Australian Market Phase Analysis
Bull Market Phase One: Reviving Confidence

Completed for this cycle and will not be further updated

The analysis in this file is in terms of my investment plan. Readers need to assess the relevance of anything in this document to their investment plan, seeking advice from a licensed adviser if unable to make their own assessment of the material.

This document is an example to teach the way I think about investing. In doing so, I am neither making nor implying any investment advice. My thinking about my own strategy should not therefore be seen as making or implying any recommendation for any reader to take, or not take, any action with regard to their investment plan.

Navigation

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by clicking this icon at the left of the screen:

The document is a PDF file, which allows you to use the zooming tool in Adobe Reader to enlarge detail in the charts.

Terms and acronyms used in this document

See the ***Glossary*** page on the ***Free Resources*** menu for definitions.

If I use a term or acronym that is not in the Glossary, please email me for an explanation and I will add it to the Glossary page.

This phase of the bull market cycle began in the first half of 2009 and all of the phase markers were in place by the end of 2009. This means that the charts shown in this document stop at the end of 2009. For updated charts see the other phases, where that marker is relevant, or in the *Charts of Fundamental Data* on the *Charts and Data* page on the *Building Wealth Resources* menu.

News about the economy and market tends to be negative

This is a marker for the phase that many inexperienced investors find confusing. We will have just passed through a bear market, which may be mild or severe. In 2009 we were emerging from one of the few really severe bear markets that each of us might normally experience in a lifetime. The previous severe bear markets in my investing lifetime were in 1974 and 1987. In all bear markets, but especially in the severe ones, at the bottom of the decline the general investing public will be in a state of shock, lacking understanding of what has happened and very afraid for their wealth.

This is not the case though for professional investment managers and more experienced private investors who recognise that bear markets are gifts that only come around infrequently. They are unusually attractive buying opportunities because sound stocks will have been sold down to very low prices in the bear market, driven by fear rather than cold analysis. These investors do not invest on the news of the day, they buy based on their expectations of recovery to more normal conditions and realistic pricing of stocks based on rational analysis rather than fear. The news around them does not have to be good, in fact it will still be driven by fear and uncertainty, but they know that normality if not far away.

This is a case of savvy investors being able to act contrary to the general views of the public around them. News today is about what has happened or is happening; it is rarely about the future. Yet their view of the future is what should and does drive their investment decisions. It does not require an early return to boom conditions, which is unlikely, just a return to normality.

This is therefore one of the more difficult phase markers to grasp. However, by understanding it we can act to our great advantage by buying when prices have been driven down to very low levels, in short an opportunity that does not come around very often. The key is being able to ignore the stock price trend and assess the price of each stock against the perceived value of its business. This is value investing. Technical analysis is of little help with value investing, being a tool better suited to momentum trading. Though a trend change may give us confidence, only fundamental analysis of the business can enable us to assess value, which we can then use to compare to price. We buy sound stocks whose price is at a significant discount to perceived value of the business.

The key to this phase marker is to see the bear market as presenting an opportunity and grasping it. We may not be buying right at the bottom (my strategy is to start buying before the bottom in the last part of the bear market – distress selling), but we should be buying at unusually low prices. Waiting for the recovery to be obvious to everyone is to miss the opportunity.

The market is anticipating a recovery

"The market" here is what the weight of money is doing. For individual stocks, it is their share price. For the market in aggregate it is the price index for the market. If the weight of money is expecting a recovery, then a greater weight of money will be buying than selling and prices of stocks will be rising.

So, to know what the weight of money, the "market", is expecting we look at a broad index of the market. In Australia, I use the broadest index, the ASX All Ordinaries index, but the ASX 200 or ASX300 will give a similar picture. The chart of the index below shows that there was a final spike down in March 2009 (on low volume

indicating that the weight of selling had been done) and after that a rally began. As the weeks went on, the index never came back into the range of the two weekly bars at the bottom and moved steadily higher, which can only happen if the weight of money is expecting a recovery:

Notice also that this upward move has clearly exceeded the last peak formed in the bear market (marked A on the chart), which move was one of the technical analysis definitions for the end of a bear market and change to a bull market.

