

The return of gloom

Investment insights

Dr Shane Oliver, Head of Investment Strategy and Chief Economist, AMP Capital Investors

Key points

- Share markets and other listed growth assets have fallen sharply on the back of European public debt worries, regulatory action against US and European banks and worries about Chinese tightening.
- It's too early to say the falls are over, but we see it as part of a correction – albeit a severe one - rather than the start of a new bear market.

Introduction

The last few weeks have seen a big return to gloom about the global financial and economic outlook. This has seen sharp falls in share markets, commodity prices and commodity currencies like the New Zealand dollar. From their recent highs in April, US shares have fallen 9%, European shares 10%, Japanese shares 11% and Asian shares 10%. New Zealand shares and the New Zealand dollar have also been hit hard on the back of rising risk aversion, with the former down 8% since its recent recovery peak in April and the New Zealand dollar down 7% from its recent high of US\$0.7326. So what's driving the gloom? Does it mean the cyclical recovery in shares is now over? And what should investors be looking out for?

Key drivers of the slump

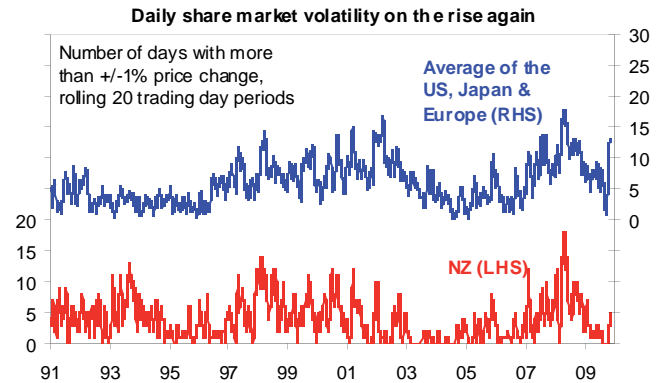
A number of factors have been driving the slump, including:

- An intensification of concerns about Europe. While the Europeans have responded with an aggressive support package, investors remain concerned about the impact of austerity measures on economic growth of the so called Club Med countries, the tainting of the debt of stronger euro-zone countries and long term questions about whether the euro will survive.
- Legal action against US banks in relation to transactions around sub-prime mortgage debt and moves in both the US and Europe towards a tougher regulatory/tax environment for banks.
- Worries that tightening in China to cool a property bubble and inflation will lead to a hard landing for the Chinese economy.

This has all occurred at a time when shares were vulnerable after a strong run up into April and memories of the bear market are still fresh such that investors remain pretty skittish.

The renewed uncertainty and investor skittishness is evident in a rebound in share market volatility. Over the last 20 days overseas

shares have seen 13 days where the market has moved by more than 1%. Volatility in New Zealand shares is also on the rise.



Source: Bloomberg, AMP Capital Investors

Likely to be a correction, not a new bear

The first thing to note is that it is too early to say that shares and other listed growth assets have bottomed. Measures of investor fear are yet to fall to the levels that are normally seen at market bottoms. However, several considerations suggest the slump over the last month is a correction and not the start of a new global bear market.

First, global leading indicators are still pointing to a continuation of the global economic recovery ahead. This is in contrast to the situation in 2008 when they were already weakening in response to prior monetary tightening before share markets went into free fall.

- While aggressive tax increases and spending cuts in Club Med countries (Spain, Greece and Portugal) will ensure they remain in recession for several years, these countries are not big enough to drag Europe back into recession (being only 16% of the euro-zone);
- The focus on southern Europe also neglects the benefit to businesses in northern Europe from the fall in the euro and ongoing easy monetary conditions. Germany in particular will likely be a key beneficiary – only 6% of its exports go to Club Med countries but 60% goes outside the euro-zone.
- Despite the debt crisis in southern Europe from late last year, so far there has been no impact on key business conditions indicators in the rest of Europe.
- European authorities have acted quickly to head off further contagion regarding sovereign debt and this seems to be working (with bond yields in Greece, Spain and Portugal having fallen). And there is no sign of any contagion to the public debt of the US, UK, France and Japan where bond yields have actually fallen.

Second, reflecting the more positive economic backdrop, recent profit reporting seasons have been strong in the US, Europe and Asia. In Europe, the proportion of results beating expectations is at its highest level in at least five years. This augurs well for profit growth going forward.

