

### Has Europe's 'wall of liquidity' contained the problem?



For all the talk about doom and gloom in H2 2011, Europe remains functioning, the US did not fall into recession and China is achieving a soft landing. Matt Sherwood, Perpetual's Head of Investment Market Research analyses recent trends and concludes that despite being a piecemeal approach, Europe's policy responses have, to date, kept market forces at bay and supported a technical sharemarket rally. However, this defense is only temporary and a complete solution will have to be found in 2012 or these gains may be lost.

#### Key takeouts:

- The World Bank's 2012 Global Economic Prospects report may have indicated that the European crisis could trigger a credit freeze, but this is an extreme worst case scenario and didn't tell financial markets anything that they didn't already know.
- Europe's €1 trillion+ 'wall of liquidity' is not a permanent solution, but it has lowered yields and appears to have provided valuable time to formulate broader and longer-lasting reforms.
- While market headwinds are likely to persist in 2012, pressure on valuations is likely to ease, whereas pressure on earnings may intensify if growth disappoints.
- During the 28-year leverage boom to 2008, weak economic data was on many occasions good market news (as it meant rate cuts, rising leverage and a stronger recovery). However, household debt reduction should prompt an end to this unusual relationship.

#### Introduction

Most investors were only too happy to see the back of 2011. The Australian sharemarket's calendar year price return (-15.2%), was the fourth worst in the past 30 years with defensive sectors outperforming cyclicals and large caps outperforming small caps. In comparison, the US market's return (-0.0%) was the seventh worst over the same period. The major theme of 2011 was surprisingly declining sharemarket valuations. Indeed, of the 43 largest markets in the world, valuations declined in 34 of countries in 2011, even though earnings rose in 36 of the markets.

#### The World Bank's comments are an extreme worst case scenario

Many investors are questioning what is going to happen in 2012. In their 2012 Global Economic Prospects report, the World Bank (WB) cut its global and regional growth forecasts for 2012 and 2013 and stated that the crisis in Europe could trigger a credit freeze and have other adverse effects. The International Monetary Fund subsequently downgraded its growth forecast and highlighted similar risks. However talk about credit freezes and GFCII are extreme worst case scenarios and even though it captured the headlines and undoubtedly scared numerous households, the comments didn't tell financial markets anything that they didn't know. Global sharemarkets shrugged off the WB report and have extended their rally since early November 2011, despite persistent headwinds from Europe.

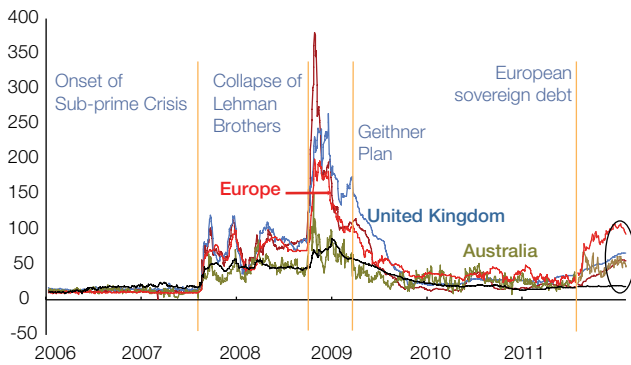
#### Europe's 'wall of liquidity' has contained market forces

Most investors are aware of the sorry state of Europe and it remains paramount that the regional authorities establish a credible well-funded backstop to deal with the inevitable regional headwinds. Although muddled and piecemeal, after eight summits and numerous announcements, the European policy response does appear to be suspending market forces as evidenced by declines in both government funding costs and inter-bank spreads (see Chart 1). The combination of the European Financial Sustainability Fund (EFSF, worth €780 billion), IMF loans (€150 billion) and the regular European Central Bank interventions (averaging €6 billion per week) has culminated into a massive 'wall of liquidity'. This should provide stressed regional government funding for much of 2012, even in the unlikely event that the Spanish, Italian, Greek, Portuguese and Irish government cannot raise any funds in the primary market.

### ... but it cannot contain these forces forever

The 'wall of liquidity', combined with the European Central Banks Long-Term Refinancing Operation (LTRO, which adds liquidity to the banking sector via a 1%, three-year loan totalling €0.5 trillion (to date, with another round in February 2012)) is helping to reduce funding stress in the European financial system. Since the announcement, the risk premiums in European banks have declined, although they still remain elevated relative to the past two years.