The rise was thought to be another bear market rally

As is always the case after a bear market decline, most private investors were traumatised and confused about what had happened. More importantly, the inexperienced mass of private investors will have seen earlier rallies in the bear market and been trapped into buying, only to learn that they were bear market rallies, not the start of a bull market. This was strongly the case at the time; fear that the rise was only another bear market rally.

Of course, one can never be absolutely certain that it is not a bear market rally. If it was certain and obvious to all, then it would not be an opportunity because everyone would be in there buying with all the capital they had left. The reality is that we can never know for sure, but that is why we have a series of markers for this phase of a bull market. If all or most of the markers start to line up, we can buy with more confidence.

The other fact that may have helped our confidence in buying at this time was to have studied history. In 115 years we had never seen a bear market fall more than 40-50% from the top in Australia. Yes, there are examples in other markets such as the US in 1929-32 and Japan in 1990-2003, but not in our market since 1900. Of course, it could happen, but if we think that the price of the average stock had fallen 40-50% and the underlying business was still sound, the odds favoured grasping the opportunity that may not come around again for a decade or more. My approach is not to invest everything back into the market at this time, but 20 to 40% of capital spread across say 15 stocks would not be a big risk and the odds favoured it being a great opportunity to buy some great stocks at bargain basement prices.

I think that it is easier for me to deal in these situations because I have been investing for 50 years and seen it all before. Also, I have read and continue to read widely on the history of stock markets. Having read about it in many different booms and busts in many countries from the 1600's onward, it is easier to be able to see

what is happening at the time in a wider context. I often talk about the need for experience, which takes many years to accumulate up, but reading and study of history can widen and deepen our experience and speed up the path to a sound understanding of how bull and bear market cycles unfold. My phase markers are based on a combination of my reading, study, contemplation and experience.

Disbelief that the rally is the start of a bull market turns to fear of missing out

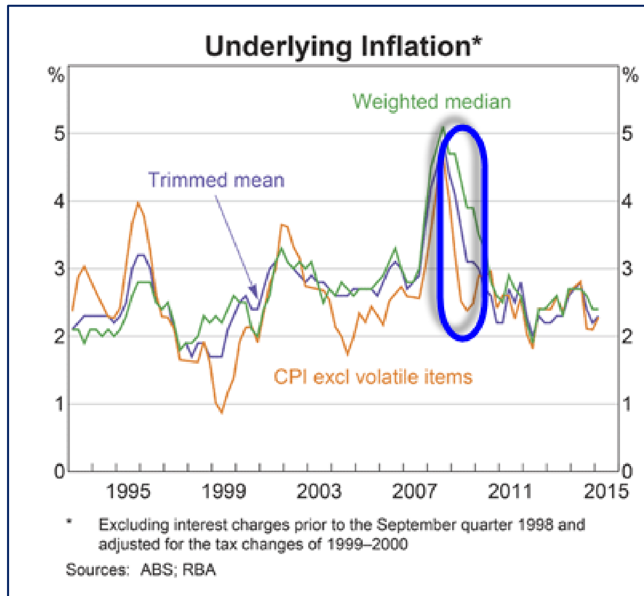
As 2009 wore on and the market continued rising, there was a great deal of comment about the likelihood of a “double-dip recession”. This was interesting when we consider that Australia had not experienced a recession to that point, so how could a non-event have another dip to it? I think that this strange phrase was actually an expression of the expectation that there would be a re-testing of the bear market low. This was also a continuation of the fear that the rise was only a bear market rally. The black dashed arrow on the chart below shows my interpretation of the expectation in mid-2009:

Instead, there was a moderate correction and then a strong rise indicating fear of missing out, which is especially the case among professional investment managers; the red arrow on the chart above. Notice how steep and uninterrupted the rise was from the bottom of the correction in July 2009. This is buying driven by a fear of missing out in action.

