

Beginning of the end, or end of the beginning?



After declining in April and May, global sharemarkets have stabilised to date in June. However, investors seem uncertain as to whether the June performance represents the low point of the recent turbulence or the calm before the next storm. Matthew Sherwood, Perpetual's Head of Investment Market Research examines these questions and concludes that while the global economic recovery is likely to be anaemic, the Australian outlook remains very positive despite recent volatility.

Introduction

June and July are two of the best months for sports. In that nine week period every year there are so many things to watch that a sports nut could easily justify not sleeping for 61 days. Events including The French Open tennis final, Wimbledon, the Tour de France, US Open golf, British Open golf, NBA finals, Stanley Cup finals and not to mention this year the largest sporting event in the World in the form of the FIFA World Cup. In these events champions are determined and legends are born through complete domination or enthralling victories and it is the latter which stay in the memory the longest. Most sports enthusiasts can remember the battle between Greg Norman and Nick Faldo in the final round of the 1993 British Open, Nadal vs. Federer at Wimbledon in 2007 and 2008, Greg Lamond vs. Miguel Indurain in 1991. Sometimes it is hard to know why precisely champions win, many of them talk about visualising victory and others mention the battles of wills. One such battle is currently underway in financial markets in the form of the bulls and the bears and the winner is likely to have a larger personal impact on investors than any of the aforementioned sporting contests.

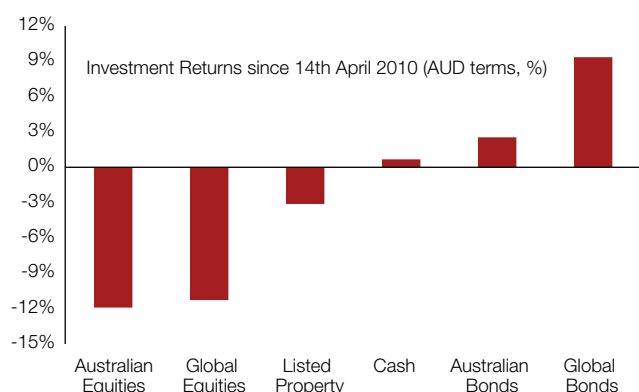
Recent market activity

Since 1975, the Australian sharemarket has typically performed well in the month of May rising on 26 occasions and declining on only eight (only December is superior (27 and seven, respectively)), delivering an average monthly return of 1.3%. However, in 2010 the combination of sustained European sovereign debt concerns and the embryonic signs of a mid-cycle slowdown in China underpinned the second worst monthly performance (-6.8%) over the 35-year period and things have only slightly improved in June. Since these global headwinds surfaced in mid-April, returns in other growth assets have also been negative, whereas typically defensive assets have outperformed by a wide margin (see Chart 1).

It is hard to determine the largest surprise when it comes to market returns. One might be concerned that the Australian sharemarket has underperformed its global peer, despite our very low Government debt, robust financial system, high population growth and strong domestic economy. However, investors should be much more concerned that investors, through their actions, have suggested that the best place to invest during a sovereign debt crisis is sovereign debt. Clearly the worst place to invest during a crisis is where the stress is at its highest. This was evident in global shares during the tech bust and in emerging markets debt during the Asian financial crisis. This suggests that either investors are unsure of what to do in the current market malaise or there may be more to the current market decline than just sovereign stress. Indeed, investors may also be concerned about the prospect for a double dip global recession and its impact on earnings. Whether or not this is likely depends on which side of the sentiment fence an investor sits.

Chart 1: Global government bonds have outperformed during the sovereign debt crisis

The markets may not know how to cope with heightened sovereign stress



Source: DataStream as at 14 June 2010.

The bear case for a double-dip global recession

The primary market concern is high European government debt, which could trigger an economic downturn if markets lose confidence in governments' willingness to alleviate this. Several countries have been forced to announce significant fiscal policy tightenings before their respective economic recovery has become firmly entrenched, which makes their economic outlook more fragile and potentially volatile. Despite the reduction in government spending, sizeable deficits are expected to persist for a number of years, raising concerns about fiscal sustainability. Any double-dip recession in Europe would be sparked by deterioration in global attitudes to risk and an associated rise in funding costs. If this was to eventuate, it would be quite dire, as interest rates in most major economies could not be reduced any more and governments would not be in a good position to sell large amounts of bonds to the private sector and increase spending, without triggering major disruptions in financial markets. The only solution here would be to print money.¹

The bull case for sustained economic recovery

In contrast to the turbulence in financial markets, recent data has confirmed that the global economy is expanding at an average pace. US employment growth has resumed and this has positively impacted US consumer spending and industrial production and Chinese investment, exports, retail sales and credit all continued to rise in April after a strong increase in the March quarter – a trend evident across most Asian economies. Strength in Asian consumer and business spending was, in turn, benefiting Japan's export-based economy. Even though Europe remained the primary drag on global growth, activity in their largest economy, Germany, continues to be surprisingly strong reflecting the impact of the weaker Euro on exports and also a rise in construction spending.

