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Are we in for another mid year bout of weakness?

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Introduction

After a strong start to the year, share markets have had a few wobbles lately and defensive assets like bonds have rallied again. An obvious concern is that share markets will go down the same path as the last three years that saw the year start off solidly only to see sharp falls in either the June or September quarters led by flare ups in Europe, worries about US growth and fears about China. From highs around April, global and Australian shares had falls of around 15% in mid 2010, around 20% in 2011 and by around 10% last year.

There are some parallels with the last three years – namely a strong start to the year for shares, followed by a loss of breadth in share market strength both across countries and within markets, renewed Eurozone worries, recent softer jobs data in the US and uncertainty about China. So its natural to wonder whether markets will follow the same pattern again. And will it be more like 2010 and 2011 which proved to be tough years or 2012 where markets picked up strongly after a milder mid year correction resulting in a strong year?

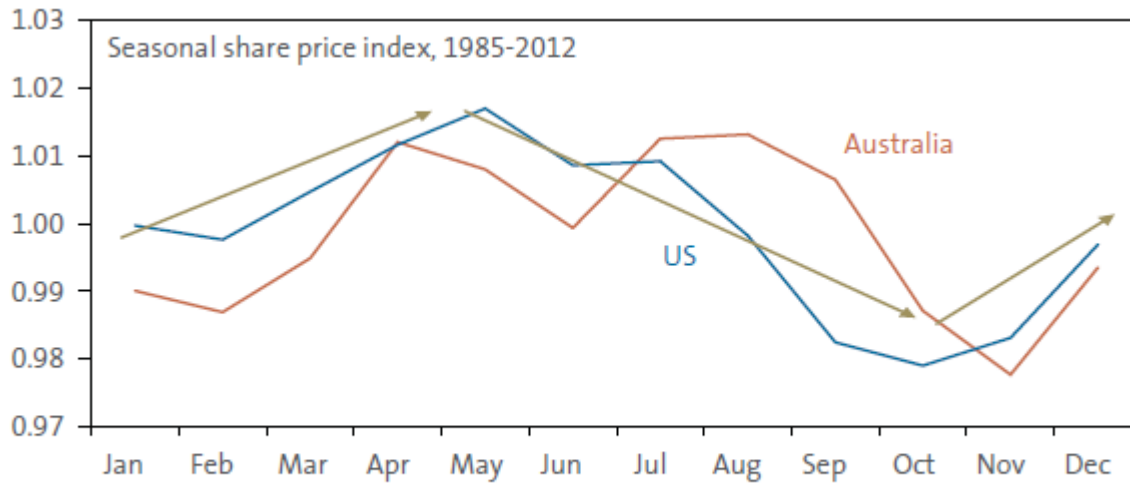
Exaggerated normal seasonal swings

The first thing to note is that the pattern of the past three years is consistent with the normal seasonal pattern in share markets that sees gains from around October to May, followed by weakness into around October. The next chart shows the seasonal pattern for US and Australian shares over the period from 1985. (The chart shows seasonal indexes which indicate the pattern shares track through the year after removing the underlying trend of the market.)

This seasonal pattern reflects a number of considerations including new year optimism and the investment of bonuses early in the year which peters out around May, US mutual fund tax loss selling into

September which results in weakness, followed by the need to buy back in as this reverses into year end. This seasonal pattern is observed in multiple markets beyond the US and was initially thought to relate to crop cycles. Of course 2010 and 2011 were more pronounced reflecting the more serious problems in Europe and a greater degree of investor nervousness.