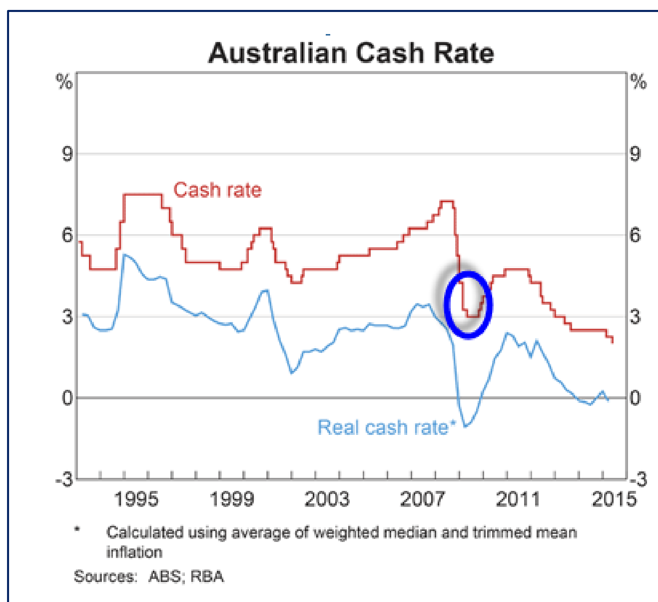
The idea of the fear of missing out needs further explanation. At this time, the great mass of largely uneducated and inexperienced private investors was generally not doing the buying. Observation at the time was that they were still heavily in cash, later substantiated by returns from self-managed superannuation funds as reported by the Australian Taxation Office. I believe that the weight of money in the market that was causing the rise was experienced and savvy private investors and mainly professional fund managers. The big problem for a professional manager of money is that if their fund is too heavily in cash and not performing relative to funds that were more fully invested, then funds would be taken from them and given to better-performing managers. This is where the fear of missing out gets its prime momentum.

Inflation and interest rates relatively low

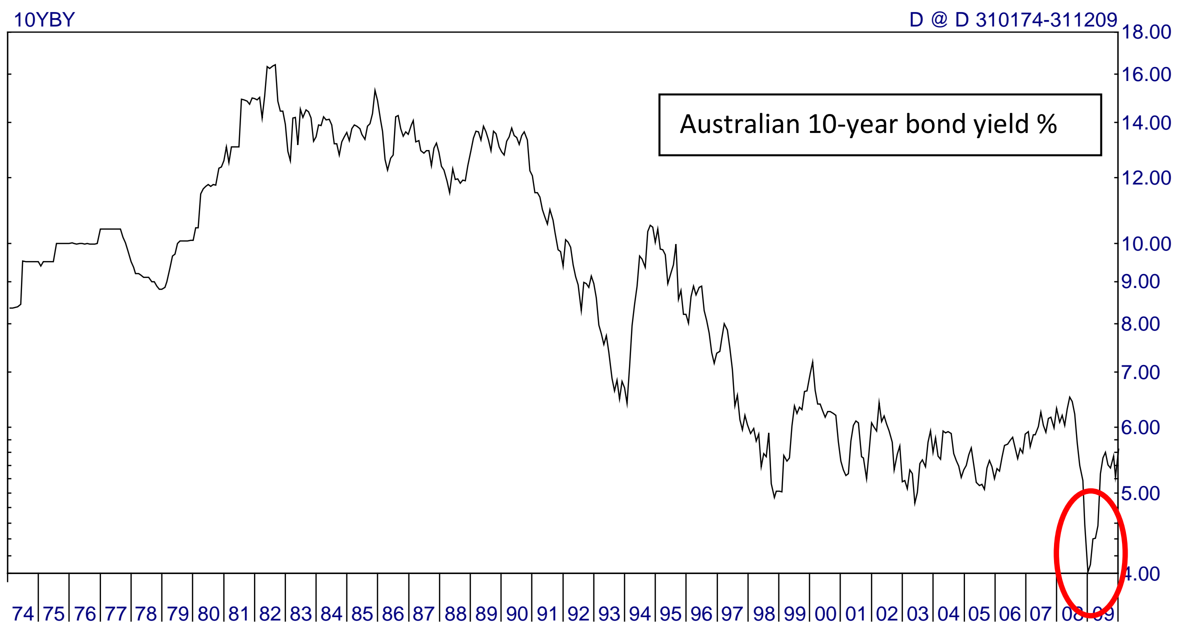
Interest rates had been driven up by the Reserve Bank to control the rate of inflation, which had risen strongly towards the end of the boom. As the rate of inflation fell sharply in 2008-2009, interest rates had been reduced as the rate of inflation fell back into the Reserve Bank's target range of 2 to 3%:



