

Australian Equities: Where are we in the cycle?

Economic research paper

14 October 2009

- Sharp falls in the Australian equity market over 2008 and early 2009 could mean a greater focus on economic fundamentals to understand where equities are in the cycle.
- The more recent recovery of the equity market has been driven by a combination of unprecedented policy action helping the world avoid the worst case scenario for global economic growth. A recovery in credit markets, the successful raising of equity capital, debt reduction and the return of some investor risk appetite has also supported the market.
- The equity market tends to lead the economy by around six to 12 months, indicating it is important to know where the economy is in its cycle.
- While recent economic data has been better than expected, with the RBA responding to this news by raising interest rates, further improvement in the economy will likely be needed to support the equity market recovery.
- Company profits are also key to gains and falls in the equity market. For continued growth in the equity market, profits must rise, with operating margin expansion the likely driver.
- Other factors to drive the equity market are capacity utilisation and cash looking for a home, both of which point towards a positive outlook, although these factors tend to more long-term drivers.

Introduction:

One consequence of the equity market downturn experienced as a result of the global financial crisis (GFC) and subsequent recession could be a return to a more active focus on economic fundamentals and their impact on financial markets. In this paper we look at the recent performance and outlook for the equity market in the context of the outlook for the Australian economy. As part of this we will consider some key drivers of the equity market, including company profits, capacity utilisation, interest rates, valuations and cash to be invested.

The equity market over the past 18 months:

The S&P / ASX 200 Index reached a closing low of 3,145 on 6 March 2009. This day looks like it marked the end of the collapse in share prices that had begun in late 2007 and accelerated through 2008, with a peak to trough fall of 54%. In this period the GFC resulted in the near-collapse of the global financial system, a globally synchronised downturn in economic activity and a broad loss of confidence amongst financial markets, consumers, businesses and investors.

In the first quarter of 2009 the value of most listed Australian companies fell to levels not seen, on a trailing price to earnings ratio basis, since 1980. At the minimum, this level of valuation suggested many Australian firms were likely to fail and that earnings growth over the medium term would be negligible to negative.

The Australian equity market has since risen sharply from its lows in early March 2009. As at 13 October 2009 the S&P / ASX 200 Index has risen around 51% from its low in March 2009.

The recovery was driven by a number of factors:

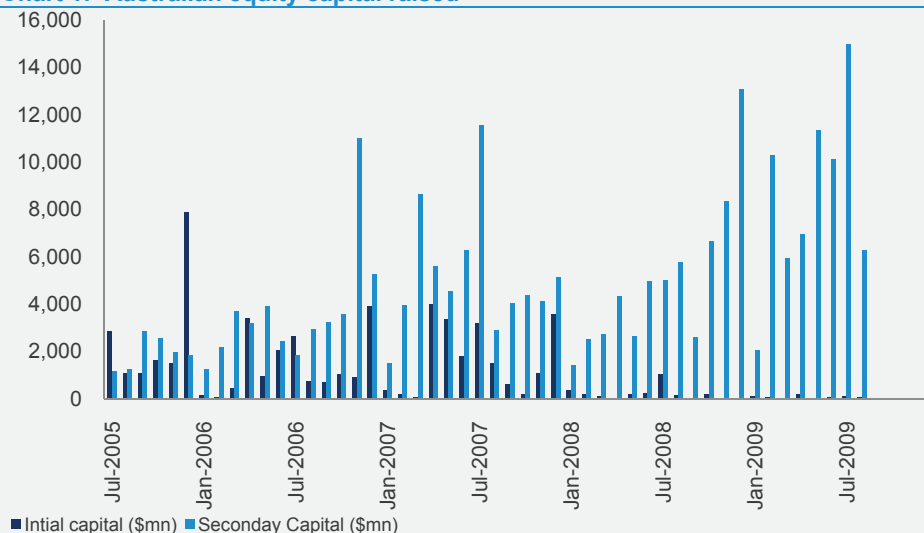
- 'Armageddon' (ie. a repeat of the 1930s Great Depression) did not eventuate, the equity market had priced in the worst case scenario
- The credit crisis has passed, stability appears to have returned to the global financial situation
- Companies have successfully raised capital to improve the health of balance sheets
- A recovery in economic activity has emerged, particularly in Australia and significant Asian countries, and
- Investor risk appetite returned with inflows into the equity market.

