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The risk of a correction or new bear market in shares

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Key points

> Expect more volatility in shares this year as earnings take over as a key driver and the Fed moves to further taper its monetary stimulus.

> However, the cyclical bull market in shares is expected to continue as global monetary policy is likely to remain easy, shares are not expensive and we are still not seeing the investor euphoria that goes with market tops.

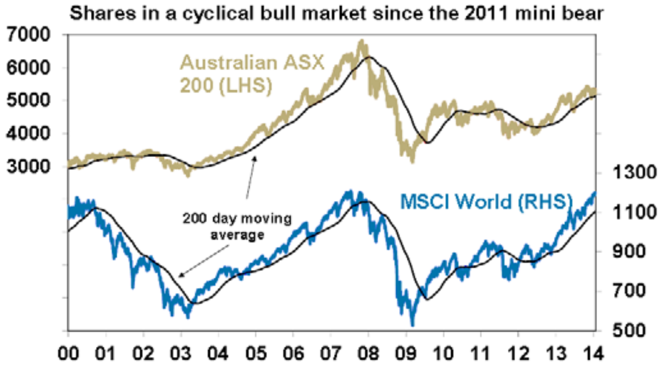
> Since 1950 the average cyclical bull market in Australian shares lasted 48 months with a 126% gain. The current bull market has gone for 28 months with a 37% gain.

Introduction

Since the height of the Eurozone public debt crisis in September/October 2011, global shares are up 58% and Australian shares are up 37%. After such strong gains an obvious issue is whether shares have got ahead of themselves, leaving them vulnerable to a fall. This note looks at the risks.

Cycles, the US and other risks

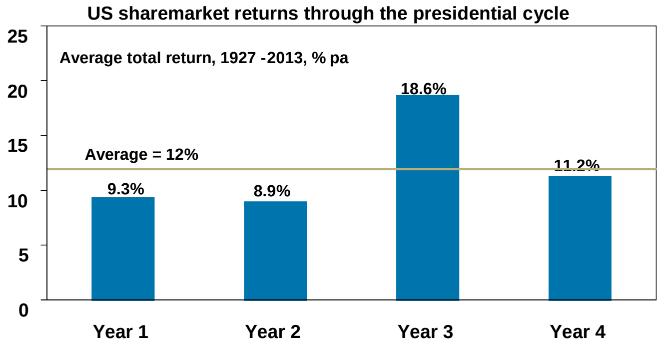
As my good friend Don Stammer has rightly reminded us over the years there is always a cycle and after two good years in share markets maybe it's worth considering whether we are due for a turn in the cycle back down. Since 2011, shares have been in a cyclical bull market, with a clear pattern of rising highs and lows. See the next chart.



Source: Bloomberg, AMP Capital

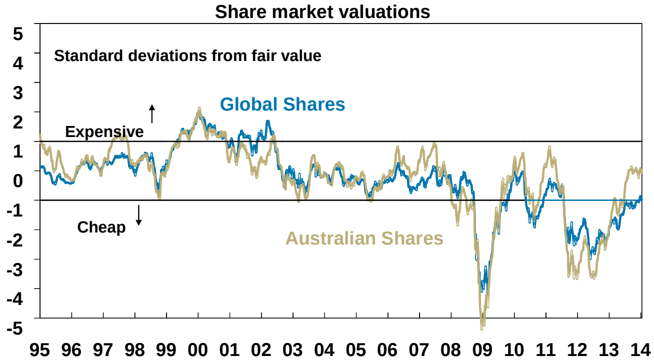
However, there are several risks factors at present.

- We are in the second year of the four year US Presidential Cycle and this historically sees below average returns from shares. This takes its lead from the view that the US President tries to stimulate the economy in year 3 of his term to help his party's re-election chances in year 4 but winds back the stimulus in years 1 and 2 resulting in below average returns those years.



Source: Bloomberg, AMP Capital

- Improving growth and Fed tapering will bring with it worries about a faster removal of US monetary stimulus.
- The rising trend in bond yields could occasionally pressure share markets and high yield sensitive sectors, like financials and utilities, in particular.
- Short-term investor sentiment is very bullish, which is bearish from a contrarian perspective. For example, the ratio of bullish to bearish investor newsletter writers in the US is at its highest since the mid-1980s.
- Finally, after two strong years, shares are no longer dirt cheap meaning the easy gains are behind us and we are now more dependent on rising earnings coming through.



Source: Bloomberg, AMP Capital

The rough start to the year in share markets has led to some concern about the so called January barometer that basically says that "as goes January for shares, so goes the year". This has heightened some of the above mentioned concerns.

A correction could occur, but…

Some or all of these factors could contribute to a correction this year and at the very least more volatility in share markets. While 2010 and 2011 saw roughly 15% and 20% top to bottom falls in shares around the middle of each year, in the last two years corrections were quite mild with a roughly 10% fall around May-June in each year, so maybe we are due for a bit more volatility. However, a new cyclical bear market in shares seems unlikely just yet:

First, the track record of the January barometer is mixed. For the US S&P 500 there have been 22 positive Januarys since 1980 of which 19 saw positive years, indicating an 86% hit rate. But the hit rate for negative Januarys (of which there were 12) going on to negative years was only 42%. Similarly for Australia, since 1980 there have been 20 positive Januarys for the All Ords index of which 15 saw positive years, giving a hit rate of 75%. But of the 14 negative Januarys since 1980 only 5 saw negative years resulting in a hit rate of 36%. So based on history if January is positive it augurs well for a positive year, but if January is negative it doesn't really tell us much at all.

