

## The share market panic – what happened to the global economic recovery?

EDITION 24 – 18 AUGUST 2011



### Key points

- The fall in share markets over recent weeks reflects increasing worries about US and European growth and concern governments are no longer able to respond.
- Shares are cheap, but the risk of a US recession has clearly increased and if one is on the way shares can get a lot cheaper. Short-term investors should remain cautious. However, if we are right and the more likely outcome turns out to be low messy growth but not a return to recession, then current valuations make shares attractive from a long-term perspective. Therefore averaging in over time would make sense.

*I have observed that not the man who hopes when others despair, but the man who despairs when others hope, is admired by a large class of persons as a sage.” J.S. Mill*

### Introduction

After the events of the last few weeks it's easy to be bearish. After plunging nearly 20% from their highs earlier this year to the lows last week, global share markets have rebounded by around 6%. But markets remain twitchy.

The slump in markets over the last month naturally raises a lot of questions: What is driving it? Are we seeing a re-run of the global financial crisis? What is the risk of a return to recession? Can China save the world again? Have shares bottomed? How vulnerable is Australia?

### Why the sharp fall in shares (and other growth trades)?

Put simply, shares have taken a tumble on fears of a return to recession in the US and Europe, and worries this will drag down the rest of the world. A few months ago we thought that global growth was just going through a temporary soft patch (on the back of Japanese supply chain disruptions and the earlier surge in oil prices) and that even though shares might remain volatile and see further weakness through the September quarter, the trend would remain up as profits continued to rise and global monetary conditions remained easy.

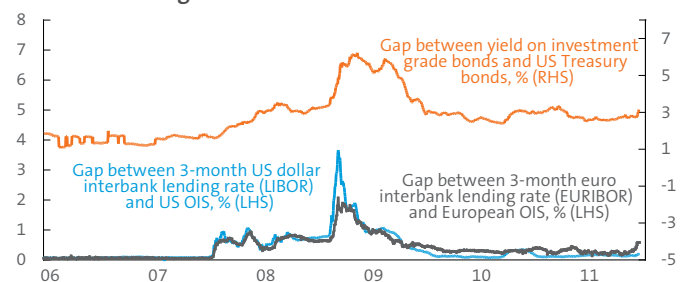
But the events of the last few weeks have called this view into question. Economic data has remained weak and debt crises in the US and Europe are increasing the pressure for more fiscal austerity at a time when growth is fragile. Political bumbling on both sides of the Atlantic, Standard & Poor's downgrade of America and fears of more downgrades to come have only compounded these fears. Furthermore, memories of the 2008-09 global financial crisis are still fresh in the minds of investors so the attitude seems to be shoot first and ask questions later.

### Are we seeing a re-run of the global financial crisis?

It's still early days yet, but our view is this is very different to the global financial crisis. Public debt problems have been brewing for some time so exposures should be well known and more transparent. The leverage and complex financial engineering that caused so much trouble in the global financial crisis is not

a factor now. Interbank lending markets are much better supported by central banks. Consequently, while interbank lending spreads (the difference between what banks charge to lend to each other and expected official short-term interest rates – i.e. the overnight indexed swap [OIS] in the chart below) and credit spreads (the difference between corporate and government borrowing rates) are picking up, they remain relatively low.

### Money and credit market spreads are up, but well below global financial crisis highs



Source: Bloomberg, AMP Capital Investors

While it's early days yet, the risk of a complete seizing up in lending markets – including in areas like trade finance that helped spread the global financial crisis to emerging countries – as occurred in late 2008 seems low. However, the recent speculative attacks on French banks and moves by US money market funds to stop lending them US dollar funds are worth watching. This is evident in the greater rise in European lending spreads compared to the US in the chart above.

### What is the risk of a return to global recession?

The risk of recession has increased significantly in Europe and the US. Fiscal austerity is occurring much earlier than is desirable, and recent political wrangling has put public debt problems front and centre in investors' minds and dealt a huge blow to business and consumer confidence. Europe is probably the biggest risk. It seems to be stuck in an ever-worsening cycle of periodic investor panic over debt blow-outs, causing more fiscal austerity, causing weaker growth, causing further budget deterioration, causing more market panic, causing more austerity and so on. This process started in the peripheral countries but now appears to be spreading into Italy and France. A fiscal union is a long way off and won't solve current problems anyway, and the European Central Bank seems unwilling (or unable) to provide monetary relief.

And the US is now starting down the same path with fiscal austerity set to knock up to 2% from growth next year. However, there are several reasons to believe that while the risk of recession in the major industrial countries has increased substantially, it will probably just be avoided:

- The fall in oil and commodity prices generally will take pressure off household budgets and business costs.
- Cyclical sectors that can push the US economy into recession are already at recession levels – e.g. housing.
- Longer-term borrowing costs in the US have fallen to extraordinarily low levels and the US Federal Reserve is effectively committing to keep them there for two years. This is enabling homeowners to refinance to lower rates.
- Near-zero returns on cash are making it very difficult for US companies to continue adding to their already record cash stockpiles. The incentive to get out and invest, or at least buy back shares or other companies, is huge.

- It's looking increasingly likely the US will head down the path of another round of quantitative easing (i.e. QE3 – which involves pumping more cash into the US economy). While one can debate the seeming failure of QE1 and QE2 to spark a strong recovery, the US probably would have been a lot weaker were it not for these actions and at least it seems to have prevented the US from sliding into price deflation.

We put the risk of a return to recession in industrialised countries at 40% – slightly higher in Europe, but slightly lower in the US – with fragile sub-par growth of around 1% to 1.5% being the most likely outcome at around 60% chance.

