Why stocks will end the year higher

Comment
Geoff Wilson

For those investors wondering where the sharemarket will finish the year amid all the challenges it faces right now, the answer is it will be higher.

But the gains of between 5 per cent and 10 per cent won't be driven by earnings growth. Instead they will come courtesy of lower interest rates, investors willing to take on more risk and an expanding price-earnings ratio.

We are now four years into a decade of deleveraging. Growth over the next six years will be at a lower rate than we saw in the noughties and a lower growth rate means a lower price-earnings (P/E) ratio then we have experienced over the past decade.

Although some expansion in P/E ratios can be expected, investors should not expect them to return to the lofty levels sometimes seen over the past 12 years.

Elsewhere, the main factors affecting the sharemarket this year will be how officials work their way through the European sovereign debt crisis, how much the American consumer decides to spend, the health of the Chinese economy, domestic political uncertainty, local interest rates and the Australian dollar.

Europe is a basket case, which will be unwound over time once the European banking system is recapitalised by the free money they are receiving through the interest rate differential between the European Central Bank lending facility and the rates on European government bonds

When the system is strong enough, Greece will be cut loose and default, while the euro region itself will be disbanded.

The American consumer is recovering, with a slew of economic indicators turning positive. The US makes up roughly 25 per cent of global gross domestic product and the American consumer is a large part of that and appears to be on the march again.

The Chinese economy has slowed in recent years, but is still expanding at a rapid pace compared with the anaemic growth rates in much of the developed world.

While there are concerns over a possible housing bubble bursting and the sustainability of its demand for iron ore, coal and other commodities, the Chinese government thus far seems to be managing this well. Australia remains inextricably linked to the continued China growth story.

The current domestic leadership battle within the Labor Party ranks adds another layer of uncertainty to the equity market as they try to evaluate what, if any, government policy changes could be expected from the eventual winner.

While we do not see the current battle being a major concern for equity markets, its broader impact on business and consumer confidence is definitely negative at a time when it is already at low levels.

The uncertainty will dissipate over time.

The high level of the Australian dollar relative to other currencies will continue to hamper export-driven business and manufacturers, while on the other hand benefiting importers. If China's growth holds, so will the Australian dollar.

The market always leads the economy by six to nine months. This means the equity market will begin to rally well before economic data shows any sign of improvement.

Domestic interest rates will fall over the course of the year but the impact will be muted as banks refuse to pass on the full reduction as they attempt to recoup lost margins. Even so, lower interest rates are positive for equity markets.

When investing, it is worth remembering that the market always leads the economy by six to nine months. This means the equity market will begin to rally well before economic data shows any sign of improvement.

■ *Geoff Wilson is the chairman of Wilson Asset Management.*