

Monetary tightening and the recovery in growth assets



Oliver's insights

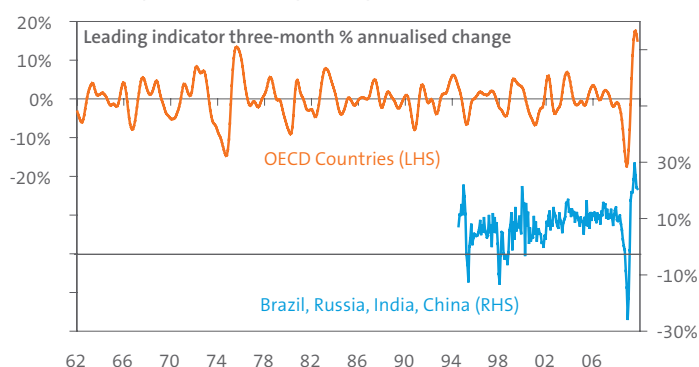
Key points

- After very strong gains in equity markets from the lows in March last year, past experience after bear markets suggests rougher and more constrained gains ahead.
- This reflects a transition in the investment cycle from the 'sweet spot' to a somewhat tougher environment, where shares are more dependent on earnings growth but momentum in leading growth indicators peaks and cost pressures and interest rates start to rise.
- Although this may cause fluctuations and more constrained gains, the broad trend in shares and other growth assets is likely to remain upward. We are still early in a typical bull market, earnings growth is likely to be strong and global interest rates are likely to remain low.

More good news on the economic recovery

Recent weeks have seen more good news on the global recovery. Surveys of manufacturers continue to recover, the Organisation for Economic Co-operation and Development's (OECD) leading indicators of global growth are still rising strongly, the US labour market looks closer to jobs growth and this, along with improving US retail sales, suggests a better outlook for the all-important US consumer. Exports are also rising strongly in most countries.

OECD leading indicators of global growth



Source: Thomson Financial, AMP Capital Investors

Share markets have reflected this good news by breaking out to new recovery highs. However, the obvious sting in the tail is that central banks and governments will eventually start to unwind the monetary and fiscal stimulus, creating speed bumps and uncertainty for growth assets.

Are the easy gains behind us?

After the spectacular recovery in growth assets in 2009, it is reasonable to expect slower and more volatile gains in the year

ahead. In fact, past experience of recoveries out of bear markets suggests exactly that. During the post-war period, the first 12 months after a bear-market low saw an average 39% rise in US shares – so far the market is up 70% from its March 2009 low. However, as shown by the table below, the average gain in the second 12 months is just 8%.

Post bear market recoveries, US shares

Bear market	% decline in S&P 500	% gain in first year from low	% gain in second year after low
May 1946 - Jun 1949	-30	42	4
Aug 1956 - Oct 1957	-22	31	10
Dec 1961 - Jun 1962	-28	33	-2
Feb 1966 - Oct 1966	-22	33	7
Nov 1968 - May 1970	-36	44	11
Jan 1973 - Oct 1974	-48	38	21
Nov 1980 - Aug 1982	-27	58	2
Mar 2000 - Oct 2002	-49	34	8
Average	-33	39	8
Oct 2007-Mar 2009	-57	70	?

Source: Bloomberg, AMP Capital Investors

Similarly, during the post-war period in the Australian market, the average gain in the first 12 months following a bear-market low is 28% (compared to a 60% rise so far from the March low last year). The average gain in year two is just 6%, although with a broad range. Please refer to the following chart.

Post bear market recoveries, Australian shares

Bear market	% decline in All Ordinaries	% gain in first year from low	% gain in second year after low
May 1951 - Dec 1952	-34	8	13
Sep 1960 - Nov 1960	-23	12	-2
Feb 1964 - Jun 1965	-20	8	11
Jan 1970 - Nov 1971	-39	49	-25
Jan 1973 - Oct 1974	-59	54	16
Aug 1976 - Nov 1976	-23	6	21
Nov 1980 - Jul 1982	-41	39	9
Sep 1987 - Nov 1987	-50	35	5
Sep 1989 - Jan 1991	-32	39	-9
Jan 1994 - Feb 1995	-22	25	8
Mar 2002 - Mar 2003	-22	28	24
Average	-33	28	6
Nov 2007 - Mar 2009	-55	60	?

Source: Bloomberg, AMP Capital Investors

The slower gain in the second 12 months of equity market recoveries reflects the fact the initial bounce is usually from extremely undervalued levels as investor panic is unwound, whereas thereafter gains are dependent on earnings growth. Shares also start to become vulnerable to higher interest rates,

as central banks move to unwind the stimulus put in place through the economic downturn. This essentially reflects a shift in underlying economic and investment conditions from the 'sweet spot' in the cycle (where leading indicators of growth are strong and accelerating, profits are being revised up but shares are cheap and inflation, interest rates and bond yields are low) to a tougher phase where growth momentum peaks but cost pressures, interest rates and bond yields start to rise.

