FINANCIAL REVIEW

Times are bad but don't hit panic button

PUBLISHED: 01 OCT 2011 00:10:21 | UPDATED: 01 OCT 2011 05:05:42

The stockmarket is performing worse than in the Great Depression.

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Most economists will say that the crisis gripping the world today is not as bad as the Great Depression, but the market is telling quite a different story.

The accompanying graph shows an Australian sharemarket performance worse than 80 years ago.

The ASX All Ordinaries has fallen about 35 per cent over the past four years and that is about 14 per cent worse than the performance of the Commercial and Industrial Index (the predecessor to the All Ordinaries) four years after it peaked in 1929, according to a chart compiled by Adrian Blundell-Wignall, a deputy director at the Organisation for Economic Co-operation and Development in Paris.

While there is a real risk the global economy will sink back into a second global financial crisis if Europe is unable to contain the sovereign debt contagion, few would argue with the proposition that our economy is much better placed this time to deal with the fallout than it was in the 1930s.

Could current prices just be a mispricing of undervalued assets that could be exploited by the astute investor, or are they a harbinger of a dire outcome waiting around the corner?

"One thing the chart doesn't tell you is how overvalued the Australian market was back in 1929," says Morgan Stanley Smith Barney financial adviser James Dakin.

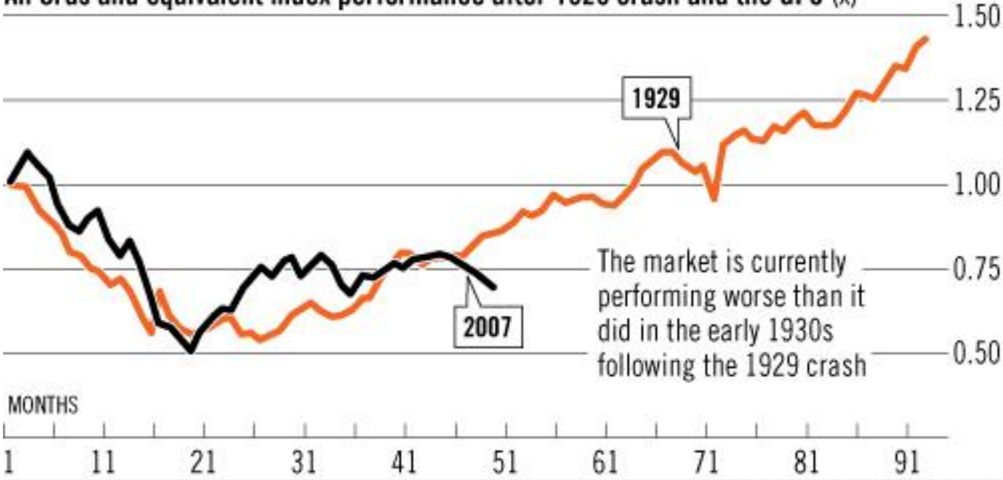
"The other point is the world wasn't so interconnected back in the early '30s. In this globalised world, as soon as something happens overseas, it impacts our market."

With these caveats in mind, Dakin believes that Australian equities are very cheap and that investors are overestimating the risks facing the market.

He compares shares today with what he saw happen to investment-grade corporate bonds in late 2008 as the market was pricing defaults to be worst than during the Great Depression. He believes the pessimism is too extreme and is advising clients to go overweight on these bonds, which have rallied strongly since.

Looks depressing

All Ords and equivalent index performance after 1929 crash and the GFC (x)



SOURCE: ADRIAN BLUNDELL-WIGNALL

It is probable that Australian equities will generate total returns of about 13 per cent a year over the next seven to 10 years, according to Morgan Stanley Smith Barney's estimates.

This compares favourably with the 5 per cent expected average return from cash and term deposits.

However, now may not be the time to go overweight on equities as investors could be better off sitting on their hands for the time being.

"You've got serious macro issues where the downside risks are larger than normal because this is not a cyclical recovery but a structural issue," Dakin says.

"Therefore, if policymakers make the wrong moves, then they can exacerbate the problem."

There is also an issue with market sentiment, and while the market is cheap, it could still fall further if the bad news continues to flow out of Europe.

"We haven't seen 'peak fear' and the optimum time to buy is at that point," Dakin says.

"Unfortunately you don't know 'peak fear' until after the event, but I don't believe we have hit that yet."

There is another reason why investors may be better off waiting on the sidelines and it has nothing to do with Europe.

There is growing evidence that Australia’s most important trading partner, China, is coming in for a hard landing.

“We are cautious on China and less optimistic than most because there is a credit bubble and it’s becoming unstuck,” says the managing director of Platinum Asset Management, Kerr Neilson.

“That will hurt us. While our exports of raw materials may not diminish greatly, the prices they fetch could fall quite a lot.”

Chinese bond and equity markets also appear to be pointing to a sharp slowdown in the residential property market – a sector that contributes significantly to China’s gross domestic product.

The Australian Financial Review