The seasonal pattern in US and Australian shares



Source: Bloomberg, AMP Capital

The same old threats and some new ones

Apart from the normal seasonal profile indicating that we are now entering a tougher period seasonally, several factors point to the risk of a re-run of the last few years:

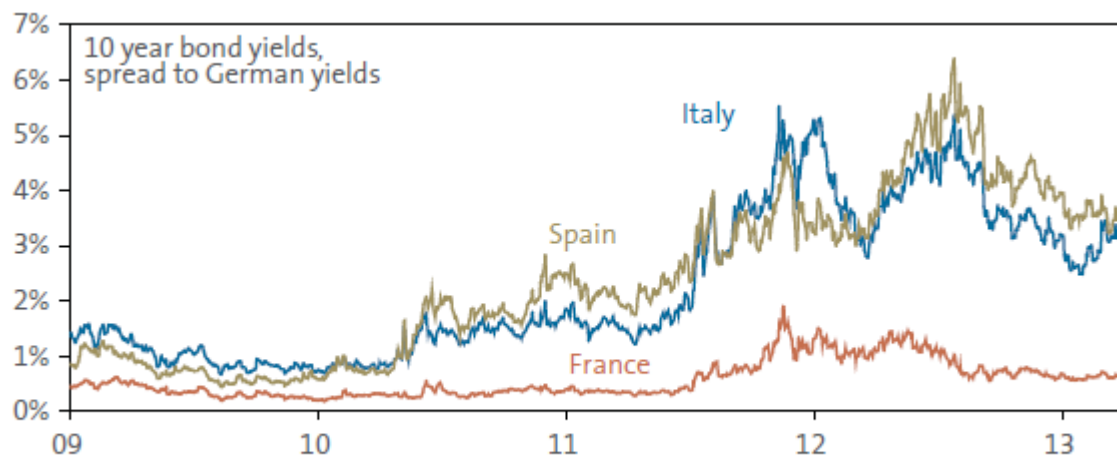
- The botched bailout of Cyprus with talk that it forms a template for future bank rescues, political uncertainty in Italy and continuing recession highlight that Eurozone risks remain. While much has been done to settle fears of a break up in the euro, little has been done to boost growth leaving in place the risk that troubled countries continue to miss deficit reduction targets.
- US data over the last few years has had a pattern of strength over the (northern hemisphere) winter months followed by weakness in the summer months. The softer readings for payroll employment which was up just 88,000 in March and the softer than expected ISM business conditions readings for March fit this pattern. The US also faces another debt ceiling debate mid year.
- Uncertainty remains regarding China and the impact of renewed property tightening measures.
- India and Brazil remain a bit uncertain with both facing less favourable growth and inflation tradeoffs and government reform efforts looking stalled.
- The threats from North Korea and a new strain of bird flu (H7N9) are adding to the uncertainty.
- Australian economic data is likely to remain mixed in the short term as mining investment slows and other parts of the economy take a while to pick up.
- Some market indicators are flashing warning signs, eg while the US share market has made new record highs recently, it came with reduced breadth in terms of the number of shares participating and was led by defensive sectors with cyclicals and small caps taking a back seat and at the same time commodity prices failed to rally with shares and bond yields fell.

Difference versus the last three years

However, there are a number of offsetting positives compared to 2010 and 2011 in particular.

→ Firstly, Europe is looking less scary with the ECB's LTRO bank funding measures and its commitment to do "whatever it takes" to defend the euro combined with moves towards a banking and fiscal union and a strengthened bailout fund seeing fears about a break up in the euro fade. This has been evident in a relatively muted response to the problems in Italy and Cyprus as evident in Italian and Spanish bond yield spreads to Germany remaining well down on recent highs.

