Edition 28 – 9 September 2010
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Lessons for US shares today from Australia in the early 1990s

Key points

- Shares normally go through a tough patch in the second year following a bear market low. This can reflect worries about monetary policy tightening or worries about a double dip into recession.
- This is certainly the case in the US this year and has affected most global share markets.
- The US today appears to resemble the performance of the Australian economy and share market following its early 1990s financial crisis and recession.
- Double dip fears were also a big worry in Australia in 1992, contributing to a difficult year for the local share market at the time. However, this gave way to better conditions in 1993. The US may be following a similar path.

Introduction

The second 12 months after a bear market ends is often rough, compared to the big rebound that normally occurs in the first year. This has certainly proven to be the case this year. However, it is interesting to note the parallels between the weakness in the key direction setting US share market this year and the experience of Australian shares in 1992, when Australia was struggling to recover from its worst financial crisis since the Great Depression and worries about a double dip into recession were intensifying. But if the Australian experience 18 years ago is any guide, US shares are likely on track for much better conditions next year

Bear market recoveries

The tables that follow show the experience following post-war bear markets in US and Australian shares. While the first 12 months typically sees strong gains – 39% on average in US shares and 28% on average in Australian shares – the next 12 months are often much tougher – with 8% average gains in US shares and 6% average gains in Australian shares.

The tougher performance in the second year usually reflects either worries about a tightening in monetary policy once the economic recovery is underway or worries about a double dip into recession. In the US, Europe and Japan this year it has largely been a case of the latter, with concerns about a double dip into recession intensifying in the last six months or so.

Post bear market recoveries, US shares

Bear market	% decline in S&P 500	% gain in first year from low	% gain in second year after low	% gain in third year after low
May 46-Jun 49	-30	42	4	13
Aug 56-Oct 57	-22	31	10	-5
Dec 61-Jun 62	-28	33	-2	2
Feb 66-Oct 66	-22	33	7	-10
Nov 68-May 70	-36	44	11	-3
Jan 73-Oct 74	-48	38	21	-7
Nov 80-Aug 82	-27	58	2	13
Mar 00-Oct 02	-49	34	8	6
Average	**-33**	**39**	**8**	**1**
Oct 07-Mar 09	-57	69	?	?

Source: Bloomberg, AMP Capital Investors

Post bear market recoveries, Australian shares

Bear market	% decline in All Ords	% gain in first year from low	% gain in second year after low	% gain in third year after low
May 51-Dec 52	-34	8	13	5
Sep 60–Nov 60	-23	12	-2	18
Feb 64–Jun 65	-20	8	11	67
Jan 70-Nov 71	-39	49	-25	-33
Jan 73-Oct 74	-59	54	16	-4
Aug 76-Nov 76	-23	6	21	27
Nov 80-Jul 82	-41	39	9	36
Sep 87-Nov 87	-50	35	5	-19
Sep 89-Jan 91	-32	39	-9	46
Jan 94-Feb 95	-22	25	8	10
Mar 02-Mar 03	-22	28	24	16
Average	**-33**	**28**	**6**	**15**
Nov 07-Mar 09	-55	53	?	?

Source: Bloomberg, AMP Capital Investors

Double dip worries in the US along with policy tightening have also weighed on share markets in China, Asia and Australia.

Parallels with Australia in the early 1990s

However, it's interesting to note that the US economy and share market seems to be going through something very similar to what the Australian economy and share market went through in the early 1990s. Back in the early 1990s Australia was struggling to throw off the effects of a severe recession that in part had its genesis in excessive corporate lending by the banks in the late 1980s. The share market fell 32% from a high in September 1989 to a low in January 1991, which ushered in a recession through 1990-91. While the share market rose by 39% between January 1991 to January 1992 and the economy started to recover from September 1991, throughout 1992 worries about a double dip into recession intensified as:

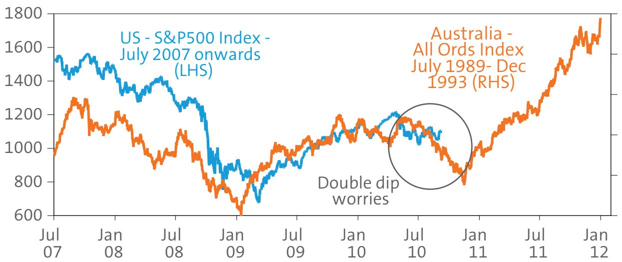
- the recovery was initially anaemic - with growth averaging around 2.8% in the first year;
- unemployment continued to rise, not peaking until it reached 10.9% in December 1992, nearly 18 months after the economy had started to grow again;
- commercial property prices continued to collapse (office values fell around 50% over 3 years) and corporate failures threatened the financial system, with the failure of numerous financial organisations – e.g. Estate Mortgage, Pyramid Building Society, all the state banks in Western Australia, South Australia and Victoria - and concerns that two of the top four banks might go bust. This was Australia's equivalent of what the US has been going through over the last few years; and
- as a result of the financial crisis private sector credit continued to fall in 1992, even though the recession had ended the year before.

Reflecting worries about a double dip into recession, the Australian share market fell sharply into a low in November 1992 and its weakness is evident in the 9% fall over the January 1991 to January 1992 period in the second table above.

There are numerous parallels between Australia in the early 1990s and the US today: the size and scale of the financial crisis, the collapse in property markets, the anaemic jobless recovery and the continuing contraction in bank lending.

The chart below shows a comparison between the Australian share market over the four and a half years from July 1989 and the US share market from July 2007 to the present.

Are US shares following the pattern set by Australian shares around the early 1990s financial crisis and recession?



Source: Bloomberg, AMP Capital Investors

So far the US share market is tracking the experience of the Australian share market back in the early 1990s quite closely with a sharp bear market, strong gains in the first year of recovery, followed by weakness in the second year on the back of double dip fears. And since the short-term swings in the Australian share market are (irrationally) heavily influenced by the US share market, it has been following the US today even though its economy is in far better shape now.

Interestingly, if the relationship continues to hold, while further weakness is possible in the next few months, the Australian experience of the early 1990s would suggest strong gains over the year ahead if double dip fears fade and the recovery continues as occurred in Australia then.

Of course the US today is more fragile than Australia in the early 1990s, which had much lower levels of public and household debt and was a much smaller country so gained immensely from a global economic recovery. So the US recovery is unlikely to be as strong as seen in Australia in 1993 and the returns from US shares are likely to remain constrained and volatile in the years ahead. Nevertheless, the severity of the Australian financial crisis at the time is instructive in reminding investors there can be a continuing recovery after such events and once it becomes clear a double dip into recession is not happening there is plenty of upside for share markets over the year ahead.

In this regard, the tables on the first page include what happens in the third year after a recession ends, and it can be seen to be somewhat mixed – flattish in the US but up solidly in Australia. Out of interest over the January 1993 to January 1994 period the Australian share market rose by 46%.

Conclusion

The parallel between the anaemic and fragile post-financial crisis US economic recovery of today and of Australia in 1992, suggests the current double dip worries in the US could give way to better conditions in the US in the year ahead. This is particularly the case with share markets now very cheap, notably against government bonds where yields are now very low.

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