

We're back to the old normal right? Wrong



With most countries returning to growth, things look a lot better than was the case twelve months ago. Conditions have improved so much that some investors are asking if things are back to normal why aren't sharemarkets rising? Matthew Sherwood, Perpetual's Head of Investment Market Research examines this question and finds that the global economic recovery has been driven by temporary factors and that the 'new normal' will be quite different from the 'old normal' and this will have major implications for investment markets and portfolios alike.

Introduction

Have you ever received an email where a picture seems to vibrate, rotate, bend and skew even though they remain still? Welcome to the world of 'visual phenomena', where apparently people's motivational states (their wishes and preferences) influence their processing of visual stimuli. Unsurprisingly, this area of science has been heavily researched and one conclusion reached has been that people's perception is generally selective, and that motivational influences explain what people perceive to be true, even though it may defy all knowledge and common sense. This phenomenon has also been seen in finance, where the power of greed can at times be greater than that of common sense. The tech boom was one example when people saw rapidly rising share prices and somehow convinced themselves that the prices were justified.

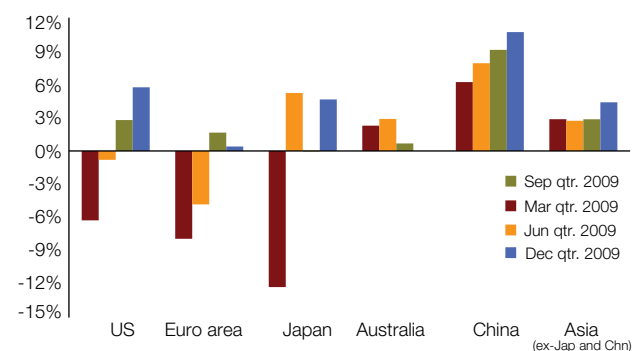
The global economy has rebounded, but is it sustainable?

This behaviour can also be seen in economic trends. Only recently, growth in the major regional economies has been quite strong, albeit from a low base. In the December quarter 2009, economic growth in China was 11%, in the US it was 6% (quarterly annualised), Japan 5% and Europe a rather disappointing 0.4% (see Chart 1). Some investors have concluded that in light of these growth results (other than Europe) the worst has passed and that we are back to the 'old normal'. The first part of this conclusion appears reasonable as the global financial crisis has clearly passed, the risk of financial system meltdown has diminished and general confidence has been restored.

Indeed recent market turbulence has appeared to be one-off events; Dubai World, Greece debt, China reducing excess liquidity and so on, rather than widespread systemic problems as was the case in 2008. Consequently, global economic growth for the next few years has been upgraded by the International Monetary Fund to around 4%. While this figure is much better than the scenario 12 months ago and is around its decade-long average, it is a subdued recovery considering the severity of the downturn.

Chart 1: Economic growth has improved in most regions

Regional Economic Growth: Quarterly Annualised (%)



Source: Macquarie Securities as at 31 December 2009. China and Asia growth are annual growth rates.

Things are not back to normal

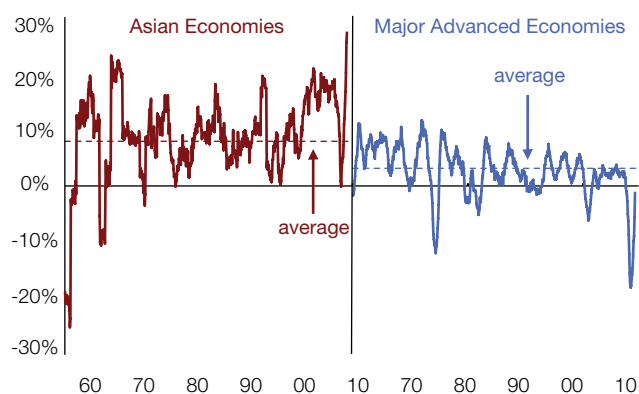
While the outlook for the global economy has considerably improved, sizable risk and uncertainties remain evident. Many of the advanced economies face very significant fiscal challenges and high household debt that will need to be addressed over time. In addition, some economies have banking systems that are still experiencing credit losses from subdued economic conditions. In addition, the rebound in global economic growth has been driven by temporary factors such as the dynamics of the inventory cycle and temporary fiscal measures (such as handouts) and this impact will fade reasonably quickly. Accordingly, the advanced economies' recovery is likely to remain subdued for a considerable time and in light of this, things are not back to normal and won't be for an extended period.

