Prospects are good for a fourth leg to bull market in shares

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Investors and dividends. *Source:* TheAustralian

SINCE their extremely depressed levels in March 2009, average share prices in advanced countries have moved strongly higher. They've followed the direction, but not matched the extent, of the lead from the US, where average share prices have about trebled.

To understand why sharemarkets have rebounded so well — and to gain a better view of what investors can next expect — it's useful to break up the uplift in share prices in the past 5½ years into its three main phases.

The first stage came when investors felt central banks and governments had done enough to avoid the financial crisis morphing into a worldwide depression. Then shares were boosted by the cyclic rebound in profits — particularly powerful in the US. In 2012 and 2013, average valuations of shares pushed higher, mainly because of market perceptions the major central banks would persist with their ultra-accommodating monetary policy, with interest rates being "lower for longer".

Sharemarket valuations now stand at, or a little above, "neutral" levels. For example, one-year forward price-earnings ratios are 15 times in the US and 15.5 times in Australia. With sharemarkets vulnerable to suggestions of early increases in US cash rates or to heightened geopolitical risks, there will need to be increases in company earnings for the bull market to resume and run further.

Recently, most listed companies in the US and Australia have reported their profits and financial positions (for the June quarter in the US and here for the 2014 financial year). In both countries, average earnings per share have been stronger than investors generally expected — with average increases of 9 per cent in the US

(3 percentage points more than forecast when the June quarter began) and 13 per cent in Australia (also about 3 per cent above earlier expectations).

Somewhat offsetting this good news, gains in earnings often came from cost-cutting and many companies expect subdued revenue growth in the coming 12 months. Profits have also been extremely uneven by sector and by company: it's a stockpickers' market.

In both countries, relatively high amounts of money are going back to shareholders via dividends and share buybacks, rather than being retained by companies to grow their businesses. In the US, buybacks are averaging 3 per cent of market capitalisation and dividends 2 per cent.

Our system of franked dividends means most Australian investors love dividends, which make up a large part of total returns. About two thirds of Australian companies have increased their dividends this time and companies such as Rio, Telstra, CSL, Wesfarmers and Suncorp have also announced sizeable share buybacks.

Investors paying low or zero rates of tax — including many retirees — can l; ook at Australian shares paying an average dividend yield, including franking benefits, of 6.5 per cent over the next 12 months if dividend payout ratios stay at very high levels.

In summary, the reporting seasons in the US and Australia have on balance been positive for investors. In particular, corporate earnings have, on average, grown more than had been expected, while the heightened emphasis on dividends and capital management will benefit many shareholders. But on current forecasts, earnings growth is modest.

Sharemarkets could experience a bump or two when the US Fed starts down the path of raising its cash rate, or if geopolitical risks worsen. But, in the thoughts of this veteran investor, there are good prospects we'll then see a fourth leg in the bull market in shares that began in 2009 — supported in the US by the boost to corporate earnings from a pick-up in growth, and here, maybe, from a weakening Aussie dollar.

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