

Shares climbing a wall of worry

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Oliver's Insights



Key points

- Global growth is likely to be in the process of reaching a low ahead of a pick up next year. The risk of a Euro-zone meltdown is receding, more monetary easing is also likely to keep the US recovery going and, at the same time, Chinese growth should soon pick up a bit.
- While shares may see short term volatility, the combination of a stabilising global growth outlook, cheap valuations and easy global monetary conditions point to further gains by year end and into next year.

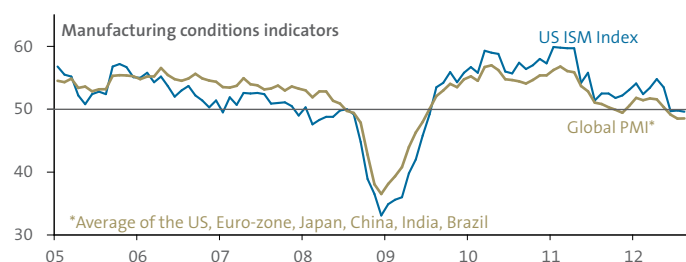
Introduction

A casual observer could be forgiven for thinking that this is a terrible year for shares. Europe has continued to convulse, the US has seen growth slow to less than 2%, China's economy has continued to slow, as have Brazil and India's economies, and in Australia the mining boom is losing momentum. And yet, the reality has been that shares have so far had a good year. Global shares are up 11%, led by a 14% gain in the US, and Asian, emerging market and Australian shares are up 6 or 7%. Add on dividends and Australian shares have returned around 11% so far this year. To be sure, there are still lots of worries but shares seem to be climbing the classic wall of worry. So can it be sustained?

Global growth

2010 and 2011 were interrupted by sharp 15% to 20% corrections in share markets which were driven by worries about global growth. This year has been no exception, although the weakness (so far) was focussed in May with smaller falls in shares. Europe's grinding debt crisis, the fragile US recovery and earlier monetary tightening in China and the emerging world have seen the global economy lose momentum. This is clearly evident in a fall in global business conditions indicators (or PMIs) as seen in the next chart.

Global business conditions indicators (PMIs have lost momentum, but still point to moderate global growth)



Source: Bloomberg, AMP Capital

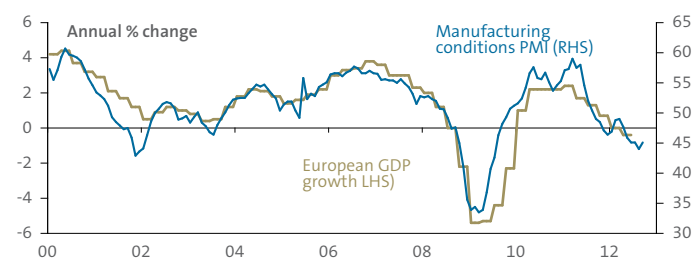
Australia has not been immune to this and has been impacted by a sharp fall in key commodity prices. This, in turn, has led to the deferment of projects previously under consideration at a time when the rest of the economy is still struggling.

This is all well known and factored into markets. Following the experience of the last few years, investors have been quick to see black swans around every corner and quickly move to price

in the tail risk of a return to a global recession. However, in recent months the tail risks have started to recede for the global economy. In fact, there is a reasonable chance that we are passing through the weakest phase of the global growth slowdown that's been underway, and that global growth may actually pick up a bit over the year ahead.

- Everyone knows Europe is in recession. However, following recent announcements from the European Central Bank (ECB) Europe finally seems to have arrived at a credible and well articulated plan to bring bond yields back under control in troubled countries. This involves countries like Spain applying for assistance and agreeing to reforms with the European bailout funds. It then involves the ECB acting in concert with the bailout funds to buy bonds in order to reduce borrowing costs to more sustainable levels. The unlimited nature of ECB bond buying effectively means that worries about the limited firepower of the bailout funds has been addressed. The ECB's actions once they commence should have the effect of repairing the transmission of easy money across Europe which should take pressure off the Spanish and Italian economies and allow a return to growth next year. All Spain has to do is ask for assistance which is likely to happen soon. If they don't, their borrowing costs will rebound. Having earlier acted to stop a credit crunch in Europe via cheap 3 year loans to Euro-zone banks, the ECB is now moving to deliver on its commitment to keep the euro together and to remove the tail risk of a much deeper economic slump, say a 5% fall in gross domestic product (GDP). The recession remains in Europe but it is likely to remain 'mild'. Interestingly, recent European PMI readings have been flat-lining which is consistent with a 'mild' recession. This is all consistent with a 1% fall in GDP this year, followed by a return to modest growth next year.

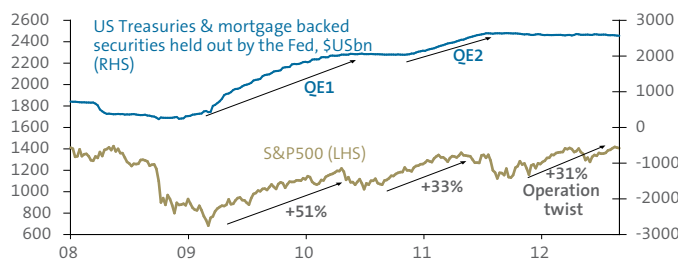
Euro-zone business indicators point to a "mild" recession



Source: Bloomberg, AMP Capital

- The problem in the US is that growth has been too slow to sustainably reduce unemployment. However, the Federal Reserve (Fed) appears to be aware of this and is likely to soon announce another round of quantitative easing (QE). They may well do this on an open ended basis so they can keep it going from meeting to meeting until they get the outcome they want. All the evidence suggests that the costs of QE are manageable – certainly there's no sign of the hyperinflation many feared from QE1 and QE2. In addition, it has helped boost growth relative to the alternative (just look at the US versus Europe). Both QE1 in 2009 and QE2 in 2010 were associated with gains in US and global shares (and upwards pressure on bond yields) and there is no reason not to expect a similar positive impact from QE3, although it may be a bit smaller as shares are starting from a higher level. See the next chart.

