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Wealth/Super

Market dips are all part of the ride

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By James Dunn

Corrections such as the 7.6% plunge that has rocked the Australian stockmarket over the past fortnight are part and parcel of investing in shares. Because the market revalues shares more often than any other asset – every minute of the trading day – changes in investor sentiment show up faster there than anywhere else.

So when rising interest rates and falling house prices in the United States turned rising arrears in the US sub-prime mortgage market into surging defaults, the US sharemarket reacted savagely; and when that happens, it flows very quickly into other markets.

Since July 20, the blue-chip US index, the 30-stock Dow Jones Industrial Average, has lost 12.5%, while the broader S&P 500 index and the indicator of the technology stocks, the Nasdaq Composite Index, have both shed 6.5%. In London, the FT-100 Index was down 9.1% before last night's 3% rebound.

The US markets have not rebounded to that extent, but they have stabilised over the weekend and Monday after the world's central banks began to pump cash into the financial system to calm nerves.

The Australian market regained more than 1% yesterday, but was struggling to keep its head above water this morning.

Quite simply, volatility will continue to rule the stockmarket until we get a clearer picture of whether the housing downturn in the US will hurt the rest of the US economy, and thus the rest of the world.

The first thing to keep in mind is that what is happening is affecting prices, not companies' operational health. A correction makes good stocks cheaper than they were before. This can mean both good buying opportunities and increased yields; if a stock has predictable earnings and dividends, the yield on that dividend increases as the share price falls.

The second salient fact is that investors would have had to be greedy not to expect a correction in the Australian stockmarket at some point. The Australian market has delivered a total return (share price growth plus dividends) of 25% a year over the last four financial years – and 28.7% for 2006-07. An investor who entered the market (as measured by the S&P/ASX 200 index) in June 2005 has doubled their money in three years.

The stockmarket is not supposed to be that generous. According to research house Andex Charts, the total return from Australian shares since 1950 has averaged 13.3% a year. Clearly, the market has been running well ahead of that pace.

All that was needed for a correction was a trigger, which the turmoil in the US sub-prime mortgage market provided.

Corrections are a normal part of the sharemarket's functioning. The market's bountiful rise in recent years has been punctuated by regular corrections. Two falls of 8% occurred in 2005: the first between March and May and the second in October. The market retreated 9.8% in May-June 2006, and more recently, it lost 6.5% in a week in February-March this year.

Each time, the strength of the company profit outlook – and the increased dividend yields that accompany falling share prices – has sucked buying support back into the market, stopping the correction from developing into a full-blown bear market. Australian investors haven't experienced such an event since the year from March 2002 to March 2003, when the market lost 22%.

Share prices depend ultimately on company earnings, which depend on the global and domestic economy. And neither the economic outlook nor the prospects for company earnings are gloomy for shares.

The Australian economy has entered its 17th consecutive year of growth and, with farm production rebounding after

the drought, infrastructure spending lifting and continued China-driven export strength, looks to be in very good shape. Tony Pearson, head of Australian Economics at ANZ Bank, expects GDP growth to accelerate from 2.7% in 2006 to about 4% in 2007 – and for that stronger pace of growth to be maintained through 2008 and 2009.

The global economy is still running strongly. The International Monetary Fund recently updated its forecasts for global economic growth to a healthy 5.2% this year and next. The US economy is likely to lag this rate significantly as the housing worries hit consumer spending, but the rest of the world looks to be more than capable of picking up the slack.

All of that makes the profit picture for local companies positive – although, like the index performance, it can be expected to return to more normal levels. According to research house Wren Research, profit growth for the S&P/ASX 300 stocks has averaged 19.1% compound over the past three financial years, compared to the average of earnings growth since 1975 of 9.3% a year.

Wren Research managing director Andrew Quinn expects the market's average profit growth to fall to 9.6% for the 2006-07 financial year (the results of which will be released in the next few weeks), rising to 12% in 2007-08. That will contribute to returns from the stockmarket coming down from the levels that have held for the last four years.

For business operators, the stockmarket correction should be seen as separate from the economic situation, which is more important. Most economists believe that there could be another interest rate increase by the end of the year, although the Reserve Bank might hold fire until early 2008.

“The best approach is to stress-test your finances for another 0.25% rate rise,” says Craig James, chief equities economist at CommSec.

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