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AMP CAPITAL

Investing in equities

Economic weakness, political uncertainty, and prospects for strong market returns

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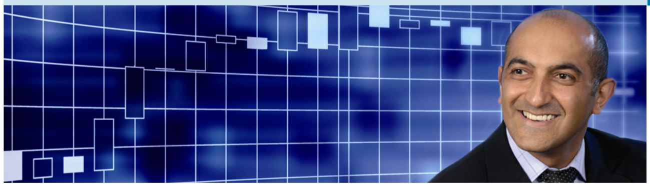


Overview

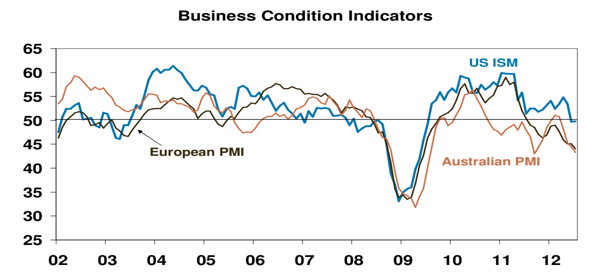
The fog surrounding the investment landscape appears to be getting thicker. The ongoing drama in Europe, the so called "fiscal cliff" in the US and softening growth in China have all taken a huge toll in business activity and a broad range of confidence measures. Investing in shares is increasingly perceived to be risky and fruitless. The widespread risk aversion, however, can have very different implications for future returns to what is broadly believed. In fact, investing is much riskier when based on the widespread belief that there are no risks. In a low return and volatile world, the cyclical swings in markets can provide significant profit opportunities for a few who are prepared to exploit the opportunities often resulted from investors' herd behaviour.

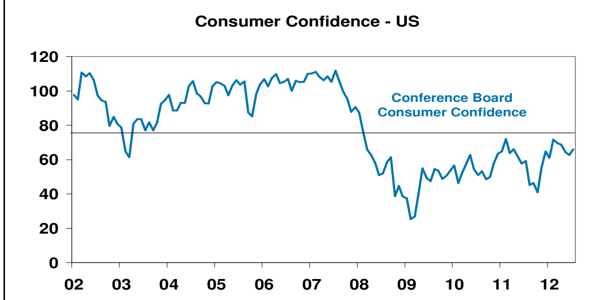
There is no denying that macro conditions are in dire straits and Europe in recession. And more worryingly political forces are now exerting a much greater influence in market movements. Worse again, political dynamics are fluid, can't be modelled and are not based on common sense. While the added political dimension does contribute to market volatility and pose a challenge to short-term investing, the same does not apply to investing over a longer time frame. Indeed, the increased volatility is creating enormous profit opportunities for investors with times horizons beyond the very short-term. Capturing these opportunities, however, requires an objective based investment framework which includes a solid emphasis to contrarian drivers. Without it, investment decision making will be dominated by emotions in a reactive fashion. Such a process does not need to be backed by political forecasting, but needs to capture the impact thought a diverse set of investment drivers. It should dynamically view forward return expectations in the context of downside risk potential at each point of time. In essence, a successful investment process does not aim to ascertain how good or bad a prevailing macro backdrop is, but how much of the good/bad news is priced in. An assessment of upside vs. downside risk/return can then be formulated.