The TICK economies remain robust

The aforementioned headwinds are some of the many reasons why annual growth in industrial production (IP) in the major advanced economies remains negative (see Chart 2). In contrast, the Asian economies (which typically don't have these household and balance sheet issues with the exception of India's government debt) are remarkably strong with industrial production growth in the four TICK economies (Taiwan, India, China and Korea) at a 50-year high of 28%. Although this partially reflects the base effect of the past year, (in which IP growth fell below trend to its lowest level in 35 years) it also reflects government stimulus and increased regional trade.

Chart 2: TICK economies' industrial production is growing at a 50-year high

Global Industrial Production: Annual Growth (%)



Source: Credit Suisse as at 31 December 2009.

Asian economies are rotating their growth engines

Over the past 50 years, IP growth in the TICK economies has risen about 15% on eight occasions (in 1963, 1965, 1969, 1975, 1978, 1987, 1995 and 2002) and on five of those occasions, the growth returned to single digit pace within 12 months. Nevertheless, in 2010 the weighted average total IP growth is almost double the 15% level and stimulus remains in the system. While it is unclear exactly when IP growth will begin to moderate, it is reasonable to conclude that IP growth is likely to contribute less to growth going forward. Consequently, the TICK economies have begun rotating their growth engines towards exports (particularly IT products, reflecting some rebound in regional business spending).

... but risks remain evident and Asia is not a one-way bet

The baseline Asian scenario of strong economic growth, ample liquidity (despite recent market fears in China) and continued capital inflows seem favourable conditions for global investors. The clear danger here is that too much liquidity may lead (or may have led to) a major asset bubble, which will require a considerably sharper policy adjustment later in 2010. With the growth recovery now well entrenched in most Asian economies, but macro policies remaining overly supportive, attention is progressively turning to the buoyant conditions in property markets (and other asset markets) and the risk that inflation could rise further. In the coming months, managing (lower, but ample) credit growth and implementing structural

reforms will be the key policies to watch. Consequently, investors should be wary of thinking that Asian economies are a one-way bet.

2009 indicated the power of government policy

There is little doubt 2009 will go down in history as a great example of the power of government policy. After the collapse of Lehman Brothers in September 2008, global financial markets froze, global industrial production was cut and global trade went into freefall. This could well have ended up in another Great Depression had governments around the world not massively increased spending and cash payments to fill the massive growth gap in the wake of a collapse in private demand. So does this mean that households and investors can escape prolonged pain and the repercussions of bad lending and over-leveraging unlike in the 1930s? Unfortunately not.

...but 2010 will show the limits of that power

Just as 2009 was a textbook example of the power of government policy, so 2010 (and beyond) will go down as a year which demonstrated the limitations of government policy. At its core the Global Financial Crisis was caused by too much leverage and bad lending. So when this debt-fuelled private-spending boom came to an end in 2007/08, what was government's answer? Massive amounts of debt. That is, the advanced economies are increasing their debt at an increasing rate and at a time when their respective share of global economic activity is declining. The private sector is borrowing less, but this impact has been completely offset by the sharp rise in government borrowings.

Bond yields are set to rise

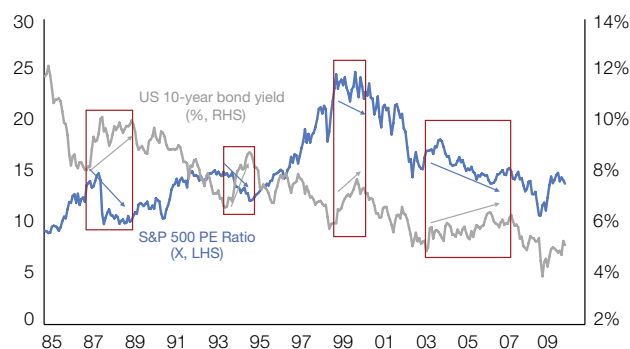
Massive increases in government debt, inflation returning back to positive territory (and potentially higher if supply issues aren't resolved), the removal of excess global liquidity and rising cost pressures in China, could prompt rising bond yields before too long. This is bad news for all investments as bond yields are the cornerstone of every asset's price. Although the Australian Government has very low debt, domestic investors will also experience an interest rate headwind as the mining boom will increase demand-side pressures on the domestic economy, which will eventually flow through to inflation and bond yields. However, this impact will be challenged by strong earnings growth as the Australian economy enters its next golden age.