Is the glass half full or half empty?

Clearly there is some support for both the bull and the bear view of markets and although both can't be right, it could be a case that neither is right and the truth lies somewhere in between. Even though, on balance, regional economic data has been surprisingly good, it is very hard to envisage that the present strength of the recovery will persist given the inventory cycle has run its course, fiscal stimulus is being wound back in many countries and the widespread deleveraging underway in the global household sector. Previous editions of Perspective have noted that the US household sector has experienced four distinct periods of deleveraging since 1959 which have lasted an average three years during which

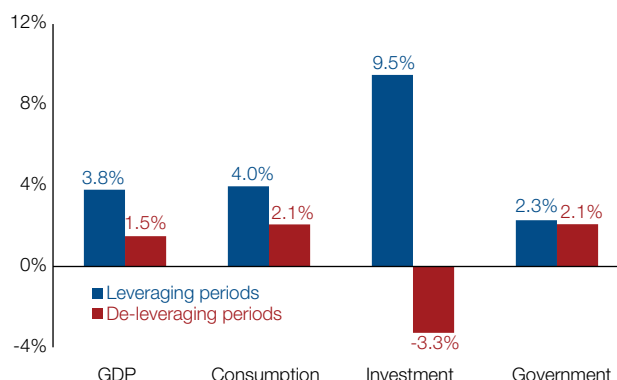
economic growth averages 1.5% per annum. All sectors contribute to the growth slowdown, with consumption growth (which is now over 70% of US economic activity) declining by half, business investment growth turning negative and government investment and consumption declining marginally (see Chart 2).

Downside risks to the global economy will impact corporate earnings

Although the US economy is currently growing at double its average deleveraging pace, this is unlikely to last. The current US situation is a rare occasion in which two sectors of the economy (households and governments) are de-leveraging simultaneously. Indeed, the US Government may struggle to lift its spending by 2% per annum, given the poor state of their Budget and the need to cut spending. This suggests that risks to US economic growth from the current level are tilted to the downside (as is the case also in Europe and Japan). This anaemic growth environment in highly-indebted advanced economies will have flow on effects to corporate earnings growth. Modest earnings growth provides the justification for lower returns in periods of de-leveraging (a total average return of around 5% relative to a return of 10% in leveraging periods) and income becomes a large contributor to total return. The strength of a firm's balance sheet and the sustainability of its business model should be key inputs into all investment decisions, particularly in an environment of anaemic growth.

Chart 2: All sectors slow during a period of US household deleveraging

Real US Economic Growth During Periods of Household De-leveraging



Source: DataStream as at 16 June 2010.

Australia's biggest risk is inflation, not growth

No matter how Europe and the US turn out, Australia is well positioned to take advantage of the growth in Asia. Over past the past generation, Australia has transformed its export base with over three-quarters of our exports now going to Asia. Asia is the region that will be least impacted by government and household balance sheet issues, which indicates that Australia's export base should remain intact. Indeed around 40% of our exports over the past year went to the 10 countries with the strongest potential economic growth based on population growth and savings and investment rates. Meanwhile, mining investment normally runs at about 1.5% of Australian economic output, but currently is at 4.5% of output and all projections indicate that that it's going higher yet. This suggests that the medium to long-term outlook for the Australian economy (which also has strong population growth) is sound. The challenge for the Australian economy for the next few years is going to be how to accommodate the mining boom, without triggering a serious rise in inflation.

1 This occurred in the Weimar Republic after WW1 and a few years after the German printing press was turned on monthly annualised inflation peaked in October 1923 at 4.4 quintillion per cent, which meant that consumer prices doubled around every six and a half days. These issues can be overcome with immense economic pain, today Germany is the world's largest exporter and the fourth largest economy.

What if China slowed down more than expected?

