

The end of the global equity 'sweet spot' is nigh



The combination of tighter monetary and fiscal policy, higher oil prices, natural disasters and sustained high unemployment is placing increased pressure on global spending. Matt Sherwood, Perpetual's Head of Investment Market Research examines these trends and concludes that the global equity 'sweet spot' has ended. However, this won't by itself end the rally, but will slow it down, and early-cycle stocks that have outperformed the market over recent years are likely to become the laggards for a while.

Key takeouts:

- There are several reasons why US bond yields could rise by a further 1% in 2011.
- The US Fed will not immediately sell bonds at the end of QEII in June, but will need to at some point in time.
- Higher oil prices, global policy tightenings and a depreciating US dollar has ended the global equity 'sweet spot'.
- Domestic interest rates are going up – the precise timing will depend on trends in the Australian labour market.

The strong global economy

The global economy has grown at a brisk pace recently. Asian economic growth has picked up and continues to outperform market expectations with industrial production and regional trade coming in better than expected on the back of a strong China. Meanwhile, US growth remains okay with data suggesting Q1 2011 growth is likely to be soft. Conversely, the recovery in Europe remains subdued as concerns about the banking sector continues to weigh on region-wide confidence and recent events in Japan are likely to prompt a brief recession.

The next stage – rising global interest rates

While the IMF forecast for global growth in 2011 (at around 4.5%) is well above its 40-year average (3.7%), investors need to remember that the advanced economies are still receiving record levels of peace-time stimulus. That is, interest rates are around 0% in the US, Japan and Europe (which has begun to unwind this with a modest 0.25% rise in the cash rate) and Budget deficits are around peace-time highs. Consequently, to sustain the global recovery at its current pace, interest rates will need to remain low. However, there are several technical reasons why US bond yields could rise by more than 1% over the remainder of 2011:

- The US Fed Funds Rate is around 4% below nominal US GDP, relative to an historic average of 0.6%.
- The real (or inflation-adjusted) 10-year US Treasury bond yield has averaged 3% since 1975, relative to the current real yield of 1%.
- There is a close relationship between 10-year US government bond yields (currently 3.4%) and nominal US GDP, which is projected to rise to around 5% by the end of 2011 (see Chart 1).

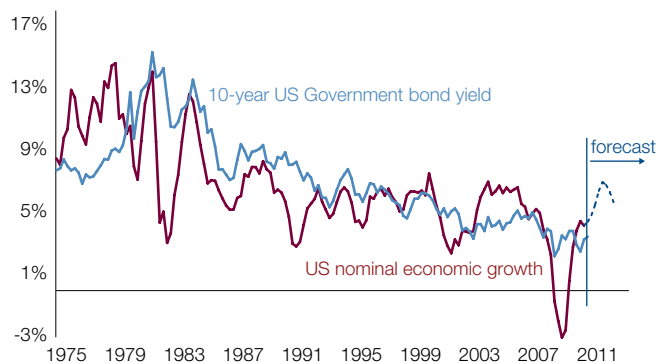
Rising US bond yields makes reversing QEII more arduous

Indeed if US 10-year yields rose in line with forecast 2011 nominal GDP, US bonds would experience capital losses of around -12%. Such a rise in yields could produce a headache for the US Federal Reserve in relation to its second quantitative easing program (dubbed QEII). Under QEII the US central bank leveraged its balance sheet by creating electronic money and then purchased government and agency debt from the private sector for cash – this raised the price of the bond and lowered the yield, and was supported by increased excess reserves in the US banking system. However, the QEII program ends in

June 2011. At that stage, the US Fed will stop buying these bonds, but, it does not mean that it will immediately start selling them. But, at some stage it will need to. However, when it comes time to reversing the program, the US Fed may discover that getting into a QE program is much easier than getting out of one.

Chart 1: Nominal US GDP versus 10-year government bonds: Yields are likely to rise

US Nominal Economic Growth and 10-year US Bond Yield



Source: US Federal Reserve and US Department of Labor as at 31 December 2010. Forecasts are from Macquarie Equities as at 17 April 2011.

So who wants to catch the falling knife?

To completely exit from its QEII program, the US Fed will have to sell bonds, but the question immediately arises as to who would purchase them – particularly if bonds are experiencing capital losses. There are only three potential groups who can purchase the bonds and each of these would have sizable headwinds (see Table 1) before they decide to potentially purchase some of the USD2.5 trillion of US securities (both government and agency debt) that the Fed holds. This suggests that the US Fed is likely to be stuck with this debt for a considerable time, as investors prefer to buy US debt when the economy is weakening, but the US Fed is only likely to reverse QEII when the US economy is strengthening.

