

Double-dip recession or modest recovery?

After a sharp recovery in early 2009, global sharemarkets have trended sideways for nearly a year and investors seem to be increasingly concerned about global economic prospects. Matthew Sherwood, Perpetual's Head of Investment Market Research examines the global picture and concludes that although the risk of a double dip recession has increased, it remains quite low. However, the earnings outlook from here appears to be more anaemic than current expectations and investors should be wary of being overly optimistic.

Key takeouts:

- The Chinese economy is experiencing a mid-cycle moderation, but remains robust
- The advanced economy recovery is anaemic
- Global markets are over-estimating the earnings rebound – volatility to persist
- Australian sharemarket to remain in a trading range for some time

Introduction

In 334BC an untried military leader changed the course of history and revolutionised military thinking. In the following year, he met the imperial forces of Persia in modern-day Syria. Although the size of his army was only one-third of that of the Persians, this man concluded that the Persians needed space to manoeuvre to be fully effective, so he attacked them in a narrow mountain range and with the terrain being wet, the Persian could not move, got bogged down and were massively defeated. Victories of this magnitude were frequent over the next six years, by which time he controlled all of the modern day Middle East, Kazakhstan, Uzbekistan, Pakistan, Northern India and Afghanistan, despite never having an army over 40,000 men and these countries having combined forces of more than one million soldiers.

The man's name is Alexander III of Macedonia and he was undefeated in battle despite typically having less troops and inferior equipment. The key to Alexander's success was in his almost clairvoyant insight into strategy and his analysis of the battlefield and terrain, which enabled him to turn risk into opportunity. Like Alexander's Generals, current investors may feel overwhelmed as unambiguously positive news about the global economy is hard to find. Investors may be concerned about the market outlook and be pondering the best course of action.

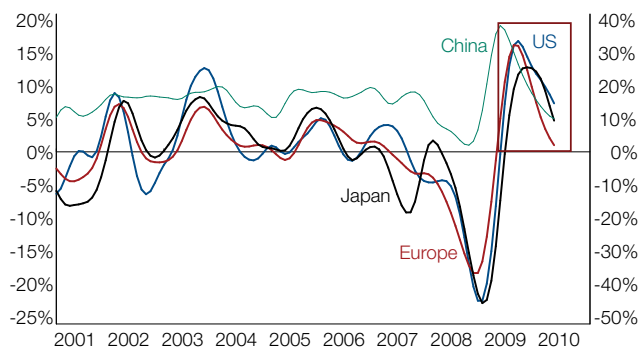
The current investment landscape

There are many battles underway at present in global financial markets which will have a large impact on investment markets and returns. These include the battle between the bulls and the bears, equities and bonds, inflation and deflation and earnings and economic growth. The main headwind for markets and investor confidence at present is that most global data points seem to be confirming that the global recovery is losing momentum. Lead indicators across all major economic regions have dramatically turned (see Chart 1). While, lead indicators are notorious over-predictors of economic downturns, they should not be ignored altogether.

Economic data has confirmed the moderating growth picture

Recent data has confirmed the global recovery is losing momentum. It appears that the global economy has too many people wanting to save and not enough people wanting to spend. In the US, for example, housing starts, building permits, existing home sales, durable goods orders, construction spending, pending home sales, auto sales, retail sales have all softened over the past month. Meanwhile, the Obama administration's effort to help those at risk of losing their homes is not working effectively. This may foreshadow a rise in foreclosures that would further depress the housing industry. More foreclosures could force down home prices and that would deter already-ailing homebuilders from starting new projects and declining household wealth could crimp consumer spending growth. Each new home built creates, on average, the equivalent of three jobs for a year and generates about USD90,000 in taxes paid to local and federal authorities, according to the US National Association of Home Builders.

Chart 1: Lead indicators have turned in every major region
Lead Indicator for Major Economies



Source: Macquarie Equities as at 21 July 2010.

Some other major regions are also softening

Chinese economic growth, industrial production, energy usage, transportation, money supply, credit growth and retail sales have all weakened from an elevated pace, which might concern nervous investors. Furthermore, China is taking steps to slow its economy by reducing bank lending growth and appreciating its exchange rate, which are likely to support a moderation in Chinese economic growth. In contrast, data for a number of European countries (most notably Germany) had been better than the case a few months earlier (reflecting the impact of the weaker Euro) which improved prospects for June quarter growth, although the outlook remains constrained. Prior to the GFC a rise in advanced economy savings and a reduction in spending was desirable, but now it is starting to negatively impact sentiment regarding the recovery.

