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Why has the Australian Sharemarket been underperforming?

Senior Analyst, Belinda Allen reviews some of the key factors that continue to impact the performance of the local sharemarket, despite the relative strength of the local economy.

Global equity markets have risen in 2012, driven by improved momentum in the US economy, resilient data out of China and signs that European leaders are finally stepping up to tackle its sovereign debt and banking crisis. While this has been positive, it has refocused investor attention on the underperformance of the Australian share market compared to international peers in recent years. It is important to consider this in a longer-term context (over 10 years, the Australian share market has been a significant outperformer).

This more recent underperformance has confused investors, especially given Australia is perceived to have a stronger, more resilient economy compared to international peers. Other positives often highlighted include a resilient banking system, a stable AAA sovereign credit rating (one of only nine countries worldwide), links to Asia through the mining boom and the ability of the RBA to ease monetary policy if required.

There are four key reasons that can help explain this underperformance; compositional issues with the Australian sharemarket, the strong Australian dollar, competition from term deposits and the earnings outlook.

1. Composition of the Australian sharemarket

It is sometimes thought that the Australian sharemarket mirrors the composition of the Australian economy. This is not the case. The sharemarket index is dominated by financial companies, including REITs (approx. 40% of the index) and mining companies (25%). This compares to 20% and 10% of the Australian economy respectively. The Australian economy is also made up of many services companies, particularly small businesses which are not listed on the stock exchange.

With over 40% of the Australian share market owned by offshore investors, their views on these important sectors have a large impact on the performance of the overall Australian sharemarket. Offshore investors tend to be more active in their holdings of Australian shares than households and super funds, which together own just under 40% of the market. These domestic investors are traditionally more passive investors and do not frequently change their share holdings. In contrast, when offshore investors begin to get nervous about the global outlook, they generally sell shares across the board, which includes exposure to Australian shares despite the more resilient economic fundamentals.

Global investors often see the Australian mining sector as a direct link to China’s economic growth, which has slowed in 2011 and is expected to continue to slow in 2012. China cut its GDP growth target for the first time in eight years from 8% to 7.5% this year. As a result many international investors are holding a benign view over the sustainability of the ’commodity boom’ with commodity prices expected to fall, just at the same time when miners are significantly expanding capacity. International investors, particularly in the US remain sceptical over the potential growth in China, directly impacting ownership of Australia’s mining sector.

In banking, offshore investors have been worried about the Australian housing market as well as exposure to wholesale bank funding markets. One of the most common questions that offshore investors ask about Australia is the potential for a slowdown in housing and how this would impact on bank profitability. The Australian housing market has remained resilient compared to countries such as the US, UK and Spain, despite similar house price gains and household debt levels.

2. Australian dollar

One of the most significant factors impacting the Australian sharemarket has been the high level of the AUD which has made the Australian sharemarket relatively less attractive to global investors. This lack of international buying interest in the local market has been a big factor holding back performance, especially when coupled with the compositional impacts discussed above.

The strength of the Australian dollar has also hurt companies competing against cheaper imports. In particular domestic retail/consumer stocks have faced the perfect storm - low consumer confidence and low sales, the strength of the Australian dollar, the rise of internet shopping and deflation all contributing to a poor year for the retailers.

3. Term deposit competition

There have been outflows of local money from the sharemarket, into cash. Term deposits have been viewed as a safer bet than share markets, given their nature of capital preservation and lower volatility of returns. Australian banks have been looking at increasing their funding from domestic sources, including deposits. That has led to elevated deposit rates being available and provided reduced incentive for investors to move out of cash.

In countries like the US and the UK, deposit rates are lower given official cash rates (currently 0% and 0.5% respectively) and are not providing the same incentive for investors to stay in cash as experienced in Australia. As a result we have seen investors move back into equities earlier and with more gusto than that experienced in Australia.

4. Earnings outlook

While fundamentals for the Australian share market – such as dividend yields and price to earnings ratios - look attractive, there have been some concerns over the earnings outlook for Australian listed companies. This more uncertain outlook has also contributed to recent underperformance. The February profit reporting season saw earnings forecasts downgraded modestly. A weaker domestic economic environment has led to a more subdued and uncertain outlook, particularly for companies exposed to the non-mining sectors of the economy.

While it is impossible to know when the underperformance of the Australian share market will reverse, investors can take comfort from understanding the sources of recent disappointments. While some of these issues cannot be overcome immediately, improvements in global sentiment around China, the Australian housing market and reduced competition from term deposits could be catalysts for improvements.

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