Perpetual

Perspective

June 2011

The long and winding road

Despite a structurally stronger economy, the combination of higher interest rates and a rising currency has seen Australian shares underperform other international markets over the past two years. Matt Sherwood, Perpetual's Head of Investment Market Research examines market recoveries and finds that multi-year side trending markets in Australia are not unusual and then discusses what is required for the Australian market to break out of this trading range.

Key takeouts:

- The Australian sharemarket has underperformed its international peer by a wide margin.
- Side-trending markets appear after every large bear market, but the current episode is unique as earnings per share have risen 28% during its existence.
- The side-trend will require a two-stage process – global economic stabilisation followed by improved domestic earnings expectations.
- Valuations are attractive and the 2012 Australian economic outlook appears strong.

Introduction - the long and winding road

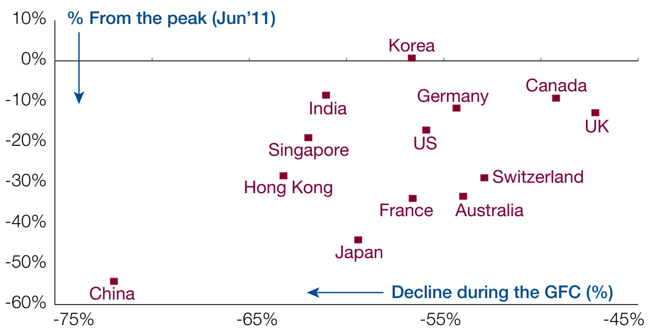
A lot happened in the world in 1969. Mankind stepped on the moon for the first time, Richard Nixon was inaugurated as US President, the Concorde and Boeing 747 had their first flights, Australian George Lazenby played James Bond and the first Woodstock concert was held. One of the less important events in entertainment that year was Paul McCartney recording a song titled the *Long and Winding Road*. The actual road referred to in the song was the B842 which is a 50 kilometre winding road in Scotland that passes by McCartney's farmhouse. The song had the notoriety of being the last single ever released by the Beatles (which as normal reached number 1 on the US and UK charts). The song details the long struggles, tensions and frustration within the Beatles at the time. McCartney said the tensions in the band were so high that it was very hard to achieve the results he wanted.

Australian shares – a long and winding road?

Local share investors could share some of these sentiments. Since August 2009, Australian shares have underperformed our international peers by a wide margin. In this near-two year period the Korean market (+30% in price terms), Germany (+29%), US (+25%) and UK (+19%) have all significantly outperformed the Australian market (+1%). Of all the international markets in Chart 1, Australia recorded the fourth smallest decline during the GFC (-54% – only the UK, Canada and Switzerland recorded smaller declines) and despite this and a solid economy, nowadays Australia has the fourth largest distance to make up for its market to get back to its November 2007 peak. The domestic sharemarket remains 33% below its peak, with only France (34%), Japan (44%) and China (54%) being further away from their respective 2007 highs).

Chart 1: The Australian sharemarket is underperforming

Sharemarket performance: decline during the GFC and % from the peak



Source: Source: IRESS as at 7 June 2011. From indices measured in local currency terms.

What catalysts have come around the corner?

No market outperforms all the time. Nevertheless, Australia's relative underperformance has not been underpinned by lower economic growth – since the end of 2008, the Australian economy has grown 4.1% in cumulative terms and outperformed the US (3.4%), Germany (3.3%), Switzerland (3.1%), Canada (2.9%), France, (1.7%), Japan (-0.4%) and the UK (-0.9% – source UBS Australia Limited as at 8 June 2011). However, having not had a recession during the GFC, Australia is clearly in a more advanced stage of its economic cycle than its developed economy peers and there are four primary reasons for the sharemarket performance differential:

- **Rising interest rates** – since August 2009, the Reserve Bank of Australia has increased official interest rates seven times (and by a cumulative 1.75%, with the banks adding an additional 0.25%). In comparison, the Bank of Japan has eased rates once (by 0.05%), the US Federal Reserve and Bank of England have not moved at all, the European Central Bank has hiked once (by 0.25%) the Bank of Canada has moved three times (0.75%). Rising rates have slowed the economy down, negatively impacted market valuations and reduced credit growth to below the levels seen during previous recessions.
- **Appreciating exchange rate** – The Australian dollar has increased 70% relative to the US Dollar since its GFC trough, which is more than double the rise of equivalent currencies. This has reduced the Australian dollar value of offshore earnings for Australian companies
- **Our market composition has been a disadvantage** – very low credit growth has meant that Australia's higher exposure to financial services firms (than our global peers) has negatively impacted relative performance.
- With more policy headwinds and an unfavourable market composition, it is not surprising that **the Australian sharemarket has been experiencing sustained earnings downgrades for the past 12 months**. Single-digit earnings growth appears to be the norm for the domestic market, with more and more stocks seeing negative EPS growth on the back of a soft domestic economy with flat revenue growth, a tight labour market and escalating government charges and regulation pressuring earnings in most sectors.

