

Share market risks

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Key points

- > Concerns about US shares being overvalued are overdone.
- > The conditions are still not in place for a major top in share markets: valuations are reasonable, the global economy is on the mend, monetary conditions are easy and investor exuberance is still modest.
- > As such, while there is the risk of a correction in shares, the broad trend is likely to remain up.

Introduction

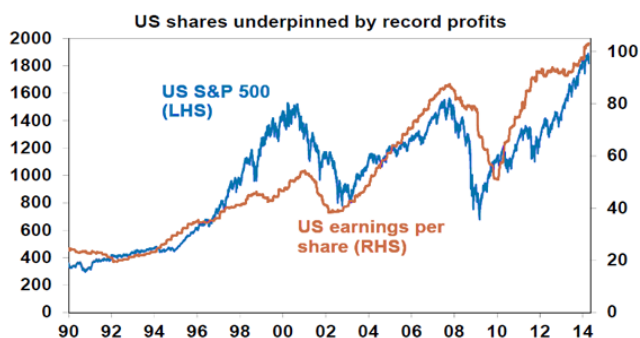
As we approach mid-year it's worth reviewing the outlook for shares particularly with numerous warnings of corrections and crashes. Our view for this year has been that share market gains would be positive, but more constrained than seen in the last two years, and that volatility would increase – including the likelihood of a 10-15% correction along the way. In the event gains in shares have been more constrained, with global shares (in local currency terms) up 4.5% year to date and Australian shares up 1.5%. However, volatility has been relatively low.

Most concerns regarding the share market outlook relate to US shares. It invariably sets the direction for global share markets including Australia's but many contend that at record highs it is overvalued and at risk of a crash.

Common concerns about US shares

There seem to be three commonly expressed concerns regarding US shares: record highs, valuations and complacency. Looking at each of these in turn:

US shares are at record highs. Does this mean they are due for a bust? The following chart shows the US S&P 500 since 1990. It broke out to record highs last year and is now up 190% from its Global Financial Crisis (GFC) low in 2009.



Source: Bloomberg, AMP Capital

However, just because US shares are at a record high does not mean a crash is on the way. The breakout seen last year came after a 13 year secular bear market, which saw US shares stuck in a huge range. Our assessment is that US shares have entered a new secular bull market helped by a range of factors including an energy boom, a manufacturing renaissance and a return to better health for US debt measures. And as can be

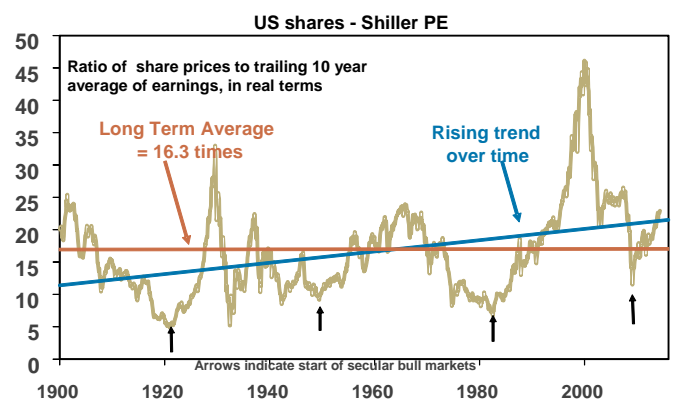
seen in the chart the surge in the share market has been supported by a surge in profits to record levels.

Are US shares way overvalued? Proponents of this view typically cite the following:

- the ratio of share prices to the 10-year moving average of earnings (Shiller PE) is well above its long-term average;
- the overvaluation is even worse if allowance is made for higher than average profit margins; and
- the ratio of the market value of US listed company capital to its replacement cost (called Tobin's Q) is well above its long-term average implying share prices have been pushed beyond levels justified by their asset base.

To be sure, these are valid concerns but while such valuation measures are useful they need to be treated with caution.

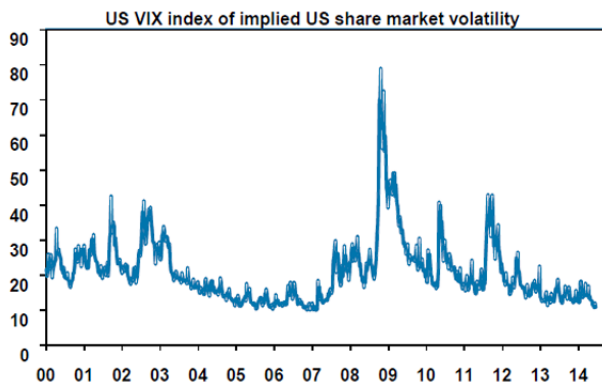
- While the Shiller PE (next chart) at 23 times is well above its long-term average since 1881 of 16, the equilibrium PE has likely risen since the 1800s. During the last 100 years, shares have become easier and cheaper to trade and it's become easier to assemble a well diversified portfolio, all of which has likely seen the equilibrium PE rise. On this basis, it's noteworthy that the Shiller PE is only marginally above its long-term rising trend suggesting US shares are not particularly overvalued.