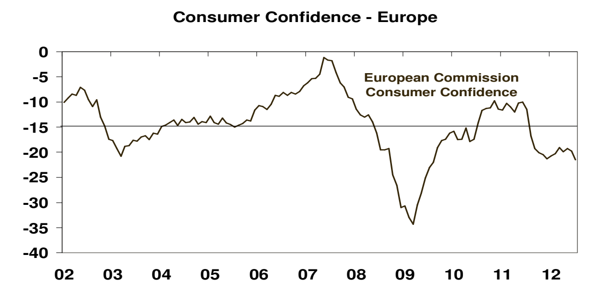
Macro conditions

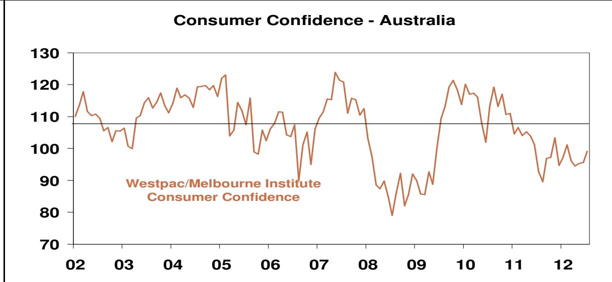
As is currently the case, there is no shortage of bad news and reasons to stay out of shares and growth assets. European debt crisis and recessionary conditions, multi-year lows in many measures of consumer and business confidence, deleveraging by consumers, banks and governments in the developed world, peaking company margins and falling earnings, Chinese slowdown and sliding exports in Asia and emerging economies, to name a few. Some of these negative dynamics are shown below.

