

The terrible twos

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It's been a tough couple of months for equity markets with both the MSCI World and the S&P/ASX 300 indices down around 15% from their April highs. Investors have been hit by a succession of worries, starting with the euro-zone debt crisis, concerns about financial sector regulation, US double-dip fears and prospects for a China slowdown and these concerns are likely to persist for a few more months.

The volatile range trading of the past couple of months is typical of the second year after a bear market. Sharemarkets almost always stage strong recoveries in the 12 months following a bear market (defined as a 20% fall in a share index). Months 13 to 24, however, can be challenging. The powerful rally following a bear market is usually accompanied by a rising PE ratio as investors anticipate a rebound in earnings. By year two, markets can be stuck in a range as investors wait for evidence that the earnings recovery is underway. Policy settings may no longer be so accommodative in the second year and many of the issues that caused the bear market may seem to have not been fully resolved.

There are plenty of examples of second year headwinds right now as markets battle with uncertainties about the sustainability of the US economic recovery and the future trend for growth in GDP and profits. Even so, we have a broadly positive view towards global equity markets. The sell-off has improved valuations and we expect nothing more sinister than slowdowns in the US and China.

US economy: Double-dip fears ahead

The US economic recovery is losing momentum. Housing indicators have turned down, jobs growth has stalled and there has been a marked deceleration in manufacturing activity. Inventory re-stocking has played a large role in the US GDP growth recovery and the indications are that this is now largely complete, signaling the end of the above-trend expansion in manufacturing.

Our US economist, Mike Dueker, draws comparisons with the slowdown in the first half of 1995, known as the "pause that refreshes" after which the economy righted itself and enjoyed a lengthy expansion. Mike expects a return to trend like growth of around 3% in 2011. He now expects the Fed to keep rates on hold until at least the second half of 2011.

One factor that gives us confidence that the double-dip can be avoided is the healthy state of US corporate cash flows. US companies have seen profits rebound and have more cash than they can spend. This doesn't mean that they are in a mood to significantly increase employment and expand capacity. However, excess cash means there is no pressure to cut back on spending or payrolls either.

Europe: Stress tests not so stressful

Just a few weeks ago there were fears that Europe's financial problems could trigger a second global financial crisis. Since then, nerves have been calmed by the USD 1 trillion IMF and euro-zone rescue package approved in early May and the bank stress tests released in late July. It would be premature, however, to conclude that these issues have been resolved. Greece, for example, will have a debt-to-GDP ratio of around 150% by 2014. It will almost certainly need to restructure its government debt, implying a haircut of some form for bond holders.

The stress tests of 91 banks might have given all but seven a pass mark, but a further 21 only barely scraped over the line. Nerves may have been calmed for the time being, but the bigger test will be whether the banks that have marginally passed the tests can successfully raise funds without government support and whether the risk premiums charged on government bonds from high debt countries start to narrow.

The European outlook is a trade-off between negative impact from fiscal tightening and positive impact of euro devaluation. The net result is likely to be fairly uninspiring growth – the survey of analysts by Consensus Economics predicts just 1.4% growth in 2011. The one positive, however, is that the continental turmoil has returned value to euro-zone sharemarkets. Russell's London-based strategist, John Velis, thinks battered European financials offer particularly good value with price-to-book value at historic lows.

China: Slow motion slowdown

A big issue for the second half of the year will be the extent of the slowdown in the Chinese economy. The June quarter GDP figures showed only a modest slowdown; fourth quarter ended GDP growth slowed to 10.3% from 11.9% in the March quarter. The first indications of a more prolonged slowdown are showing up in the property sector. According to UBS, property sales recorded a year-on-year decline of 2.7% in May and average property prices recorded a monthly decline of 0.1% – the first drop since February 2009.

The clearest indication of the unfolding slowdown comes from the money and credit aggregates. Annual growth in M2 – a measure of money supply – reached nearly 30% in 2009 and has now slowed to 18% in June, highlighting a couple of important points. First, it implies the success of the authorities in pumping up the economy last year to offset the impact of the GFC and the effectiveness of the tightening measures this year. The second point is about the lack of overall leverage in the Chinese economy. Money supply is just the opposite side of the balance sheet to credit growth – both show similar growth trends. Money (and therefore credit) growth has not been excessive for an economy averaging 14% nominal GDP growth over the past decade. Three or four years of 30% credit growth might create excessive leverage, but not one year. Low leverage reduces the risk of a self-sustaining slowdown.

Australia: Mixed messages

It's been hard to get a clear handle on the direction of the Australian economy. Jobs growth has been surprisingly strong and the unemployment rate at 5.1% suggests little spare capacity. Six RBA interest rate increases, however, have dealt a blow to consumer confidence and measures of business confidence are off their peak.

The most bullish views on Australian growth rely on continued strong commodity prices delivering a large income boost to the economy. On this view, inflation pressures will continue to build, forcing the RBA into a sequence of further interest rate increases.

Our view is more measured. The rates rise so far, continued strength in the AUD and the unwinding of fiscal stimulus measures will act as significant headwinds to growth. Our relatively cautious view on commodity prices means we are less confident that the economy will be boosted by windfall gains in 2011. It also means that we are more agnostic on further RBA tightening. Glenn Stevens has achieved phase one of his tightening agenda by getting interest rates back to "normal levels". Stage two is to take policy to an outright restrictive level. This will require evidence that domestic inflation pressures will be sustained – something we're not sure will be the case given a lacklustre global growth outlook and signs of peaking in the local economy.

Conclusion: Looking for clarity

Fed Chairman, Ben Bernanke, recently described the economic outlook as "unusually uncertain". This pretty much sums up the mood of financial markets right now. Valuations on risk assets such as shares are relatively appealing from a medium-term perspective, but the fog of uncertainty regarding sovereign risks in Europe, double dip risks in the US and slowdown risks in China has most investors sitting on the sidelines.

We expect that the global economic recovery will be sustained and that company profits will continue to grow. It will, however, continue to appear fragile and the headwinds worrying markets will not disappear quickly. Sharemarkets should end the year higher, but volatility is likely to be an ongoing theme.