The side trending market

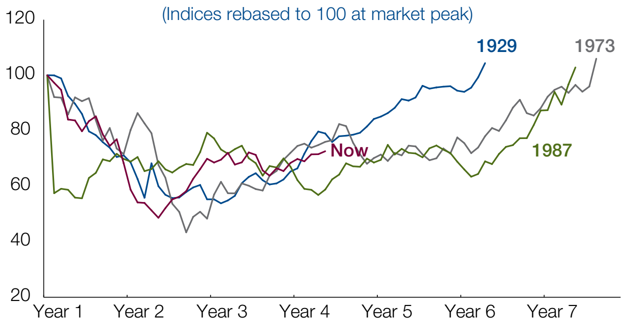
These combination of factors has seen the Australian sharemarket trend sideways for nearly two years, even though economic activity has continued to rise (with the exception of the March quarter 2011, where Australian economic output contracted by 1.2% due to the temporary impact of natural disasters). However, side trending markets in Australia are nothing new. The Australian sharemarket has experienced 13 declines of 20% or more since 1875, but of the four occasions where the market has declined by more than 40% (in 1929/31, 1973/75, 1987/88 and 2007/09), after a short recovery, each of these markets have experienced a multi-year side trend (in 1931/33, 1975/77, 1988-92 and 2009-11 – see Chart 2). Side trends are typical after bear markets as the market needs time for earnings to catch up with valuations. However the 2009/11 side-trend is unique as it is the only occasion where there was no domestic economic recession, the Australian dollar appreciated and earnings per share rose (by 28% to date). This suggests that there may also be some external influences at play.

External pressures have increased

More recently, investors have been concerned that the global economic recovery has hit a wall. This has reflected economic data which has indicated that the US was weak in the March quarter 2011 (and this has continued with a weak labour market report in May, declining auto sales and a report that indicated that manufacturing activity experienced its eight largest monthly drop since 1950), China is slowing down, lead indicators for Asia have rolled over, Europe is looking woeful and Japan is set to enter recession. This has sent global markets into a small tail spin with the MSCI World Index down 4% in local currency terms, but the S&P/ASX 300 Index has declined by a much larger 9% and is now in the low part of its two-year trading range. These growth concerns are unlikely to dissipate for several months and may continue to weigh on market sentiment for a while.

Chart 2: After major market declines, side trending markets are quite normal.

Australian sharemarket: decline and recoveries (Index)



Source: Australia Stock Exchange as at 6 June 2011

What are the street signs truly telling us?

Despite the market volatility, it important to be mindful that most of the growth disappointment has reflected the impact of short-term factors, rather than long-term structural issues. There has been a very cold and wet northern hemisphere winter, flow-on effects of the Japanese earthquake (as they are a very large component manufacturer for Asia and the US) and inclement weather in the southern United States. All of these factors have combined to give the impression that the global economy is heading south. However, apart from Europe, it is hard to envisage these factors being sustained throughout 2011 and into 2012.

A two-stage end to the side trend

Despite the temporarily soft global economic climate, the outlook for risk assets appears better for the second half of 2011 and this could see the Australian sharemarket break out of its two-year side trend. It could well be that the ending of this phenomenon will occur over two stages.

Stage 1 – Global economic stabilisation

Stage one will require a stabilisation of the global outlook, as growth appears to be the key for risk-assets' outlook for the remainder of 2011. Importantly, improved economic prospects on a global scale appear likely – Japan's diminishing economic profile in global trade has reduced the fear of a broad-based domino effect (even though high Japanese component exports into Asia have the potential to disrupt local supply and production chains). Elsewhere in Asia, China is only likely to experience a moderate growth slowdown in the next few months as de-stocking takes place and as power shortage constrains heavy industry production. As the inventory adjustment runs its course, economic activity is likely to rebound, supported by accelerating social housing construction and market forecasts for 9% growth in 2011 seem reasonable.