Business and consumer confidence are weak

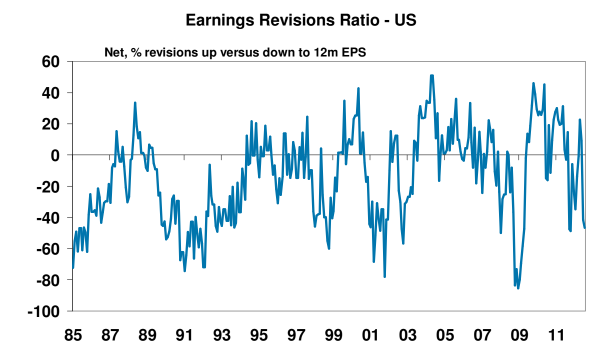


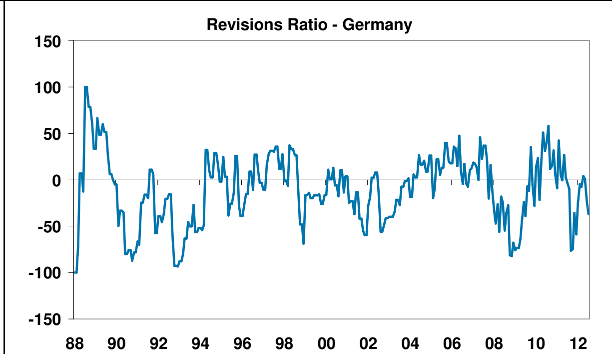


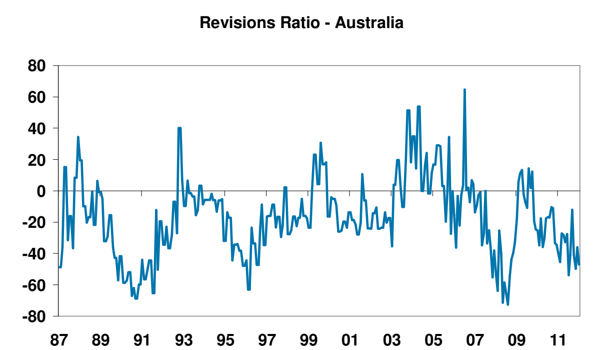


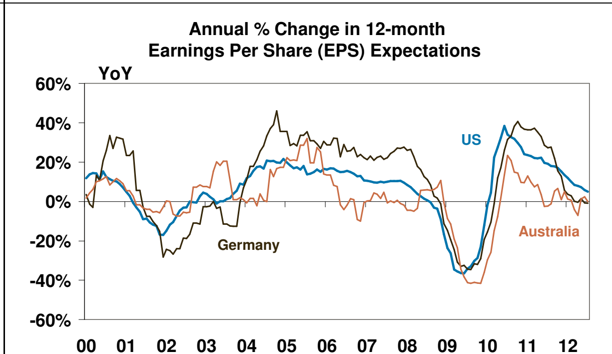


Earnings expectations are sliding







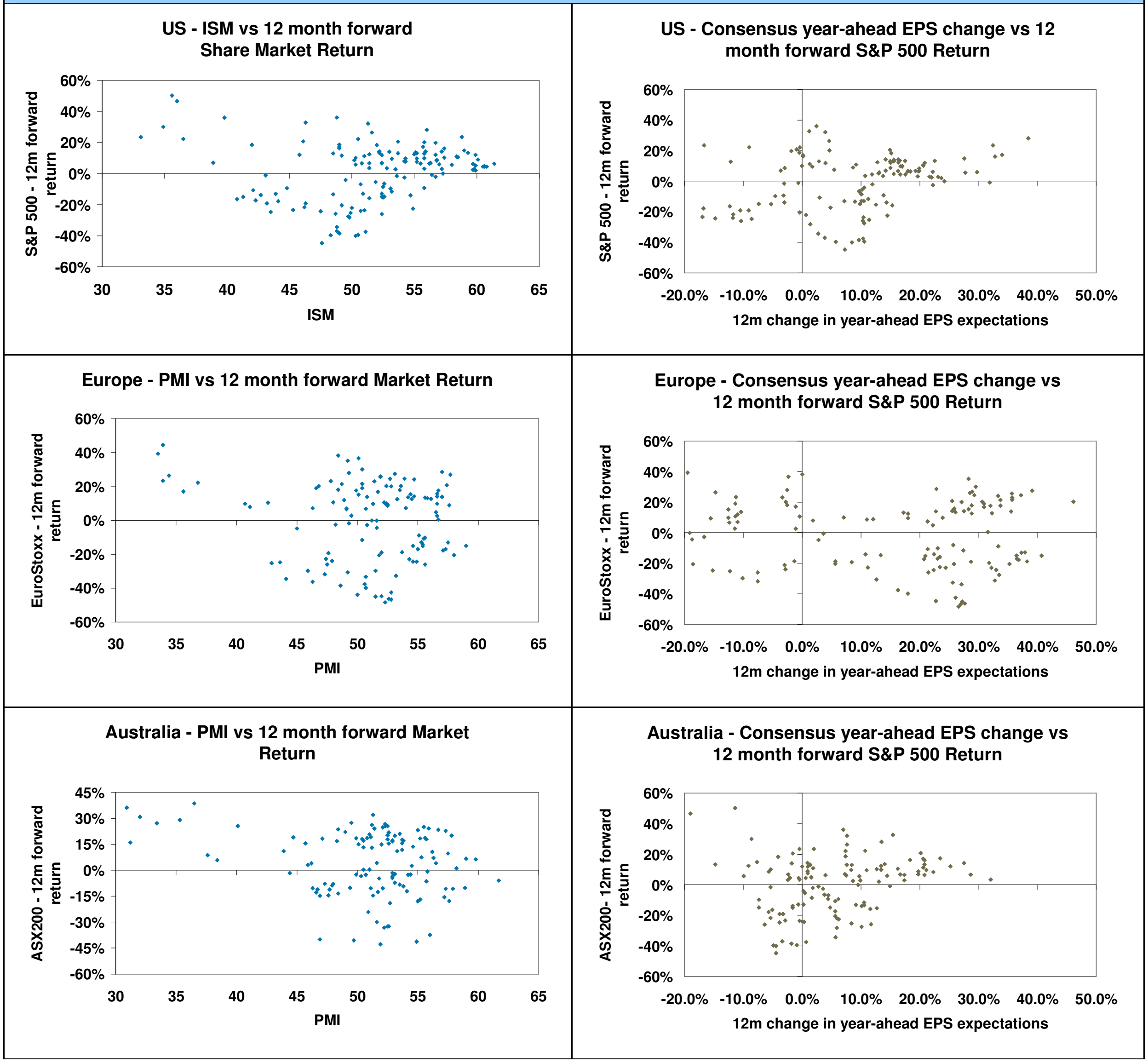


Source: Bloomberg, Thomson Reuters, AMP Capital

Macro indicators and future market returns

To be sure, macro and earnings trends have a strong correlation with the market performance and the weakness (as shown above) explains the poor performance of equities in recent months. What about future returns though? While it makes sense to expect poor returns from equities and other growth assets given the ominous macro backdrop, the fact that the challenges to growth are so widely known should provide little guidance to future returns. In fact historical analysis shows that there is little or no consistency in the predictive power of macro indicators/earnings growth expectations on future market returns. This is shown in the following graphs where Purchasing Manager Indexes (PMI) for the US, Europe and Australia are plotted against 12 month forward share market returns.

