

Why are Australian shares lagging? Will it continue?



Key points

- Australian shares have disappointingly underperformed traditional global shares over the last year on the back of monetary tightening, worries about a housing bubble, the strong Australian dollar (A\$) and Chinese tightening.
- Many of these concerns should be largely factored in and we see better returns this year, but some linger so it is too early to say the relative underperformance is over.
- However, on a five-year basis, the combination of higher dividends, better growth prospects, fewer structural constraints and franking credits for Australian-based investors suggest investors should maintain a bias towards Australian shares.

Introduction

At the end of 2009, there was much optimism Australian shares would continue to outperform their counterparts in other developed countries. In particular, Australia had come through the global financial crisis in good shape without the structural constraints faced by many other developed countries, the Australian economic outlook looked good and Australia was well keyed into high growth Asia. However, Australian shares have disappointed over the last year, returning just 1.6% in 2010 whereas global shares returned 10.4% in local currency terms. Global shares have reached new recovery highs whereas Australian shares are still below their April high. So what happened? What drove the underperformance? Is it just a short-term setback in Australian shares or does it signal something more fundamental? This note focuses on Australian shares relative to traditional global equity markets, as opposed to Asian and emerging markets where we generally expect underperformance by Australian shares.

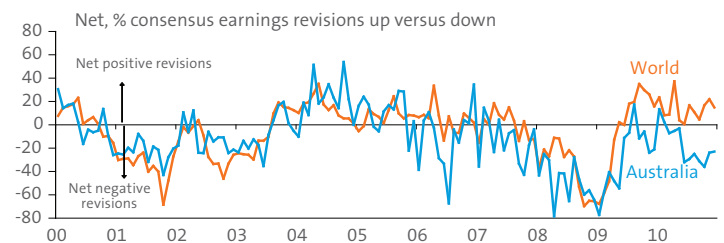
Australia's relative underperformance

Australia's relative underperformance over the last year appears to reflect several factors:

- Rising interest rates at a time when interest rates were at or near zero in other developed countries and, in some instances, monetary conditions were still being eased. This led to concerns about the outlook for domestic cyclical sectors, notably retailing and housing, and bank credit growth. It also made bank term deposits look attractive compared to shares (unlike in the US where yields on term deposits are poor).
- There has also been concern internationally that Australian housing is in a bubble that is about to burst, with bad consequences for Australian banks.

- The strong A\$ has weighed on internationally-exposed companies that don't have a hedge in the form of high commodity prices.
- Concerns Chinese authorities will over tighten and crash the Chinese economy in an effort to beat inflation have also weighed on the Australian share market, given the degree to which many global investors now see Australia as being connected to China.
- These concerns have all been reinforced by earnings downgrades in Australia whereas earnings expectations have been upgraded globally – see the following chart.

Earnings expectations are being revised up globally, but down in Australia



Source: Thomson Financial, AMP Capital Investors

This has all seen the price to forward earnings ratio for Australian shares fall from 15.3 times at the end of 2009 to 12.7 now, whereas that for global shares has fallen by a smaller amount (i.e. from 14.1 times to 12.5 now). In an absolute sense, we see Australian shares rising this year as the global recovery continues. The price to earnings contraction has left Australian shares reasonably attractive, profit growth locally should be solid and Australian companies have scope to re-leverage, reflecting high cash levels and low gearing – see the following chart.

Australian corporate sector gearing down, cash is up



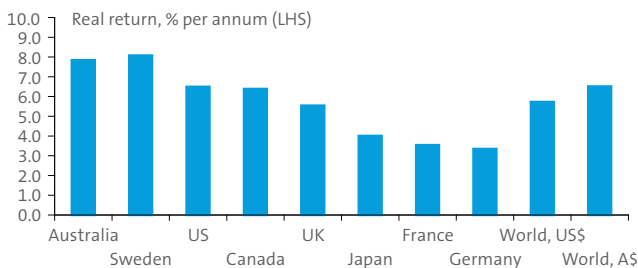
Source: Reserve Bank of Australia, AMP Capital Investors

However, it is too early to say that the relative underperformance of Australian shares has run its course. Concerns about an imminent collapse in Australian house prices resulting in massive damage to Australian banks are overdone. The threat to domestic growth from the strong A\$ and rising interest rates should be largely factored in, and in any case recent benign inflation data and the disruptive effects from the floods suggest that the Reserve Bank of Australia will be on hold out to mid-year. However, concerns about Chinese, and more generally Asian, tightening may linger for a while yet. So, on balance, we see global and Australian shares having similar returns this year.

