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Share market correction

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Key points

> Global, and particularly Australian, shares have seen a bit of a pull back over the last month which could have further to go in the short term.

> However, what we are seeing is likely a correction as opposed to a new bear market. From a fundamental point of view the cycle still looks okay with no sign of the overvaluation, overheating economic conditions, onerous monetary tightening or investor euphoria that normally precedes major bear markets.

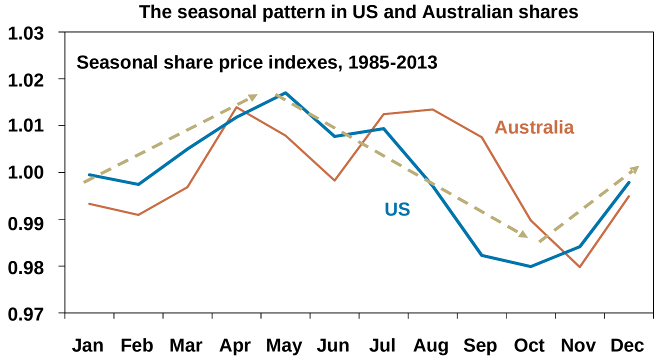
Introduction

Share markets have seen a bit of volatility and a pullback over the past month. This has been particularly so for Australian shares. This note looks at the key drivers and whether it's just a correction or a new bear market.

Drivers of recent volatility

Our view for this year has been that shares would have positive but more constrained returns than seen over 2012 and 2013 and that volatility would increase. Our basic reasoning was that with shares no longer dirt cheap, investors would have to depend more on earnings growth for share market gains and this would be more constrained and uncertain. Until recently it has been relatively calm though despite a range of worries and deep scepticism amongst many commentators. Lately though, it seems the worry list has intensified and this has been reflected in increased volatility. The list of worries includes the following:

- Top of the list has been unease about the gradual shift at the US Fed towards eventual monetary tightening. Ultra easy Fed policy has been a key source of support for the global economy and investment markets. Investors are naturally concerned about what will happen when this ends with the Fed's third round of QE set to end later this month and the Fed talking about raising rates next year.
- The global economic recovery has proved yet again to be fragile and uneven: with the Eurozone flirting with deflation; Japan struggling after a sales tax hike; the Chinese economy going through another soft patch; and emerging markets generally remaining subdued.
- Meanwhile a range of geopolitical threats are causing nervousness including: the escalating involvement of the US and its allies in the conflict with IS in Iraq and Syria; the conflict in Ukraine; the protests in Hong Kong accentuating concerns regarding China; & the worsening Ebola pandemic in Africa & the arrival of cases in the US.
- A range of "technical" concerns regarding US shares have added to these worries including: the absence of a "decent" correction since 2012 and low levels of volatility (or VIX) leading to fears investors may be complacent and the narrowing breadth of the US share market rally.
- Finally, we have been going through a seasonally weak period of the year for shares. The September quarter is historically the weakest quarter of the year.



Source: Bloomberg; AMP Capital

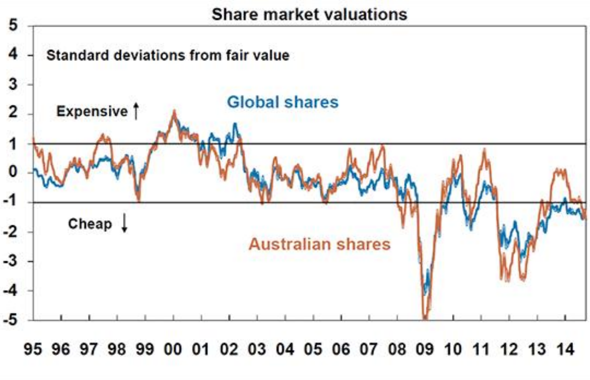
While US and global shares have had only modest pullbacks of around 3 to 4%, Australian shares have been particularly hard hit with a fall of 7% reflecting the overlay of global concerns along with:

- A sharp fall in the iron ore price and commodity prices generally on China worries;
- Increasing talk that Australian banks will be forced to increase their capital ratios; and
- Foreign investors retreating to the sidelines as the $A falls. They are 30-40% of the market and it's quite normal for them to pull back as the $A falls as they fear a double hit to the value of their investments. Indeed $US based investors lost 12% in Australian shares last month.

The correction in shares could go further: US shares, which tend to lead global markets, are only off slightly so far whereas corrections often go to 5 to 10%; nervousness is likely to intensify in the run up to the end of QE3 later this month; nervousness in Europe may well continue until uncertainty is cleared up around banks with the ECB to announce results of stress tests later this month; and finally seasonal weakness often runs into October. However, we view this as a correction, not the start of a new bear market.

A correction, not a new bear

There are several reasons why what we are seeing is likely a correction, rather than a bear market. First, valuations are not extreme.