Source: AMP Capital

- In a world of very low inflation, interest rates and bond yields, earnings yields on shares should be lower & price to earnings multiples higher than longer-term averages.
- Although US profit margins are high, they have been high for a long time and attempts to forecast their return to some long-run average have failed. It's debatable what the normal level should be and with falling capital prices and with a global supply of cheap labour it's hard to know what will cause profit margins to fall.
- Finally, there is reason to be sceptical of Tobin's Q as it does not allow for a world where corporate capital is increasingly dominated by intellectual capital as opposed to physical capital.

Is the decline in volatility a major concern? The next chart shows the VIX index, which is a guide to expected volatility in the US share market implied by options.



Source: Bloomberg, AMP Capital

It is clearly very low and is consistent with the US share market having traded in a relatively narrow rising trend since mid-2012. There hasn't been a 10% or more correction in US shares since mid-2012. In many ways this is a good thing. It is far better than the extreme volatility seen through the GFC and its aftermath and worrying about it is perhaps a bit like worrying that there is nothing to worry about! The concern, though, is that periods of low volatility can lead to a false sense of investor security and excessive risk taking, eg using high levels of gearing to buy overvalued assets.

However, the low level of volatility is arguably a rational reaction to the more stable macro-economic environment seen in more recent times. It is doubtful that risk taking has reached the extremes seen at previous major market tops and, as the 2004-07 period showed, volatility can remain at very low levels for a long time before it runs its course.

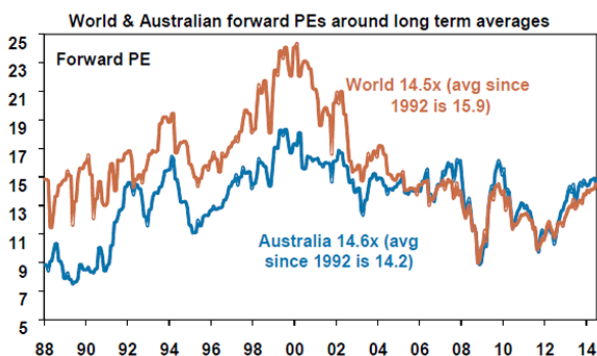
Broad cycle view

More generally, our view remains it's too early in the investment cycle to expect a new bear market or crash. The normal play out for a cyclical bull market is as follows.

- 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 pushing cash flows into shares to extremes. The combination of tight monetary conditions, overvaluation and investor euphoria then sets the scene for a new bear market.

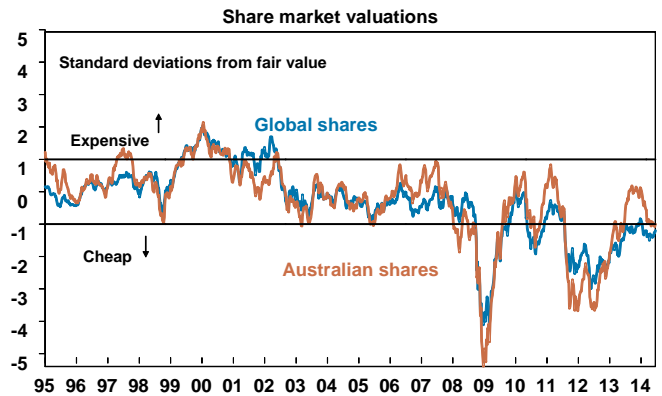
Our assessment remains that we are still in Phase 2. We still don't see the signs of euphoria that become evident in Phase 3 as precursors to a new bear market:

- Price to earnings ratios based on forward earnings are around or below their averages seen during the low inflation era seen since the early 1990s.



Source: Thomson Reuters; AMP Capital

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



Source: Bloomberg, AMP Capital

- Global economic indicators have been gradually heading higher, which should be supportive of earnings growth. US growth is rebounding from its March quarter soft patch, Japan seems to be weathering its April sales tax hike pretty well, European growth remains slow but at least it is continuing and Chinese growth appears to have bottomed after slowing earlier this year with various mini-stimulus measures helping.

In Australia, a likely softening of some of the measures in the Federal Budget to allow it to pass through the Senate combined with continuing low interest rates, strong housing construction activity and strong resource export volumes should see the economy back on track by year end.

- Global and Australian monetary policy remains easy and is likely to remain so for some time yet.
- Finally, there is no sign of the investor exuberance usually seen at major market tops. Various surveys show that investor scepticism towards shares remains high. 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 superannuation system remains double pre-GFC levels.

Concluding comments

None of this rules out a short term correction in shares and a return to more volatility. Numerous possible triggers for a correction exist including: a continued run of stronger US economic data raising concerns about an earlier Fed rate hike; risks around Ukraine and Iraq; maybe a return of worries about Europe on the back of European Central Bank bank stress tests and independence referendums later this year in Scotland and (possibly) Catalonia. And in Australia, we need to see confidence levels pick up. However, we still seem a fair way from a major market top in shares. As such, the cyclical bull market in shares likely has further to go. Our year-end target for the ASX 200 remains 5800.

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