Outlook 2010: Transition to the new normal

February 2010 // Market commentary

If a single word could describe the outlook for 2010 it would be 'complicated'. While there's less cyclical upside for Australia, the outlook for other markets is that the recovery is likely to be protracted.

Hindsight makes the past seem simpler than it was, but at the beginning of 2009 two things were clear:

1. sharemarkets, credit securities and other risk assets were exceptionally cheap; and
2. a recovery was likely sometime given the depth of the downturn and the amount of monetary and fiscal stimulus underway around the globe.

A year on and markets have rebounded and valuations on most asset classes are back to 'normal' levels. The major economies are moving out of recession, led by the US. It is far from clear, however, just how strong and sustained the global recovery will be. Our view is that the recovery will be a long and drawn out affair. Consumer deleveraging, the gradual withdrawal of fiscal stimulus, and the ongoing process of bank balance sheet repair will provide strong headwinds.

The challenges of 2010 will involve judging just how much cyclical upside is left in the recovery, what is the new mean reversion trend for economic growth and corporate profits and how the GFC affected risk premiums. Markets are likely to worry at times that monetary policy settings are too inflationary and at other times that the withdrawal of fiscal stimulus will stall the recovery. Concerns about excessive public sector debt levels will hang over government bond markets.

The amount of cash still sitting in low return accounts is another factor to keep in mind. The cash that panicked out of shares at the bottom of the bear market last March is only slowly returning. A lot of investors presumably sold at the bottom and missed the rebound. This cash could move rapidly back into the market should a run of positive news have investors worried about missing out on further gains. Equally, there could be another rush to the exits on any bad news. In short, volatility is likely to be a continuing feature of asset markets.

U, V or W?

Scenarios for the US economy this year tend to focus on three letters; U, V and W. The usual rule of thumb is that the recovery from a recession is in proportion to the depth of the downturn.

The main impediment to a stronger recovery is the fragile state of the US banking system. Banks have largely dealt with the sub-prime losses, but they now face escalating loan losses arising from the severity of the recession and are likely to spend most of this year focus on maintaining capital ratios rather than balance sheet expansion. A 'V' shaped economic rebound seems fairly unlikely.

What about the 'W' or double-dip scenario? The prominent economist and New York Times columnist, Paul Krugman, worries that the US will slide back into recession in the second half of the year unless there is a new fiscal stimulus package. This is a realistic concern, but seems unlikely given the Fed's aggressive efforts to reflate the economy. The 'W' is obviously a scenario that investors don't want to see. The S&P 500 is priced for a 29% rebound in corporate earnings over the year and a double dip outcome would be reflected in a market reversal.

The 'V' is a superficially appealing scenario as a significantly stronger economic rebound than forecast would mean a much stronger corporate earnings recovery. However, investors should be wary of what they wish for as a much better than expected economy could also trigger concerns that the Fed had left policy too easy for too long, causing a large rise in longer-term interest rates.

The best scenario for investors (and the one we think most likely) is the deep 'U'. Modest growth should allow corporate profits to recover in line with expectations, while interest rates will remain anchored by the lack of inflation pressure.

Australia: less pain, less gain

A brutal recession in the rest of the world has been a slowdown in Australia. According to the January survey of forecasters from Consensus Economics, the Australian economy grew by 0.9% in 2009, making it the only OECD economy to have recorded growth.

Some caution on the Australian outlook seems appropriate. Although Australia's banks are in much better shape than those in the US or Europe, the economy faces other headwinds. Monetary and fiscal tightening and the high Australian dollar will take a toll. RBA Deputy Governor, Ric Battellino, made the observation recently that interest rates on housing and business loans and on deposits and debt securities ("the interest rates that matter in the economy") have risen relative to the RBA's cash rate by at least 100bp since mid-2007. This means that the current 3.75% cash rate is probably close to a neutral setting. Further rate rises seem inevitable and these will take monetary policy to a restrictive setting.

Having avoided the deep downturn, Australia lacks the cyclical upside of other economies. An implication for investors is that Australian corporate profits will have less rebound potential than in other markets. Earnings per share in Australia fell around 30% from their peak, slightly less than the 34% decline recorded by companies in the S&P 500 . This, however, exaggerates the fall in Australian corporate profits. 2009 was a bumper year for share issuance with companies raising nearly $100 billion to strengthen balance sheets. This significantly diluted earnings per share; we calculate that trailing EPS for the S&P/ASX 300 would be 15% higher if not for the issuance. In contrast, share issuance diluted S&P 500 EPS by just 1%.