A global economic slowdown is not only likely, but desirable

It is important to remember that in the first half of 2010, the global economy was growing at an above-trend pace and as such a slowdown was not only likely, but also desirable to prevent a boom-bust cycle from taking hold. Interestingly, this slowdown is consistent with recoveries in the first half of the 1990s and 2000s, during which growth slowed in 1994 and 2004 (as policy stimulus was withdrawn), before resuming a year later. In addition, policy has not been tightened in the US (the largest economy), nor high-growth Asia regions (with a few exceptions) and is still not restrictive in Europe where government spending cuts have been partially offset by the lower Euro over the past three months.

An anaemic global recovery is more likely than a double-dip recession

With policy stimulus fading, many commentators are highlighting the risk of a prolonged double-dip global recession. This is unlikely as interest rates remain at all time lows, employment growth remains positive (albeit, modest), corporations have strong surplus cashflow, population growth continues and Asia is continuing to industrialise and urbanise. Although economic data indicates that growth from here is likely to be more subdued, there does not appear to be any imminent deep recession on the horizon. Growth appears set to remain quite anaemic as two sectors of the advanced economies (households and governments) need to simultaneously slow their spending growth and reduce the debt growth. While government balance sheet issues have gained much of the headlines lately, the household sector in many advanced economies remain highly indebted and while this historically high level of debt has eased back recently, it will be a prolonged process before it returns to a sustainable level. Together, the household and government sectors represent 70% to 80% of most economies' activity and their simultaneous reduction in spending growth will continue to constrain global prospects.

Market concerns may swing from weak growth to deflation

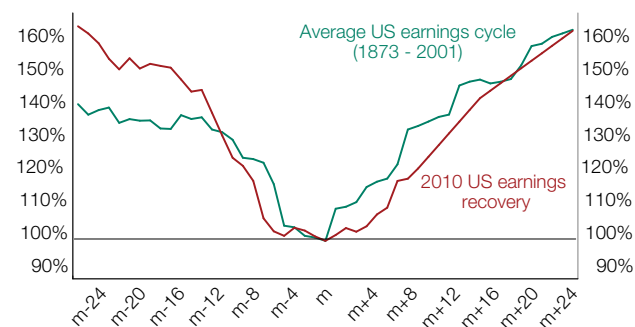
If global economic data continues to confirm a weakening in the global recovery, market sentiment may eventually be subjected to a deflation scare. This fear coupled with more modest economic growth could present a headwind for markets. Deflation and its negative impact on spending and employment is to be avoided at all costs, but the risk of this becoming a sustained issue for global investors is very low, if Asian growth remains intact. If markets realise that Asia is likely to remain robust in response to their strong internal demand, then market returns are likely to be driven by the earnings outlook.

Investors seem overly optimistic about earnings growth

Despite the sub-trend US economic recovery, investors appear quite optimistic about earnings. Presently, market consensus expects a recovery (excluding the impact of asset write-downs) in line with the historical average of the last 20 earnings recoveries since 1873 (see Chart 2). This forecast recovery this cycle is the strongest since World War 2 and considerably stronger than the recoveries in 1949, 1954, 1958, 1960, 1969/70, 1973/75, 1980, 1982/83, 1990/91 and 2001. This is expected even though the economic recovery is likely to be anaemic rather than strong.

Chart 2: household debt has doubled (at least) in most advanced economies

Earnings around US Recessions
Recessions are rebased to 100 at their respective troughs



Source: US Bureau of Economic Analysis and UBS Australia Limited as at 30 June 2010. The Great Depression is excluded from this analysis because of its extreme result impacting the overall average

US reporting season has been good, but guidance is softening

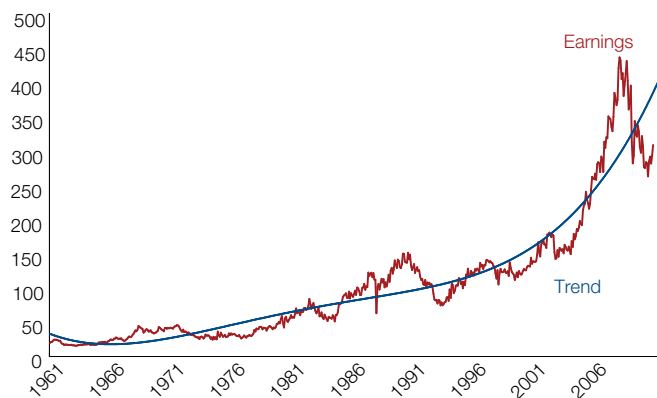
The Q2 US reporting season is in its early days, but the results to date have been quite solid and continue to be supported by cost cutting, although there have also been some cases of solid revenue growth. This will need to continue across most sectors to improve market sentiment. In contrast, should firms indicate that earnings growth is likely to be impeded by the economic environment, a strong rising market is unlikely to develop. Already investors have seen softer guidance offered by Walgreen, Dell Computer, 3M and General Electric. If the US economy remains anaemic, the only plausible way that earnings could experience a strong rebound is through a major rise in US productivity. However, one has to wonder how much efficiency gains are left in the labour market, given the widespread corporate cost-cutting since the US Sub-prime Crisis began in 2007 and tighter lending standards are likely to limit growth in non-labour productivity. Consequently, a slow recovery in advanced economies could frustrate investors who are expecting a stronger earnings rebound.