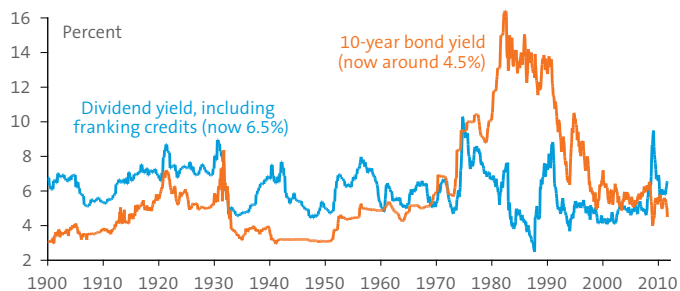
## Can China save the world again?

This brings us to the emerging world and China. Providing there is no drying up in trade finance, it is likely China and the emerging world will be able to hold up. Inflationary pressures in China and the rest of the emerging world are already fading on the back of lower oil and food prices, and with growth coming off the boil this should clear the way for easier monetary policies. With short-term interest rates having increased over the last two years there is plenty of scope to cut, unlike in advanced countries. Secondly, public debt levels in the emerging world remain low so there is still plenty of room for stimulus if need be. Overall China is likely to see growth of around 8% to 9% and emerging countries around 5.5% which implies global growth of 3% to 3.5%. This is well below International Monetary Fund expectations but not disastrous.

## Are shares a good buy?

After sharp falls in share prices and bond yields, shares are good value on several metrics. Price to earnings multiples on global, Asian and Australian shares have fallen to around 10 times, well below long-term averages. And dividend yields have risen sharply compared to bond yields. This can be seen in the following chart which relates to Australian shares. This means shares only require modest capital growth to provide an attractive return premium versus bonds.

### Australian shares – the dividend yield is 2% above the bond yield



Source: Global Financial Data, AMP Capital Investors

However, while shares may be cheap, it doesn't mean they have bottomed. The next table focuses on US shares as they set the cyclical direction for shares elsewhere. As can be seen, all US recessions over the last 50 years have been associated with a sharp fall in the US share market. What's more, the low in the share market has always come after the recession has begun (by an average of nine months). Right now, it's hard to argue a US recession has commenced, but if you believe one is on the way then US shares are arguably a long way from bottoming. And this means global and Australian shares as well.

## US recessions are invariably bad for shares

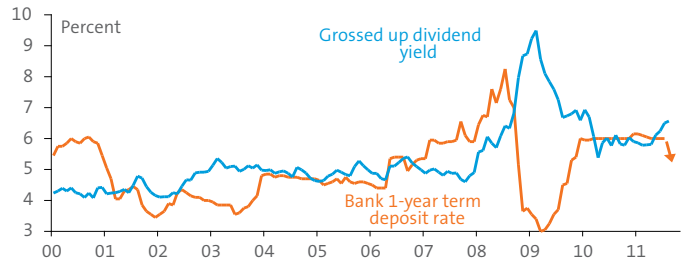
US recessions*		Associated fall in US shares (S&P500)	
Period	Period	Low versus start of recession, months	% Fall
Apr 60-Feb 61	Aug 59-Oct 60	6	-13.9
Dec 69-Nov 70	May 69-May 70	5	-34.7
Nov 73-Mar 75	Jan 73-Oct 74	11	-48.2
Jan 80-Jul 80	Feb 80-Mar 80	2	-17.1
Jul 81-Nov 82	Nov 80-Aug 82	13	-27.1
Jul 90-Mar 91	Jul 90-Oct 90	3	-19.9
Mar 01-Nov 01	Mar 00-Oct 02	19	-49.1
Dec 07-Jun 09	Oct 07-Mar 09	15	-56.8
<b>Average</b>		<b>9</b>	<b>-33.4</b>

\*As defined by the National Bureau of Economic Research in the US.

Source: Thomson Financial, AMP Capital Investors

However, if recession is avoided in favour of just low messy growth then the downside may be less concerning on, say a 12-month horizon. For example, with Australian shares providing a grossed up dividend yield of over 6%, assuming profits grow just 4% per annum (pa) and share prices move in line with this then the total return on a medium-term view is around 10%. This is at a time when the bond yield is just 4.5%. Furthermore, bank deposit rates are starting to fall as banks are awash with cash, wholesale interest rates have fallen and credit growth has slowed to just 3% pa. This means the cash flow from shares is now back above that from bank interest.

### Australian dividend yield is up, deposit rates are going down



Source: Reserve Bank of Australia, Bloomberg, AMP Capital Investors

## How vulnerable is Australia to a new global downturn?

Australia is vulnerable to any renewed global downturn, given impacts on confidence, financial flows, and potentially trade. However, Australia is far better placed to withstand a global downturn and we see the risk of recession here as low at around 20%. Interest rates have a long way to fall. The Australian dollar would likely fall if the global economy returns to recession boosting competitiveness. Public debt is a fraction of that in other countries and so more stimulus can be applied if need be. Corporate gearing levels are low and companies are cashed up. Banks are less dependent on global markets for funding than in 2007. Australian households have also built up a large savings buffer. Finally, our key export markets in Asia are more secure than those in Europe and the US.

## Concluding comments

For short-term investors, there is a case to remain cautious. For long-term investors, attractive share market yields, low and falling yields on bonds and bank deposits and the likelihood of more monetary stimulus on the way suggests shares may be attractive on a longer-term basis, meaning there is a case to average in over time.

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