



Market concerns have changed in the past six months from growth being too brittle in advanced economies to being too strong in the emerging economies. Matthew Sherwood, Perpetual's Head of Investment Market Research discusses this change and concludes that balance of risks have swung in favour of advanced markets and that domestic investors will have to be a bit patient before experiencing the returns we are seeing in the US market.

Key takeouts:

- The US economic recovery is in full swing.
- Rising interest rates have hampered share price growth in emerging markets, but not the developed markets.
- Australia's impending mining investment boom will be twice as big as the 1960s boom.
- Stocks that are growing their top line revenue are standouts in a soft growth environment.

Introduction

The State of the Union address is an annual address by the US President to the US Congress. The address not only reports on the condition of the nation but also allows the President to outline his legislative agenda and his policy priorities. What began as a communication between President and Congress has generally become a communication between the President and the United States people. George Washington gave the first State of the Union address in 1790, but this stopped within a few decades and it became a written report for around 100 years. In 1913, this procedure was reversed as Woodrow Wilson re-established the practice, despite some initial controversy.

In his recent 2011 State of the Union address, President Obama declared the US is poised for progress with the sharemarket and corporate profits on the rebound after a prolonged downturn. This is a welcome change relative to the past three years and the view could easily be shared with many of the US's economic peers and rivals, as it is quite clear the global economic recovery has strengthened and it appears that 2011 will be the eighth best year of global growth since World War Two.

The US economic recovery is in full swing

There is little doubt that the US economic recovery is strong and is broad-based. The US manufacturing and services sectors, industrial production, core durable goods, consumer spending, export growth, retail sales, and mortgage applications are demonstrating improved strength, which is indicative of a solid recovery brewing. Importantly, inflation is also low and there is plenty of spare capacity from unutilised capital and labour, which suggests growth can be strong without necessarily triggering higher inflation. Accordingly, market consensus believes that the US can grow at an above-trend 4% for the next two years, and core inflation will remain around 1%, which is at the bottom of the US Federal Reserve's unofficial inflation target of between 1% - 2%.

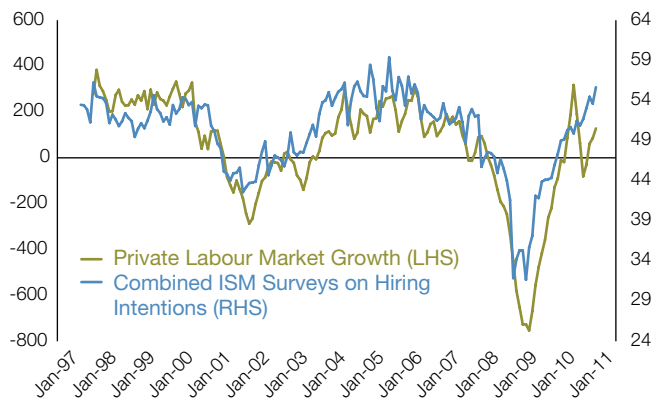
The US labour market recovery is imminent

Federal Reserve Chairman Bernanke says that no economic rebound is sustainable without a labour market recovery. However, data from the Institute of Supply Management indicates this recovery is imminent, with private payrolls likely to rise from the recent 80,000 per month average to around 250,000 (see Chart 1). Although this pace of job creation is welcomed and was last seen six years ago, if sustained, it would still take a further

three years to recover all of the job losses that have occurred since the US economic malaise started in 2007, and seven years for the US unemployment rate to return its pre-GFC peak of 4.5%. Nevertheless, the imminent jobs recovery will strengthen the US economic recovery.

Although growth looks like being strong for the next couple of years, it is important to remember that growth has been heavily supported by policy and is only likely to be around 4%. That is, official interest rates are virtually at 0% and the imbalances in government and household balance sheets have not been fixed, so structural issues remain in the US economy. When these are addressed US economic growth will moderate. However, this is unlikely to be soon.

