

New worries for investors – how serious?

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Key points

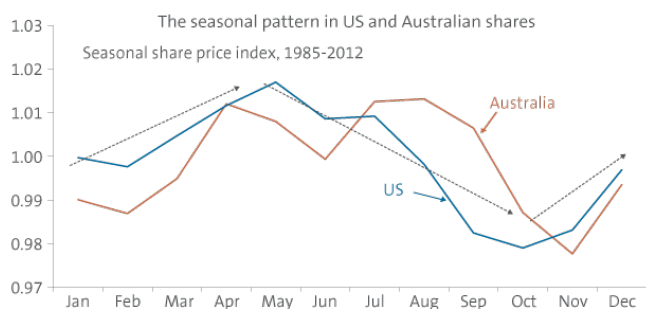
- > Shares were due for a correction after registering strong gains. Worries about the US Federal Reserve (Fed), Japan, China and the growth outlook in Australia have provided the trigger.
- > However, with Fed tightening fears overdone, the US economy on a sounder footing, Japan looking stronger, China likely to grow around 7.5% and the Australian economy to benefit from low interest rates and a lower A\$, a re-run of the 15 to 20% falls seen around mid-2010 and 2011 are unlikely. Our cyclical view for shares remains positive, with further gains likely this year.

Introduction

The volatility of the past two weeks has naturally led many to fear the rally in shares is now over. Markets have been upset by fears about the Fed slowing the pace of easing, uncertainty about whether the stimulus program in Japan will work, an intensification of fears about China and a new sense of gloom about Australia. From their mid-May highs, Japanese shares have fallen by 15%, Australian shares - 6.5%, Eurozone shares -3% and US shares -2%.

Sell in May?

Recent weakness fits the "sell in May and go away" seasonal pattern that sees strength in shares from October to May, followed by weakness into October. See the chart below.



Source: Bloomberg, AMP Capital

Our assessment is that shares had become vulnerable to a correction after having risen sharply. This was particularly the case for Japanese shares which had risen 80% over six months and seemed to be everyone's favourite to overweight. Similarly, high yield stocks had also become vulnerable after a huge surge. With markets now entering a seasonally weak period of the year, stocks were vulnerable to bad news. However, our view remains that this is just a correction, and not the start of a renewed bear market. Let's look at the threats that emerged over the past two weeks.

The Fed and bond yields

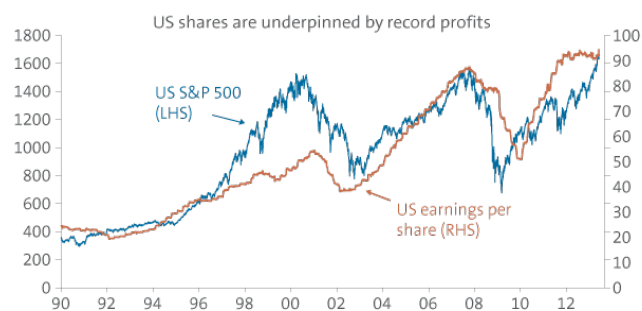
After comments by Fed Chairman Bernanke, many are fearful the Fed will soon wind down or "taper" its quantitative

easing program. This has led to a sharp rise in bond yields which has put pressure on investments that have benefited from low bond yields. This issue will continue to create uncertainty in the months ahead as the US economy continues to improve. However, several points are worth noting.

First, while Bernanke said he could slow the pace of quantitative easing (QE) "in the next few meetings", this was conditional on seeing increased confidence in the sustainability of the economic recovery. So far, Bernanke and the majority at the Fed lack that confidence, suggesting tapering is still months away.

Therefore, it follows that when the US economy does become strong enough to allow a wind down in QE it should also be strong enough to support share markets. In other words, the potential negative of less Fed stimulus should be offset by the positive of stronger profits.

Thirdly, there is a danger in exaggerating the degree to which QE has boosted share markets. Sure it has helped but shares have also been underpinned by record US profits.



Source: Bloomberg, AMP Capital

Next, interest rate hikes are still a long way off. While the US and global economy is looking better, growth is still a long way from booming, spare capacity remains immense, bank lending is subdued and inflation is very low. So it is very hard to see central banks, led by the Fed, raising interest rates soon and as such, the extent to which bond yields will rise will be limited for now. This is particularly the case in Australia where the debate is still about how low the cash rate will go. For this reason, while low yields and a gradual rising trend in them suggests poor returns from bonds, a 1994 style bond crash seems unlikely, at least for now.

Finally, by the time the Fed does start to taper, it will be highly anticipated and will hardly come as a surprise.

For some time I have characterised the US economy as being in a coma and the Fed being the drip that was keeping it alive until it can be taken off life support. If the Fed starts to feel confident that it can start doing this at some point later this year, then it can only mean that its mission has been accomplished. This is surely a good thing.

Japan looks good, but what about JGBs?

