Bear it out: hope on the horizon as growls get softer

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Once the final selloff occurs, there is a real chance shares can begin a multi-year recovery, writes Matthew Kidman.

The thing that kills most people in bear markets is time. They just take so long to play out, causing the deflated participants to give up and walk away. Hope-filled rallies are dashed by another gut-wrenching fall. As Al Pacino said in *Godfather: Part III*, "Just when I thought I was out, they pull me back in." This scenario played out again recently as the gradual gains notched up in the first quarter evaporated in a matter of weeks. We are now just shy of five years in a bear market in which the benchmark All Ordinaries Index has declined 40 per cent.

So what does the road map from here look like? Predictions are fraught with danger because they are invariably wrong, but worth a shot regardless. It is my belief that we are entering the final stages of the third major secular bear market to hit the Australian sharemarket in 45 years. Despite the pall of gloom emanating from the big engines in the northern hemisphere, there are road signs popping up that give us hope things are not far away from getting better. If proven correct, these would dovetail nicely with historical events.

For the record, I believe the next six to eight months will be a turbulent period. The collapse in global markets since the beginning of this month is the first sharp leg down in a market that will not hit the bottom until late this year or early next year. This year's decline will be punctuated by rallies that are short and uninspiring. The first of these is not too far away given sentiment is floundering. Since the global financial crisis in 2008, the best time to buy shares has been when the All Ordinaries Index has fallen below 4000 and it should be the case again.

Turning points in sharemarkets are characterised by V-shaped bottoms with a nasty selloff at the death. We have not reached this point yet. The end of a bear market should also see company valuations crunched, and while the market is historically cheap, it is not at historical lows.

Once this final selloff takes place, there is a real chance the market can begin a big multi-year recovery, with the old high of 6873 recorded on November 1, 2007, taken out in 2015 or 2016.

With all the negative news around the globe and at home, how can the sharemarket possibly start to recover in such a short period of time? There are several positive shoots appearing.

At the top of the list is a reduction in official interest rates. The Reserve Bank of Australia has been reluctant to reduce rates, but eventually pulled the trigger earlier this month and hopefully will continue to do so for the remainder of the year. A reduction of at least 50 basis points would be a huge stimulant for economic activity next year and in 2014.

The second indication we might be limping towards the end of the bear market is the very real prospect the mining boom is ending. Hard commodity prices are traditionally late cycle plays and tend to be the last shoe to drop. The ASX Materials Index peaked in April last year, after rising 253 per cent from 2003 when the boom took hold. Since then, it has fallen about 35 per cent. Like all bear markets, the rate of decline is accelerating as it matures. I would expect this trend to continue for some months, with more companies going broke and only the best-funded and lowest-cost producers surviving. Ironically, lower commodity and particularly lower energy costs are a boon for the West. As the Credit Suisse strategist Atul Lele puts it, significantly lower oil and gas prices might just be the "productivity shock" that kick starts global growth again.

Third, investors are racing towards high-yielding and defensive stocks such as Telstra, Tatts, CCL and Woolworths. These companies are becoming expensive, with people forgetting equities have a capital risk. This will become a crowded trade, with the realisation Telstra remains a low-growth company with a treacherous service record. Investors will look elsewhere for superior growth as the economy finds it feet next year and through 2014.

Finally, the secular bear market is 4½ years old. The previous two major bear markets in the past 45 years took five years from top to bottom. The Australian market peaked in 1969 and bottomed out in September 1974. It took about another four years to breach the previous record. Similarly, in 1987, the sharemarket crashed, losing 49 per cent in just four months. It did not gain any traction until November 1992, staging a 60 per cent rally over 14 months. It was not until 1995, though, that a record high was set.

The rally that kicks off later this year or early next year might just stick this time around, and those still in the game could enjoy tremendous gains.

This scenario might be too rosy for many who only see gloom on the horizon. This is understandable given most of us are gun-shy. However, history tells us that at some stage, the bear crawls back into its cave.

matthewjkidman@gmail.com