Negative macro and earnings conditions do not always lead to poor future returns



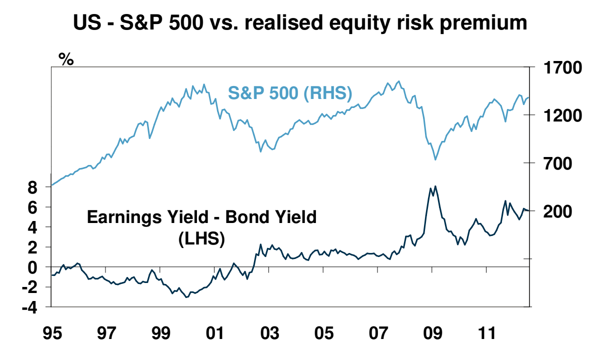
Source: Bloomberg, Thomson Reuters, AMP Capital

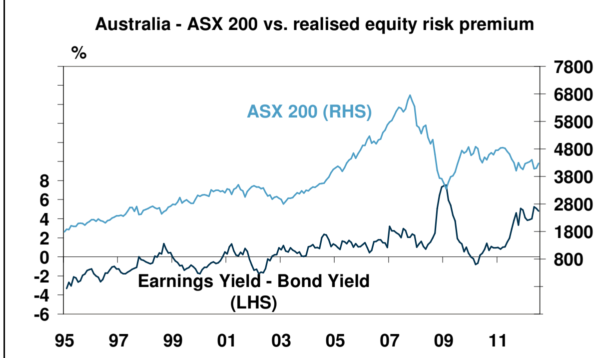
The following observations are worth pointing out:

- Weak/strong macro conditions do not lead to weak/strong future share market returns;
- There is a strong tendency for share markets to post solid future returns when PMIs fall to extreme "recessionary" levels below 40.
- Weak earnings do not necessarily translate to weak future market returns. Similarly, disappointing market returns can be achieved even despite a strong earnings growth outlook.

Of course, it would be unreasonable to assume that macroeconomic and earnings impact on future market returns is random and insignificant. Indeed, a sustained and durable move higher in shares requires a strong support from earnings growth and a healthy macro backdrop. There is, however, an important caveat. The macro impact becomes insignificant and often counter intuitive as it becomes conventional wisdom. In other words, the fact that Europe is in recession, austerity measures crimping growth in the periphery and US is experiencing anaemic growth is nothing new. In fact there is a silver lining to all the bad news now and that is, bad news is largely priced in and central banks are increasingly easing monetary policy. The equity risk premium (the gap between nominal bond yields and earnings yield on shares) is at multi year highs in major share markets. Similarly, share markets now offer dividend yields well in excess of cash rates.