Table 1: Ending QEII – who wants to catch the falling knife?

Purchaser	Issues to address
US private sector	Private sector investors would want to purchase US bonds when the US economy is subdued and the US Fed won't reverse QEII while this is happening. If the US economy is growing solidly, bond yields would rise and prompt capital losses for investors.
US Government	Governments need to be running surpluses to repurchase their own debt; otherwise the private sector has to fund a larger government borrowing program each year (reflecting deficits plus bond rollovers). The US Congress seems incapable of agreeing with the Obama Administration on a plan to reduce the deficit, let alone produce a surplus.
Foreign investors	All the risks for the private sector are evident for foreign investors in addition to the risk that the US dollar could continue to depreciate and produce larger capital losses in foreign currency terms. Meanwhile, the US government debt has been placed on negative watch by Standard and Poor's.

S&P's 'outlook' downgrade has made the QEII exit strategy more complicated

The QEII exit strategy has become more complicated after Standard and Poor's (while confirming its AAA rating for US government debt) downgraded the US outlook from 'stable' to 'negative'. This marks the first US sovereign debt downgrade in history and this reflects the agency's view that the US has at least a one in three chance of a ratings downgrade in the next two years – only a credible fiscal consolidation plan by 2013 will prevent this. However, the US Congress and the Obama Administration seem incapable of reaching consensus about tackling the US deficit.

The recent spending cuts agreed by legislative leaders to prevent a closing of the US Government, resulted in only a 1% reduction in total Government outlays (reductions totalled USD38 billion, from a budget of USD3.7 trillion in 2011). Indeed, the Congressional Budget Office indicates that the US deficit will worsen from 8.9% of GDP in 2010 to 9.5% in 2011 (in the wake of the extension of the Bush tax cuts) and decline to 7.4% of GDP in 2012 (reflecting a growing US economy, rather than an explicit fiscal contraction). Given the currently divided Congress, a more serious fiscal adjustment seems unlikely and the Republicans will ensure President Obama's job is very hard with an election only 18 months away.

A double tightening of policy plus strengthening headwinds

With interest rates low and earnings growth strong over the past two years, global shares have been a 'sweet spot'. However, global headwinds such as higher oil prices, policy tightenings in China and Europe, rising US yields, the peak in the global industrial production cycle and a depreciating US dollar are significant headwinds for financial markets by themselves. Nevertheless, what is most striking this cycle is that many economies will be facing simultaneous tightenings of both monetary and fiscal policy (normally higher rates aren't associated with fiscal contraction). The extent of the latter here is likely to be one of the major themes for markets in 2012 as the spending cuts required to put fiscal policy back onto a sustainable footing are quite large and these spending cuts will slow growth, all other things being equal.

The global shares 'sweet spot' is over

These strengthening forces mean the 'sweet spot' for global shares is over. This won't necessarily end the equity rally, but it does signal a slowdown in the upward trend and may prompt some sector rotation. In particular, the perfect storm for commodities of accelerating economic growth and surging liquidity is coming to an end. This means that further improvements are dependant on the economic cycle. In addition, higher oil prices could restrain the advanced economy recovery and with tightening liquidity conditions, the outlook for bulk commodity prices is more clouded. Consequently, early cycle stocks such as materials and energy that are priced for earnings perfection may start to experience a moderation in earnings growth and lag the market index, whereas later-cycle stocks might find themselves the subject of increased interest from global investors.

The RBA seems to be on hold, but not for long

Global investors may not be the only group changing strategy. After undertaking the sharpest 18 month rise in domestic interest rates since the mid-1990s, the Reserve Bank of Australia is clearly balancing increased uncertainty about the near term (reflecting the Japanese disasters and local floods) against a robust medium term outlook for the economy. In the minutes of its April 2011

