

### Will 2012 be a repeat of 2011?

After being positive for much of 2011, global sharemarket sentiment has rapidly deteriorated in recent months. Matt Sherwood, Perpetual's Head of Investment Market Research examines this trend and concludes that the solutions recently purposed by the European authorities are doing more harm than good and that investors' patience has run out. Markets are extremely volatile and as this is a confidence game more than anything else, until a solution is found cheap sharemarket valuations will not trigger a recovery.

#### Key takeouts:

- All major international sharemarkets have declined in 2011 despite earnings per share rising in the vast majority of countries.
- European authorities have been unable to stop the ascent of stressed government bond yields and the market is proving more powerful in getting yields to their desired levels.
- In July 2011 European banks had to pay an additional 20 basis points for funding (above the riskless swap rate), which was similar to other regions, but now they have to pay an extra 92 basis points, relative to 41 basis points in the US and 50 basis points in Australia.
- Until Europe is resolved, market risks will be elevated, volatility high, markets will remain unusually correlated, and investor's total return will be dominated by income.

#### Introduction

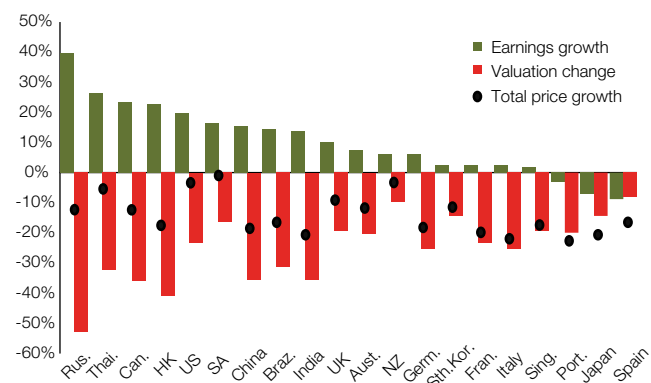
While the world left 2010 with good market momentum and with the global economy growing at 5% (which was around the strongest growth rate since 1973), 2011 will undoubtedly go down as a year that has seriously underachieved from a global investor's perspective. While gold rose 20% (to date in 2011) and Australian and US 10-year government bonds recorded 11% and 14% price gains, respectively, global sharemarkets have declined across the board. The pace of the decline was led by European markets (with France, Italy, Portugal and Germany all down by more than 20%) reflecting regional balance sheet problems in the household, government and banking sectors. In contrast, the US sharemarket (down only 3%) recorded one of the best results, reflecting their rising productivity, tight cost controls and strong earnings growth from Asian operations.

#### 2011 had three key investment themes

There were three key investment themes in 2011; the Japanese natural disasters (and their impact on global economic and earnings growth), the Eurozone debt crisis and declining sharemarket valuations. Although earnings growth was positive in the vast majority of countries in 2011, this was outweighed by the decline in sentiment (see Chart 1). Indeed, of the 20 countries listed, 17 experienced rising earnings growth with the growth strongest in the Asian and Asia-related markets (such as Canada and South Africa), but all countries recorded declining market valuations and negative 2011 price returns.

#### Chart 1: Valuations have declined by more than earnings have risen

Changes in Earnings and Valuations in 2011 (%)



Source: UBS Australia Linked as at 21 November 2011.

## European authorities are still not getting ahead of the problem

This universal decline primarily reflected the impact of debt concerns in the northern hemisphere. What started in the periphery European economies (of Greece, Ireland and Portugal) has now spread deep into the core (Italy, Spain, France and now maybe Germany). Policy changes in the Euro Area have so far failed to stem the momentum of the crisis. This reflects a lack of political will across Europe to unwind the massive debt excesses of the past decade and to only attempt to rectify things when markets 'lose it'. Worse still, governments have had ample time over the past two years to solve things and have been short of the mark.

In late October, the European authorities announced a 'comprehensive solution' including a 50% write down of private sector bank's Greek debt holdings and a €1 trillion rescue fund to aid stressed government debt. This prompted a solid 10% to 20% rise in most major markets. Unfortunately, a lot of the plan's detail, including who will fund it and how the banks will recapitalise their balance sheets, remains absent today and this has sent markets lower.