Chart 1: The US labour market is about to turn
ISM Surveys and Employment Growth (Index, %)



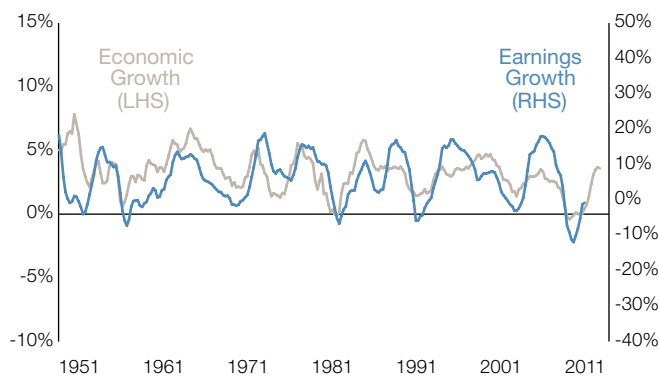
Source: Macquarie Equities as at 31 January 2011.

A very good terrain for shares

Strong economic growth supported by impending improvements in the US labour market suggests that the pace of economic growth is sustainable. Previous episodes of US economic recovery have coincided with a rebound in corporate earnings growth (see Chart 2). The relationship between US economic and earnings growth is not perfect, but both time series follow similar trends and share identical turning points. Historically, a US rebound is typically associated with 3-year US earnings growth peaking around 15%. This indicates that, if history is any guide, US corporate earnings will improve further and this should provide further price support for US shares.

Chart 2: The environment is supportive of the US sharemarket

US Economic and Earnings Growth (3-year %pa)



Source: Datastream as at 31 December 2010.

But investors are getting worried about Asian inflation

While the US recovery has buoyed the market, concerns are rising that the Chinese economy is growing too fast. The Chinese authorities have used unorthodox policies such as raising their reserves requirement, raising property taxes and appreciating the Renminbi to slow growth, but growth actually rose in the December quarter 2010 for three key reasons:

1. The reserves requirement only removes foreign direct investment from the banking system and has no direct impact on economic growth.
2. The money supply is growing at 20% per annum and most of this goes into the financial system, which ends up fuelling higher spending.
3. Real interest rates remain around their lowest levels in 10 years. Examining real rates suggests that the Chinese central bank is trying to stimulate economic growth, not reduce it.

Advanced economy sharemarkets are outperforming

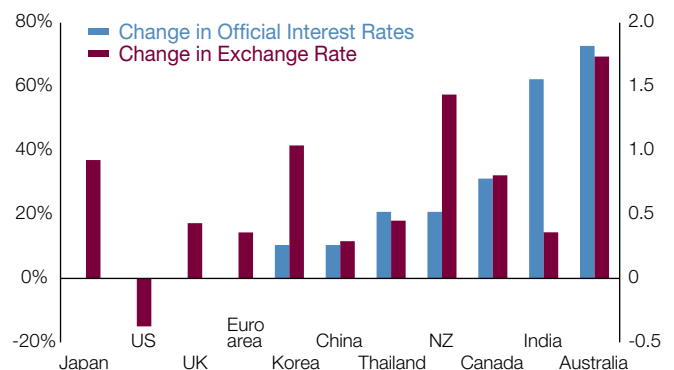
Some investors are surprised that despite emerging economies outperforming their advanced peers in terms of economic growth, they have underperformed in terms of sharemarket returns. Since the end of November 2010, the MSCI Advanced Economy Share Index has risen 11%, relative to 1% for the MSCI Emerging Economy Index. What is happening here is that investors are factoring in normal economic conditions into US share prices, particularly in relation to earnings growth and interest rates. In contrast, rising rates in emerging economies is not a sign of things returning to normal, but rather inflation continuing to rise to uncomfortable levels and Asian central banks need to be addressing this issue now, before it escalates.

Australian policy is 12 months ahead of the economy

Over the past few months Australian economic data has continued to indicate that the domestic economy is experiencing highly anaemic growth, as evidenced by weak retail sales, credit growth, softening employment growth and business investment growth remaining negative. The primary reason for the growth halt is that the Australian economy has experienced more policy headwinds than any other economy. Over the past 18 months, our exchange rate has appreciated around 70% against the US dollar and the Reserve Bank of Australia has increased rates by 1.75% (see Chart 3). Banks have also expanded their variable housing interest rates by around another 40 basis points.