Capital has been raised:

As stated above, one of the positives for the Australian equity market is that local companies have successfully raised capital. This has facilitated corporate deleveraging, as debt costs rose and investors shied away from companies with high debt to equity ratios. As Chart 1 shows, Australian companies raised a total A\$98.6 billion from September 2008 to August 2009.

The equity market was an important source of capital for Australian companies because debt markets were effectively closed to many companies at nearly any price at the depth of the credit crisis (with the exception of the banks, who were able to borrow money with the benefit of the Commonwealth government guarantee).

Chart 1: Australian equity capital raised

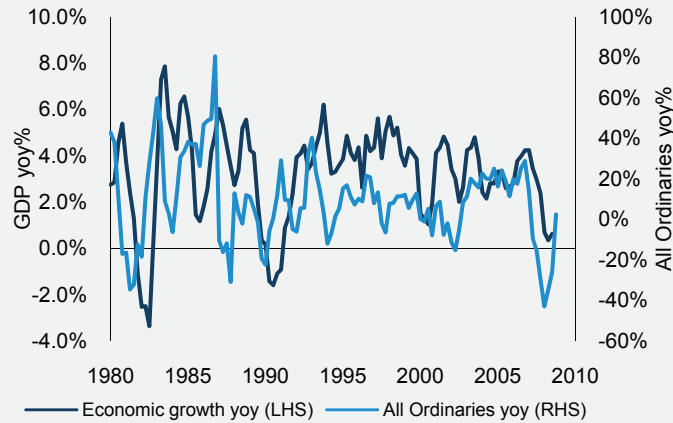


Source: ASX. Data to 31 August 2009

What drives the equity market?

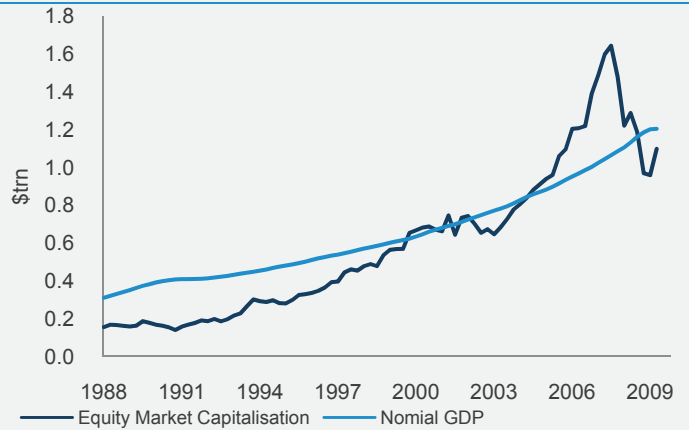
- The Australian equity market tends to lead the Australian economic cycle – most typically with a lag of six to 12 months, see chart 2. Q2 09 GDP showed the Australian economy growing at an annual pace of 0.6%. Market expectations suggest that the annual pace of economic growth is likely to have bottomed in Q1 09, which looks pretty closely aligned to the historical relationship with the equity market. This appears to have bottomed (in annual change terms) in Q4 08.

Chart 2: Annual change in real GDP and Australian equity market



Source: ABS & Bloomberg

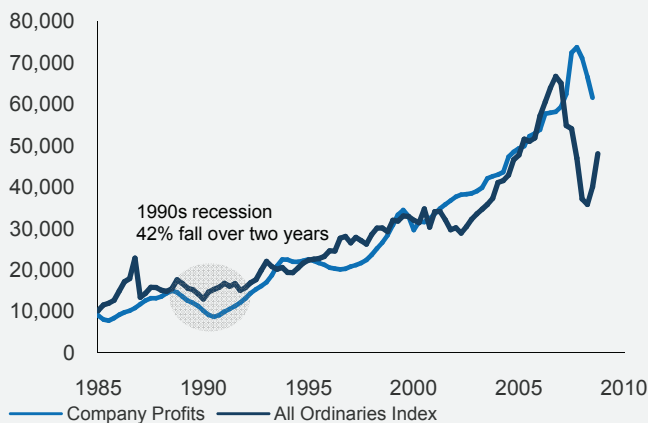
Chart 3: Australian equity market capitalisation and nominal GDP



