

FEATURE ARTICLE: Not a time to be fearful

One of Warren Buffet's more famous quotes is:-

"We simply attempt to be fearful when others are greedy and to be greedy only when others are fearful".

In recent days, we have seen the fearful investor dominate the greedy. But given the magnitude of the share price fall, is now a time to be greedy?

To answer this question confidently probably requires some understanding of why many investors have once again become so fearful. Share markets around the globe have fallen from their cyclical peaks 3 months ago by between 10% to 15%. Despite the size of this fall, it is difficult to pin-point exactly what has fundamentally changed in the outlook for corporate earnings to justify the collapse.

Certainly, there has been a continuation of somewhat disappointing economic growth data coming out of the US, with the lack of any significant fall in unemployment raising doubts over the sustainability of the economic recovery. The commitment demanded of the US Government to cap future expenditure may have brought forward the timing of fiscal restraint to a period earlier than was previously anticipated by markets. However, the need for US policy to be tightened is hardly new news. Medium term growth prospects were always going to be ultimately constrained by a less accommodative policy stance. Meanwhile, there has been an apparent huge vote of confidence in the ability of the US Government to manage its debt, with US Treasury bonds rallying and 10-year yields falling from 3% to 2.5% over the past week.

In Europe, there has been heightened concerns over the debt position of Italy. Unlike Greece, Portugal and Ireland, Italy is a very large economy with the world's third largest sovereign debt. Undoubtedly, if Italy did default on its debt, there would be serious repercussions throughout the global financial system. However, why Italy has suddenly been targeted as a concern, is not clear. It is not apparent that there has been any deterioration in its fundamentals in recent weeks. The outbreak of concern has seen Italy's 10-year bond yield increase from around 5% to 6% over the past month. This is a material increase, but still well short of a crisis situation. Italy is one of the few European economies to be running its government primary budget at close to a surplus position. As such, it is in a position to achieve a stabilisation of its debt, without outside assistance (providing further interest rate increases on its debt don't eat too far into the government budget).

So without any apparent fundamental driver that justifies the magnitude of the recent equities sell-off, it would appear that much of the change has been driven by sentiment alone. The dearth of any positive news in recent weeks has seen sentiment deteriorate and this lack of confidence has escalated into fear.

Share prices in the cheap zone

There are several rationale arguments that can be described to justify why it is a good time to buy shares; Australian shares in particular. On all mainstream measures of valuation, share prices are cheap. Price to earnings ratios (i.e. the ratio of share price to earnings per share) on world markets and in Australia are now below 11 times. This compares to longer term averages in the 15 to 16 times range, suggesting there is around a 30% discount to longer term valuations. Company earnings growth, both here and abroad, has been relatively strong, with corporate balance sheets holding less debt than they have for many years. Corporations are well placed to withstand some decline in economic growth. The level of cash held by US companies in the S&P 500 Index is equivalent to around 18% of the total market company valuation.

Dividend yields around the world are now above prevailing interest rates. Even in the US, where yields are typically insignificant, the average dividend of 2.1% is well above the 5-year government bond yield of 1.2%. In Australia, yields being generated from some sectors have reached historical highs. The banking sector is currently trading at an expected 2011 yield of 7%, resulting in post franking returns of 10%. Given that the Australian banks continued to produce profits and dividends through the financial crisis, this rate of income should be a solid enticement to potential buyers.

Australian remains a special case

The ability of Australia to avoid a serious downturn in the last financial crisis is well documented. It can be argued that little has changed when it comes to our likely resilience. Both fiscal and monetary policies have been tightened in recent times, creating an opportunity for stimulatory policy to be re-introduced if required. The Australian dollar has reached record highs, creating the potential for the \$A to fall should the global growth outlook continue to deteriorate. In fact the tendency for the \$A to fall when negative moods sweep financial markets has come into play already. The \$A is currently trading at US 104 cents, which is around 6% below its recent peak. A falling currency protects Australian exporters from the full affect of a global slowdown by making our exports cheaper and more competitive on world markets.

As was also the case in the Global Financial Crisis, China is likely to continue to expand at healthy rates despite a lower growth scenario in the developed economies. It is significant to note that despite the all the recent turmoil, we have not seen a significant sell-off in the prices of base metals from existing highs. Compared with prices recorded in early July, both copper and aluminum have fallen by less than 2%. Zinc is down just 3%. The maintenance of high prices for these normally volatile commodities, suggests that the Chinese growth story remains largely intact in the minds of financial markets.

Unfortunately, the Australian share market is often victim to the waves of selling on global equity markets when confidence collapses, even though the fundamentals impacting on our company's earnings remain solid.

Major Australian Sectors	Stocks in top 10 (which represents 52% of ASX 200)	Earnings source
Mining	BHP Billiton, Rio Tinto, Newcrest	Record high commodity prices, Ongoing industrialisation of China.
Banking	Westpac, Commonwealth, NAB, ANZ	Interest margin improvement given domestic funding growth. Reduced competition.
Retailers	Woolworths, Wesfarmers	Strong household income growth. Strong population growth.
Telecommunications	Telstra	Rising technology take-up. Sale to NBN underwrites some value.

The table above lists the top 10 Australian companies (which make up more than 50% of the ASX 200 Index), and provides a snapshot of our assessment of key influences over future earnings. What is apparent from this snapshot is that a downturn in economic growth in Europe or the US does not have a direct discernable relationship with company earnings. Certainly, lower economic activity in the northern hemisphere may have some impact on demand for our exports and Chinese growth; however with Chinese demand increasingly being driven by domestic consumers, this relationship is far weaker than it has been previously.

Given the apparent more favourable position of Australian companies, it is somewhat perplexing as to why the correction on the Australian share market has been of a higher magnitude than that in the US over recent weeks. Between the end of April and today (5th August), the US S&P 500 Index had dropped 12%. Over the same period, the local S&P ASX 200 Index fell 15%.

What makes the recent relative price movements even more difficult to rationalise is the fact that the US market had rallied much harder than the Australian market in the lead up to the latest correction and therefore should have had further to fall. The fact that the US S&P 500 Index had jumped 28% in the 2010/11 financial year, suggests that there was a fair amount of optimism built into earnings forecasts. In contrast, the Australian market appreciated by a much more conservative 12% over the same period - yet has experienced a larger fall over recent weeks.

Is it time to be greedy?

At current prices, the fundamentals appear to be strongly in support of view that buying opportunities are attractive. However, in times of a crisis of confidence, investors require courage to either maintain or add to their share investments. The analogy of "catching a falling knife" is an apt description of the risks faced by prospective investors.

None-the-less, in the case of Australian equities in particular, the sell-off would appear to be driven by negative sentiment rather than any significant deterioration in underlying earnings outlook. History suggests that such times present good opportunities for buying and are a poor time in which to sell. Ultimately, the balance of motivation of greed will take over from fear.

What will trigger the change in sentiment is hard to predict and the negative sentiment may dominate for some time yet. One possible light on the horizon for local investors is the profit reporting season now commencing. Rio Tinto has just announced a 35% rise in underlying earnings to \$7.8 billion for the 2011 first half. This proves the resources boom is strong enough to swamp negative influences such as the high \$A. More results like this may enable the nexus between the Australian market and global negativity to be broken.

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