"A brutal recession in the rest of the world has been a slowdown in Australia."

The consensus forecast is for a 15% rebound in Australian EPS over the next 12 months (12% ex resources), while S&P 500 earnings are expected to grow by 29%. The story of sharemarket returns in 2009 was PE multiple expansion in anticipation of a profits recovery. PE multiples in both markets are now near or above long-term averages, meaning that EPS growth will be the main driver of returns. Australia's smaller cyclical earnings upside argues for lower returns relative to other markets.

This means that 2010 is shaping as a challenging year for managing asset allocation strategy. In terms of asset class valuation, we see shares as broadly fairly valued, with global shares offering more upside than Australian shares. Corporate credit is still relatively attractive, although not the value opportunity of six months ago. Global government bonds are expensive, although the absence of inflation pressures means a significant sell-off may not happen until later in the year. Australian government bonds, with 10-year yields at 5.5% look more fairly valued.

Enhanced Asset Allocation

For clients who are interested in strategies which are designed to take advantage of current market valuation levels to add incremental return potential over the strategic asset allocation policy of a portfolio, contact your Russell representative who can provide more information about Russell's suite of Enhanced Asset Allocation strategies.

Market Review

A review of the market activity during the quarter ending December 2009

Australian shares

- Australian shares had a relatively understated end to the year compared with the exceptional rally of the September quarter. The local market returned 3.4% during the December quarter, recovering from a monthly fall in October, its first since the recovery rally began in March.
- For the 2009 calendar year, Australian shares rose by 37.6%.
- The official cash rate was raised from 3.0% to 3.75% during the quarter. While rate hikes are generally a negative factor for sharemarket performance, in this case they signaled the RBA's confidence in the strength of our economy and did not spark a selloff in Australian shares.
- Sector performance was mixed during the quarter. Resource stocks were well supported, including Metals & Mining ex Gold (14.5%) and Gold (14.1%), while Diversified Financials (-8.4%), Property Trusts (-5.0%) and Banks (-1.4%) recorded falls.

International shares

- International shares continued to rise in the final quarter of 2009, with the MSCI World Index returning 2.1% in AUD and 5.3% in AUD hedged terms during the December quarter.
- Among developed countries, macroeconomic and company indicators were most positive in the US. A dip in jobless claims beyond that anticipated, coupled with rising consumer confidence and a high degree of positive earnings revisions caused the US (5.9%) to outpace other regions in local currency terms. Japan (1.1%) continued to lag as political uncertainty increased, unemployment crept up and confidence in the Bank of Japan deteriorated further.
- Materials stocks (11.3%) led global sector returns, boosted by continued commodity strength. Consumer-related sectors also enjoyed a strong quarter, as did the IT sector (8.6%). Financials weakened (-3.4%) as investors questioned future growth potential in the sector.

REITs

- The global REITs market delivered a return of 5.3% in AUD hedged terms, as measured by the FTSE EPRA/NAREIT Developed Real Estate Index Net TRI. Regional returns in local currency terms were positive, but not as strong as last quarter, led by North America (8.7%), Asia (4.3%) and the UK (3.9%).
- With the exception of Germany (-5.8%), most property companies in Continental Europe advanced over the quarter supported by stabilisation in property valuations and evidence that the Eurozone has emerged from recession.
- Asian REITs bounced back in relative terms after lagging considerably last quarter. However results remained mixed, with Singapore (12.1%) and Hong Kong (6.0%) rallying and Japan (-1.1%) experiencing continued weakness.
- Both Canada (7.5%) and the US (8.8%) had a strong quarter as confidence in the viability of REITs in those countries was restored.

Bonds

- Australian bonds returned 1.0% during the December quarter. Credit spreads continued to narrow although the pace of contraction slowed considerably since the credit rally in the previous two quarters.
- The Reserve Bank of Australia was the first of the G20 central banks to begin tightening monetary policy, raising the official cash rate from 3.0% to 3.75% during the quarter. Rationale for the move included an expectation of growth close to trend over the next twelve months, inflation remaining broadly in line with the RBA's target and the risk of serious contraction in Australia now having passed.
- International bonds returned 1.1% in AUD hedged terms. Credit securities continued to outperform, including high yield debt and emerging markets debt.

R_MKT_Commentary_RET_V1F_1002 MKT/2362/0210