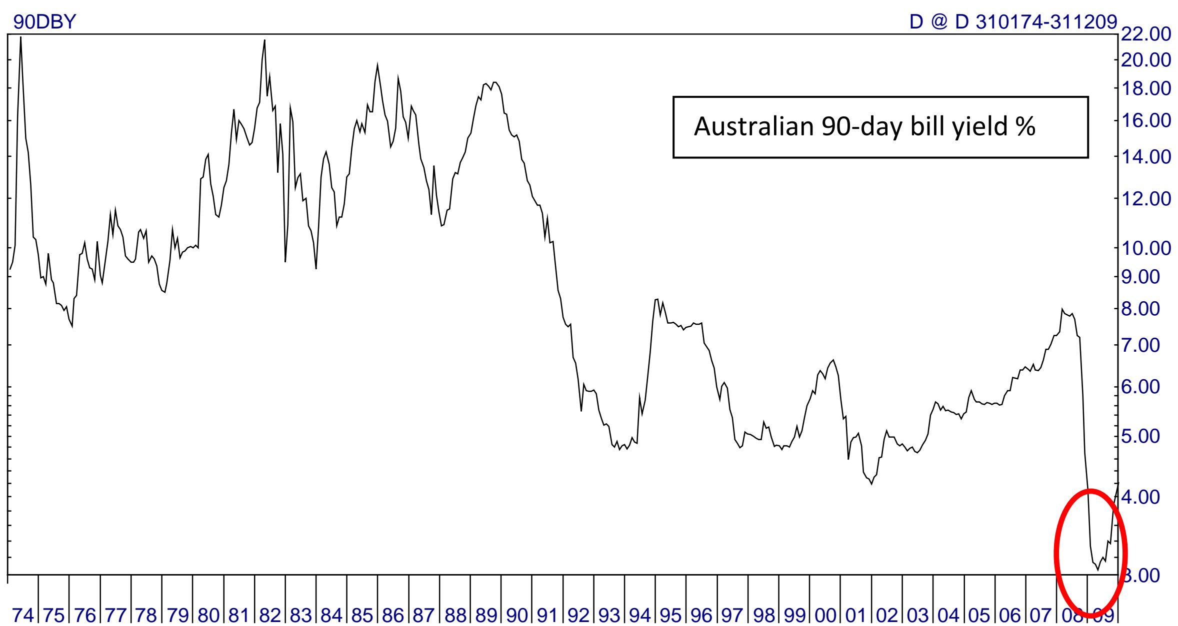
It can be seen that by mid-2009, the Reserve Bank had reduced the official cash rate from 6.5% to 3%. That rate was the lowest it had been for many years and after inflation, the before-tax yield on the cash rate, which is closely tracked by the 90-day bill yield, was negative:



I keep a chart of the 10-year bond yield, regarded as the risk-free rate and it showed in 2008-9 that the risk free yield had fallen to the lowest it had been since before my data in 1974:



