

# Crash calls for share markets

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## Key points

- > Expect more volatility in shares this year as earnings take over as a key driver and Fed rate hikes gets closer.
- > While some are suggesting a crash is on the cards, it's hard to see as shares are not expensive, the global economic cycle is gradually improving, monetary conditions are easy and we lack the euphoria that goes with major market tops.
- > As such, the trend in share markets is likely to remain up.

## Introduction

The past few weeks has seen several predictions of a share market crash by some perennial high profile bears. The broad claim is that share markets – namely US shares – have disconnected from fundamentals and that the Fed is to blame for a poor recovery and/or doesn't know what it is doing. And of course this is all against the background of talk of some sort of "demographic cliff" that will contribute to a "great crash ahead." This note takes a look at the risks.

### A tougher, more volatile year for shares..

Our view is that this year will see more constrained returns from shares with increased volatility – including the likelihood of a 10-15% correction along the way – than we saw in 2012 and 2013. Shares are no longer dirt cheap, they are more dependent on earnings for gains, the prospect of Fed rate hikes are starting to loom and as usual there are numerous other "worries" that could give us that volatility: China, Ukraine, etc. And of course, the seasonal pattern in shares often sees corrections occur around mid-year.

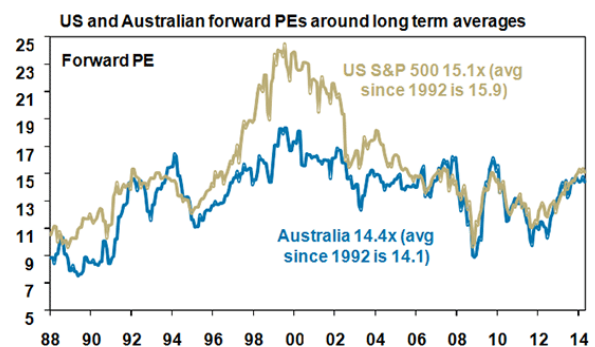
### ..but the trend is likely to remain up

However, it's too early in the economic and investment cycle to expect a new bear market or crash.<sup>1</sup> A typical cyclical bull market goes through three phases.

- Phase 1 is driven by an unwinding of very cheap valuations helped by easy monetary conditions as smart investors start to snap up undervalued shares as investor sentiment moves from pessimism to scepticism.
- Phase 2 is driven by strengthening profits. This is the part of the cycle where optimism starts to creep in.
- Phase 3 sees euphoria with investors backing their bullishness by pushing cash flows into shares to extremes. The combination of tightening monetary conditions, overvaluation and investor euphoria then sets the scene for a new bear market.

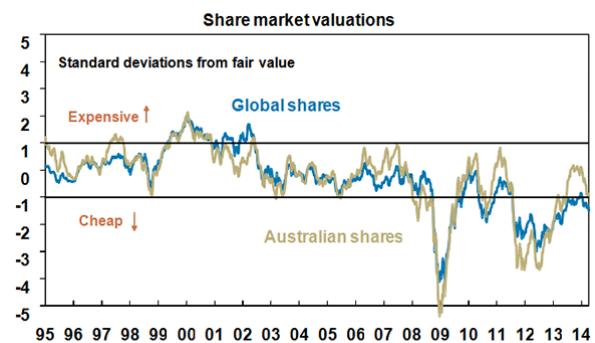
At present we are likely in Phase 2. Some optimism regarding the economic outlook and share markets has returned but we don't see the signs of euphoria that become evident in Phase 3 as precursors to a new bear market:

- Valuations aren't dirt cheap, but they're far from expensive. Price to earnings ratios are only at long term average levels of 14.4 times in Australia (average of 14.1 since 1992) and 15.1 in the US (average of 15.9). Some tech stocks have rich valuations, but the tech heavy Nasdaq trades on a price to earnings ratio that is one third of the tech boom peak and the broader US share market on 15x forward earnings is way below its tech boom peak of 24. So it's hard to see a tech driven crash.



Source: Thomson Reuters; AMP Capital

The gap between earnings yields & bond yields, a proxy for the excess return shares offer, remains above pre GFC norms. This is reflected in our valuation indicators which show markets slightly cheap. See the next chart.



Source: Bloomberg, AMP Capital

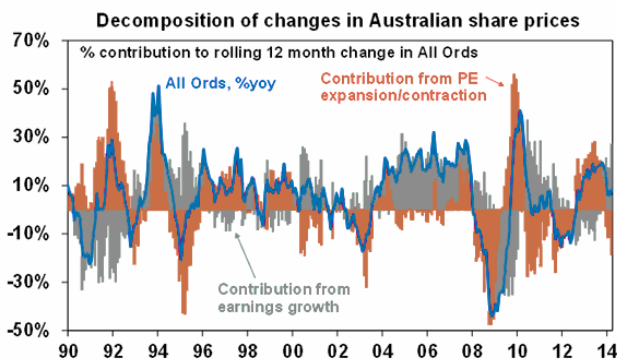
- Global economic indicators have been gradually heading higher which should be supportive of earnings growth. This is indicated in business conditions PMIs (next chart).



