



The global and Australian sharemarkets have rallied around 40% from their March lows in anticipation of an earnings recovery. Matthew Sherwood, Perpetual's Head of Investment Market Research evaluates the recovery and finds that although economic growth should improve in H2 2009, markets appear to be experiencing valuation fatigue and will need analysts to upgrade FY2010 and FY2011 earnings to move higher.

Introduction – the first 100 days

The global sharemarket recovery has been in progress for around 100 trading days. As at late August, the Australian and global sharemarkets have both rallied around 40% after one of the most severe bear markets in history. In Australia, the 12 month market rise after the domestic sharemarket's 13 bear markets has averaged 21% since 1894, so the current market rise in around twice the historic average and this has occurred in less than half the time, with only the recovery in 1975 having been greater (see Chart 1). Interestingly, the five month rise to August 2009 is very similar to the five month rise after the trough of September 1975 (of 42%). Nonetheless, the size and speed of the market rise has concerned some market analysts as it has been driven by valuation expansion and the earnings recovery appears to be a late 2009/early 2010 story, given the results in the August reporting season.

August reporting season themes – cost cutting and a resilient domestic economy

The August 2009 reporting season is now almost complete. Of companies that have reported, nearly as many are reporting earnings improvement as earnings contraction. On balance, earnings per share (EPS) for FY2009 are down around 20% for the overall market, but this result has been somewhat diluted by equity raisings in the past six months. A large proportion of the better-than-expected earnings results reflects the positive impact of early cost-cutting by companies which has cushioned margins at a time of low revenue growth (particularly in the industrials and materials sectors) and also a strong domestic economy (which has supported results in financials, consumer-related and media stocks). The reporting season has clearly indicated that earnings have entered a recovery phase, which is likely to support shares in the medium and long term.

Is the glass half full or half empty?

Optimists would indicate that aggregate earnings for H1 2009 are around 7.5% above pre-reporting season forecasts and firms with earnings surprises have beaten disappointments by a ratio of around four to three. This is a similar result to the February 2009 reporting season, during which the market took a half-empty view of things and sold down heavily any stock that disappointed expectations. However, given profits survived a tough economic challenge and prospects have improved, solid results in August 2009 are generating positive reactions.

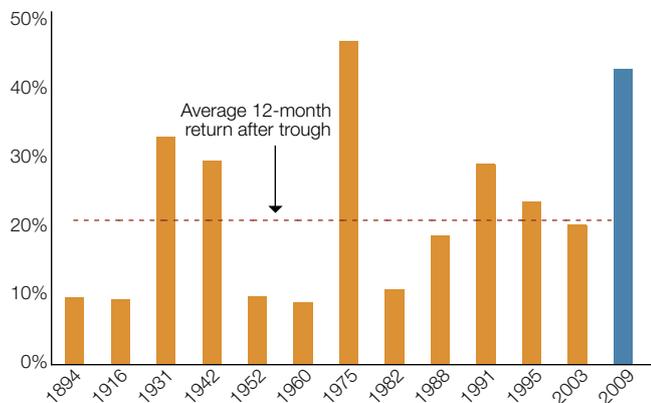
The sector rotation is running out of steam

In contrast, pessimists might point out that the market has not risen in response to a strong earnings season and improved conditions in the domestic and global economies. Indeed sector leadership has been mixed lately with some cyclical sectors (including materials and information technology) underperforming defensive sectors (healthcare) despite the improved macro environment. This is in stark contrast to performance since the March 2009 lows, where all six cyclical sectors (information technology, materials, industrials, financials, consumer discretionary and energy)

outperformed their defensive peers and the entire market (see Chart 2). This suggests that the market impact of the rotation out of defensives stocks and into cyclical companies (that contribute 80% of market capitalisation), which has pushed the market considerably higher, is running out of steam and that investors have begun to refocus on earnings and valuation fundamentals.

Chart 1: The second largest sharemarket recovery in history

Australian Sharemarket Return: 12 months after Market Trough



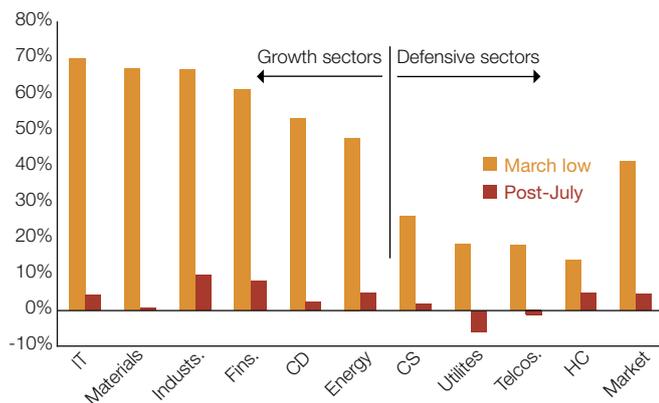
Source: Australian Stock Exchange as at 21 August 2009.

