available to global private equity investors are looking for a home. While this latter factor has an inevitable component of hype and froth, it does suit the holders of under-valued stocks.

Is the Australian sharemarket expensive?

On a collective basis, the Australian market heads into 2007 valued on an average prospective P/E ratio of just below 14 times earnings, compared to the ten-year average of 15.2 times. While that looks like an under-valued market, investors should understand that this figure is being dampened by the resources component of the market, which are trading on lower-than-average P/Es because their earnings have been rising faster than their prices. BHP Billiton, for example, ended 2006 trading on 8.1 times expected 2007 earnings.

If the resources component – which accounts for about 20 per cent of the index – is stripped out, the Australian market is estimated to be trading at an average P/E of 17–19 times earnings. All of a sudden, if this adjustment is made, the Australian market does not look so attractive – and the fact is that many top companies appear to be fully priced.

The problem in using prospective P/E ratios for resources companies lies in the volatility of the commodity prices that determine the ‘E’. BHP, for example, is trading on 8.1 times expected 2006-07 earnings based on prevailing forecasts for commodity prices: but if commodity prices were to decline to the extent that BHP earned a profit similar to what it earned in 2003-04, the stock would be trading on 32 times earnings. Conservative investors are prepared to price BHP and its peers for falls in commodity prices – it’s the extent that differs.

IML's outlook for 2007

The Australian share market in 2007 looks to have sound prospects, but investors pampered by the 20 per cent-plus gains of recent years should temper their expectations of what their share market investments can achieve. According to research house Andex Charts, the Australian share market has delivered an average total return of 13.1 per cent a year since 1950, with about five percentage points accounted for by dividends, which flow in regardless of what share prices do.

Recent history should tell investors that some kind of reversion to the mean should be expected – even a reversion to less than the mean.

Accordingly, IML has postioned its portfolios with a more defensive stance, such that they are underweight in their exposure to the large cyclical resource stocks, relative to the market, and overweight in our holdings of more defensive industrial companies. This type of a portfolio is well placed to weather any increase in volatility and to perform solidly in an environment where growth is moderating.