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Shares at new recovery highs – is it sustainable?

Key points

- Share markets have broken out to new recovery highs.
- Although a short-term pause or correction is a high risk, the cyclical recovery in shares still has much further to run. Global economic activity is continuing to recover, with the recovery looking increasingly self-sustaining. Earnings growth is likely to be strong over the year ahead, the liquidity backdrop for shares is still favourable and the recovery from March last year is still modest by the standards of past cyclical bull markets.

Shares at new recovery highs

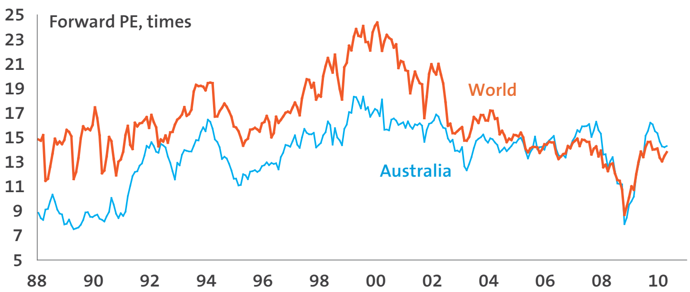
Shares are hitting new recovery milestones, with the Dow Jones index in the US back over 11,000 points, Asian shares rising above January recovery highs and the Australian share market pushing though the 5000 level. But is it sustainable?

The recovery has further to go

With expectations running very high coming into the US March quarter profit-reporting season and China still in tightening mode, there is a high risk of a short-term pause or correction in share markets. However, beyond the usual short-term uncertainties, our assessment remains that the cyclical recovery in shares has much further to go.

Firstly, while shares are no longer dirt cheap, as was the case in March last year, they are not expensive either. Australian shares are trading on a forward price-to-earnings (PE) ratio of 14.3 times, which is just below the average over the last decade of 14.5 times. Similarly, global shares are also trading on a forward PE multiple which is below the average of the last decade.

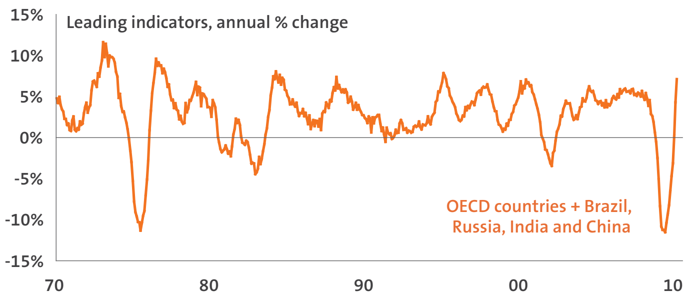
Shares are not expensive



Source: Thomson Financial, AMP Capital Investors

Secondly, the global economic recovery is continuing and is becoming self-sustaining. The next chart, put together by the Organisation for Economic Co-operation and Development (OECD), shows the combination of leading economic indicators such as economic confidence and building approvals, which lead future economic activity by about six months. They are continuing to point to strong growth ahead for both OECD and developing countries.

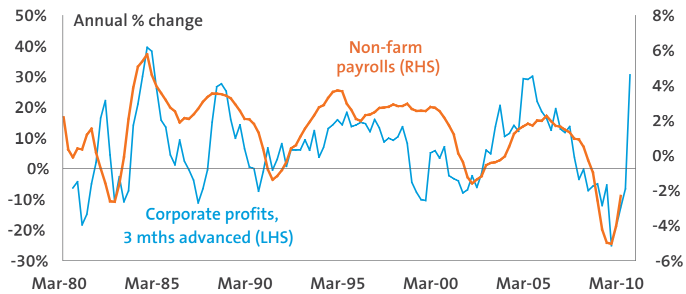
From bust to boom – global leading indicators are pointing to strong global economic growth ahead



Source: Bloomberg, AMP Capital investors

Importantly, in the US, jobs growth is returning and a huge surge in profits over the last year points to further gains in employment ahead. See the next chart.

Rising US profits point to more employment gains ahead

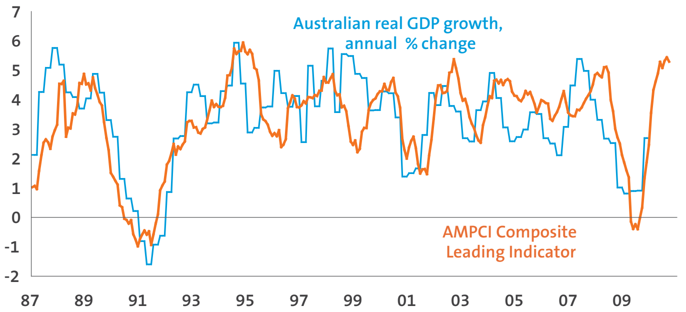


Source: Bloomberg, AMP Capital Investors

The return of jobs growth will help underpin a continued recovery in US consumer spending and will also help drive a housing recovery. In turn, this will provide a further boost to profits and employment. In other words, the flywheel of the US economy is starting to turn again and the reliance on stimulus spending is fading as the recovery becomes self-sustaining.