The market needs earnings upgrades to move higher from here

The Australian sharemarket valuation is currently around 16 times forward earnings (based on current subdued earnings expectations) which is significantly higher than the depressed levels recorded in late 2008 and early 2009. This suggests that the market is no longer cheap, but given that the rise from trough valuations (74%) is identical to the rise experienced after the early 1990s recession, and given valuations are now around their long-term average, the market is not expensive either. However, the rise in valuation has stagnated in August despite a stronger-than-expected reporting season and this suggests that the market may have run into valuation fatigue. If this has occurred, share prices are unlikely to move higher until earnings for FY2010 and FY2011 have come through.

Chart 2: The rotation into cyclicals is losing momentum

Australian Sector Performance: March vs July lows (%)



Source: IRESS as at 25 August 2009.

... but what will drive earnings growth?

The large-scale nature of cost-cutting initiatives over the past 12 months indicates that there is probably only marginal efficiency gains left in company operations. Consequently, earnings growth going forward is more likely to be driven by revenue growth, which is dependent on overall economic activity. Indeed like in the early 1990s, if the Australian and global economies could improve further, it is possible that earnings revisions might not be too far away, which could provide the foundation to a further market rise.

The Australian economy – looking increasingly positive

There are many headwinds and tailwinds which will impact the size and speed of Australia's economic recovery in the short and long term. Inventory restocking, low interest rates, improved growth in Asian trading partners, rising asset prices and government stimulus should help sustain Australian economic growth in the near-term. However, modestly rising unemployment and potentially soft consumer spending indicates that the upside in the near term is limited.

... and the market thinks interest rates will increase in late 2009

One determinant of earnings growth in the next year will be the speed and aggressiveness of any tightening cycle by the Reserve Bank of Australia (RBA). Between August 2008 and April 2009, the RBA aggressively cut interest rates to a 50-year low of 3% in what has been described as an emergency move. With the emergency not there, the economic rebound within sight and the root cause of the crisis been US interest rate kept too low for too long, the RBA would be keen not to repeat the same mistake.

In its recent semi-annual statement on monetary policy the RBA stated, 'with the cash rate at an unusually low level and the global economy stabilising, movement towards a more normal setting of monetary policy could be expected'. However, given the fragility of the global recovery it is unlikely that the RBA would raise rates aggressively, but rather they may use a 'rise-wait-review' approach to confirm that any increase has not endangered the economic recovery. There is little doubt that a rate increase by the RBA will precede almost all of its global peers and that rising rates will be part of the investment landscape for several years.

The global economy – all roads lead to China

The global economy has clearly stabilised after contracting sharply in early 2009 and the pick-up in economic conditions is most evident in China. China's response to the global financial crisis has been simple and relatively successful with the government turning its relatively large budget surplus into a deficit and Chinese banks increasing their lending. This has given Chinese companies the opportunity to find new markets and consumers have been given incentives to purchase housing, cars and some durable goods. Growth elsewhere in Asia has been supported by increased spending in China, domestic fiscal and monetary stimulus and the absence of any major financial system problem. Accordingly, Asian economic activity has rebounded strongly.

... but advanced economies are mixed

There are fewer signs of recovery in the advanced economies although the rate of economic decline has considerably improved. In Japan growth has returned (albeit with deflation), in the US activity appears to have reached a turning point and in Europe things are still contracting. The important factors that have underpinned this improved economic outlook in all regions are record low interest rates and substantial discretionary fiscal policy actions. Looking ahead governments and central banks will need to balance withdrawing stimulus too early (endangering the recovery) against removing it too late (and creating problems with price stability and asset bubbles).

The long-term issue will be reducing government debt

One of the most significant impacts on investment returns in the long run will be the impact of the massive build up of government debt, which is likely to pose significant challenges for many of the G20 economies. Once the economic recovery is sustainable it will be very important that governments around the world begin to reduce debt. This is particularly important in the US, Japan (where government debt to economic activity is forecast to be in triple figures by 2014), the UK, Germany and France (which are forecast to be in the nervous nineties – see Chart 3).