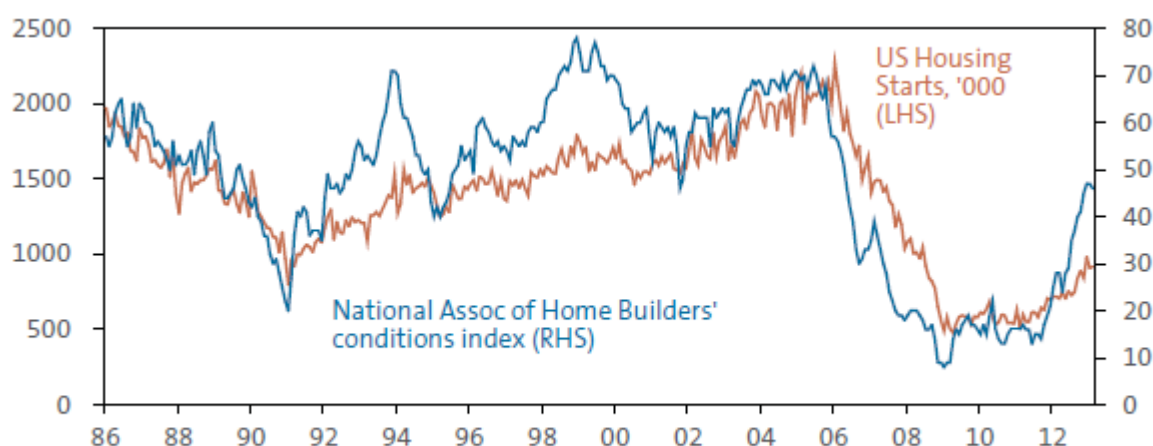
Italian & Spanish bond yields are well down from crisis highs



Source: Bloomberg, AMP Capital

→ While fiscal tightening equivalent to 2% of GDP this year will be a drag in the US it has come at a time when the US economic recovery is looking more self sustaining. A housing recovery is now clearly underway, business investment looks to be picking up and the energy production boom is also helping.

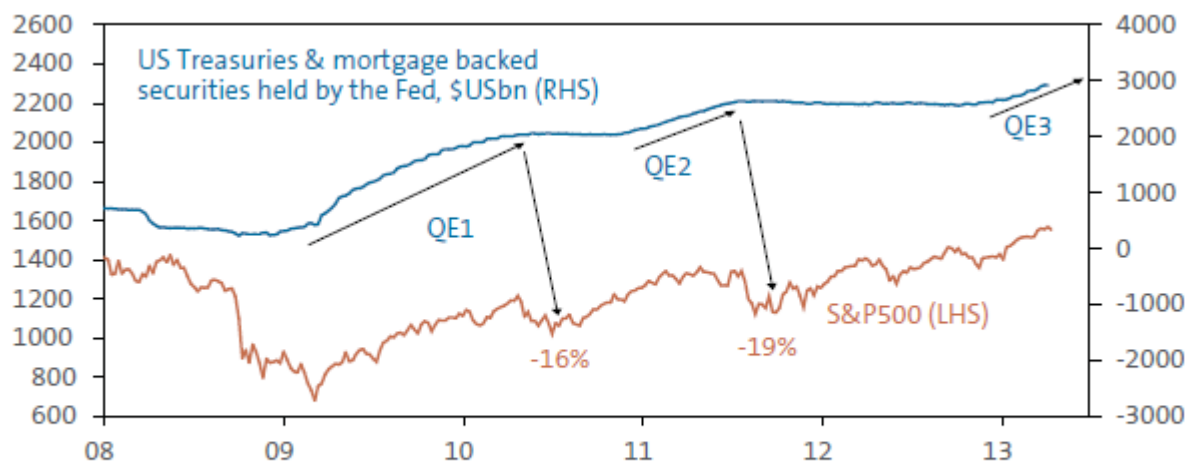
The US housing recovery is building momentum



Source: Bloomberg, AMP Capital

What's more the share market slumps of mid 2010 and mid 2011 were arguably made worse by the premature ending of the first round of quantitative easing or QE1 in March 2010 and then QE2 in June 2011. By contrast QE3 is open ended and set to continue.

