

## Should I stay or should I go?

### Dealing with the sub-prime market volatility

Global equity markets are reeling from the impact of the sub-prime mortgage crisis. The S&P500 has fallen 14% since October and 8.3% so far in January. These falls have been matched in Australia - the S&P/ASX 300 has lost 15% since the end of October.

American banks are announcing multi-billion dollar losses and several key US economic indicators have turned alarmingly weak. A growing chorus of market economists are talking up the prospects for a US and perhaps global recession this year.

Many investors will be viewing these events with a growing sense of dread, with some wondering if there is still time to head for the exit before things get even worse.

Our view at Russell is that periods of volatility are an inevitable part of investing and that investors should remain focused on their long-term plans. Investors should take comfort from attractive equity market valuations and the prospect for further aggressive US monetary easing.

### Volatility is a normal part of equity market upswings

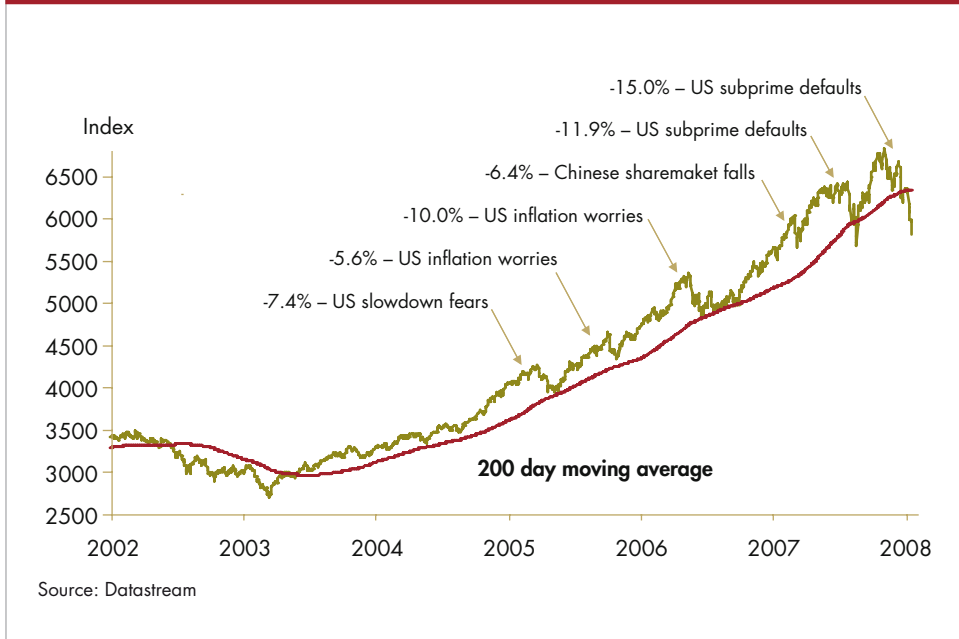
The global equity bull market is now entering its sixth year. Australian shares have returned 160% since the end of 2002. The current episode is the sixth and largest pull-back in the current upswing. The S&P/ASX 300 was clearly overbought in late October when it rose to 10% above its 200 day moving average. At 10% below the 200 day average, it now looks oversold.

### More volatility is possible

Markets trade on cycles of fear and greed and right now fear is in the ascendency. More talk of recession and more rumours of large sub-prime losses could easily trigger another wave of fear based selling. Equally, decisive action by the Fed and confidence that sub-prime losses have been accounted for could see markets rebound.

*"Investors should take comfort from attractive equity market valuations and the prospect for further aggressive US monetary easing."*

CHART 1 | S&P / ASX 300



Source: Datastream

### Equity market valuations are attractive

The price to earnings (PE) ratio based on the one-year ahead expected earnings of stockbroking analysts for the S&P500 stands at 13.2 times - the lowest since 1995 and well below the 23 times at the peak of the Internet bubble. Australian shares are now on a forward PE ratio of 13.5 times and a 4% dividend yield. The company earnings estimates these PE ratios are based on could be revised lower in coming months, but the low level of PE ratios suggests that a lot of earnings pessimism has already been priced in.

### Recession fears are overdone

US economic growth is almost certain to slow over the first half of the year and the economy may come close to contracting. But there is good reason for confidence that the US economy can rebound through the second half of the year. Outside of the banking sector, corporations are generally in good shape

with low debt levels and strong profit margins. There is little evidence of excess capacity or over-investment outside of housing. The trade-weighted US\$ has fallen 25% from its peak, boosting export competitiveness and the thirty percent of US corporate profits earned offshore. The 100bp of monetary easing so far should start to kick-in through the second half of the year and the Fed has signalled that further monetary easing is likely in coming months.

### Investment success is about sticking to a long-term plan

Investors do the most harm to their long-term wealth generation when they chase market performance; that is, chasing into investments after they have generated large returns and chasing out of investments after an inevitable period of losses.

### The probabilities favour long-term disciplined investing

The S&P/ASX 300 returned 13.9% per annum over the past 10-years. But an investor who missed out on the best 15 trading days (out of over 2,500) saw their annual return reduced by over 4% to 9.5%. Most of these "best" days occurred during periods of volatility.

### Summary

Predicting the near term direction of markets is a task even the most skilled investors find difficult. In times like now, it helps to step back from the market drama and look at the longer term fundamentals. These suggest that equity market valuations are attractive and nowhere near levels that have previously triggered prolonged market downturns. There is lots of uncertainty about the economic consequences of the sub-prime mortgage crisis, but there is already significant Fed easing in the pipeline and the prospect of more to come.

Investors are understandably nervous about the possibility of further market declines, but global market valuations were not excessive heading into this episode. Disciplined investors should think about sticking to their long-term plan, staying diversified and looking past short term market distractions.