Australia's economic and earnings outlook remains intact

Recent data has suggested that Australian economic growth remains solid, supported by high public spending. This was a significant contributor to March quarter 2010 economic growth which rose to just under 3%. The labour market has remained strong with employment growth rising to over 3% in June, driven by another strong rise in full-time employment. Business surveys and job advertisements tend to suggest solid employment gains in the period ahead, with the chances high that unemployment could be below 5% before too long. Employment growth is expected to be supported by investment growth in the second half of 2010, as measures of firms' investment intentions had increased quite strongly, and capital goods imports increased in June. In addition, with 80% of our exports now going to Asia, the Australian economic outlook remains robust. This and strong Asian growth should provide a solid foundation for a solid August 2010 reporting season and current expectations in relation to FY11 do not seem too stretched with close-to average margin growth expected. Earnings are unlikely to trend backwards despite the heightened global stress as earnings growth remains 17% below trend and back-to-back earnings recessions have been unprecedented over the past 50 years (see Chart 3).

Chart 3: Earnings growth has resumed again and double-dips are unprecedented

Australian Sharemarket Earnings Per Share (Index)



Source: Citigroup, IRESS and UBS Australia Limited as at 30 June 2010.

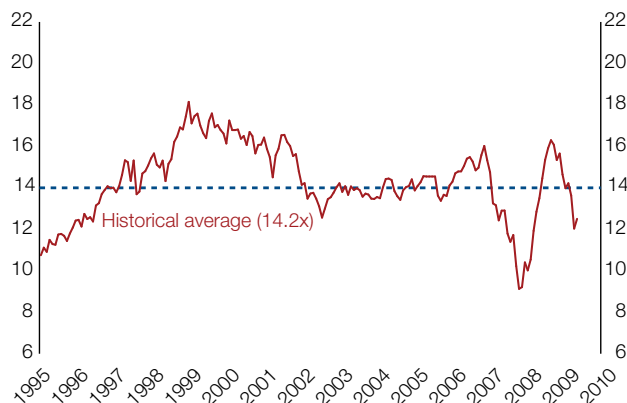
Valuations were due for a correction, but are now at historically low levels

Over the past year, the Australian sharemarket has tracked sideways and is currently around levels seen in late-2005. However, earnings have recovered back to levels seen in late 2006 and this indicates that valuations are attractive again. From bottom-up, the ASX 200 is trading on 12 times forward earnings (which is based on expected earnings for the coming year). This means that the forward looking market valuation has gone from an eight-year high in September 2009 to a 14-year low (excluding the lows

seen during the Lehman Brothers collapse in late 2008). Current valuations are 15% below their 15-year average and industrials are around 10% below their 15-year average. Although lower valuations partially reflect investor's marking down companies share prices faster than analysts reduce their earnings forecasts, the key for investors is determining which stocks have reasonable earnings outlooks and which have been oversold.

Chart 4: Australian share valuations are at historically attractive levels

Australian Sharemarket Valuation (X)



Source: Credit Suisse as at 30 June 2010.

Implications for investors

Clearly in such a clouded terrain, the key question is where is a risk budget best spent? Had Alexander simply charged the Persians in an open field, he would have been slaughtered and joined a long list of vanquished leaders in history. But he didn't, he reduced his risk and played in the environment that gave his side the highest probability of favourable outcomes. In the current economic landscape, the headwinds and tailwinds for investment returns are gaining strength and as such the difference between good investments and bad investments in each asset class is likely to be wider than they have been in the past. At present, investors may rightfully question, 'how do I reduce risk in the current environment and enjoy any potential upside'? Regardless of asset class, investors most likely know that risk is best diversified by companies with strong balance sheets, steadfast operating models that produce earnings growth in subdued economic climates and are shareholder focused in their payout strategies. This is unlikely to change in the period ahead. Australia's outlook remains positive on an absolute and relative basis, but risk needs to remain a key focus in the current environment, even though valuations appear to be attractive.

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