The same observation is evidendt on the 90-day bill yield chart that I maintain:



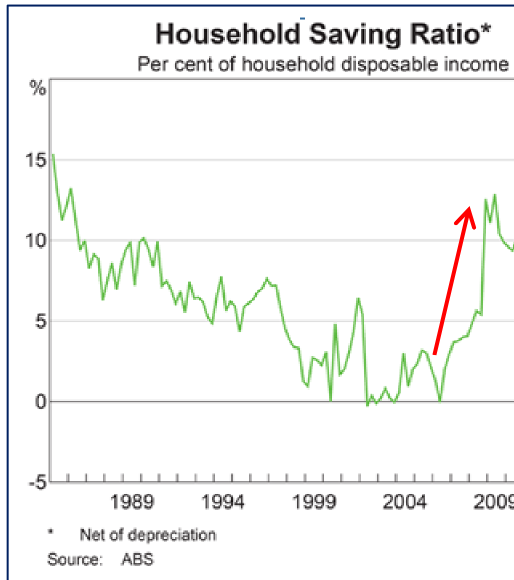
These charts of the 10-year bond rate and 90-day bill rate are updated monthly on the members website on the Charts and Data page.

Generalising from these charts, we can see that interest rates fell sharply to a very low level and then rose through 2009, but to a still historically low level.

Household savings ratio still high

When the economy is strong, with rising incomes and rising asset values, households tend to spend strongly and to save very little. However, when there is a financial crisis, leading to a bear market, we have falling asset values and there is real fear in the community for the security of employment. This is a time when households save more. They pay off credit cards and other consumer debts, pay their mortgages in advance using offset

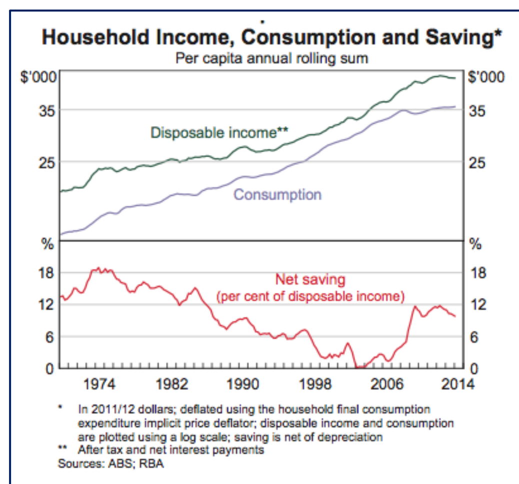
accounts and cut back spending on non-essential items and services. This is reflected in the household savings ratio:



As this chart shows, the household savings ratio had fallen steadily through the good years in the early 1980's, risen after the 1987 crash and then fallen steadily to zero through the boom years of the 1990's. The end of the tech boom saw some upward spikes, but the 2003-2007 bull market saw it fall to zero again. The financial crisis of 2008 and the bear market of 2008-2009 saw the household savings ratio soar to over 12% and hover above 10%.

I am often asked whether compulsory superannuation is included in the savings ratio and was therefore the cause of the rise in the ratio. Compulsory super is included in the household savings ratio. However, it is easy to explain that compulsory superannuation played very little part in the rise in 2008-2009. This is because the compulsory superannuation rate was steady at 9% from 2002 to 2013. Thus, the increase in the household savings ratio in 2007 – 2009 was not attributable to an increase in compulsory superannuation. I believe it was almost entirely due to falling asset values so people felt less rich and to fear and insecurity about the situation looking forward.

Net Household Saving is defined as the Total Disposable Income of Households less Total Consumption of Households. This Reserve Bank graph shows the relationship:



Private investors largely absent from the market

During 2009 there were many media reports about private investors being heavily in cash. They were frightened about the future for the economy, world events and fear of the stock market itself. As the self-managed superannuation fund returns came in, this was later confirmed by the compiled statistics from the Australian Taxation Office.