Source: Bloomberg, AMP Capital

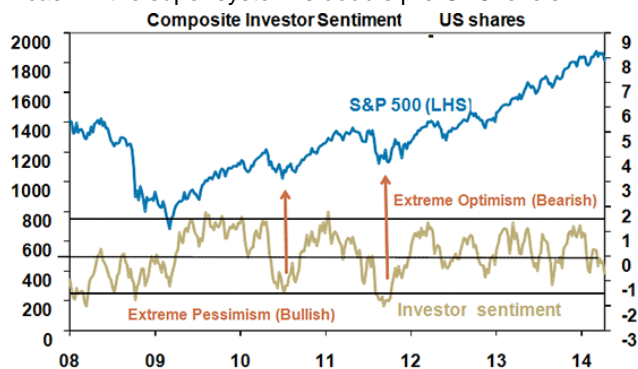
<sup>1</sup> We are defining a bear market as a 20% plus fall in share markets that takes more than 12 months to recover its losses.

There are now more indicators pointing upwards in Australia and profits are now helping share market gains, as evident in the following chart that breaks down annual changes in the All Ords into that driven by profits and that due to changes in the ratio of share prices to earnings.



Source: Bloomberg, AMP Capital

- Inflation remains benign and monetary policy easy. Ample spare capacity has meant that global inflation remains low. As a result even though the Fed is slowing its quantitative easing program, interest rates will likely remain low for some time.
- Finally, there is no sign of the investor exuberance seen at major market tops. Short term measures of investor confidence in the US are around neutral levels. See next chart. The mountain of money that built up in bond funds in the US has yet to fully reverse. In Australia, investors still prefer bank deposits over shares and the share of cash in the super system is double pre GFC levels.



Source: Bloomberg, Sentimentrader, Investors Intelligence, AMP Capital

Of course there could be a left field shock – an escalation in Ukraine, a policy mistake in China or the Fed. But if you worry too much about such things you would never invest.

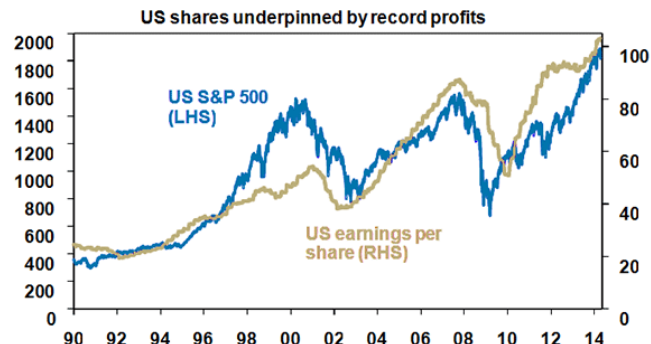
### Is the Fed to blame?

One thing I find many of the perennial bears seem to have in common is a hatred of the Fed. They argue the Fed should have stood by and done nothing through the Global Financial Crisis – as advocated by whacky disciples of Austrian economics – to allow a full “cleansing” of the economy and that it is in some way causing the slow recovery seen over the last few years. There are several points worth noting on this.

First, just standing by and doing nothing through the GFC could have led to a re-run of the Great Depression which left an unmeasurable human toll and scared a generation, many of whom were innocent bystanders during the excesses of the 1920s. Allowing the same so called “cleansing” to happen needlessly again after the GFC would have been immoral and pointless.

Second, while the Fed's actions have not led to a boom in the US it has at least bought time to allow the economy to heal – much like keeping a coma patient on life support. The slow recovery is not the Fed's fault but rather the desire to reduce debt and caution seen post the GFC.

Third, while the Fed's quantitative easing program has helped support the US share market the main driver has been a surge in US company profits to record levels. In other words the rise in US shares has not detached from reality but reflects fundamental improvement. See the next chart.



Source: Bloomberg, AMP Capital

Fourth, the Fed's move to wind down or taper its quantitative easing program and talk of eventual rate hikes is a sign of success. In other words, extreme monetary easing has done its job and so can now start to be withdrawn. This is a good thing, not bad. And of course even when US interest rates do start going up next year it will be a long time before they reach levels that seriously threaten economic growth.

Finally, misinterpretations of Fed communications are inevitable and are not a sign that it does not know what it is doing. The Fed under Bernanke and Yellen have made it pretty clear what they are looking at and in this context their policy moves have made sense.

### What about the demographic cliff?

Some have long tried to link demographic trends with share markets, but it is very messy. The basic thesis is that as the baby boomer wave moves through the population it will stop being a big positive for shares (as they either run-down savings or consume less depending on which demographic thesis you follow) and that this should start around 2009-10. This approach predicted a big rally through the 1990s and 2000s and got it completely right in the former but disastrously wrong last decade in relation to US shares. Given shares never got anywhere near the levels they were supposed to reach last decade (the biggest advocate of the demographic model had the Dow Jones going to 40,000 through the 2000s) it's hard to see why they will now crash.

### Concluding comments

While shares might see a brief 10-15% correction at some point this year, a new bear market is unlikely and as such returns should remain favourable through the year as a whole. The time to get really worried is when the topic of conversation with cabbies and at parties is about what a great investment shares are, but I have yet to find a cabbie talking about shares in recent years and at a party I attended last weekend the only person who mentioned shares told me he had just switched all his exposure to cash!

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