Similarly, real Gross Domestic Product (GDP), our leading economic indicator for Australia, is pointing to over 5% growth ahead.

Strong growth on the way for Australia



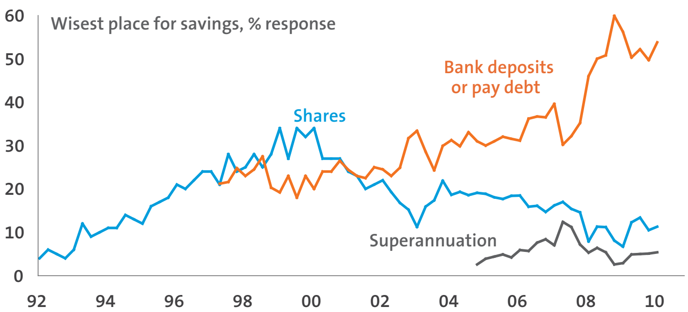
Source: AMP Capital Investors

Thirdly, the profit outlook is very strong. Earnings estimates are continuing to be revised upwards. The combination of low cost bases and the rebound in revenue now underway points to over 20% growth in earnings in most major share markets including Australia and Asia over the year ahead.

Fourthly, global interest rates are still extremely low, making shares relatively attractive for investors. Even in Australia, where interest rates have been rising, they are still below longer-term average levels.

Finally, there remains considerable scepticism about the sustainability and strength of the global economic recovery and hence the recovery in share markets. For example, Australian superannuation funds are still reportedly well overweight cash and when asked what the wisest place for their savings is, only 11% of Australians nominate shares. This is healthy because it means there are still plenty of funds on the sidelines that can push shares higher.

Australians are still sceptical about shares



Source: Melb Institute/Westpac Consumer Survey, AMP Capital Investors

Still early days in a cyclical bull market

It would be unusual for a cyclical recovery in shares to end when leading economic indicators are still rising, earnings are still recovering from depressed levels, interest rates are so low and so many investors are still sitting in cash. As such, our assessment is that it's still early days in the cyclical recovery in shares. Since 1950 the typical cyclical bull market in Australian shares lasted four years and saw average gains of 132%. This is longer if data back to 1894 is included. This time around we have only seen a gain of 61% over 13 months. So, if history is any guide, there is still a lot further to go.

Cyclical bull markets in Australian shares

Cyclical share bull market in Aust shares (All Ords price index)	Prior bear market % fall	Months after low to make new high	Total bull market% gain	Duration in months
Mar 1894-Jun 14	-36	112	253	243
Dec 1916-Jul 29	-22	37	196	151
Aug 31-Mar 37	-46	38	168	68
Apr 42-May 51	-32	43	175	109
Dec 52-Sep 60	-34	62	146	93
Nov 60-Feb 64	-23	33	42	39
Jun 65-Jan 70	-20	25	120	55
Nov 71-Jan 73	-39	94	57	14
Sep 74-Aug 76	-59	59	101	23
Nov 76- Nov 80	-23	21	173	48
Jul 82—Sep 87	-41	17	421	62
Nov 87-Aug 89	-50	75	55	21
Jan 91-Feb 94	-32	30	94	37
Feb 95-Mar 02	-22	20	89	85
Mar 03-Nov 07	-22	15	156	56
Avg from 1894	**-33**	**45**	**150**	**75**
Avg from 1950	**-33**	**41**	**132**	**48**
Mar 09- ?	-55	?	62 ?	13 ?

Source: Bloomberg, AMP Capital Investors

Concluding comments

Share bull markets normally have three phases: Phase 1 - recovery as shares go from dirt-cheap panic-driven PE multiples to more normal PE levels; Phase 2 - earnings driven growth; and Phase 3 – exuberance as PE's rise to unsustainable extremes. With PE multiples having recovered from very low levels back to longer-term averages, Phase 1 is likely to be over and we are now more dependent on earnings growth going forward. This probably means the pace of gains in share markets will slow, but with the economic and profit recovery continuing, global interest rates remaining low, and plenty of cash still sitting on the sidelines, our assessment remains that the cyclical bull market in shares still has a lot further to go. By year end we continue to see the Australian All Ordinaries and ASX 200 indices rising towards 5600 points.

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