This fear and loathing for stocks is normal after all bear markets, but is extreme after the really big bear markets like 1974, 1987 and 2008. Many people will never go back into stocks after they have sustained large losses on speculative stocks in these severe bear markets. It usually takes quite a few years before many private investors venture back. It needs time for the memories to fade, and for a new bull market to have been running for several years before the greed impulse overtakes that of fear. That and a new crop of beginners who have not been in the market before and who think investing and speculating in stocks to be easy.

Writing in 2015, we can see that interest rates have fallen so low that more private investors are venturing back earlier than usual, driven by the need for income. This has created a boom in bank stocks, Telstra and other high-yielding securities, often by inexperienced investors who are largely ignorant of the basic rule that high yield is an indication of high risk.

The market may start to ignore bad news

We cannot use any statistics here. We have to rely on observation of what is happening.

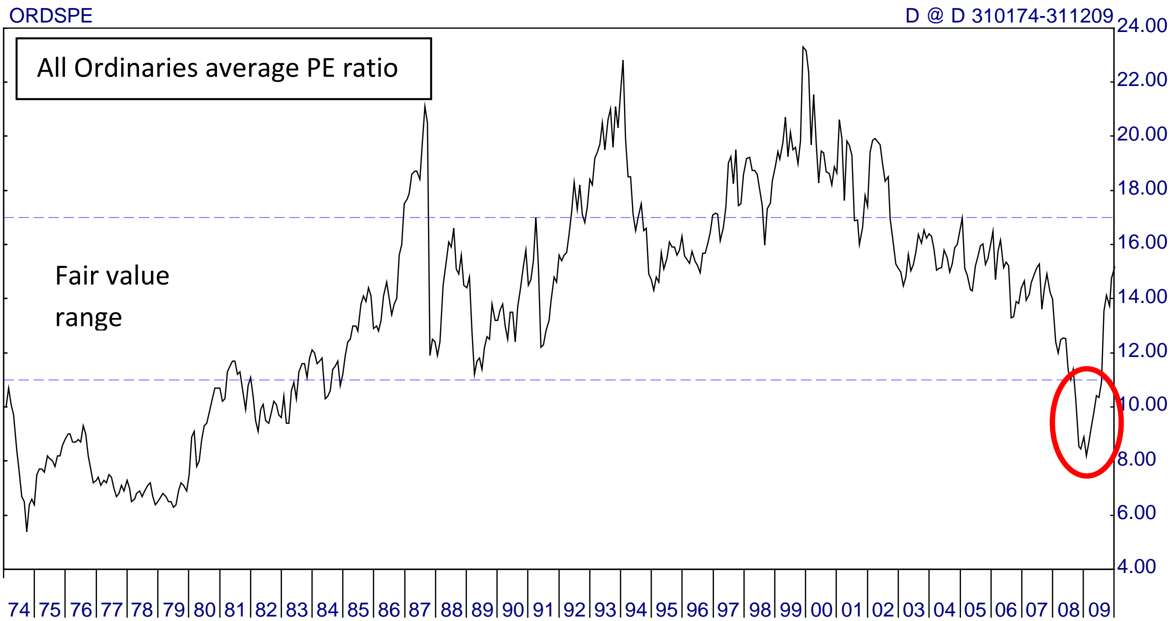
During the financial crisis and bear market 2008-2009 there was a flood of bad economic and political news from around the world and in Australia. Most stocks fell sharply in price. Many former high-flying and high risk companies failed. Two smaller banks failed in Australia and were taken over by big-four banks. Banks, many major ones and large US mortgage insurers failed all around the world and were rescued by governments, often wiping out the shareholders, with governments becoming the owners. So, the bad news was economic, political and financial. It did not matter what the bad news was, either general or stock-specific, stock markets fell and kept falling.

Once we were past to crisis by early 2009, our market began to largely ignore general bad news. If there was bad news about a stock, it might fall in price and maybe similar businesses also fell in price, but the market overall did not react as it had in 2008.

