

Where are we in the investment cycle for shares?

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Key points

- While mainstream global shares may be due for a short-term correction, the cyclical recovery still has further to go. Shares are still cheap, confidence in the sustainability of the global recovery is continuing and share market liquidity remains favourable.
- US shares are in the 'sweet spot' of the investment cycle and are likely to outperform for a while.

Introduction

Improving confidence in the global recovery has seen mainstream global share markets post strong gains since mid last year. However, many fret that it is unsustainable with high unemployment, high public debt and unsustainably easy monetary policy hanging over advanced countries and emerging markets increasingly subject to inflationary pressures.

Cyclical recovery has further to go

While, as always, there is lots to worry about, our assessment is the cyclical recovery in shares is panning out broadly as expected and has much further to run. After a major bear market ends the recovery in shares often goes through several stages: an initial rebound during the first year, a period of correction or consolidation in the second year and then a continuation. This is illustrated in the table below for Australian shares which shows strong average gains in the first year, typically poorer performance in the second year and then strong gains in the third year.

Post bear market recoveries, Australian shares

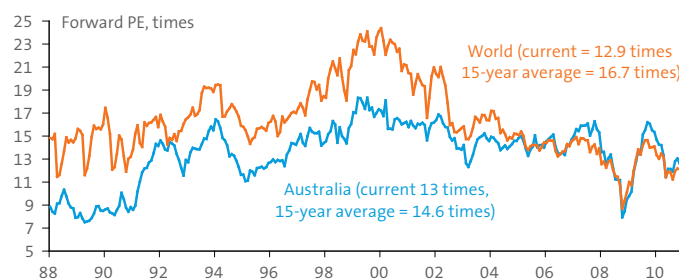
Bear market	% decline in All Ords	% gain in first year from low	% gain in second year after low	% gain in third year after low
May 51-Dec 52	-34	8	13	5
Sep 60-Nov 60	-23	12	-2	18
Feb 64-Jun 65	-20	8	11	67
Jan 70-Nov 71	-39	49	-25	-33
Jan 73-Oct 74	-59	54	16	-4
Aug 76-Nov 76	-23	6	21	27
Nov 80-Jul 82	-41	39	9	36
Sep 87-Nov 87	-50	35	5	-19
Sep 89-Jan 91	-32	39	-9	46
Jan 94-Feb 95	-22	25	8	10
Mar 02-Mar 03	-22	28	24	16
Average	-33	28	6	15
Nov 07-Mar 09	-55	53	?	?

Source: Bloomberg, AMP Capital Investors

So far, so good with the correction in share markets last year being consistent with this pattern. Of course, markets don't always follow a precise 12-month pattern, but if history is any guide this would suggest strong returns over the next six to 12 months. More fundamentally, the broad cyclical backdrop for shares and other growth trades remains fundamentally positive.

Firstly, share valuations are still attractive. The forward price to earnings (PE) multiple for global shares is 12.9 times which is well below longer-term averages for the low inflation period. Similarly, the forward PE ratio for Australian shares is 13 times compared to a longer-term average of 14.6 times. Emerging market and Asian shares are only trading on 11 to 12 times forward PEs.

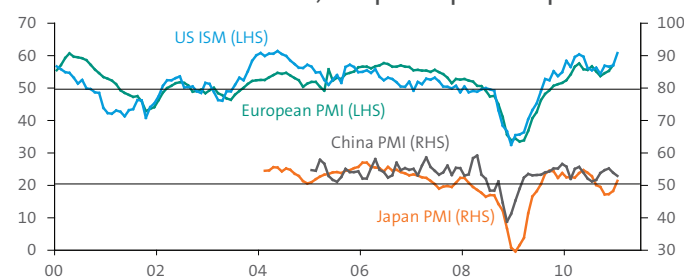
Shares are still attractive



Source: Thomson Financial, AMP Capital Investors

Secondly, while some of the heat is starting to come out of emerging countries, leading indicators for the US, Europe and to a lesser degree Japan have moved back up after a soft patch mid last year. This is evident in business conditions indicators as shown in the next chart.