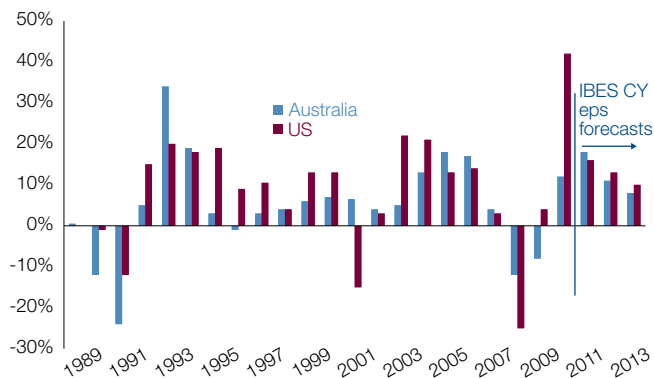
board meeting, the RBA indicated that our record high terms of trade and the impending mining boom were good reasons not to decrease the target cash rate despite a string of global crises. To this you can now add rising domestic inflation. Domestic core inflation (which removes the impact of volatile items such as fruit, vegetables and fuel) rose 0.9% in the March quarter 2011, relative to 0.4% in the previous quarter. This suggests that after a temporary pause, inflation is on the rise again. If unemployment (currently 4.9%) continues to decline, the RBA will lift rates before the end of the financial year. If not, then the RBA can wait until July to confirm that inflation has troughed, and hike rates in August. But make no mistake, rates are going up.

Why have Australian shares underperformed?

Although the Australian economy has outperformed all of its international advanced peers over the past 10 years, the Australian sharemarket has severely underperformed most international markets over the past 18 months. During this time, Korea (up 34.3% in local currency price terms since end-August 2009), Germany (31.9%), US (29.8%) and UK (21.8%), for example, have significantly outperformed the Australian sharemarket (7.4%). The key reasons for the underperformance are the sharp rise in domestic interest rates and oil prices and fairly subdued household wealth, which have all increased pressure on household spending. Meanwhile, the rise in the exchange rate has negatively impacted foreign earnings and this combination has seen the Australian sharemarket record lower earnings per share growth in the past two years relative to the US and this trend is forecast to continue in two of the next three years (see Chart 2).

Chart 2: Australian companies have under-earned the US and this is likely to continue

Calendar Year EPS: Australia vs. United States



Source: Citigroup as at 20 April 2011.

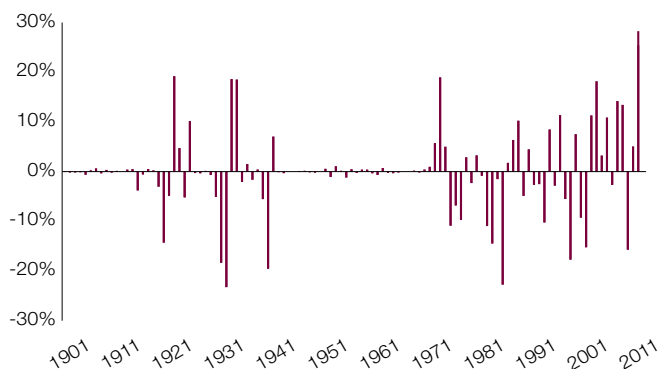
The line during confession season could be long

The higher-than-elsewhere domestic rate increases have underpinned a drop in the relative valuation of the Australian market (down 12% compared to the global sharemarket since September 2009). Rate increases have also meant that

domestically exposed cyclical sectors such as financials and consumer discretionary have underperformed the broader market by around 10%. Meanwhile, the month of May has often witnessed its fair share of earnings surprises as companies confess to discrepancies in earnings guidance as the end of the financial year approaches. Five of the past ten years have seen notable downgrades in May, with a rising Australian dollar the major driver in four of these five periods. Given that the Australian dollar has (to date) recorded its largest financial year appreciation (28.2%) against the US dollar in history (dating back to 1900 – see Chart 3), the confession booth this May might be unusually well attended.

Chart 3: The Australian dollar will experience its largest financial year rise in history

Financial-year Movement in the Australian-US dollar Bilateral Rate (%)



Source: The Reserve Bank of Australia as at 21 April 2011. The result for 2010/11 financial year is the financial year to date. The years 1937 and 1951 has been removed as the extreme negative results blow out the scale.

Implications for investors

It appears that the global sharemarket is changing gears and is moving into a less egregious part of the cycle, where the upward trend is driven by different sectors and is a bit more of a grind than it has been in the past few years. Australia has already been in this part of the cycle for an extended period in the wake of higher interest rates and the higher exchange rate. While growth prospects appear marginally less bright than three months ago, consistency in cash flow generation and dividend income growth, and market valuations are things to watch. Companies with more sustainable business models that can deliver earnings growth and dividend income growth should outperform in this environment – but with markets more volatile and prone to quick changes in sentiment, patience will be key for investors.

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