US quantitative easing and US shares



Source: Bloomberg, AMP Capital

Longer term, healing in the US is continuing – the housing recovery is looking entrenched, companies are continuing to expand manufacturing operations in the US, private sector debt levels are coming under control, shale oil and gas is a real game changer, and the tech boom is still centred on the US. This, along with ongoing monetary stimulus, is likely to see US growth edge up to 2.5% next year. The ‘fiscal cliff’ next year is a risk but likely to be substantially reduced after the November election.

> China has been the big surprise this year with growth continuing to lose momentum and looking like it’s going to come in around 7.5% this year rather than our expectation for 8%. However, while we are yet to see a large stimulus announcement (and probably won’t given the overheating experience from the 2008-09 stimulus) there are some positive signs. Money supply growth and new loans appear to be stabilising and picking up consistent with easier credit conditions. A speed up in the pace of infrastructure (notably road and rail) project approvals appears aimed at boosting infrastructure investment after it slowed to a crawl earlier this year, and a pick up in housing starts, land purchases and floor space sales points to a pick up in residential construction. Lately, the Chinese leadership seems to be providing more assurances that it is focussed on meeting its growth forecasts for this year and providing more stimulus if needed. These considerations point to a stabilisation and modest pick-up in the pace of growth over the next six months. Meanwhile, non-food inflation at just 1.4% means there is plenty of scope for further stimulus.

> Finally, growth in Brazil looks to be picking up following a 5% cut in short term interest rates.

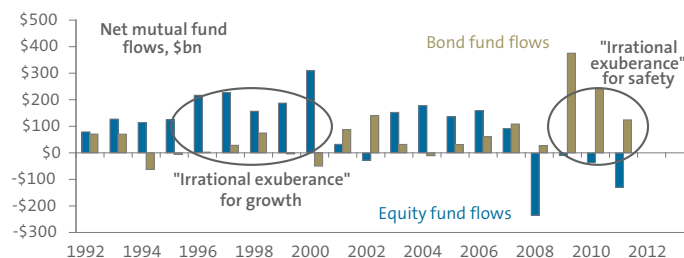
Overall, this suggests global growth is on track for around 3% growth this year ahead of a modest improvement to around 3.5% growth next year. Not brilliant, but not the disaster many have been fearing and factoring into share markets. And enough to underpin modest profit growth.

Shares remain cheap

In 1996 the term ‘irrational exuberance’ was coined to explain the rush of funds into shares and particularly tech stocks. For several years it looked to be the right thing to do until we hit the tech wreck from 2000. In recent years we have had something similar, but with the exuberance focussed on safe assets like cash and bonds. It is evident in huge flows out of equity funds and into bond funds in the US. It is also evident in Australia where there has been a huge build up in cash to double its normal level in the Australian superannuation system. In a recent survey, a record

39% of Australians claimed bank deposits are the wisest place for savings, whereas only 5.5% nominated shares.

US funds still flowing into bonds and out of equities

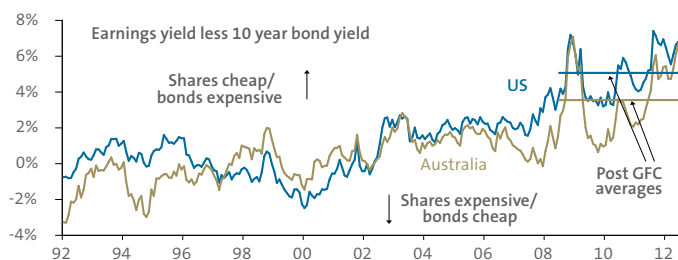


Source: US Investment Company Institute, AMP Capital

Again with hindsight, so far it has proven to be the right thing to do, but the problem is that all investment trends get taken to an extreme and the fad for cash and bonds is likely in the process to become irrational, particularly as cash and bond yields are getting lower and lower.

The outcome has been that equity markets have become very cheap relative to bonds. This is evident by the 6% or so gap between equity yields and bond yields - a measure that provides a rough guide to the risk premium of shares over bonds. This is well above the levels that prevailed prior to the global financial crisis and also at the high end of the range that has prevailed since the crisis.

Shares remain very cheap relative to bonds



Source: Bloomberg, AMP Capital

Investment implications

The August to October period is often the toughest time of the year for share markets. And the next few weeks are still riddled with various events that could trip up markets. However, the fact that we are already into mid-September and share markets are holding up well is a positive sign.

Our assessment remains that any setback in markets should be seen as a buying opportunity. Risks of a Euro-zone financial meltdown and return to global recession are receding, the global growth outlook is improving, shares remain very cheap relative to bonds and monetary conditions are favourable. Against this backdrop, the odds favour further gains in share markets into the year end and over the year ahead. By contrast, low bond yields point to low returns from bonds and falling interest rates in Australia are likely to further depress bank term deposit rates.

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