A longer-term perspective

It is worth noting that despite Australian shares lacking the breadth and diversification of global shares, over the last 110 years Australian shares have had better real returns than most global share markets (Swedish shares being the exception). See the next chart.

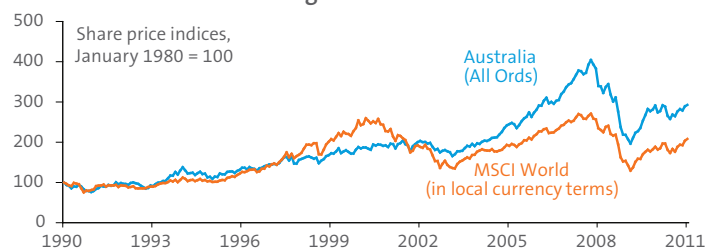
Real equity returns since 1900



Source: Global Financial Data, AMP Capital Investors

However, within this long run of outperformance there have been lengthy periods of relative underperformance (such as in the 1970s due to relatively poor economic management in Australia) and the 1990s (the global tech boom), but also on a short-term basis (say in 2003 in the first year of recovery from the tech wreck).

Australian shares relative to global shares



Source: Thomson Financial, AMP Capital Investors

While it is too early to say the relative underperformance of the last year is over, there are several reasons to believe the longer-term period of outperformance in Australian shares that started in 2000 will continue:

Firstly, **Australian shares still pay higher dividend yields than mainstream global shares.** The average dividend yield on Australian shares is 4% versus 2.6% for global shares. This is important because over long periods dividend payments constitute a significant component of the return an investor gets and so the higher the dividend yield, the better (assuming it is not debt financed).

Moreover, high dividend yields augur well for future returns, as they signal corporate confidence about future earnings and excessive retained earnings are often wasted.

Secondly, **the Australian economy offers higher growth potential than the US, Europe and Japan.** Australia has stronger population growth which is feeding through into much stronger labour force growth. Australian households have not seen the same deterioration in their net wealth as has occurred elsewhere, public sector debt is very low and Australia is heavily exposed to

high growth Asia and strength in commodity prices. All of these considerations are likely to translate into higher growth in earnings for Australian companies over the medium term compared to earnings growth in traditional global share markets.

Reflecting the last two points, **return projections (see the table below) based on current dividend yields and likely earnings growth tend to favour Australian shares.** Over the medium term (say, five years), a good starting point to project likely returns is to add current dividend yields to likely long-term nominal gross domestic product growth as a proxy for earnings growth and hence capital gains from shares.

Projected medium-term pre-tax equity returns, % per annum

Region	Dividend yield, plus	Growth, equals	Projected total return
US	1.8	4.8	6.6
UK	3.1	4.0	7.1
Europe	3.4	3.8	7.2
Japan	1.9	2.8	4.7
Asia, ex Japan	2.1	8.0	10.1
World – local currency	2.3	4.6	6.9
Australia	4.0 (5.2*)	5.5	9.5 (10.7*)

* Adjusted for franking credits. Source: Bloomberg, AMP Capital Investors

Australian shares with a five-year pre-tax return projection of 9.5% per annum come out well ahead of traditional global shares with a return projection of 6.9%.

Finally, **franking credits add over 1% to the post-tax return from Australian shares for Australian investors.** The higher dividend yield from Australian shares and franking credits mean Australian shares have a 2.9% per annum return advantage over traditional global shares for Australian-based investors.

Concluding comments

Australian shares have underperformed traditional global shares over the last year on the back of monetary tightening, worries about a housing bubble, the strong A\$ and Chinese tightening. While many of these should be largely factored in and we see better returns this year, some still linger (notably Chinese/Asian tightening) so it is too early to say that the period of relative underperformance is over.

However, on a strategic, or five-year basis, the combination of higher dividends, better growth prospects, less structural constraints and franking credits for Australian-based investors suggests investors should maintain a bias towards Australian shares over traditional global shares, although maybe not as big a bias as was warranted a decade ago.

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