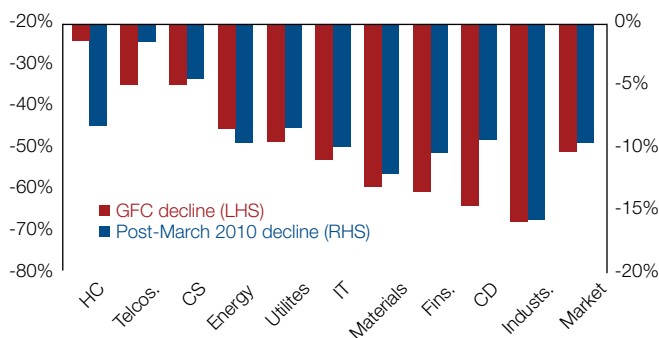
During the Asian financial crisis in 1997/98, around two-thirds of our exports were going to Asia and most of these economies experienced a major financial crisis, which should have severely impacted the Australian economy. However, it didn't as the exchange rate depreciated to absorb the trade shock. This also highlights that one large advantage of being a commodity exporter is that it is easier to find new markets when your existing trade base experiences major stress. It is more difficult to find new markets if your exports are services or manufactured goods, because alternative distribution channels have to be found, product advantages need to be identified and marketed and brand loyalty established to gain a foothold. Alternatively, when you are selling coal or iron ore, you can more easily send the produce to another market. That is not to say that a major slowdown in China would not impact the domestic economy, but rather the Australian economy should be better able to respond to such a development than our manufacturing or serviced-based exporting peers.

Australian sharemarket performance – defensives outperform cyclicals

Despite the positive outlook for the Australian economy, the sovereign debt concerns have impacted market trends. Indeed, there are many similarities between recent turbulence and the GFC with respect to investment performance, in that telecommunications services, consumer staples and energy stocks have been the three of the best four performing sectors and that industrials, financials and materials have been three of the four worst sectors (see Chart 3). However, on a positive note, the across-the-board declines in market prices have resulted in market valuations (currently around 12 times forward earnings) declining below its 20-year average (14x) for the first time this year, which could represent a buying opportunity if Europe stabilises and the domestic economy and corporate sector remain intact.

Chart 3: The recent market selloff has some similarities to the GFC

Australian market decline



Source: DataStream as at 16 June 2010.

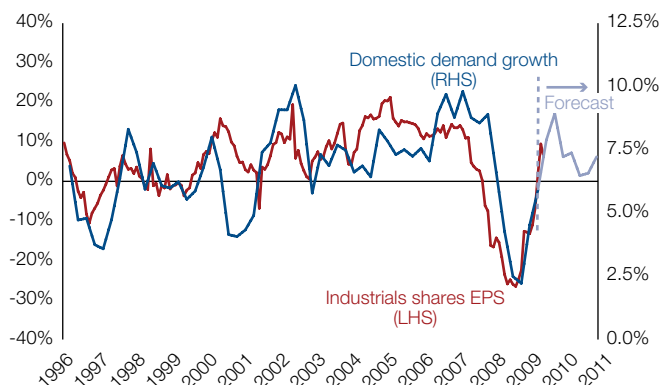
Domestic demand to support industrials sector earnings

The mining surge will place large growth pressures on the Australian economy with the household sector having to make way for booming investment and exports (and NSW and Victoria

will have to make way for a booming WA and Queensland). This indicates that domestic demand (the total of consumption, investment and government spending) should remain quite strong despite the consumer (being weighed down by deleveraging of their balance sheet) remaining quite subdued. Growth in nominal domestic demand is forecast to remain above its 15-year average for the next 18 months, which suggests that industrial sector earnings could also be above their 15-year average until end-2011 (see Chart 4).

Chart 4: The domestic earnings outlook remains solid

Australian Domestic Demand and Industrials EPS Growth



Source: UBS Limited as at 10 June 2010.. Forecasts are from Goldman Sachs JBWere.

Implications for investors

Market turbulence is not unusual for investors. Nevertheless, there is little to suggest that the European, Japanese, US and Chinese economies can maintain their current growth rates. However, China's growth is likely to remain around 8%-10%. Meanwhile, with the debt associated with Greece, Portugal and other club med economies being considerably less than the debt associated with the US housing market, there is little to suggest that growth is likely to turn negative for a prolonged period of time. Investors will have to decide what the more likely scenario is: weak growth, strong growth or something in between. Despite an improvement in June, there is likely to be considerable market volatility ahead as investors' debate whether the bulls are right and the global recovery obtains a firmer footing or whether the bears are right and a prolonged decline takes hold. Whether investors believe that the stabilisation of markets in June represents the beginning of the end for fears of a double-dip global recession or the end of the beginning for sovereign stress-induced market volatility, Australia's outlook remains positive on an absolute and relative basis. Meanwhile, the long-term rationale for remaining in shares remains intact in that earnings growth is presently solid, interest rates remain historically low and valuations appear to be attractive.

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