Chart 3: Australia has had more policy headwinds than anyone else

Change in Official Interest Rates and Currency Relative to the US Dollar (%)



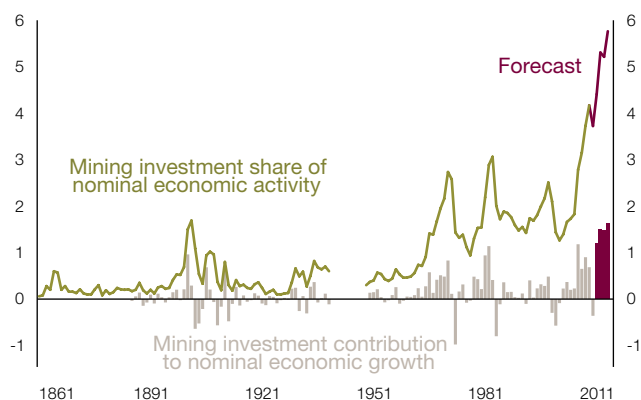
Source: DataStream and Macquarie Equities as at 7 February 2011. Change in USD is calculated using its trade-weighted index.

These policy adjustments are at least three times more than the global average and have been implemented to prepare the Australian economy for its largest ever mining investment boom. Twelve months ago, data suggested this would occur in 2011, however, given the initial heated debate about the mining tax, the subsequent Federal election campaign and the prolonged uncertainty about who would form government, the boom has been delayed until 2012. So the RBA has put policy in place for something that is not here yet. As such, growth is likely to remain soft for some time.

Preparing for our biggest ever mining boom

Growth is likely to accelerate in 2012 as the mining investment boom starts (see Chart 4). This is not the goods that miners extract out of the ground and export – this is what they invest in each year. In the 150 years before 2010, mining investment was around 1% pa of the economy on average. In the next four years, that number is set to average 5.2% pa – more than five times its long-term average and twice as big as the boom in the 1960s. In terms of its contribution to growth, it is set to add 1.5 percentage points (which is seven times more than the post-1861 average). If everything was equal, the Australian economy would grow at 5% per annum for these four years and this would create a boom-bust cycle we have rarely seen. That is why policy has been put in place, even though this has resulted in the Australian economy struggling of late.

Chart 4: The biggest mining investment boom ever is coming
Investment and Australian Nominal Economic Activity



Source: UBS Australia Limited as at 31 January 2011.
Forecasts are a database of investment projects from ANZ Bank.

Reporting season results have been reasonable

Australia is in its second year of earnings recovery post the GFC. Despite some very good results, the earnings recovery is showing clear signs of softening with most sharemarket sectors experiencing downgrades over the past nine months. The exception to this has been the mining sector which has benefited from rising commodity prices. However, cost pressures for these companies are rising and the February 2011 reporting season has clearly differentiated between stocks that are managing their cost base well and those that are not.

Single-digit earnings growth is now the norm, with more and more stocks seeing earnings per share turn negative on the back of a subdued domestic economy where revenue growth is minimal, the labour market remains tight and government charges continue to rise - all of which increases earnings pressures. Meanwhile, on the surface, valuations appear fair relative to history, forward earnings expectations and bonds. However, the market valuations are being weighed down by resource companies that are experiencing top-of-the-cycle earnings growth that are lowering the market's P/E ratio. Outside this sector, it is quite hard to find compelling value.

Implications for investors

The investment climate is changing and investors are factoring normal conditions into US share prices. In contrast, investors are also factoring in rising inflation into emerging economies asset prices. This would be expected to negatively impact regional economic and earnings growth. However, this has not been factored into the sharemarkets of economies with high trade links with China, such as Canada and Australia. This suggests that investors hope that higher rates will curb Asian inflation, but not have too negative an impact on growth. This view may change if Asian rates have to increase further than current expectations. From a stock perspective, the two keys in a slowing economic environment are being able to control costs and being able to grow your revenue in a difficult climate. Stocks with these two characteristics, a strong balance sheet and shareholder focused in their payout strategy are likely to find favour with return-hungry investors. The economic slowdown will be temporary and investors will need to be a bit more patient. This can be hard when other markets are rallying aggressively.

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