## The European Central Bank is struggling to lower yields

Most importantly, the rescue fund remains completely unfunded. Consequently, the plan is now lacking credibility and Italian and Spanish government 10-year bond yields have subsequently risen to new 14-year highs. In a recent 'bill' auction, the Italians had to pay an implied yield of 6.5% to have €8 billion of 6-month bills funded, which is well and truly above the approximate 3.5% they had to pay just a month ago. After this poor result, Italian yields spiked across the curve with the 10-year government bond up to 7.3%. The European authorities have tried to lower these yields through open market operations, but the market has proved to be much more powerful in moving yields. Rising yields, in turn, have prompted Standard & Poor's to cut Belgium's sovereign rating from AA+ to AA-, citing new funding and market risks, and Moody's cut Hungary's rating to 'junk'. The Eurozone crisis is threatening to impact all the region's governments as their ability to raise market capital at manageable interest rates is increasingly in doubt.

## The austerity solution has become self-defeating

In the stressed periphery economies, the European authorities are forcing through major austerity measures. While these smaller economies need to cut wasteful spending, the fact that they have a German-dominated exchange rate means that the cut backs in government spending cannot be offset by rising exports and recessions are inevitable. Accordingly, the austerity approach is producing a vicious circle where the spending cuts weaken growth and forces more austerity to meet fiscal targets, which further saps growth and requires more cuts, and so on.

## There is no clear and concise messaging from Europe

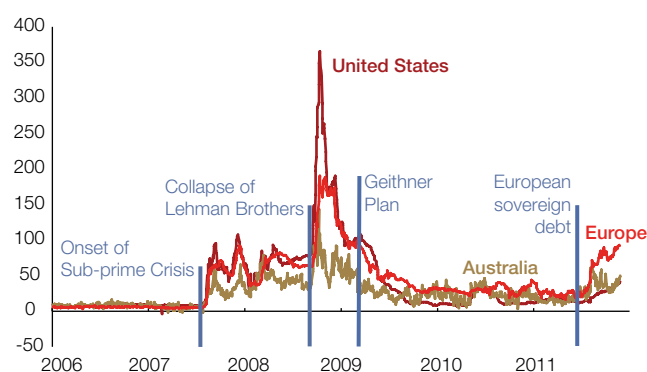
With all this volatility and worsening sentiment, it is clear that this is a confidence game more than anything else. The fastest and best way to stabilise market sentiment is to have everyone talking about a solution that has credibility with the markets. However, the public comments to date have no common thread and continue to highlight the divisions and limitations of what each country is willing to do. For example, the French and several other countries want much greater involvement of the European Central Bank (ECB), the ECB wants respective governments to do more, the European Union Commission is angling for common Euro-area bonds and Germany wants treaty changes before considering further measures. This confluence of views makes for a contradictory and inconsistent message that provokes questions instead of answers.

## Is Europe dragging Germany down?

Recent economic data has showed Europe recorded its biggest decline in factory orders in three years, heightening fears of a European recession and the prospects for a European debt downgrade. These concerns were further heightened when Germany had what was perceived to be the worst bond market auction failure in living memory, which has suggested that the current crisis has now spread into Europe's primary creditor. This funding pressure has also been seen in the bank funding market, where European banks have had to rapidly increase their funding premium to attract capital flows. In July 2011, European banks had to pay an additional 20 basis points for funding (above the riskless swap rate and this risk premium was similar to other regions), but now they have to pay an extra 92 basis points, relative to 14 basis points in Japan, 41 in the US and 50 in Australia - see Chart 2). Consequently, the Eurozone Crisis appears to be unresolved and unpredictable and as such Europe is likely to be the source of sharply changing risk premiums well into 2012.

### Chart 2: Bank funding has become more difficult

Three Month Libor relative to the Swap Rate (basis points)



Source: UBS Australia Linked as at 21 November 2011.

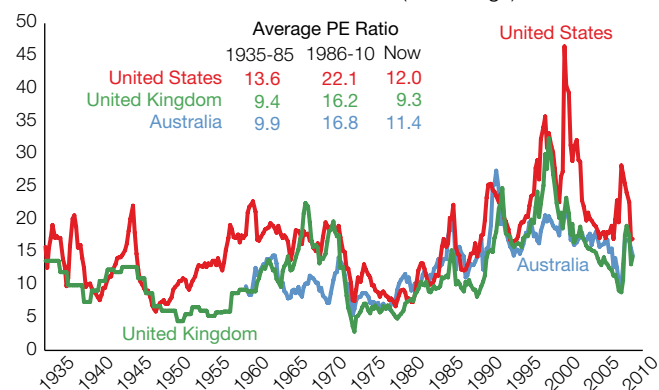
## 2012 has some similarities to 2011

With the European situation likely to be present well into the new year, investors might think that there are now four certainties in life; death, taxes, Black Caviar winning and that 2012 will be a repeat of 2011. There is little doubt that next year's outcomes are likely to be influenced by Europe and questions about the speed and sustainability of the global recovery. As such, some investors might conclude that market risk premiums will be elevated and price indices will remain range-bound with above-average volatility. However, it is important to recognise that some key features of 2012 will be different to 2011.