Third, global monetary policy is easy and not consistent with the start of a bear market. Prior to the 2007-2009 bear market, global

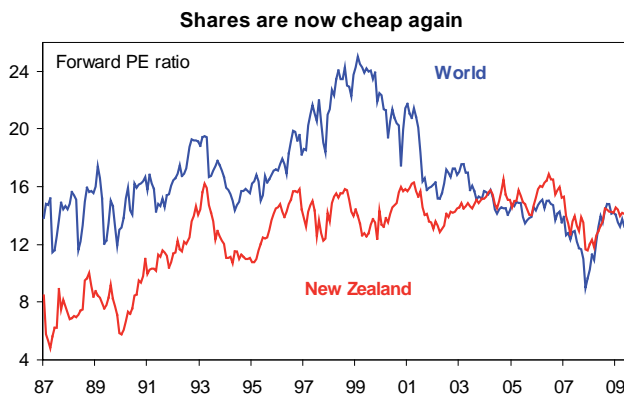
monetary policy was tightened to deal with rising inflation. Now monetary policy is very easy with near zero interest rates in key countries and short term rates running well below long term bond yields.

- If anything, the situation in Europe will ensure easy global monetary policy for longer.
- This is being reinforced by still falling underlying inflation rates in Europe and the US. In fact, the inflation rate in the US, excluding food and energy, has now fallen to just 0.9%, its lowest since the 1960s, further pushing out any monetary tightening in the US into 2011.

Continuing low global interest rates are very positive for share markets, and ultimately may run the risk of fuelling the next global asset bubble, as occurred with technology shares in the aftermath of the 1997-1998 Asian crisis.

Fourth, with increasing signs the property market in key cities in China is coming off the boil (house prices in some areas of Beijing are reportedly down 25% and the Chinese share market has fallen 24% from last year's high), it's increasingly likely **the Chinese authorities will be starting to think about easing up on the brake**. When this occurs, it will likely remove a big weight from Asian shares, commodity prices and resources stocks.

On top of this, **shares are now very cheap again**. Global shares are trading on a forward price to earnings ratio of 12.3 times, which is well below their long term average of 16.6 times. Asian ex Japan shares are trading on just 11.8 times forward earnings.



Source: IBES, AMP Capital Investors

The historical record after major bear markets end indicates a distinct pattern of very strong gains in the first 12 months, followed by a much more constrained and volatile ride in the second 12 months as the easy gains have been seen and some of the stimulus starts to be unwound. This certainly seems to be the pattern now unfolding – the easy gains are behind us. What's more, volatility is likely to be higher than normal, reflecting the

Investing. It's what we do.

Contact us

Wellington office
AMP Capital Investors (New Zealand) Limited
Ground Floor, PWC Tower
113 - 119 The Terrace
PO Box 3764 Wellington
Telephone: +64 4 494 2200

or visit www.ampcapital.co.nz

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legacy problems from the global financial crisis such as high public debt levels and poor household balance sheets in rich countries and the eventual need to unwind very easy monetary conditions. However, if we are right and the global recovery remains on track then the current set back will provide good buying opportunities – in share markets and in related trades such as the New Zealand dollar.

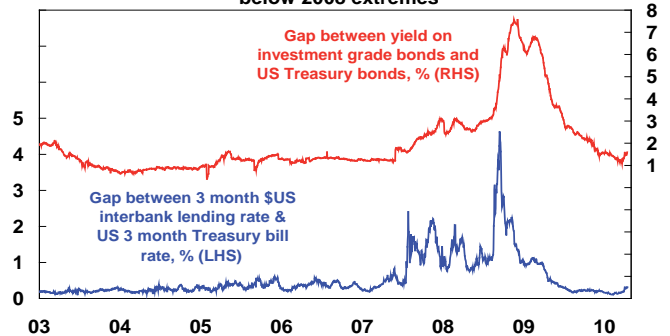
The New Zealand dollar often falls sharply when shares fall as traders fret about the commodity price outlook and unwind “carry trades”. But once current jitters settle down the dollar is likely to rebound, helped by the still strong medium term outlook for commodity prices and the reality that New Zealand interest rates are set to rise well above US, Japanese and European rates.

What to watch?

But admittedly the risks are higher than normal, so what if we are wrong and the slump in share markets is signalling a return to global recession ahead? There are several things to watch, in particular the following:

- Credit and money market spreads, as indicated in the chart below, for signs of a return to a global credit crunch. So far the impact has been minor.

Credit and money market spreads - so far they are still well below 2008 extremes



Source: Bloomberg, AMP Capital Investors

- Signs that global business conditions indicators are starting to turn down significantly.
- “Bond vigilantes” starting to focus on the high public debt levels in the US and UK.

Conclusion

If we are right and the global recovery remains on track then the current set back in share markets, commodities and growth currencies like the New Zealand dollar will provide a good buying opportunity. This would be further reinforced if we see signs that China is starting to ease up on measures designed to slow its economy.