Source: ABS, Bloomberg and Colonial First State Global Asset Management

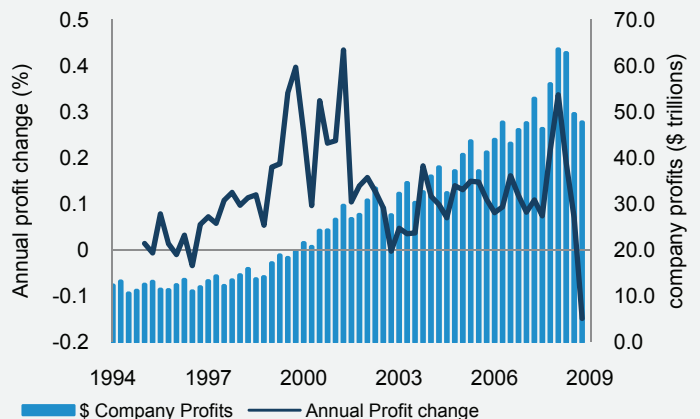
- Also helpful in assessing the outlook for further gains in the equity market is the historical relationship between the size of the economy and the size of the equity market, see Chart 3. The fall in the equity market has been much greater than the fall in the economy, although this could also be seen as a correction to the previous gains over and above the size of the economy. Nevertheless, expectations for further growth in nominal GDP do raise the prospect of a further pick up in the equity market in the years ahead.
- Not surprisingly, the Australian equity market has, over time, moved relatively closely with the profit performance of Australian companies. In the 1990s recession Australian company profits fell by approximately 42% over a two-year period and this resulted in the equity market trading relatively sideways for a three to four year period.
- This time around, the Australian equity market fell by just over 50% from peak to trough, suggesting that the equity market had factored in a fall in company profits of closer to 50%. This is seen in Chart 4.
- Based on ABS data to Q2 09, company profits in Australia were actually down around 15% over the past year and down around 25% from the peak in Q3 08. Profits have been better than expected given the resilience of the Australian economy and a large push by companies to reduce costs. This better-than-expected performance of company profits is one of the reasons why the Australian equity market has been able to recover a significant amount of lost ground over the past six months.

Chart 4 – Company profits and the equity market



Source: ABS Gross operating earnings, All Ordinaries index, Bloomberg. Earnings to 30 June 2009. All Ordinaries index to 25 September 2009. Index created starting 1985.

Chart 5: Australian company profits - \$Am and %/yr



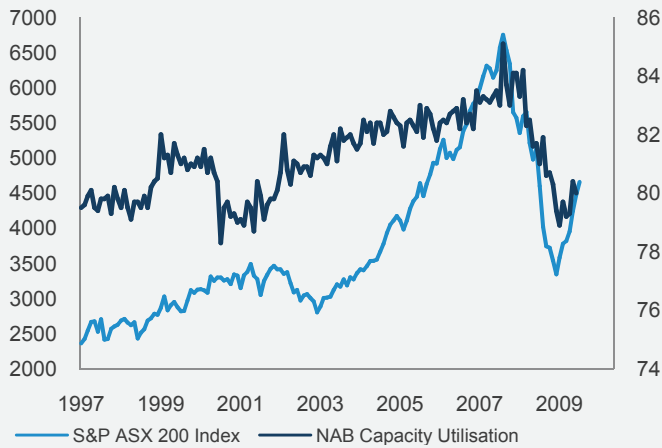
Source: ABS

- Looking at components of the economic cycle more specifically, we can see from Chart 6 on the following page that the downturn in the Australian equity market over the past two years or so has been closely related to the sharp downturn in capacity utilisation.
- Capacity use by Australian companies was on a solid upward trend from late 2001 to its peak in October 2007. This period corresponded with solid economic growth, the monetary policy tightening cycle from the RBA and the strong gains in the Australian equity market. Since late 2007 there is a strong visual relationship between capacity use and the equity market, with

both falling sharply as the effects of the global financial crisis and subsequent recession took hold. However, both capacity use and the local equity market turned higher in early 2009.

