Shane Oliver, Head of Investment Strategy
& Chief Economist

AMP CAPITAL

Shares in another rough patch

EDITION 38 – 21 OCTOBER 2012

Key points

> Global shares entered a rough patch in mid-September on profit taking and worries about earnings, Europe and the US fiscal cliff more recently. This has affected most listed growth oriented assets.

> As a return to global recession or severe slowdown is unlikely in 2013, we view this as just a correction with the broad rising trend in shares likely to remain intact helped by attractive valuations and easy monetary conditions.

Here we go again, or are we?

Global shares have hit another rough patch recently. This started in mid September, spread to Australian shares in mid October and to Asian shares this month. The weakness accelerated post the US election. And consistent with the classic risk on/risk off pattern of the last few years the fall in shares has been associated with lower commodity prices and a rally in sovereign bonds. So far the top to bottom falls in share markets have been mild at around 5 to 6%, except for the US which had an 8% fall. And there has been a partial bounce back over the past few days.

As usual whenever shares hit a rough patch over the past few years the usual perma bears come out in force warning of a crash ahead and "double dip" back into global recession. But how big are the risks? Is this just another correction or the start of something more serious?

What's driving the rough patch?

But to start with, what's driving the recent rough patch? Several factors are involved.

- Firstly, after a 15% rally in global, Asian and Australian shares coming out of the low in early June, shares were vulnerable to a correction.
- Secondly, while the ECB has done well to back stop Spain with its promise to buy its bonds under certain conditions, Spain's failure so far to apply for assistance, ongoing uncertainty about Greece, renewed fears regarding France (we heard this one late last year and early this year, but why not give it a whirl again!) and soft economic data across the Euro zone has seen uncertainty continue regarding Europe.
- Thirdly, September quarter earnings reports were generally soft, particularly on the revenue front in the US.
- Fourthly, post the US election US shares priced out the possibility of a smooth solution to the US "fiscal cliff" and started to fret that it would trigger a recession next year. Soft data on the back of Hurricane Sandy hasn't helped.
- Renewed tensions in the Middle East – this time between Israel and Gaza – hasn't helped either. This is likely to be just another regular flare up of the Israeli/Palestinian conflict, but without Saudi Arabia and other major producers deciding to punish the US for supporting Israel by cutting oil supplies – which seems unlikely – the impact on oil prices is likely to be trivial.
- To this list may be added investors cashing up ahead of the end of the world on December 21 when the 5125 year long cycle Mayan calendar ends. But then again whats the point of cashing up ahead of the end of the world. Once it ends cash will be no more valuable than shares. More seriously the whole obsession with the world ending on December 21 seems to be based on a complete mis-representation of Mayan culture and their calendar. And if the Mayans are not enough there are claims that US psychic and prophet Edgar Cayce prophesied a share market crash on December 18, 2012 – obviously trying to get in ahead of the Mayans! Taking this one seriously, I searched through Edgar Cayce's prophecies (yes – I have his books) only to struggle in vain when it came to any references to 2012.

What's the risk of recession in 2013?

But back to reality, for shares to continue to plunge taking us into a new bear market, global growth really needs to head back towards or into recession next year. So the key issue is how realistic is this? It's certainly a risk:

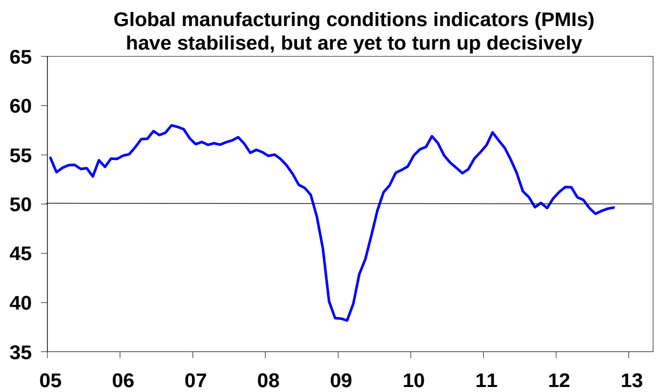
- Europe is still very weak, with peripheral countries likely to remain in recession next year;
- The US economy will almost certainly plunge into recession if the legislated tax hikes and spending cuts that kick in from January amounting to 4.3% of GDP and known as the "fiscal cliff" are not reduced to something more manageable - say around 1.5% of GDP. The US economy is running around 2% growth so a 4.3% of GDP fiscal contraction would probably knock it into recession;

US Fiscal Cliff – 2013 fiscal drag 2013 under current law

Budget item	$bn saving 2013	% GDP in 2013
Bush tax cuts for wealthy	45	0.3
Bush tax cuts for middle income	150	0.9
Payroll tax cut	116	0.7
Unemployment benefits	25	0.2
Budget Control Act 2011	85	0.5
Payment rate for physicians	20	0.2
Other items	229	1.5
Total	**670**	**4.3**

Source: Congressional Budget Office

- Global business conditions indicators have stabilised but are yet to really strengthen – see the next chart; and



Source: Bloomberg, AMP Capital

- A return to global weakness next year would be consistent with the three to five year business cycle given that the last severe downturn was in 2008-09

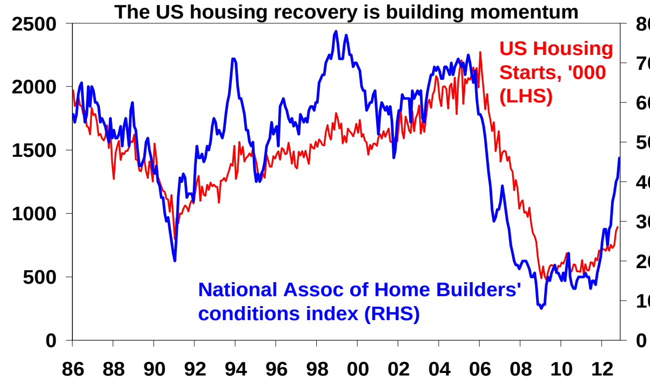
However, we don't think that a return to global recession or even a sharp further slowdown is probable next year.