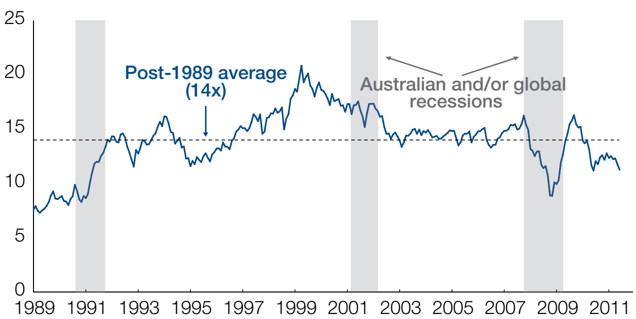
Meanwhile, US growth concerns appear to be overdone as auto sales will recover when Japan components arrive, exports should rise further in the wake of a depreciating US dollar and the labour market will consolidate as weather-related disruptions dissipate. In Europe, a short-term fix to Greece's funding woes appears to have been reached. Confirmation of all of these factors may enable the Australian sharemarket to stabilise and rise towards the top of its two-year trading band in the second half of 2011 as global risks diminish.

Stage 2 – Breaking through the top of the side-trend

While employment growth is essential for any economic recovery to be sustainable, so to earnings growth is essential for any sharemarket rise to be sustained. Consequently, with Australian sharemarket valuations appearing attractive at 11.3 times FY2012 earnings (which is a 22-year low for a non-recessionary period – see Chart 3), an end to the side-trend will require an improvement in the earnings outlook for domestically-listed companies. This will probably require the RBA moving to an 'on-hold' stance and a stabilisation in the ascent of the Australian Dollar. The former may be occurring at present given the weak Australian National Accounts data in March 2011 and recent confirmation that annual labour market growth (now 2.0%) has halved in the past two months. What else is required over the remainder of 2011 is increased confidence in the US economic recovery, in order to provide more strength to the US Dollar. This will require US labour market improvement, which should improve global risk appetites and the Australian Dollar value of global earnings.

Chart 3: Australian sharemarket valuations are at a 22-year non-recession low

Australian sharemarket valuation: forward price earnings ratio (X)

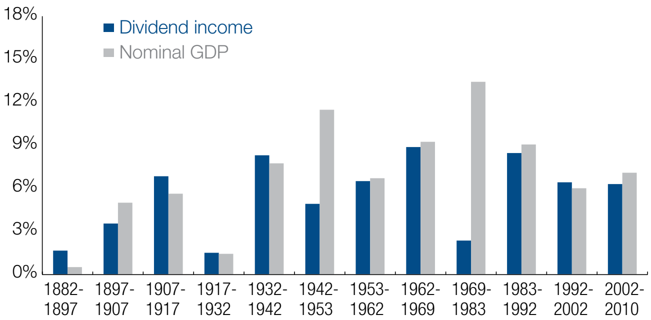


Source: UBS Australia Limited as at 9 June 2011

If the Australian capital expenditure survey figures for 2012 are reasonably accurate with respect to the mining investment boom, the Australian economy will have little trouble growing at an above trend pace next year, particularly when supported by Queensland housing reconstruction. There is a very strong correlation between nominal GDP growth and dividend growth over multiple business cycles (see Chart 4). During our last mining boom in late 1960s, the Australian sharemarket recorded its highest period of dividend income growth, which is one of the key drivers of share price trends. If investors believe the Australian economy's outlook is good in the next decade on the back of our second mining boom, then Australian shares might break out of its trading range before too long. However, this appears to be a little way off at present.

Chart 4: Our last mining boom produced record dividend growth

Australian listed company dividends and nominal economic growth (%pa)



Source: Datastream as at 7 June 2011

Implications for investors

Investors may think that they are on a long and winding road, however, history and the economic dynamics suggest that there may not be long to go on that journey. The current economic slowdown appears to be a series of temporary impacts, rather than a structural global downturn fuelled by global imbalances. Global growth is likely to pick up in H2 2011 and this should provide some uplift for advanced economy sharemarkets. Advanced sharemarket trends are likely to closely follow growth expectations, whereas in emerging markets inflationary expectations are likely to prove more dominant. The Australian market is being held back by several factors which are likely to diminish in the next six months. In this environment, consistency in cash flow generation growth, dividend income growth and valuations are things to watch. Companies that can deliver these to investors should outperform in a more difficult trading environment. Investors will need to be patient while these transitions play out, but in six months time market bears may well be singing McCartney's 1967 Sgt Pepper song, *'I've got to admit it's getting better, a little better all the time'*.

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