- Given the recent run of better-than-expected local and global economic data, it is likely that capacity use by Australian companies will continue to recover over the remainder of 2009 and into 2010. While capacity use is unlikely to reach the highs seen in late 2007 in the near-term, given expectations that the global economic recovery will be relatively muted, any further gains from current levels could be expected to be supportive for the equity market.
- In addition, one of the main drivers of the equity market recovery has been forward price to earnings ratio expansion. This usually drives the first stage of an equity market recovery in anticipation of earnings upgrades. For the Australian equity market to make further gains from current levels it will likely require a profit performance from companies that at least matches improved expectations.
- For profits to rise, companies will need to expand revenues. A prerequisite for this growth will be gains in private final demand (post stimulus packages) and a sustainable economic recovery. When revenue growth resumes, operating margins should rebound quickly given recent cost cuttings. Although it could be expected that some costs will rise (ie. labour) as the economic recovery takes hold.
- The best way to look at this is by earnings per share (EPS) expectations. What we can see is that analysts have started to upgrade forecasts for 2011, with some upgrades to 2010. This should also prove supportive of the equity market, as long, of course, as these higher earnings expectations are met. See Chart 7.

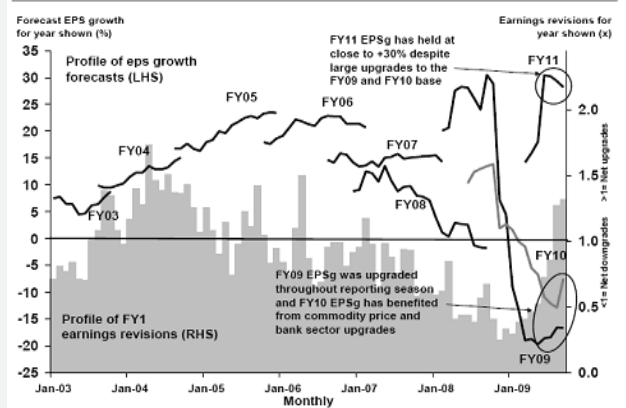
Chart 6: Capacity Utilisation and the Equity Market



Source: NAB and Bloomberg. NAB data to 31 August 2009. S&P/ASX 200 Index to 28 September 2009

Chart 7 – EPS upgrades

Market EPSg has been upgraded in recent weeks, following the FY09 EPSg upgrades throughout reporting season



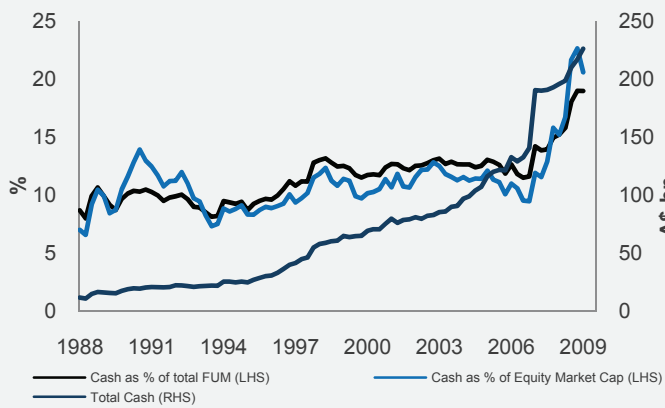
Source: Macquarie Research, September 2009

- Another likely supportive factor for the Australian equity market could be the level of cash currently on the sidelines. As shown in Chart 8 on the following page, the onset of the GFC, not surprisingly, resulted in a substantial increase in cash holdings, especially relative to the size of the equity market. With the economic outlook now brightening and the recent return for equity market holders improving, this excess liquidity is likely to be looking for a home. As a result, any subsequent shift of cash holdings back into the Australian equity market could be expected to provide some support for local shares.
- Also of importance for the equity market is the level of interest rates – both the official cash rate and longer dated bond yields. Of course, we know that the RBA raised the cash rate by 25bp to 3.25% in early October and signalled that further rate hikes are likely – returning monetary policy to a more ‘normal’ setting. Market expectations are currently for a move to a 4% cash rate by early 2010.
- For the equity market, rising interest rates can be a two-edged sword. While higher official interest rates usually translate into higher funding costs for Australian companies (via both higher interest rates charged by the banks and higher bond yields), rising official interest rates are also usually representative of a strong/strengthening economy.
- The RBA has made it clear that the likely further increase in the cash rate in the months ahead will be a reversal of the ‘emergency’ cuts in interest rates put in place over the final few months of 2008 and in early 2009. With the ‘emergency’ now passed, the RBA is beginning the process of returning interest rates towards more ‘normal’ levels. Under this scenario, the move to higher official interest rates in Australia is unlikely to prove to be a significant structural impediment to a higher equity market, given that tighter monetary policy will be occurring against the backdrop of a better performing economy. In fact, this has been the case for the last three rising interest rate cycles. Chart 9 shows the equity market performance around the first 12 months of interest rates first being tightened.
- In the 1994 rising interest rate cycle, the equity market did fall around 18% in the six months to December 1994 before resuming an upward trend. However, this policy tightening period was accompanied by a massive sell-off in the bond market

and these higher bond yields were significant to the equity market sell-off. When interest rates were tightening in October 1999 till September 2000, the equity market rose around 7%. In April 2002 at the beginning of a long tightening program by the RBA, the equity market suffered falls of around 14% over the first 12 months before resuming a long bull market till the peak in November 2007 and the last tightening in March 2008.

