Edition 3 – 29 January 2010
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Shares hit a speed bump – 2004 all over again?

Key points

- Shares have fallen over the last week on the back of concerns about China's tightening, the regulation of banks in the US and sovereign risk.
- This is consistent with our expectation for rougher and more constrained gains in share markets this year after the strong rebound from March 2009. Notwithstanding increased volatility, rising earnings are likely to underpin a rising trend in shares this year.
- The experience of 2004, when US shares spent nine months stuck in a range, and when Asian shares, some commodities and the Australian dollar had a decent correction but all within the context of a still rising trend, is a reasonable guide as to what to expect this year.

Market weakness

Concerns that Chinese monetary tightening will trigger a hard landing in China, increasing US bank regulation and continuing financial stress in Greece have contributed to a pullback in share markets and other growth-oriented investments over the last week or so. From their highs in early January, most share markets have fallen by around 6%. Chinese shares have fallen about 9%, although they have been range bound since August. Does this mean the recovery rally in shares and related trades is over?

A correction in a still rising trend

Our assessment is no – the rally in shares is not over. What we are going through is a correction within a still rising trend, consistent with our assessment that this year will see a bumpier ride for investors with more constrained but still positive returns. There are several reasons for this:

Firstly, **while further monetary tightening in China is likely, the hard landing in China now being feared by investment markets is most unlikely**. Without the tightening now underway, growth in China this year would probably be heading to 14% or so, creating excessive inflation and other imbalances. By moving pre-emptively, growth should be capped at a more sustainable pace. In fact, China is a long way from needing to undertake a draconian tightening designed to crunch growth[1]. China has proved very successful in managing its economy over the last decade and we see no reason why it will be any different this time around. Sure, growth slowed more than desired in 2008, but this was due to a collapse in exports on the back of the global financial crisis; and by its reaction, China showed it will not tolerate a sharp downturn in growth. In fact, recent data is already showing signs of a slowdown in the pace of growth in credit, money supply, fixed asset investment, steel production and industrial production, suggesting the authorities won't have to go too far to prevent the economy from overheating. While inflation is rising, excluding food it is still just 0.2% year-on-year. Overall, we remain of the view that growth in China this year will be 10%, which is still strong by anyone's reckoning, and will provide ongoing support for global growth and commodity prices.

Secondly, there is no doubt President Obama's more aggressive proposals to regulate banks by limiting their size and barring them from owning hedge or private equity funds and engaging in proprietary trading unrelated to their clients has created much uncertainty for the sector. Some view it as a hastily-conceived move designed to tap popular anti-bank sentiment after the Democrats lost Ted Kennedy's Massachusetts Senate seat. More broadly, it is consistent with a theme of bigger government involvement in the economy post the global financial crisis. However, **the US bank changes will take some time to be enacted and there is a good chance the Republicans will block the restrictions on bank activities**. Other countries, including Australia, are unlikely to go down this path, but rather focus on strengthening capital adequacy requirements. (Reserve Bank of Australia Treasurer Swan has indicated that the latest US approach is not being considered in Australia.)

Also, **while Greece's public finances are a mess and several other countries face similar problems, they are not big enough to derail the global economic recovery overall**. For example, Greece is just 2.6% of the Euro-area economy. High public debt levels are also a big issue in the US, UK, Europe and Japan more generally, however none of these countries are at risk of default. The more likely scenario is that efforts to wind back debt will be made, creating a constraint for growth in these countries, but not a major crisis.

Further, while interest rates globally are heading higher, the process is likely to be very gradual in key advanced countries with high levels of unemployment and low underlying inflation. In short, **we are a very long way from the adoption of aggressive share market threatening interest rate levels in the US, Europe and Japan**.

In addition, **profits globally are starting to move higher**. While there have been some notable disappointments in the current reporting season in the US, so far nearly 80% of companies to have reported have beaten profit expectations and around 65% and exceeded revenue expectations. The profit reporting season in Asia is also proving to be strong. A 20% to 30% gain in profits this year will be the key factor underpinning the continuation of the bull market in shares this year.

