Hillross Market update

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It's not the GFC Mark II

Fear has once again gripped financial markets, with global share markets falling by approximately 10% over the first 3 weeks of May, most of this loss occurring over the past three days. The sell-off appears to be a culmination of escalating concerns over the management of Government debt in Greece and the risk that Greece, or other heavily indebted European Governments, default on their loans. If there was default, or a widespread expectation of default, the banks who lent money to these Governments (by buying Government bonds for example), would experience losses in the value of their assets. This would then force these banks to scale back other lending to preserve capital. Doubts could be created over the solvency of these banks.

As was shown during the Global Financial Crisis (GFC), if there is a loss of confidence in the financial system, credit markets can dry up rapidly and the global economy cannot function normally without an ongoing supply of credit.

Fear over fundamentals

For investors, the sell-off has brought back fresh memories of the GFC. As was shown in the GFC, fear driven share markets can fall to illogically low levels of valuation. The current fall on share markets does appear to be essentially a fear driven event. Unlike the GFC when the banking system almost ground to a halt and corporations experienced a shut down of loan financing, the link between company earnings and the Greece debt crisis that has triggered this fear seems highly remote.

In economic terms, Greece is a small country. The size of the Greek economy (and others in Europe with similar debt profiles) is dwarfed by the economic super powers such as the United States, Japan and China. The size of the EU relative to the size of the problem debt suggests probability is on the side of the debt problem being managed with limited contagion. To put this in perspective, the size of Greek Government debt is approximately 2.6% of the size of the value of annual production in the European Union. Faced with the choice of offering further assistance to Greece or risk a systematic breakdown of the European financial system, authorities in Europe have opted for the former.

However, despite the fact that the European debt crisis appears highly likely to be contained, share markets have been dominated by selling pressures. This fear driven selling appears to have pushed share price valuations back into the "cheap" zone.

Australian shares now at a discount

It could be argued that the spotlight placed on European debt will force all heavily indebted nations, including the United States, to take measures to reduce debt earlier than otherwise would be expected. The action to reduce debt (via raising taxes or cutting Government expenditure), could detract from economic growth. However, with the Australian Government already well on a path to turning around its small deficit to surplus, no such danger exists here.

Despite the lack of debt driven constraints on economic growth in Australia (and indeed our major trading partners in Asia), the Australian share market has fallen further than many international markets in recent days and the All Ords Index is currently around 4,200. International investors appear to have exited commodity linked currencies and markets. The $A has also been sold off heavily as a result, falling from U.S. 90.1 cents to 81.3 cents over the past week.

The combination of a lower $A and falling share prices appears to have created particularly good value on the Australian share market. Whilst the earnings outlook of the resource sector has been impacted by weaker commodity prices, much of this has been neutralised by the lower currency. The lower $A has also improved the prospects of other non resource exporters, as well as those competing with imports.

Dividend yields on the Australian share market have increased to around 4.2%, suggesting that when franking credits are taken into account, yields are back above prevailing cash interest rates. The price to earnings ratio of the Australian market has dropped to 13.7 times, now well below the longer term average of 15 times. Both these valuation indicators suggest very attractive buying opportunities exist, providing the economic environment remains favourable.

As the GFC experience showed however, buying when others are fearful requires some bravery and also a capacity to withstand ongoing volatility. As was also the case in the post GFC period though, fortune can ultimately favour the brave. Not panicking, sticking to your long term wealth strategy, while sensibly taking advantage of buying opportunities remains the right approach for investors.

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