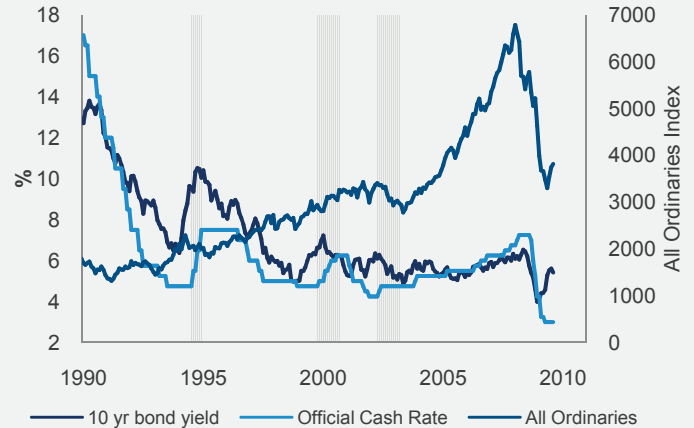
- Much of the impact on equity markets from higher interest rates is likely to be factored into prices before the first tightening, with bond yields moving well in advance of official moves in the cash rate as Chart 9 also shows. Currently the bond market is already factoring in rising official interest rates, and there has been no setback for the equity market.
- Equity markets will therefore keep a closer eye on bond market developments. A gradual increase in bond yields on the back of the better economy and a continuation of better levels for credit spreads is also unlikely to be a big negative for the equity market. A sharp and significant rise in bond yields (perhaps driven by a combination of rising inflation expectations and/or concerns over the sharp increase in government debt levels) could, potentially, have a more damaging impact on the equity market over the next year or so.

Chart 8: Cash holdings in Australia



Source: Citi, RBA, ASX. Data to 30 June 2009

Chart 9: Official cash rate and the equity market



Source: RBA, Bloomberg, Colonial First State Global Asset Management. Data to 31 August 2009

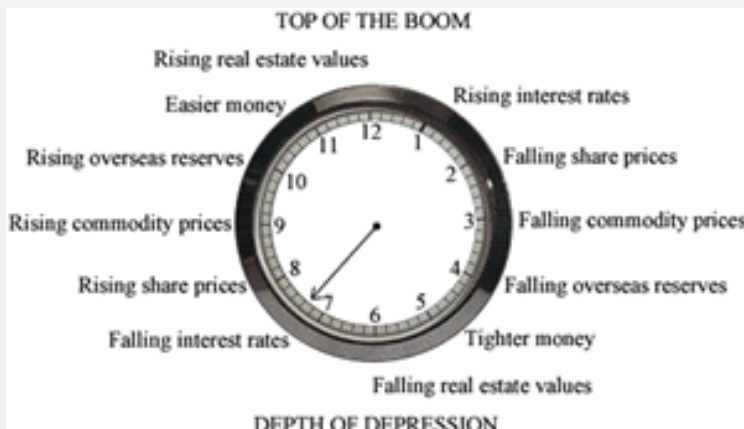
The Australian equity market and the Investment Clock:

First published in the London Evening Standard in 1937, the investment clock has long been one way in which investors in markets can analyse the economic cycle. The original theory behind the clock was that economic cycles moved in an identifiable pattern, taking about seven to nine years to complete a cycle. This is pretty consistent with the generally held view that an economy experiences a recession once every decade or so.

Of course, economic cycle have changed a lot since the 1930s, with Australia not experiencing a recession for around 17 years (until the current, very mild, one hit) and with markets no longer following some of the simplistic patterns shown in the clock.

Nevertheless, in March 2009 the ASX Investor Update newsletter included an Investment Clock, with an estimate that the cycle was now a little past 7 o'clock, as shown below, consistent with a period just after the bottom for interest rates and just ahead of rising share prices.