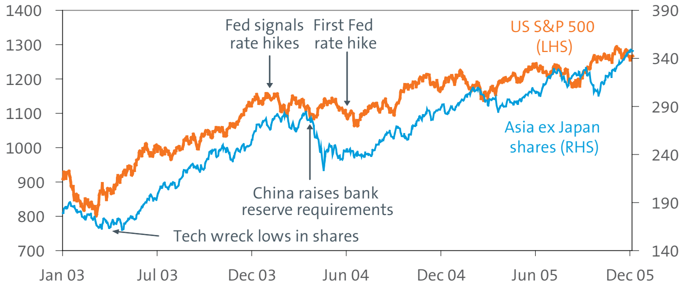
Finally, **we are still in the early stage of a typical bull market cycle, valuations are still reasonable and investors are still relatively underinvested in shares**.

[1] See "China starts to unwind some of the stimulus", Oliver's Insights, January 2010.

Déjà vu all over again

In a recent note we indicated that after an initial rebound, the second year in a cyclical bull market is often tougher as the easy gains have been seen, shares become more dependent on earnings but stimulus measures start to be unwound, and that is what we are likely to face for this year[2]. In this regard, 2004 is a good guide as to what to expect this year. The global tech wreck bear market ended in March 2003 and was followed by very strong gains in share markets and other growth-oriented investments into early 2004, much as we have seen since March last year. However, with the economic recovery at the time, in late January 2004 the US Federal Reserve (Fed) signalled a shift towards higher interest rates which it started to do from June 2004, and China commenced monetary tightening setting off fears of a hard landing in the Chinese economy. This ushered in nine months of range trading in US shares and a 20% correction in Asian ex Japan shares in April to May 2004 (refer to the chart below) on worries that global monetary tightening would be negative for emerging markets.

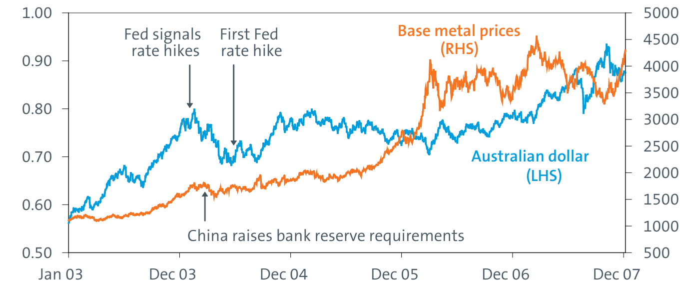
2004 saw a correction and more constrained gains in US and Asian shares, but the trend remained up



Source: Bloomberg, AMP Capital Investors

Similarly, the move to higher US interest rates and worries about the outlook for growth in Asia on the back of Chinese tightening triggered a correction in metal prices and the Australian dollar into May-June 2004 (refer to the chart below).

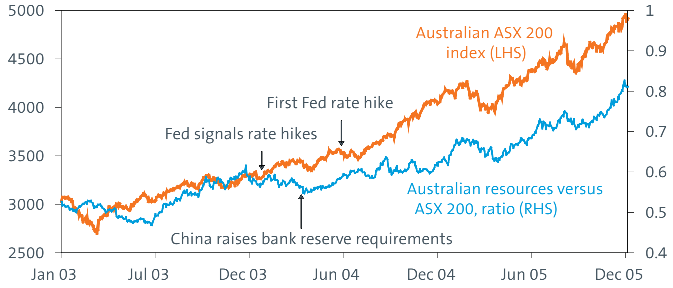
2004 also saw a corrections in commodity prices and the Australian dollar, but the trend remained up



Source: Bloomberg, AMP Capital Investors

While the Australian share market was little affected in 2004, resources shares underwent a correction relative to the broader market (refer to the following chart).

2004 saw a correction in Australian resources shares versus the broader market, but the trend remained up



Source: Bloomberg, AMP Capital Investors

However, despite US and Chinese monetary tightening causing corrections in growth-oriented investment markets in 2004, the broad trend in global shares, Asian shares, commodities, resources stocks and the Australian dollar remained up as global and Chinese economic growth remained solid and fears of a hard landing dissipated. **So, the lesson from 2004 is that while the initial phase of monetary tightening can result in a rougher ride for growth-oriented investments - particularly Asian shares, commodities and resources shares - provided a hard landing doesn't eventuate, then the rising trend will continue, and any corrections will prove to have been buying opportunities. This is what we expect to unfold this year.**

Conclusion

Recent weakness in shares and other growth assets is likely to be a correction rather the start of a new bear market. While the correction may have further to go and this year will see more volatility than has been the case since March last year, we remain of the view that profit growth and still low interest rates are likely to underpin further gains in shares this year.

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[2] See "Monetary tightening and the recovery in growth assets" Oliver's Insights, January 2010.

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