While it's hard to see Europe strengthening much next year it's hard to see it getting a lot worse either. Thanks to the ECB, Europe finally seems to have a decent program to bring bond yields under control in troubled countries. While Spain has yet to apply for assistance the threat that the ECB will aggressively buy its bonds if it does has led to a distinct calming in bond markets across Europe. This plus the ECB's provision of cheap funding to banks seems to have completely headed off a re-run of the GFC and has left Europe with a mild recession. However, the ECB is likely to provide more monetary stimulus if growth doesn't pick up and the Euro zone seems to be relaxing the pace of fiscal austerity granting Greece another two years to meet its targets and indicating that Spain could be granted assistance without having to undertake further austerity.

While the US "fiscal cliff" is unlikely to be resolved until December, the most likely outcome is that a compromise will be reached. The Republicans won't want to be blamed for triggering a recession and President Obama won't want his legacy to be remembered for recession, trench warfare with the Republicans and inaction in terms of a long term budget solution. Both sides now seem to agree on the need for increased tax revenue and spending cuts. While the risks are high the most likely outcome is a compromise involving:

- tax hikes for high earners, but with President Obama agreeing to maybe a 1% hike and limits on deductions rather than the full hike implied by current law;
- a delay in spending and tax measures such that the fiscal cutback in 2013 is more like 1.5% of GDP; in return for
- longer term entitlement cuts and tax revenue hikes; and
- there is also a chance that the US debt ceiling will be raised at the same time, heading off another debate about it early next year.

A 1.5% of GDP fiscal drag in 2013 would be manageable as it's not much bigger than the 0.9% fiscal drag that applied this year. Three other factors are likely to support US growth. Firstly, the US housing recovery is gaining momentum with a survey of home builders' conditions rising to its highest level since 2006 and pointing to a sharp rise in housing starts and construction. The US housing recovery is likely to add 0.75 percentage points to US economic growth in 2013.



Source: Bloomberg, AMP Capital

Secondly, the ending of Operation Twist (ie selling short term bonds to buy long term bonds at the rate of $US45bn a month) is likely to be replaced by the purchase of long term bonds using printed money to the tune of $US45bn a month boosting QE3 to $US85bn a month. The additional monetary stimulus is likely to further boost US growth. Thirdly, if as appears likely the fiscal cliff issue is resolved, business investment that had been delayed because of worries about it will likely rebound. All of this suggests that US growth could pick up to a 2.5% pace next year.

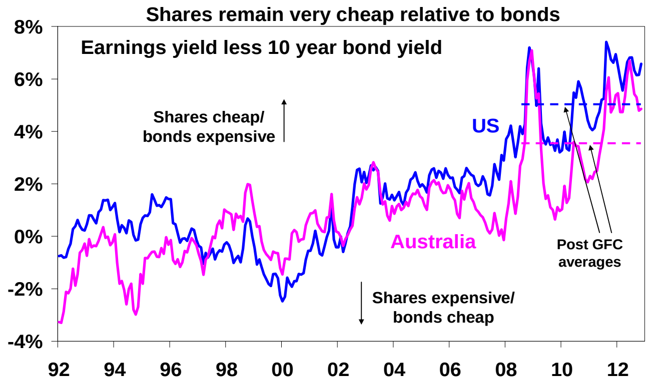
Chinese economic growth appears to be bottoming around 7.5%. Indicators for industrial production, retail sales, investment and business conditions have all bottomed or improved in the last few months. A stabilisation in China should be positive for growth elsewhere in the region.

Finally, while we are pushing into the fourth year of the global expansion and the 3-5 year cycle suggests risks the reality is that none of the normal excesses that mark the end of cyclical upswings – high inflation, labour shortages, excessive debt levels – are present.

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.

Outlook for shares

A stabilisation and modest improvement in global growth next year should provide a reasonable backdrop for earnings growth. At the same time, shares remain very cheap relative to bonds as indicated by a 6% or so gap between equity yields and bond yields, which is 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 GFC and also post GFC averages.



Source: Bloomberg, AMP Capital

At the same time monetary conditions remain very easy globally and investor sentiment towards shares has recently fallen back to near levels that normally set the scene for a rebound. As a result, while shares may still have a few more wobbles in the near term, we remain of the view that shares will end the year higher and continue to move up, albeit with occasional set backs, next year. That said I think I'll sleep with my fingers crossed on December 20 and 21.

Australian shares will also likely benefit from a rebound in global shares. They are cheap relative to bonds (see the last chart), will benefit from a likely further decline in official interest rates by the Reserve Bank and will gain from improved sentiment regarding China. One dampener though remains the strong Australian dollar which continues to make life tough for Australia companies and which makes it hard to be confident that Australian shares will outperform global shares.

Dr Shane Oliver
Head of Investment Strategy and Chief Economist
AMP Capital