At present, there are some warning signs the US/global economy may be getting near the end of its 'sweet spot'. For example, momentum in leading growth indicators has been so strong it may be close to peaking, if it isn't already doing so (refer to the first chart). Cost pressures may be starting to head up and there are increasing signs the US Federal Reserve (Fed) is getting closer to starting to unwind its monetary stimulus. It has already signalled that most of its liquidity boosting measures will expire next month.

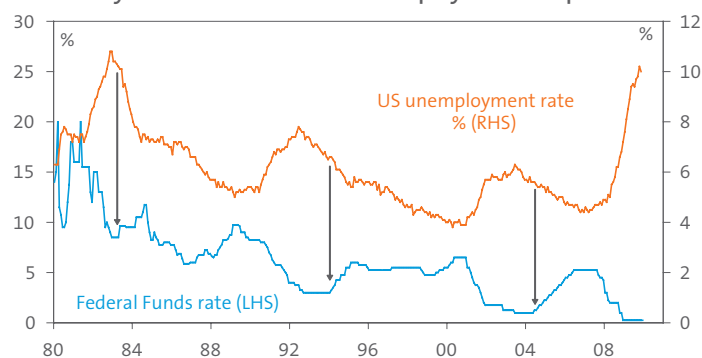
But further decent gains in shares are likely

However, while historical experience suggests a somewhat slower, rougher ride ahead as we move out of the 'sweet spot' in the investment cycle, further solid gains are still likely in share markets and in other growth assets.

The first point to note is we are still in the early phase of a typical cyclical bull market. The typical cyclical bull market has lasted about four years in Australia and seen average gains of 132%, compared to 10 months and a gain of 60% so far in this bull market. In the US, the typical cyclical bull market in the post-war period has lasted around five years (if the slump of July-November 1990 is allowed for) compared to 10 months so far.

Secondly, while the strengthening signs of recovery suggest the Fed and other central banks are getting closer to tightening monetary conditions, it should be noted that many of the liquidity boosting measures due to expire next month are no longer being used, as market conditions have returned to normal. More fundamentally, there are several reasons to expect the Fed and other key central banks to be slow in raising interest rates. Unemployment is now 10% in both the US and Europe. This, along with very low capacity utilisation rates in factories, suggests there is still downwards pressure on underlying inflation. Wage growth will stay low and it will be hard for companies to raise prices. Coming out of the last three recessions, the Fed only started to raise interest rates an average 12 months after the peak in unemployment and after unemployment had fallen an average 0.9 percentage points. While of course the Fed Funds rate is lower this time (arguing for an earlier move), against this, the unemployment rate is higher (arguing for a later move). While US jobs growth is likely to resume shortly, it may not be enough to prevent a further rise in unemployment until around mid-year. This would suggest that, allowing for a normal lag from peak unemployment, the Fed may not start raising interest rates until early next year.

The Fed only raises rates well after unemployment has peaked



Source: Bloomberg, AMP Capital Investors

Also, there is little sign of an imminent and significant tightening in fiscal policy for key developed countries. With banks happily buying government bonds with near zero interest short-term money, there is little immediate pressure for them to do so.

Further, the backdrop of low underlying inflation and high unemployment in key advanced countries means interest rates will still be at very low levels well into next year, providing a strong incentive for investors to switch into shares and other growth assets.

Despite strong gains share valuations are still reasonable – around fair value on the basis of price to earnings multiples but cheap if the prospective yield available on shares is compared to the bond yield.

Additionally, profits globally and in Australia are still being revised up as revenues now start to surprise on the upside, adding to confidence that a strong surge in profits (+20% to 30%) will underpin share market gains this year.

Finally, while recent surveys show a high level of investor bullishness towards shares (which warns of a potential correction) it is worth noting that actual commitment to shares is still low: only 44% of participants at a Bank Credit Analyst conference in New York late last year said they were overweight shares, US mutual fund investors have been switching money from share funds to bond funds and in Australia cash in the superannuation system is still a high 16.6% (versus a norm of 10%). This suggests there is still plenty of cash that can come into share markets (and other growth assets) and push them higher going forward.

Conclusion

Cyclical rallies in shares normally end when valuations are stretched, cost pressures escalate significantly, and central banks adopt tight monetary policies to combat inflation. We are not there yet. So while the easy gains may have been seen and the environment for shares and other growth assets may get rougher and more constrained in the year ahead, further gains are likely. (Subsequent editions of Oliver's Insights will look at the risks surrounding high public debt levels and China.)

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