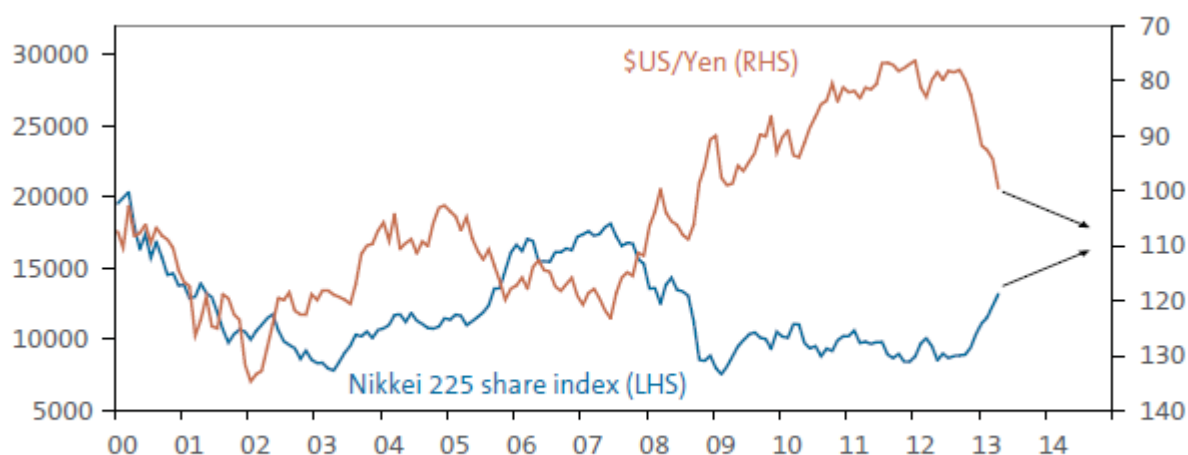
Open ended QE3 very different to QE1 and QE2



Source: Bloomberg, AMP Capital

→ Japan is finally serious about ending its twenty year malaise and has realised that to do this it has to end deflation. Following an election which saw the Liberal Democratic Party returned to power under PM Shinzo Abe with a mandate to deliver 2% inflation, the Bank of Japan under new dovish leadership has announced a doubling in its quantitative easing program which after adjusting for the size of Japan's economy is akin to the Fed purchasing \$US225bn of assets a month. In other words this will dwarf Bernanke's QE3 program which is currently running at \$US85bn a month. What's more its being backed by pressure on companies to boost wages and hence to boost inflationary expectations. This war on deflation is a profound change akin to Paul Volker's attack on inflation over thirty years ago. It holds out the best hope in decades that Japan will be back in business with strengthened growth. Its been reflected in a huge collapse in the Yen and surge in the Japanese share market, both of which likely have a lot further to go.

Japanese monetary reflation = more downside in Yen/upside in Japanese shares



Source: Bloomberg, AMP Capital

For the world this is great news. Japan is the third largest economy so its new reflationary vigour provides a strong offset to the weakness in Europe. And its monetary reflation to the extent that it puts competitive pressures on countries like Korea, Taiwan and maybe China is likely to encourage more global monetary easing.

→ Global monetary conditions are easier than they were a year ago and much easier than in 2010 and

- 2011 when some central banks were actually tightening.
- Finally, interest rates are also much lower in Australia and early signs are starting to appear that rate cuts are getting traction in boosting demand.

What's more there is a danger in reading too much into the weakness in commodities and emerging market shares as they may simply reflect a deeper shift in the relative performance of these assets. The focus on more sustainable growth in China at the same time as commodity supply is picking up and a stronger \$US largely explain the relative weakness in commodity prices. More positively though the fall in commodity prices means less pressure on inflation, more scope to do quantitative easing and less pressure for monetary tightening.

These considerations suggest a mid year correction in shares is likely to be far milder than the falls seen in 2010 and 2011 and more like that seen in 2012 or hopefully less.

Concluding comments

While shares are vulnerable to a correction as we move into the seasonally weaker period over the June and September quarters, the broad cyclical backdrop for share markets remains favourable pointing to more gains ahead this year. Valuations for shares remain reasonable ranging from cheap to fair value, European risks remain but are somewhat less scary, monetary reflation in Japan and improving US private sector demand is providing an offset to European risks and global monetary conditions remain very easy.

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