Business conditions in the US, Europe & Japan are up



Source: Bloomberg, AMP Capital Investors

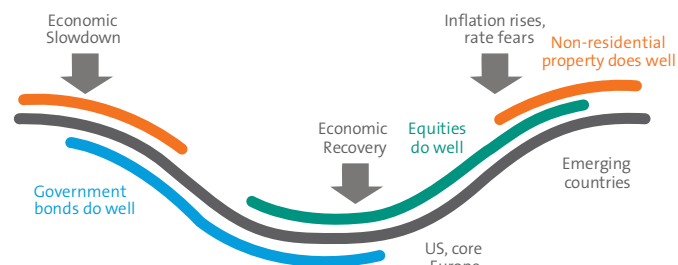
In fact, the US is leading the charge on this front. The US Institute for Supply Management business conditions indicators are about as strong as they ever get. Corporate profits are up strongly and this is boosting business investment. Various labour market indicators point to a big resurgence in jobs growth and unemployment is already falling. Finally, US consumers are starting to feel more confident again and this is boosting retail sales. Similarly in Europe, strength in Germany is more than offsetting weakness in peripheral debt-troubled countries. So there is good reason for confidence in the sustainability of the global recovery.

Thirdly, the liquidity backdrop for shares is very positive with: easy money in the US, Europe and Japan; cashed-up corporates starting to undertake takeovers and share buybacks and boost dividends; and individual investors starting to switch back from bonds to shares. At the moment the latter is particularly noticeable

in the US with the record inflows into bond mutual funds of recent years now starting to flow back out into equity mutual funds. Given the size of the bond inflows in recent years this might have a way to go before it is complete. If history is any guide and share markets do continue to rise, then the same is likely to become evident amongst Australian individual investors.

In fact, the US and northern Europe are arguably in the classic 'sweet spot' in the investment cycle – with rebounding growth and surging profits but plenty of spare capacity such that inflation is not really a problem and central banks can keep interest rates low and money easy. This period in the cycle is usually very positive for shares.

The US is in the 'sweet spot' in the investment cycle



Source: AMP Capital Investors

Finally, there are no signs of the excesses that normally mark the end of cyclical recoveries in shares. Inflation is still benign in advanced countries and even in emerging countries it is mainly reflective of higher food prices, not excessive demand. Prices for assets such as shares and property are still far from being overvalued.

But what could go wrong?

Essentially, there are four main areas of concern:

Firstly, there is a risk of a short-term pull back in shares. Many technical indicators suggest US shares are overbought and measures of short-term investor optimism are at levels that often precede corrections. However, while there is the risk of a consolidation or a 5% pullback, the positive fundamental outlook outlined above suggests any short-term dip should be seen as a buying opportunity.

Secondly, longer-term structural issues clearly remain in major advanced countries. The threat remains from very high public debt levels, still fragile household balance sheets, ongoing issues in the US housing market and poor demographics. However, our assessment is that while these are likely to be medium-term constraints for major advanced countries, they are unlikely to cause a blow up in the next year or two:

- Europe seems prepared to do whatever it can to stop its debt problems from spreading. And the US is having no trouble financing its budget deficit.

- Household balance sheets in the US remain worrying but rising share prices and the fall in household debt ratios mean they are becoming less fragile.
- While the US housing market is still a threat, rising home sales suggest it has found a floor, and in any case the significance of housing activity in the US economy is half what it used to be.
- Finally, demographics are certainly poor and will be a long-term constraint in major advanced countries, but this is a very slow moving event.

Thirdly, worries about inflation and growth in emerging countries could start to weigh on major share markets. Asian and emerging market shares generally have had a bad start to the year reflecting the need for monetary tightening in response to inflationary pressures. Basically Asia and other emerging countries are further advanced in their economic cycle (see earlier chart) and so have less spare capacity and less justification for very easy monetary conditions. As a result, monetary tightening is required to take monetary conditions back to neutral – as has already occurred in Australia - and this is seeing emerging markets go through a period of underperformance relative to the US and Europe. This is likely to continue for the next six months or so, but with underlying inflation in these countries a long way from getting out of control and policy makers already responding, a hard landing is unlikely in the emerging world. Nor does it change the favourable strategic outlook for Asian/emerging share markets.

Finally, the eventual reversal of easy money policies in the US, Europe and Japan and easy fiscal policy in the US will likely cause gyrations in share markets. However, this is unlikely to be a major issue for markets until later this year at the earliest or more likely through next year. Excess capacity in the US, Europe and Japan suggests underlying inflation is likely to remain benign for some time heading off the need for a quick return to more normal monetary conditions in these countries.

Concluding comments

The cyclical recovery in global shares has further to run, but with Asian and emerging markets further advanced in their economic cycles and US shares still in the 'sweet spot' in the investment cycle, the next six months or so may see further short-term outperformance by US shares. Australian shares are likely to be in between: monetary tightening in Asia may act as a short-term constraint on Australian shares but with monetary conditions already normalised in Australia and the Reserve Bank of Australia ahead of the curve, Australian shares are likely to continue to benefit from the positive lead flowing from US shares.

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