DON STAMMER - THE X FACTOR

Nothing lasts in markets so wait for the turn

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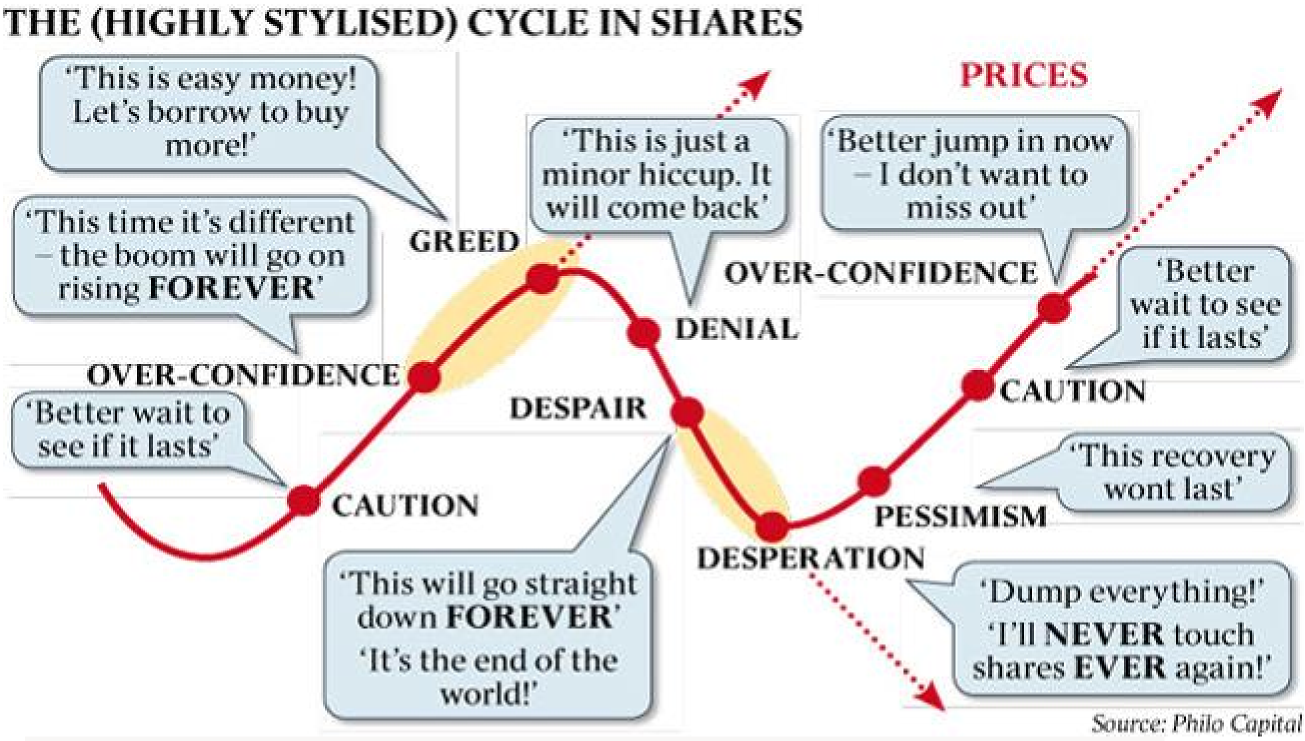

Source: News Limited

THAT investment markets move in cycles is one of the great recurring truths of investing.

And, most times, it's a huge annoyance for investors.

The main reason for these cycles is we're much affected by the moods of others. When prevailing sentiment is optimistic, we play down the chances of things going wrong. We pay excessive prices for future earnings. We're too eager to go into debt. And banks are too willing to lend. It's the opposite when prevailing sentiment is pessimistic.

The chart is a version of the highly stylised diagram that illustrates the various stages of the cycle in share markets.

It illustrates two key principles of investment. First, when one cycle ends, another begins; we should never expect a future in which investment returns run smoothly along their long-term trend lines. Second, investors too often make straight-line extrapolations of the present phase of the cycle and are not prepared for turning points. More specifically, investors become too optimistic at the top of the cycle and too gloomy at the trough.

Of course, the real world is far more complex. No two cycles in investment markets (or in the economy) are ever the same. Turning points can be sharp or drawn out. Cycles can be wide or narrow. Also, the duration of individual cycles varies greatly. Some observers suggest that investors need to allow for several cyclical patterns that overlie each other: the inventory cycle, which tends to last for one to three years; the business investment cycle, which is usually seen as running three to seven years; and the super cycle which they say extends over 40 to 60 years.

Certainly, the sharemarket cycles of the past decade are far removed from the simple rhythm suggested by the freehand sketch in the chart.

In 2002 and the early part of 2003, sharemarket gloom was pervasive, with the prevailing view after the terrorist attacks of September 2001 being that "things would never be the same again". The upswing in shares that followed, which ran from March 2003 to November 2007 (and is now termed the credit and resources boom) was powerful.

In turn, the sharemarket slump brought on by the global financial crisis was as deep as any we've experienced. Since early 2009, we've had three worthwhile upswings but each has faded. Our sharemarket is still 40 per cent below its 2007 peak while earnings per share and dividends per share are respectively 28 per cent and 15 per cent lower.

Sentiment among sharemarket investors remains somewhere between negative and subdued. Concerns about recession in Europe and slow growth in the US and China are the major driving forces. Locally, the strong Australian dollar and intense price competition are holding back growth in corporate earnings.

The Australian sharemarket is priced for tough times. On average, present valuations for shares appear somewhat cheap even if earnings and dividends remain flat or even fall a little -- and they seem not to allow for the improvements that companies, in aggregate, have made in reducing debt and adding to cash holdings.

Our sharemarket is likely to continue taking its lead not from influences at home but from what happens to US shares which, on average, also appear oversold.

Here are interesting observations on the American market from three US investment strategists. Two provide positive assessments while the third reminds us it's never easy to pick the timing of turning points in the investment cycle:

"People focus so much on potential macro pain that they don't appreciate the gains that good companies have made, and that things are slowly getting better." (C.T. Fitzpatrick).

"I do believe that markets have reacted to the current difficult situation and the likely slow-growth scenario over the next few quarters. Therefore, markets should be poised to rally through the balance of 2012 and move into new territory in 2013." (Donald Gimbel).

"As a result of the sell-off, markets offer good value. But value is not a timing device." (Abby Joseph Cohen).

Don Stammer is an adviser to the Third Link Growth Fund, Altius Asset Management and Philo Capital. The views are his alone.