Macro and economic worries are largely priced in

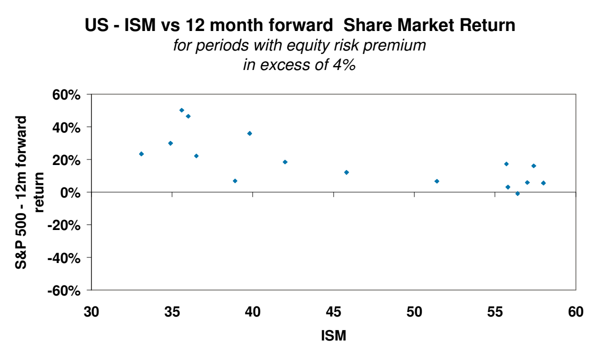


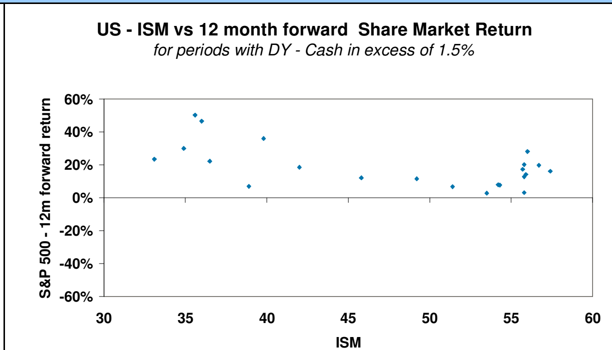


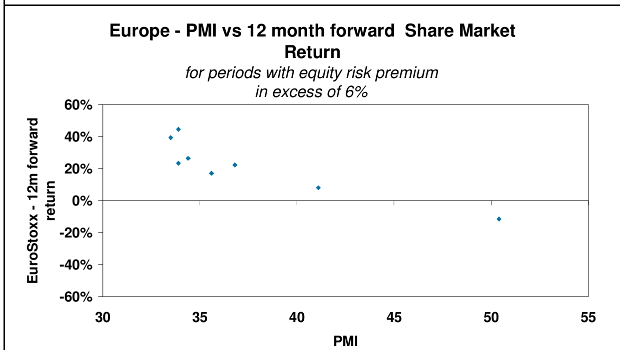
Source: Bloomberg

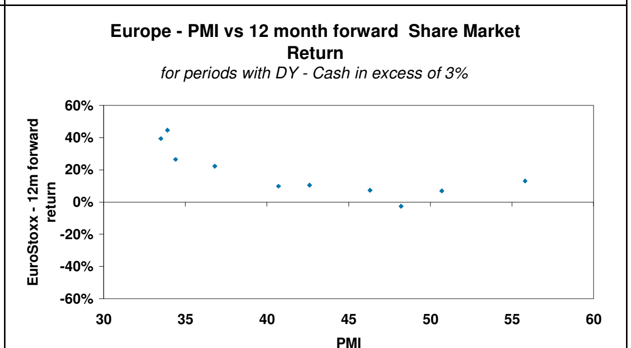
A skewed focus on the weak macro and earnings backdrop at this point entails a significant opportunity cost. With the macro backdrop likely to remain challenging for the foreseeable future investors are increasingly being drawn to cash and bonds as the wisest place to invest. History, however, shows the opposite. As expectations of poor performance become entrenched and realised equity risk premium becomes elevated, strong future market returns are often resulted, even in the face of a poor growth outlook. In fact, when we filter the scatter plots on page 3 for periods when the equity risk premium has been above 4% for Australia and the US and 6% for Europe, as is currently the case, a different picture emerges. When this is the case, 12-month forward market returns show a significant skew to strong positive returns irrespective of the prevailing PMI level as well as earnings growth expectations. In fact forward returns are much stronger for weaker levels of PMI. Similar results are observed when using the gap between dividend yield and cash rate as the filter.

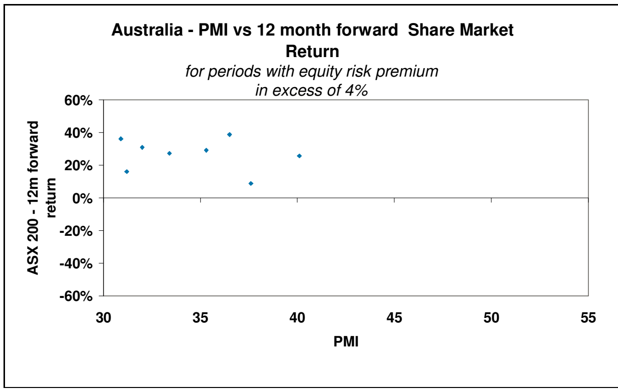
Risk/Reward firmly skewed to the upside despite the weak macro backdrop