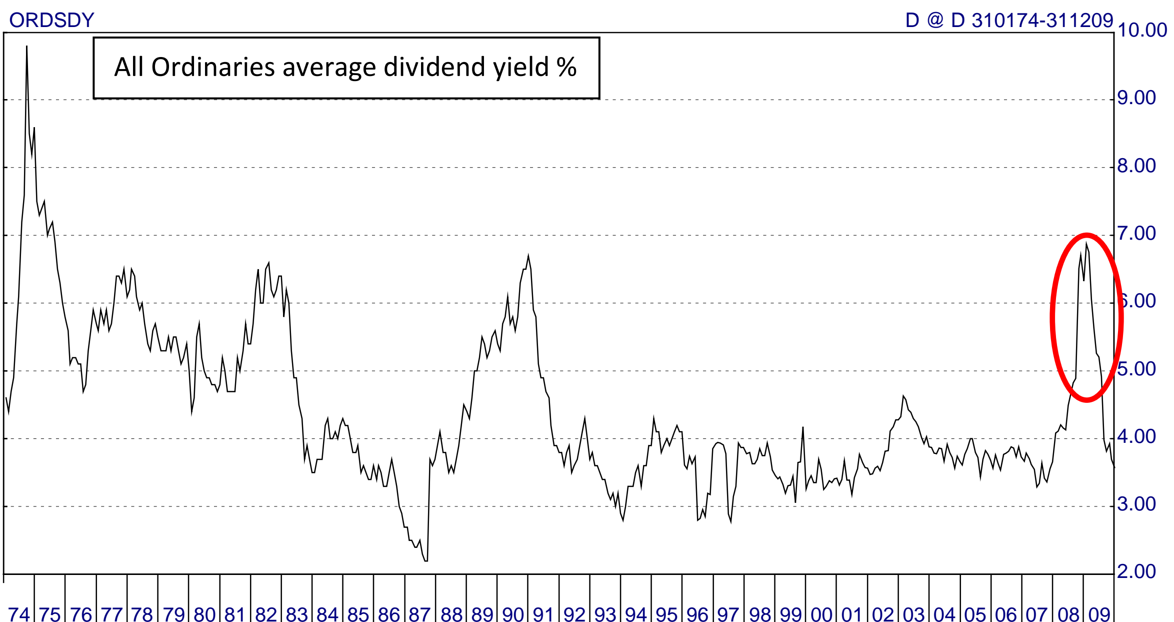
The market is fundamentally undervalued

The best easily available measures are the market average price earnings ratio and dividend yield. I also maintain charts of these market statistics and update them monthly on the members website on the Charts of Fundamental Data page.

The chart below shows that the average PE ratio for the All Ordinaries index had fallen to a level last seen in the 1970's and early 1980s:



The average dividend yield for the All Ordinaries index had likewise risen to a level last seen in the early 1990s:

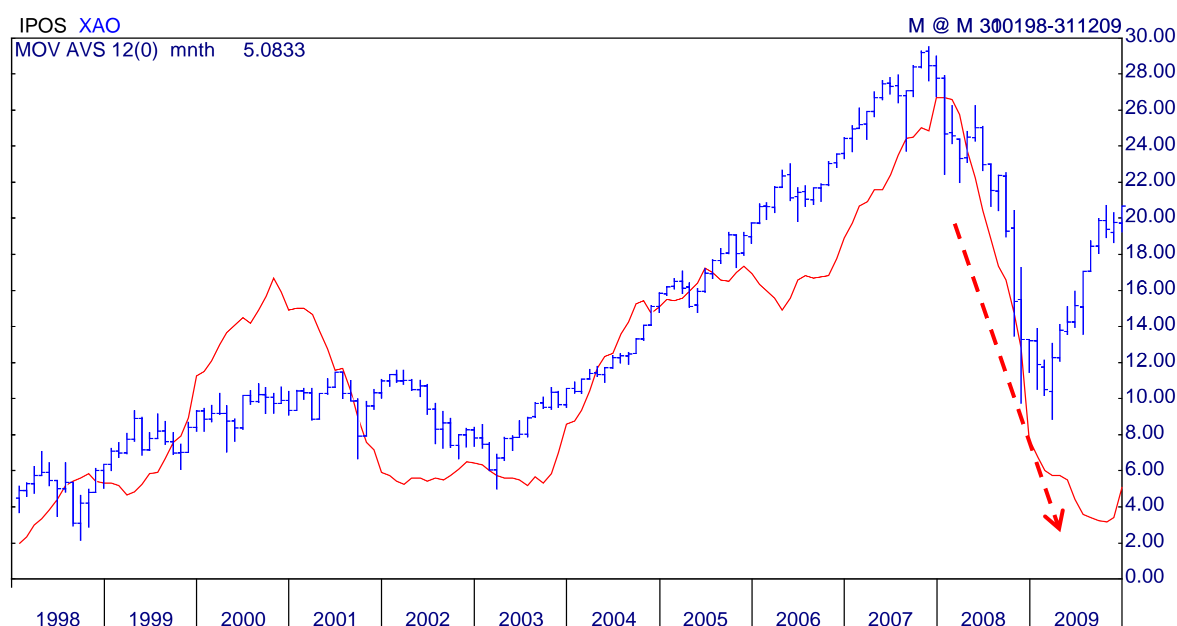


Clearly, at the bottom of the bear market, there was an opportunity that only comes around infrequently after severe bear markets to buy the shares of great companies at very low prices relative to value. Of course, this is never easy to do if we are focussed only on the trend of prices of stocks as speculative traders instead of comparing the price to the value of the business that underlies the stock, as an owner would do i.e. an investor. I have found that although PE ratios and dividend yields are arguably poor measures of value to purist analysts, they are very useful crude tool providing an indication of value, rather than price trends alone. Remember that price is very volatile relative to value, which changes very slowly.

Very few companies being floated (IPOs)

Over the last sixteen years I have been collecting the number of ASX Initial Public Offerings (IPOs) each month. It might arguably be better to use the total value of capital raised, but this is not easy to collect and does require more adjustment for inflation and other factors. However, the number of IPOs is easy to collect and I think this statistic can show what I am looking for here.

When I first collected the data, I plotted the number of IPOs each month and found that it did not tell me much because there were big spikes in the number of IPOs in May/June and November/December each year, which is just before the annual and half-year accounting periods begin. To remove this seasonality from the data, I plot the 12-month simple moving average of the number of IPOs, which gives the relatively smooth curve shown as a red line on the chart below. I update this chart every month on the members website on the Charts of Fundamental Data page.



The moving average of IPOs signals the "heat" in the market from the raising of new capital. Through 2008 the number of IPOs had plunged as the flow of IPOs dried up almost completely.

Enquiries into what went wrong

The worse the financial crisis and associated bear market, the more likely there will be for a huge hue and cry for enquiries into what went wrong. This is always a greater demand when private investors have lost money in company failures and fraud or outright crime is involved.

This time was one of those crises and busts that led to several enquiries, locally and internationally, leading to changes in laws or regulations and to criminal prosecutions.

Regulation is tightened

Out of the enquiries, many levels of regulation were tightened. This happened fairly quickly, though it is still an ongoing process in banking and financial advice in particular. This happens every time and it tends to choke off any nascent speculation. However, history shows that when political and

economic times are right and people have forgotten the pain, there will be pressure to relax the regulations and new ways will be found to get around the regulatory restrictions.

General Conclusion

Since I am seeing that every one of the markers for this phase have been in place since the end of 2009, my analysis is that we are now well past this phase of a bull market. *The document will therefore not be further updated and remains as a record of my analysis at the time, which is a teaching tool for analysing market phase.*

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