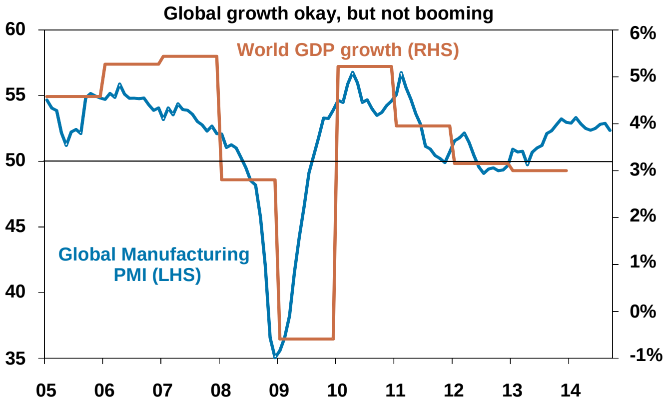


Source: Bloomberg, AMP Capital

This is evident in the previous chart which is based on a range of measures including a comparison of the yield on shares with that on bonds. Recent share market weakness has pushed valuations well into cheap territory again.

Second, the global economic cycle is a long way from posing a major threat to shares. The global economy is growing, but it's uneven and sub-par. This is a blessing in disguise:

- While the US looks to have recovered from a soft patch early this year, growth in Europe, Japan and China is dragging the chain. Europe is unlikely to slide back into recession with the ECB doing just enough to support growth but weak credit demand and a reluctance to ease fiscal policy growth will remain constraints. Meanwhile, China is doing better than most other regions but its stop/go approach to supporting growth in the face of pressure for long term reforms is likely to see growth stuck around 7%.



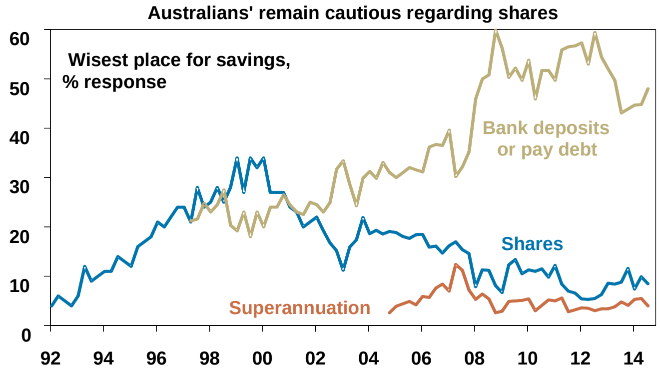
Source: Bloomberg, AMP Capital

- As a result global spare capacity and excess savings remain intense so inflationary pressures remain tame and bond yields low.
- In many ways the world resembles the 1990s after the early 90s recession with the US being a growth leader, other regions lagging and disinflationary pressure keeping a lid on inflation.
- The overall result is that global growth is strong enough to boost profits but a long way from the boom conditions that cause escalating inflation. In other words, the global growth cycle is still in the "sweet spot".

As a result, global monetary policy is set to remain easy.

- While the US is edging towards monetary tightening, Europe, Japan and China are a long way from tightening and if anything are likely to see further easing.
- This means the US dollar will likely remain under upwards pressure, which in turn will have the impact of importing low inflation into the US and delaying/limiting the extent of US rate hikes once they do start to get underway (as occurred in the second half of the 1990s).
- Finally, although the Fed will likely end QE3 this month, a 15-20% fall in US shares as we saw in 2010 and 2011 with the ending of QE1 and QE2 is unlikely as the US economy is now on a much sounder footing.

Finally, we are still a long way from the sort of investor exuberance seen at major share market tops. It seems everyone is talking about share market corrections and crashes. In Australia, the amount of cash sitting in the superannuation system is still double average levels seen prior to the GFC and Australians continue to prefer bank deposits and paying down debt to shares and superannuation. There is still a lot of money that can come into equity markets as confidence improves.



Source: Westpac/Melbourne Institute, AMP Capital

So absent a left field shock the most likely outcome is that, while shares could see more downside in the next month, this is likely to be limited with the bull market to continue.

The threat from geopolitics and pandemics

Perhaps the main potential source of left field shocks are the current geopolitical threats, but our reading is that these are unlikely to pose a fundamental threat to global growth:

- The Islamic State seems unlikely to threaten oil supplies and while a terror attack is a risk, it's worth noting that the progression of such attacks last decade seemed to have less impact on markets as investors got used to them.
- The threat from Ukraine may be receding.
- The protests in Hong Kong are certainly a risk to China, but there is a good chance that they will peter out as the people of Hong Kong grow frustrated at the disruption they pose to their ability to go about their business.
- The "arrival" of Ebola cases in the US and Spain is worth watching, but our base case is that it should be easier to contain in western countries with modern medical facilities and higher standards and ease of hygiene.

What does this mean for Australian shares?

If global shares have more short term downside then so too will Australian shares. However:

- The Australian share market is now quite cheap again with the forward PE now back below 14 times.
- The fall in the $A will further help the economy avoid recession as mining investment slows and provide a boost to corporate earnings as each 10% fall in the $A adds around 3% to earnings.
- Interest rates are set to remain at generational lows with inflation pushing back towards the low end of the RBA's target range according to the TD Securities Inflation Gauge and the RBA looking at using credit controls to slow investor demand for housing rather than rate hikes.

As such Australian shares are likely to see a strong rally into year end. Just bear in mind though that Australian shares are no longer the relative outperformer they were last decade. This decade is likely to see continued underperformance versus global shares as the commodity price super cycle is now going in reverse resulting in a headwind for the local share market and the falling $A (which we see heading down to $US0.80 or lower) will boost the value of offshore shares.

Concluding comments

The rough patch we have seen in shares lately could go a bit further. However, the bull market will likely remain intact thanks to a lack of overvaluation, the benign economic cycle, easy monetary conditions and a lack of investor euphoria.

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