Chart 11: ASX Investment Clock as at March 2009



Source: ASX

Where the 'hand' on the Investment Clock is now 'positioned' is clearly open to debate. With the recent monetary policy tightening from the RBA, this signals a level around 1 o'clock. However, perhaps the move in the cash rate could just be interpreted as reversing a policy easing that was simply no longer required – pointing towards a position around 8 o'clock. Equity market prices have also, obviously, been rising fast, with the market up around 50% from its March lows. Commodity prices have also risen well off their lows of February, with a general trend higher over the past few months.

On the more bearish side of the ledger, the commercial property sector likely remains under pressure, while the access to credit (money) globally remains relatively tight, although not as bad as at the start of the year, due to the ongoing impact of the GFC.

Nevertheless, most local economic and financial market indicators are past the 6 o'clock point and are, therefore, more consistent with a recovery in markets, rather than the declining periods.

The economic outlook

The global backdrop:

Based on estimates from the International Monetary Fund (IMF), the global economy is likely to emerge from its deepest recession since the 1930s over the course of H2 2009 and 2010. The return to growth in global economic activity is likely to be driven by the unprecedented monetary and fiscal stimulus. Much of the impact from cash handouts can already be seen in improving confidence levels and consumer spending. The second part of most fiscal stimulus packages is infrastructure spending and this is likely to assist the recovery for several years.

Re-stocking of depleted inventories should also assist growth, with much of this so far being seen in rising car production and some pick up in housing activity in the US. Rising confidence in the global economy has also been reflected in higher prices for risk assets, which has helped offset some of the wealth destruction of late 2008-early 2009. However, for a sustainable economic recovery to emerge, a pick-up in private final demand is needed. This improvement in demand will also need to flow into employment.

There are risks to this outlook. The primary risk is the timing of tightening of monetary policy by global central banks. The near-term risk is of premature policy tightening, while over the medium term delayed tightening runs the risk of higher inflation. The very large Budget deficits and government debt build-up in a number of major nations is also a medium-term risk, with rising bond yields possibly limiting an economic recovery. There are also still some concerns around the banking system, commercial property prices and changes to regulation within the financial system.

The outlook for Australia and what it means for the equity market:

The Australian economy has experienced a mild recession compared to international peers and previous recessions. Assisting recovery will be a resumption of growth within the global economy, the large stimulus packages from the government, still relatively low interest rates, links to Asia and the strong banking system.

There are, however, challenges. The two most obvious challenges for Australia in a recovering global environment seem to be capacity constraints and a rising Australian dollar. The capacity constraints are likely to be highest in the resource states. Both Western Australia and Queensland are set to benefit from strong investment, particularly in liquefied natural gas (LNG) and other energy and resource projects. While these projects should support employment, they could pose problems for firms in other sectors, where wages are likely to rise. This will also pose a challenge for policy makers coping with a two-speed economy.

The strength of the Australian dollar (AUD) could act as a limiting factor to profitability in the exporting sector. But if the AUD appreciation is based fundamentally on a return to a better terms of trade outcome (ie. export prices rising relative to import prices), then this will be an important part of spreading the benefits of the commodity export boom around the economy by helping to limit inflation pressures.

The Australian equity market has staged a solid recovery on the back of the better economic news and on rising expectations of an improving economic trend. Having staged this recovery, however, the onus will now be on the economy to continue its better performance – to justify the growing expectations and continued improvement. For the rally to be extended a number of conditions need to occur; the recovery in the global economy needs to persist, the ability of Australian companies to access growing markets needs to be sustained, the ability of companies to grow revenue and increase operating margins needs to continue and a sustainable exit from easy monetary policy into a low inflation environment needs to take place.

Summary

In conclusion, the resilience of the Australian economy and its prospects for continued economic recovery should be good news for the equity market. However, given the equity market has already risen around 50%, companies will need to deliver on rising profit expectations over the next year to ensure prices can remain at higher levels.

The good news for the equity market is that costs have been cut, allowing for gains in operating margins to help boost profits and share prices. For this to happen the Australian economy must continue to grow: supported by links to China, rising business investment in the resources sector, profitable banks and a resumption in private spending as wealth is rebuilt.

Rising interest rates should not prove a hindrance given financial markets already expect a further modest rise in the official cash rate. However, with a rising supply of Commonwealth and State government bonds offering a higher yield, the asset allocation decision could change for some investors.

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