Sharemarket valuations are set to decline

Bond yields and the P/E ratio are related by a well known rule; during times of higher yields, the P/E ratio declines and rises when yields trend downwards (see Chart 3). This occurs because rising bond yields increase the level of earnings uncertainty and accordingly investors demand a higher earnings yield from shares in compensation for bearing risk. This relationship has been evident at times in the US sharemarket (as represented by the S&P500) over the past 20 years (including 1987-88, 1994, 1999/00, 2003/07) If repeated, the bond yield increase may mean that earnings surprises may not prompt an equally strong price response as valuations are simultaneously declining. This has been occurring recently and may be indicative of balance sheets and valuations been two key metrics in all investment decisions.

Chart 3: Market valuations are likely to decline if bond yields rise

US Yield Comparison: Bonds Versus Shares



Source: Citigroup as at 27 January 2010.

Could we see a repeat of the sideways market like the 1970s?

Some market analysts have made comparisons between the current global economic landscape and that of the 1970s. During this earlier period earnings rose, bond yields rose and the market went nowhere. Indeed on 31 December 1972, the US S&P 500 Index stood at 118 points. Seven and a half years later (on July 31 1980) the S&P500 Index closed at 122 (see Chart 4). Even though nominal earnings grew a staggering 146% over the period (or 13% per annum), investor's willingness to pay for those strong earnings declined. That is, the P/E ratio for the US sharemarket declined from 19 times earnings in 1972 to eight times earnings in mid-1980 - during this period when US bond yields rose from 6.4% to 10.3% in the wake of the two global oil shocks. Australia also experienced a sideways-trending market between June 1972 and August 1979.

Clearly no-one knows precisely where the market will go from here. Nevertheless, a combination of subdued growth in the advanced economies and expectations of rising bond yields makes it hard to envisage developed sharemarkets moving up aggressively in the next few years. Consequently, investors may need to distinguish between the trends of the sharemarket and the trends within the sharemarket. That is, although the capital weighted return is 0%, there are many stocks that earn a higher rate of return (from both dividends and share price growth) and that buying and holding value-creating businesses (who can grow there earnings in subdued economies conditions) for a long period of time can provide investors with excess return.

Chart 4: The US sharemarket didn't rise between 1972 and mid-1980

US sharemarket: 1972 to 1980



Source: UBS Australia as at 22 February 2010

The power of 'quality'

The new world of below-average economic growth and potentially rising bond yields is one that investors would not have experienced in at least 30 years and in the new climate the sustainability of a company's business model, its earnings growth and dividend policy will be key to investors. In addition, rising bond yields will, ceteris paribus, prompt investors to increase their exposure to companies with a strong balance sheet as exposure to stocks with low levels of debt will reduce their exposure to the rising price of debt. This sort of stock did not do particularly well between 2003 and 2007, but the new environment seems very conducive to turn these stocks in market leading companies. Meanwhile, the new economic climate is likely to prompt bond investors to increase their exposure to floating rate credit instruments from quality companies and/or inflation-linked bonds to hedge rising inflation risk.

Implications for investors

Although the economic recovery has been strong, investors need to be mindful that the recovery has been driven by temporary factors and it also remains very fragile and this means that risks are high. In this environment investors should recognise that returns in highly indebted advanced economies (which represent over 90% of the MSCI World Index) are likely to be modest and should realign their portfolio risk and invest conservatively to receive full compensation for bearing risk. Given the increased stress possibly around going forward, investors might seek a diversified portfolio of low earnings risk, good dividend paying quality companies with attractive valuations and strong balance sheets. This would mean that investors would have access to any market upside, with downside protection should things temporarily take a turn for the worse.

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