**Chart 1: European bank spreads have declined following recent policy announcements**



Source: UBS Australia Limited as at 18 January 2012.

Importantly, the 'wall of liquidity' is providing the European authorities with valuable time to formulate more widespread reforms (in calm markets) that will increase growth, lower unemployment and, most importantly, reduce debt. While the sum of money will not prevent a regional recession or bank de-levering it should reduce downside risk. This global risk reduction is also strengthened by an aggressive quantitative easing program by the Bank of England and China's lowering of its reserve requirements. However, the 'wall of liquidity' does not represent a permanent solution or a signal that the market is about to enter a prolonged period of 'risk on' – it is a fragile and temporary solution to reduce elevated funding costs (which is working), but it's not a 'cure all'.

### ... but a permanent solution remains elusive, elevated with political risks in 2012

While the 'wall of liquidity' provides additional time, the all-important comprehensive solution remains elusive. The solution is likely to involve a European quantitative easing program and government spending cuts and higher taxes (which will be highly unpopular). These budget measures will occur in a year where seven of the G20 economies are facing elections including France (recently downgraded), Mexico, Russia and India, in addition to a change in Chinese leadership.

However, political risk will be most rife in the lead-up to the US Presidential election on 6 November 2012 and this has the potential to impact market trends and investor sentiment. There is little doubt that the (Republican controlled) US House of Representatives and the (Democrat controlled) US Senate will, at some stage, disagree on how to address the US Federal Budget problems and will use an appropriate opportunity to 'support' their candidate. This is likely to result in some paralysis in US policy management and could prompt more market volatility and impact general confidence.

### Are growth surprises or policy responses the key to 2012?

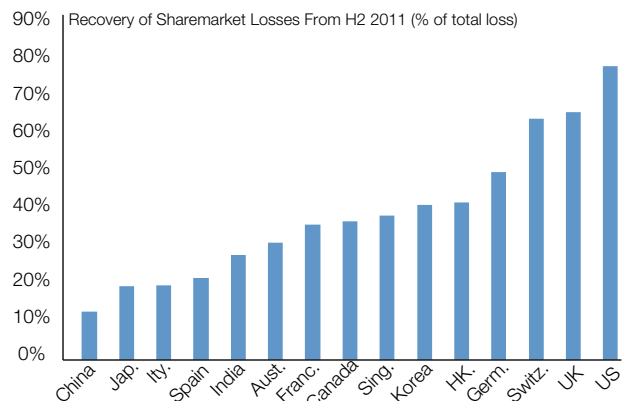
Global economic data over the past few months has come in well ahead of consensus, led by the US and China, which combined with the 'wall of liquidity', has sparked a partial sharemarket recovery. Indeed six of the 15 markets listed in Chart 2 have already recovered 40% of their H2 2011 losses in the past ten weeks, with the largest rises in the markets with the best growth 'surprises'. If the regional share markets are to rise further in 2012, then economic data will have to continue to outperform expectations.

If growth disappoints the extent of the decline will depend on the level of policy stimulus, which has been front-loaded in the emerging economies. Fortunately, pressure of sharemarket valuations should decrease in 2012 (as most are low relative to the past 10 years), but pressure on earnings may intensify given the global backdrop.

### Has the relationship between the sharemarket and the economy changed?

The positive correlation between macro surprises and sharemarket performance may have been evident in 2011, but many times over the past 30 years 'weak' economic news (as represented by the US ISM Manufacturing Index) was seen as 'good' market news (see the boxes in Chart 3). This inverse relationship can be seen on five occasions (1984/85, 1987/91, 1994/96, 1997/98 and 2004/08).