Second, the US Presidential Cycle with respect to shares has been a bit messed up in recent times by the GFC and the Eurozone crisis. 2008 and 2011 were both meant to be good years but were far from it. And this year will actually see a let up in the pace of fiscal tightening in the US (and in Europe) which should be a boost for economic growth.

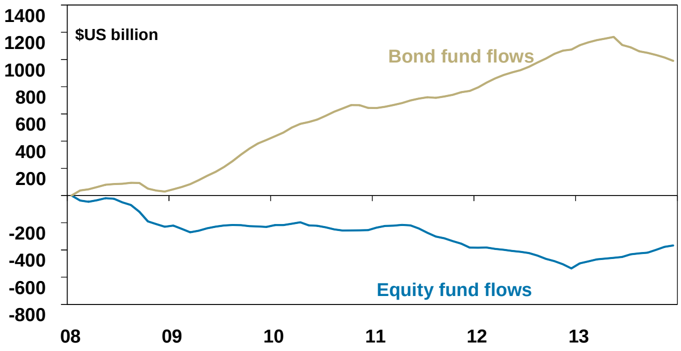
More fundamentally it's too early in the economic/investment cycle to expect a new bear market just yet. A typical cyclical bull market goes through three phases.

- Phase 1 is driven by an unwinding of very cheap valuations helped by very easy monetary conditions but with receding downside economic risks causing some investors to snap up undervalued shares. This is the phase where shares climb a "wall of worry" and investor sentiment moves from pessimism to scepticism.
- Phase 2 is driven by strengthening profits. This is the part of the cycle where optimism starts to creep in.
- Phase 3 sees euphoria with investors not only saying they are bullish but backing it up by pushing cash flows into shares to extremes. This is despite shares becoming expensive and central banks raising interest rates to combat inflation. But the combination of tightening monetary conditions, overvaluation and investor euphoria then set the scene for a new bear market.

Right now we are probably in Phase 2. Rising global growth and a pick-up in Australian growth through the year should drive stronger profits, and optimism regarding the global economic outlook and share markets has clearly returned. But we don't see the signs of vulnerability that become evident in Phase 3 as precursors to a new bear market:

- Inflation remains benign/monetary policy easy. Because of several years of below trend growth ample spare capacity has meant that inflation has been low. As a result even though the Fed may be starting to lighten its foot on the accelerator there is no sign of any monetary tightening/rate hikes in developed countries. The same applies in Australia. Despite higher than expected December quarter inflation, inflation remains benign and certainly not enough to trigger an RBA rate hike soon.
- Shares are no longer dirt cheap but they are not overvalued either. Price to earnings ratios are up but only to around long term average levels at 14.4 times in Australia (average is 14.1 since 1992), 15 in the US (average is 15.9 since 1992) and 14.1 for global shares (average is 16 since 1992). The gap between earnings yields and bond yields, a proxy for the excess return shares offer, remains well above pre GFC norms. This is all reflected in our valuations indicators (third chart above) which show markets around fair value.
- Finally, while short term sentiment measures towards shares are high, it's doubtful this is fully reflected in investor exposure towards shares. Investors started to warm towards shares last year but this likely has a long way to go given the mountain of money that built up in bond funds since the GFC. This is most clearly evident in US mutual funds. We seem a long way from the sort of investor euphoria normally seen at major market tops.

Cumulative net flows into US mutual funds



Source: ICI, AMP Capital

Of course there could be a shock from left field – the US, Europe or a policy mistake in China – but that is always the case and arguably the risks on those fronts are diminishing.

Further to go

This suggests that while shares might see a brief 10-15% correction at some point this year, a new bear market is unlikely and as such returns should remain favourable through the year as a whole. The next table shows the record of cyclical bull markets in Australian shares since 1894. I have applied the definition that a cyclical bull market is a rising trend in shares that ends when shares have a 20% or more fall that takes more than 12 months to be reversed.

Cyclical bull markets in Australian shares since 1894

Cyclical share bull market in Aust shares, All Ords index	Prior bear market % fall	Months after low to make new high	Total bull market, % gain	Duration in months
Mar 1894-Jun 14	-36	112	253	243
Dec 1916-Jul 29	-22	37	196	151
Aug 31-Mar 37	-46	38	168	68
Apr 42-May 51	-32	43	175	109
Dec 52-Sep 60	-34	62	146	93
Nov 60-Feb 64	-23	33	42	39
Jun 65-Jan 70	-20	25	120	55
Nov 71-Jan 73	-39	94	57	14
Sep 74-Aug 76	-59	59	101	23
Nov 76- Nov 80	-23	21	173	48
Jul 82—Sep 87	-41	17	421	62
Nov 87-Aug 89	-50	75	55	21
Jan 91-Feb 94	-32	30	94	37
Feb 95-Mar 02	-22	20	89	85
Mar 03-Nov 07	-22	15	156	56
Mar 09-Apr 2011	-55	NA	63	25
Avg from 1894	**-35**	**45**	**144**	**71**
Avg from 1950	**-35**	**41**	**126**	**47**
Sep 2011-?	-22	?	37?	28?

Source: ASX, Bloomberg, AMP Capital

A typical cyclical bull market since 1950 has seen shares rise 126% (column 4) and last four years (column 5). So far we are up 37% over 28 months. So history suggests more to go.

Concluding comments

While this year might be a bit more volatile, the cyclical bull market in shares likely has further to run reflecting the absence of monetary tightening, reasonable valuations and a lack of the sort of investor euphoria that characterises major market tops. When share investing becomes a common topic at barbeques and in taxi rides I will get more concerned!

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