The main worry in Japan appears to be that a sharp rise in yields on Japanese Government bonds (JGBs) will snuff out any recovery and/or lead to problems for the Japanese Government in terms of servicing its huge public debt.

However, the worries on this front seem to miss the point that any rise in bond yields will only be sustained if real economic growth strengthens and inflation rises. If nominal growth picks up it will actually help to reduce debt burdens. If Abenomics doesn't work and low growth and deflation continue, then bond yields will simply fall back again. So my view is that the concerns on this front are way overblown.

Finally, a 15% fall in Japanese shares over eight days as seen recently is big, but it needs to be seen in the context of the 80% gain over the previous six months. More fundamentally, compared to past periods of similar falls, the backdrop is far more positive this time, given unprecedented monetary stimulus, increasing evidence of an improving economy with everything from industrial production to consumer confidence on the way up, and profits set to receive a huge boost from the fall in the Yen. So the Japanese pull back just looks like a well-deserved correction.

China worries

China worries seem to have reached a crescendo lately. The latest worries were sparked by soft economic data, reduced hopes for more stimulus and worries about debt. There are several points to note though.

First, expectations/hopes of a quick reacceleration in Chinese growth after last year's slowdown have been too rich with many hoping for a deep 'V' shaped rebound. This was always unlikely with the Chinese Government warning it now prefers to focus on more sustainable growth. However, given its growth targets and recent data, this still suggests a pace of around 7.5% which is pretty good.

Second, recent data is mostly consistent with this. For example, the official manufacturing conditions PMI is running around levels consistent with solid growth.



Source: Bloomberg, AMP Capital Investors

Third, with the trade weighted level of the Renminbi up 10% over the past year, Chinese monetary conditions are actually tight and scope exists to ease interest rates if needed.

Fourth, debt fears are hard to put your finger on. Total Chinese public and private debt has increased in recent years but, even allowing for a sharp rise in local government debt, is running around 200% of GDP which is low compared to advanced countries where the norm is more like 300% plus. It is also to be expected that since China saves so much each year and these savings are largely recycled back into the economy via bank lending, its debt level will rise sharply each year.

Additionally, everyone seems to be bearish on China and this is already factored into its share market, which is amongst the world's cheapest, trading on a price to forward earnings multiple of 10.6 times.

Australia - post the mining boom

Worries about Australia have heightened over the past month, with a downbeat Budget, Ford announcing the closure of manufacturing in 2016, a run of soft economic data and increasing evidence that mining investment has peaked. Some are even talking of a recession.

These concerns have been compounded by a correction in high yielding bank and telecommunications stocks which have soared around 50% from the June 2012 lows. The fall in Australian shares has also been accentuated by the A\$ decline as foreign investors tend to exit when it's falling.

To be sure, with the resources boom behind us and the US, Japan and Europe looking healthier or less threatening at the margin, Australia is likely to be a relative underperformer in the years ahead, particularly as the A\$ heads lower.

However, notwithstanding this and while the short term risks have certainly increased, there are several positives worth noting. First, lower interest rates are gradually starting to work. In particular, home buyer demand is up and housing approvals are trending higher, which should ultimately provide a boost to retail sales. More rate cuts are likely required, but there is plenty of pent up demand in areas like housing construction to help offset the mining slowdown.

Second, the A\$ is now going in the right direction and, with commodity prices trending down and Australia seeing its interest rate advantage over other countries fade, it is likely to fall further - probably to around US\$0.80 in the years ahead. This should go a long way to unwinding the damage it caused to sectors like manufacturing, tourism and agriculture over the resources boom years.

Third, high yielding defensive sectors were due for a correction. Banks have now fallen 12% from their highs and with franked dividend yields for the banks still around 7-8%, the sector should start to find support.

Finally, the Australian share market is still not expensive, trading on a forward earnings multiple of 13.5 times. The sector remains particularly attractive compared to bonds and term deposits and we remain of the view that the S&P/ASX 200 will end the year at around 5250.

Concluding comments

The current correction/volatility in overseas shares looks very different to the worries about global recession seen around mid 2010, mid 2011 and mid 2012. We haven't heard a peep out of Europe, the worries about the Fed look overblown and in any case, relates to problems of success (stronger growth) rather than failure (poor growth). Japan is looking up and China is likely to continue to grow around 7.5%.

Moreover, share valuations range from cheap to fair value and the gradual improvement in global growth should boost profits, while global monetary conditions remain very easy.

So while the correction may have further to go, it is likely to be contained (more like 5-10%, rather than the 15-20% falls of mid 2010 and mid 2011), with the rising trend continuing.

The same applies to Australian shares. Lower interest rates and a lower A\$ should help profits on a 12 month view and high yield shares are likely to regain some favour, reflecting their still high yields and falling term deposit rates.

That said, the period of unambiguous outperformance by the Australian share market over the past decade on the back of surging commodity prices looks to be over. The A\$ also looks headed lower, highlighting the case for a higher long term exposure to unhedged international shares.

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