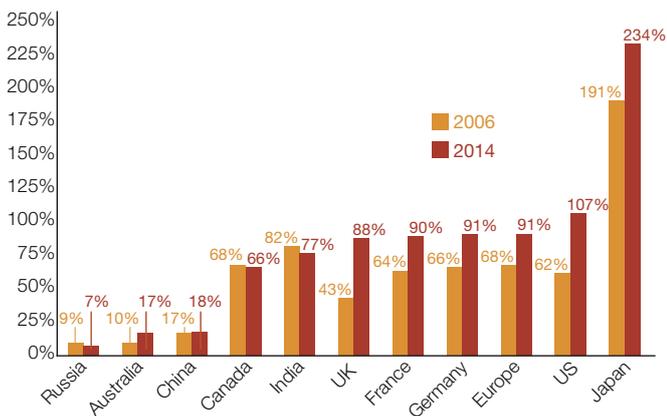
... and the aging demographics aren't too far away

Governments need to reduce debt quickly as the ageing global demographics will become more and more significant after 2015 and governments need to run surpluses in preparation for this tsunami. The number of countries in the G20 with over 15% of their population over 65 rises from 7 in 2015, to 10 in 2025 and to 14 by 2035. This is likely to dramatically increase healthcare and pension costs and reduce tax revenue. Accordingly, governments need to be taking action to return budgets to a sustainable trajectory and this can be achieved through a combination of either spending cuts and tax increases, which is likely to weigh on household spending in highly indebted countries.

Importantly, the emerging markets typically do not have the population demographic issues as severe as the major advanced economies and this, combined with their widespread industrialisation and urbanisation, should enable them to significantly outpace the advanced economies. However, growth is highly unlikely to return to the pre-2007 levels. Nevertheless, their economic power will continue to grow, with the International Monetary Fund forecasting that China will contribute 65% of the worldwide economic growth to 2011 and the entire emerging markets will account for 71% of growth in the three years to 2014.

Chart 3: Government debt has risen in most advanced economies

Gross Government Debt (% Economic Activity)



Source: Macquarie Equities as at 13 August 2009.

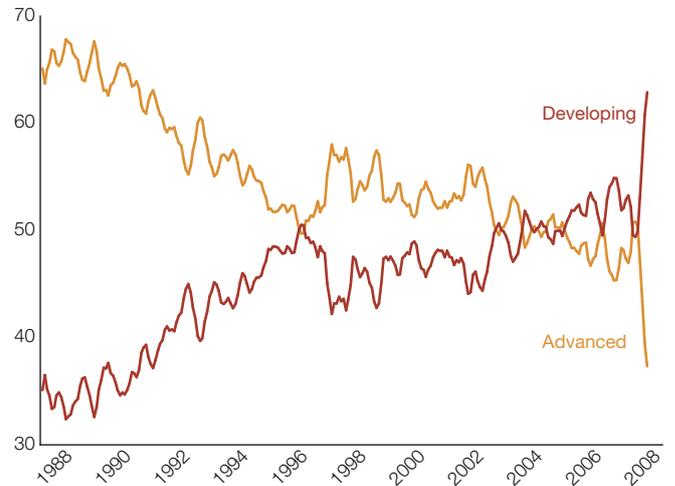
The Australian economy is very well placed

Australia is well positioned to take advantage of the growth in Asia and has diversified its exports since the turn of the century. In particular, 63% of our exports now go to developing nations up from 45% at the start of the decade (see Chart 4). Indeed 44% of exports over the past six months went to the 10 countries with the strongest potential growth rates based on population growth and savings and investment rates (source: UBS Australia

Limited, August 2009). This suggests that the medium to long-term outlook for the Australian economy (with low government debt, strong population growth and improving infrastructure and mining investment) is considerably stronger than most of its advanced economy peers.

Chart 4: Australian Exports are increasingly driven by the emerging markets

Australian Export Share: Emerging and Advanced Economics



Source: Australian Bureau of Statistics as at 30 June 2009.

Implications for investors

Although the August reporting season had a large amount of better-than-expected news, analysts will need to lift their forecast earnings for the market to rise further. In the short-term the withdrawing of some government stimulus and higher interest rates could have a negative effect on the domestic economy and investor confidence. In the longer term, the Australian economy is very well positioned with our large endowment of natural resources and strong growth likely in the emerging markets. In contrast, government balance sheet adjustment in other advanced economies is likely to weigh on growth for sometime, particularly when the ageing population begin to impact government revenue and spending. This is likely to increase the price of debt financing and firms with strong balance sheets and low debt are likely to be at a distinct advantage.

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