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Shares climbing a wall of worry

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Key points

> Global growth is likely to be in the process of bottoming 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.

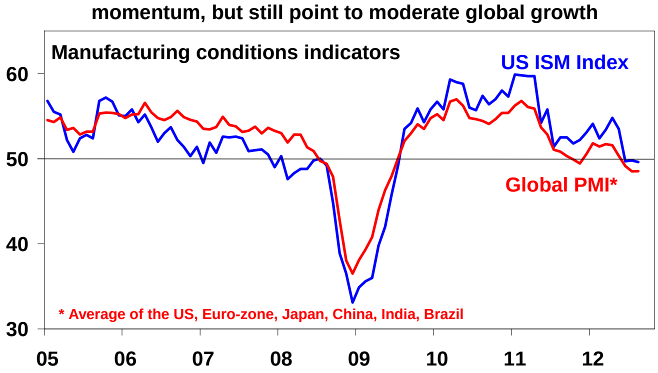
Introduction

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, and in Australia the mining boom is losing momentum. And yet the reality has been that shares have so far had a good year, with global shares up 11% led by a 14% gain in the US and Asian, emerging and Australian shares 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, so far at least anyway, 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, 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 slide 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



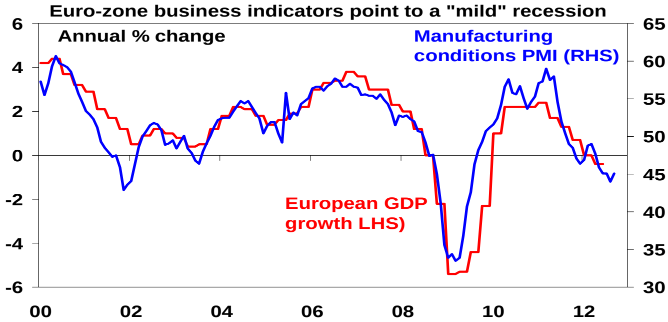
Source: Bloomberg, AMP Capital

And Australia has not been immune being impacted by a sharp fall in key commodity prices, which 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 moved to price in the tail risk of a return to 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 – probably even all the pet shop galahs in Australia! But following recent announcements from the 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 and the ECB then 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 of 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 soon as 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 GDP. The recession remains in Europe but it is likely to remain "mild". Interestingly recent European PMI readings have been flat lining 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.

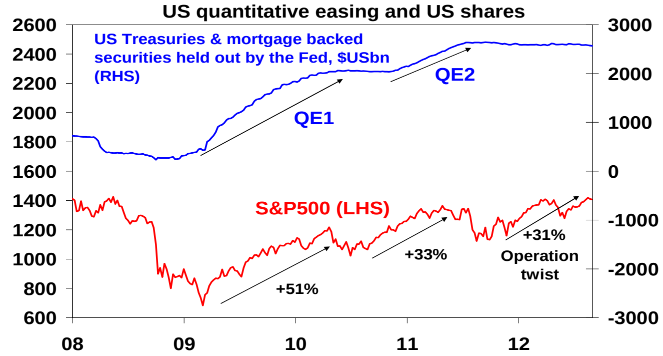
Euro-zone business indicators point to a "mild" recession



Source: Bloomberg, AMP Capital

- The problem in the US is that growth has been too slow in order to sustainably reduce unemployment. However, the Fed looks to be on to the case and likely to soon announce another round of quantitative easing (QE) – possibly 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 – and that it has helped boost growth relative to the alternative (just look at the US versus Europe). Much like a drip keeps a person in a coma alive until they heal enough to come out of the coma the Fed has been doing the same for the US economy. 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, albeit it may be a bit smaller as shares are coming 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.

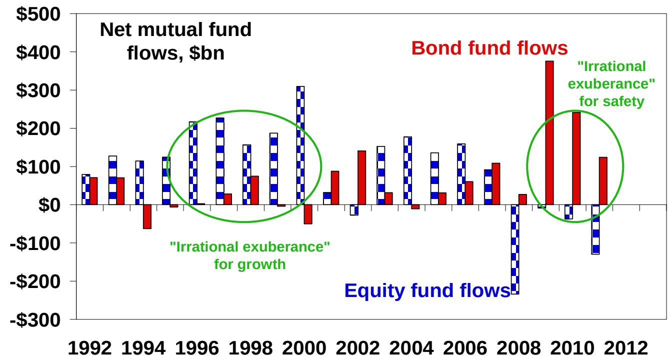
- China has been the big surprise this year with growth continuing to lose momentum and looking like its going to come in around 7.5% this year rather than our expectation for 8%. However, while we are yet to see a large stimulus announcement (and probably won’t given the overheating experience from 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. The Chinese leadership lately 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 fund flows out of equity funds into bond funds in the US. It is also evident in Australia in a huge build up in cash to double its normal level in the Australian superannuation system and in a record 39% of surveyed Australians saying bank deposits are the wisest place for savings compared to a near record low of 5.5% nominating shares.

US funds still flowing into bonds and out of equities

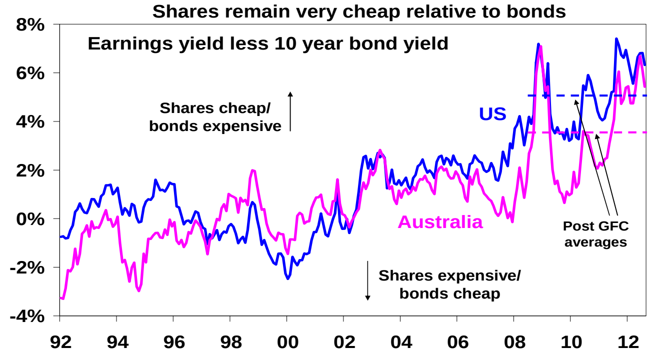


Source: US Investment Company Institute, AMP Capital

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 of becoming 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 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 at the high end of the range that has prevailed since the GFC.

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 is 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 – climbing the proverbial wall of worry – is a positive sign.

Our assessment remains that any setback in market should be seen as a buying opportunity. With the risks of a Euro-zone financial meltdown and return to global recession receding, the global growth outlook improving, shares remaining very cheap relative to bonds and monetary conditions very easy, 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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