**1. Share valuations are low.** UK and US sharemarket valuations are currently well below their respective post 1985-average (see Chart 3). While this means nothing in triggering a recovery (as 'bottom fishing' is unlikely to occur until Europe is solved and confidence recovers), it means that the market is prepared for lower earnings growth and more analyst downgrades, which will provide some cushion for investors.

### Chart 3: Sharemarket valuations have declined below their post-1985 average

Market Valuation: US, UK and Australia (X earnings)



Source: Australian Stock Exchange, Reserve Bank of Australia and DataStream as at 30 September 2010.

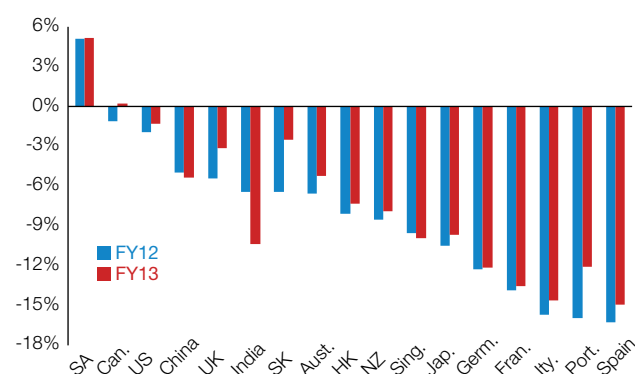
**2. Valuations in other markets have risen.** US 10-year bond yields are around their lowest level since end-WW2, which means that bond prices are near a peace-time high. Meanwhile, UK 10-year bonds are at an all-time low yield of 2.1%. While bond holders benefitted from the lowering of yields (and rising of bond prices) in 2011, they are now poorer in prospect as forward-looking returns for government bond investors are now low. Meanwhile, gold has risen near-20% in 2011 to a new year-end high (in both nominal and real terms). These record valuations suggest that the successful strategy of 2011 such as long-duration government bonds and precious metals may be less compelling in 2012.

**3. Earnings growth is set to moderate.** While profit margins have most likely peaked and analysts are likely to revise their 2012 growth rates, earnings growth should continue as long as global growth remains positive. If growth is sustained, then earnings growth will mostly be driven by cost-side management and the majority of costs are labour costs, which in a world of sluggish growth and high unemployment should remain subdued. The combination of reasonable profits and cheap valuations are likely to provide some support to both global sharemarkets and global corporate bond markets.

Importantly, against the more challenging investment climate currently unfolding, investors have lowered their earnings per share expectations for FY12 and FY13. The largest downgrades have been recorded across European sharemarkets where the earnings outlook for FY12 and FY13 has declined between 12% and 18% in Spain, Portugal, Italy, France and Germany. In contrast, Asian market FY12 and FY13 earnings per share forecast are also lower, but by a more orderly 5% to 9% (see Chart 4).

### Chart 4: Earnings have been downgraded for FY2012 and FY2013

FY12 Earnings Per Share: Change Between June 2011 and November 2011 (%)



Source: UBS Australia Linked as at 24 November 2011.

### 4. Emerging economies' inflation has peaked and authorities can provide support.

Very few central banks in the emerging economies are still tightening interest rates, whereas Brazil and Indonesia have begun to ease them. While advanced economy interest rates being at historic lows (and Government deficits being at non-war highs) has not engineered a strong recovery (due to household balance sheets being deleveraged), balance sheets in the emerging economies are in good shape and as such policy easings are likely to be successful in boosting spending. The key for market trends is whether renewed Asian strength is capable of outweighing any downturn from Europe.

### Implications for asset allocation and investors

There is little doubt that until the issues in Europe are resolved, risks remain elevated in all markets, volatility will be high and asset markets will be unusually correlated. In this market, a much larger part of investors' total return is likely to come from income, whether it is dividend income or coupon payments from corporate bonds. It may be the case that 2011's winning investment strategies such as government bonds and precious metals may have lower returns, given their high starting valuations. In this environment, investing in 'low risk' 'quality' assets (irrespective of which asset class you are in) and regular portfolio re-balancing (when securities have been oversold or overbought) will help mitigate risk. The overall key here is for seeking exposure to quality income producing assets in both the equities and the debt markets and hoping that the European debt crisis is resolved by the politicians. One can't help but think that history is being written as we speak.

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