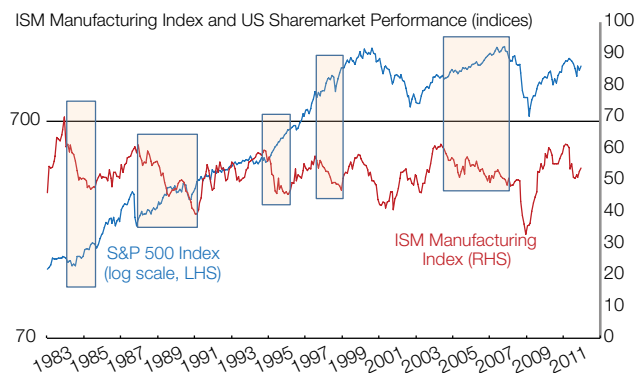
**Chart 2: Six markets have already recovered over 40% of their losses from H2 2011**



Source: IRESS as at 18 January 2012.

This unusual relationship was sparked on occasions, by weak economic data being viewed as a catalyst for lower interest rates and this, in turn, was led to expectations of higher leverage, asset prices and economic activity. However, given the impetus for households and governments to reduce debt, rate cuts are unlikely to spark a broad-based re-leveraging of household balance sheets and as such 'disappointing' economic news is unlikely to be associated with a strong market rallies going forward.

**Chart 3: The relationship between macro news and the sharemarket has changed**



Source: Datastream and Morgan Stanley as at 3 January 2012.

### Australia companies also face sizable headwinds

Although the Australian economy remains well positioned given our low debt, strong mining sector and growing trade exposure to China, there is no doubt that corporate Australia has many obstacles to overcome in FY12. Among these is the sustained higher currency, Europe troubles, the ending of a 40-year leverage boom, a stagnate labour market, government re-regulation and austerity measures and the negative impact of the mining boom on the remainder of the economy. This will culminate in a more difficult environment for the healthcare, retail and housing-related sectors, whereas developers and some gaming and transport companies face a somewhat easier terrain.

### Are earnings expectations still too high?

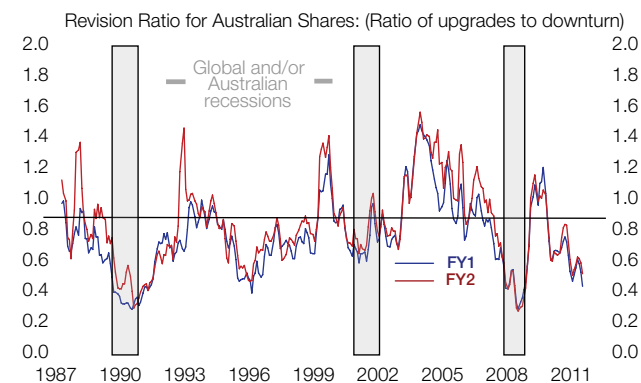
The earnings environment is already quite challenging with earnings having been in sustained downgrade territory for over a year and at their lowest non-recessionary trough since 1996 (see Chart 4). While bottom-up consensus earnings forecasts have a terrible track record in predicting earnings growth, the 2012 result seems optimistically high with domestic earnings per share forecast to grow at 10%.

While this figure is down from 16% in June 2011, it still assumes some margin expansion (which is difficult to achieve in an environment where commodity prices are declining) and 8% revenue growth (which is even harder to achieve as the Australian economy is likely to grow around 6% in nominal terms and the global economy less than that). The wildcard here remains resources - if there is a sustained recovery in commodity prices, then up to 10% can be achieved.

### Implications for investors

Until Europe is resolved, risks remain elevated in all markets. With respects to earnings, an awful lot of events have to turn out right

**Chart 4: Australian company earnings are still been downgraded**



Source: Macquarie Equities as at 18 January 2012.

for consensus to be right and the risks here are probably to the downside, which is why income and conservative investing is so important in this environment. Conservative investing should serve investors well as it gives downside protection with upside potential and the key here is an asset's 'quality' and its 'price'. That is, companies that are high surplus cash-flow generators, have a strong balance sheet, a history of recurring earnings growth and have management and Boards that reinvest capital wisely, are likely to outperform their market peers.

These low-risk stable businesses typically outperform in times of heightened market stress and over the entire cycle and a steadfast focus on valuations (buying stocks that have been oversold and selling stocks whose price is too high for its earnings capability) will help mitigate risks further. Valuations are a great risk management tool and the overall key here is to seek exposure to quality income producing assets that are undervalued by the market. History has proven consistently that there is much less volatility in dividend income than in share prices, and buying this income when it's cheap is the best path forward in any market condition.

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**For further information speak with your Financial Adviser**

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