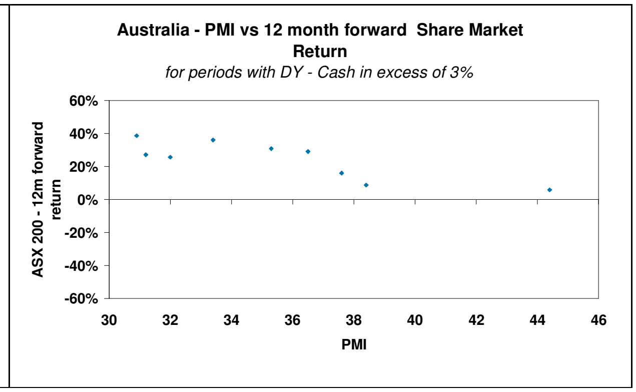










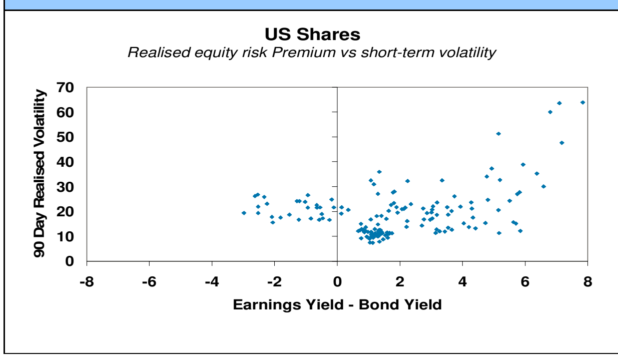


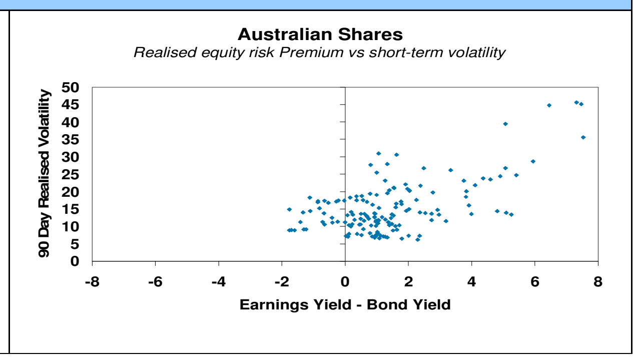
Source: Bloomberg, AMP Capital

Why do investors as a group fail to exploit valuation anomalies?

The analysis above clearly demonstrates that strong positive returns can be achieved by investing in the share market when the economic news is negative and bad news is well covered and reflected in relative valuation measures. There is of course a price to pay and that is accepting short-term volatility. Charts below show a strong positive relationship between shares vs. bonds relative valuation (i.e. realised equity risk premium) and realised short-term market volatility. Investors tend to give up at the worst possible time when short-term volatility becomes too much to handle. The emotional response by investors to quit creates strong profit opportunities for those who are prepared to trade-off short term volatility for an improved risk/return profile beyond short-term.

Shares offer attractive value when volatility is high





Source: Bloomberg, AMP Capital

Conclusion

Frequent shifts in investor sentiment in response to macro and political news are leading to intense volatility in share markets. Investors are responding to uncertainty and increased volatility by finding refuge in the safety of bonds and cash. The result has been a significant shift in relative valuation measures comparing shares against bonds and cash. Oddly, investing in shares is perceived to be much riskier now than was the case 10 or so years ago when the realised equity risk premium was hovering in the negative territory. The increased scrutiny of macro and political dynamics is adding to volatility providing fuel to the emotional and reactive investment decision making. The silver lining is that volatility and the herd behaviour is creating significant profit opportunities for those who are willing to accept short-term volatility and stay objective in making investment calls. With realised equity premium in excess of 4% in major share markets, dividend yields well in excess of cash rates and global central banks increasingly easing monetary policy, the uncertain macro backdrop and investor pessimism is likely providing great profit opportunities for equity investors.

To be sure, there are still many headwinds to a sustained long-term advance in shares posing a challenge to the success of buy and hold strategy. However, a reactive strategy based on macro news and political dynamics is likely to be destructive. This does not suggest macro indicators are irrelevant, but it cautions against a heavy emphasis on macro conditions when they become conventional wisdom.

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