Good-value shares

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See why this leading economist believes Australian shares offer long-term value.

By Shane Oliver, AMP

The risk of recession in the US and Europe is high. Australia is not immune but is well placed to withstand a renewed global slump.

Australian assets are better placed than before the global financial crisis, with cheaper valuations for shares and commercial property. Housing is vulnerable in the short term but should benefit from lower interest rates from around mid-2012. The Australia dollar is vulnerable in the short term to global growth concerns, but is likely to continue trending higher as major central banks continue to debase their currencies.

Problems feeding on themselves

The combination of European and US debt problems, softer economic data and sharemarket falls are all feeding on themselves, resulting in a significantly increased risk of recession in the US and, particularly, in Europe. Signs of rising stress in European interbank lending markets are adding to fears of a re-run of the GFC.

Our assessment is that growth in advanced countries over the year ahead will be a paltry 1 per cent and global growth will be around 3.25 per cent, well below trend and consensus. There is significant downside risk to this, particularly in Europe and the US.

During the GFC, as a result of the impact on confidence, loss of sharemarket wealth, disruptions to lending markets and reduced demand for exports, Australia was not left unscathed. However, thanks to a combination of rapid monetary and fiscal stimulus, a strong financial system, resilient Chinese demand for our exports, and a bit of good luck, Australia got by with only a slowdown in growth. It was the only advanced country to avoid recession. But would we be so lucky this time around?

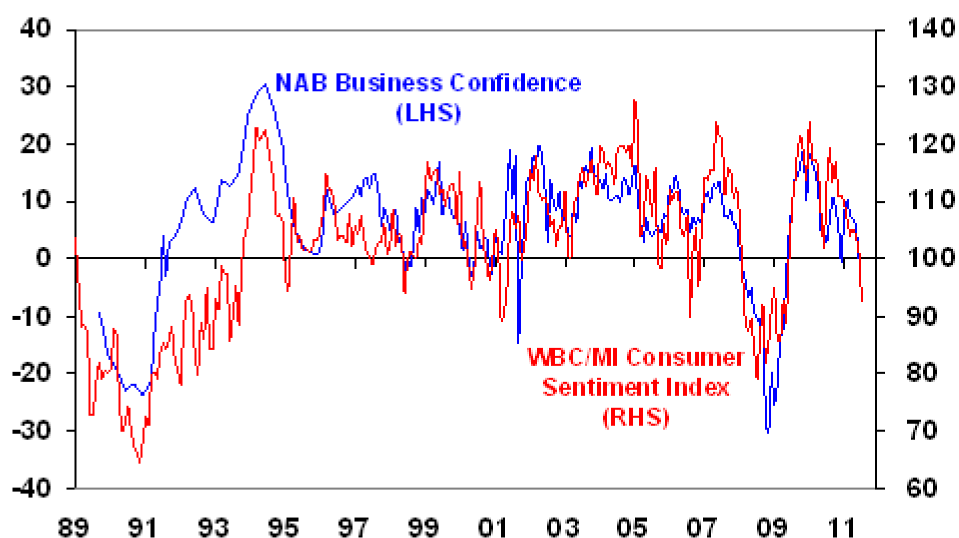
The Australian economy is vulnerable

Business and consumer confidence have already been hit hard (see chart below), the fall in sharemarkets has resulted in a renewed loss of wealth, another global credit crunch will adversely affect lending, and exports will be hit if economic weakness in the US and Europe drags down Australia's key trading partners in Asia.

What's more, the renewed threat to global growth is occurring at a time when household demand in Australia is weak on the back of consumer caution, and the global turmoil may only reinforce this. Announced job layoffs are rising - totalling around 9000 so far - and are likely to increase as companies revise down demand expectations that underpinned last year's employment surge. By year-end, unemployment is likely to rise from 5.1 per cent to 5.5 per cent.

Australia's high house prices relative to income levels, and associated high household debt, is an added source of vulnerability should an economic downturn threaten the ability to service mortgages.

Australian consumer & business confidence have fallen sharply



Source: AMP Capital Investors

Notwithstanding these risk points, Australia is reasonably well placed to withstand a possible return to recession in the US and Europe, for eight key reasons:

1. As in 2008, interest rates have a long way to fall if need be. Although it may take a month or so for the RBA to change its thinking from rate rises to rate cuts, we expect the combination of increased global risks and rising unemployment to convince it to start cutting interest rates by the end of the year. With 85 per cent of Australian mortgagees on floating rate loans, slashing them has a powerful impact on demand, as we saw in 2009.
2. The scope for fiscal stimulus (government spending) is less than it was in 2008 because the budget is now in deficit, but Australia's trivial level of net public debt (8 per cent of GDP compared to 72 per cent in the US) suggests there is room for targeted, timely and temporary fiscal stimulus if needed.
3. Gearing and financial leverage is low compared to before the GFC. Corporate borrowing is well below long-term average levels in contrast to 2007, margin lending is low, and private credit growth is running around its lowest level since the early 1990s recession. In fact, the Australian corporate sector as a whole is cashed up, having gone from a borrowing sector of the economy in 2007 to a net lender now.
4. In the event of a sharp fall in commodity prices, the Australian dollar would likely fall sharply, just as it fell nearly 40 per cent in the second half of 2008 - providing a huge boost to competitiveness and thus acting as a buffer.

5. Banks are less dependent on global markets for funding than in 2007, with 50 per cent of funding coming from deposits compared to less than 40 per cent at the time of the GFC, and are far less dependent on short-term funding. Banks are now starting to cut deposit rates as they are awash with cash at a time when credit growth is weak.
6. Although households are cautious, they have built up a large savings buffer that they are likely to eat into if unemployment rises and interest rates fall.
7. The mining sector is not immune to lower commodity prices but the huge pipeline of work in mining projects provides a degree of resilience that was not there in 2008.
8. Finally, our key export markets in Asia are more secure than those in Europe and the US, and may prove more resilient this time around. A big factor behind the transmission of the GFC to emerging countries in 2008 was a drying up in trade finance. That is less likely to occur this time.

As a result of these considerations we remain of the view that - providing the RBA acts swiftly - the risk of a recession in Australia is low, at less than 20 per cent. Although non-mining demand in the economy is likely to take a hit in the short term from reduced business and consumer confidence, the loss of sharemarket wealth and rising unemployment, growth is likely to receive a boost from monetary and potentially fiscal stimulus through next year.

Australian shares are good value

Our assessment remains that Australian shares are good value for long-term investors (particularly as grossed-up dividend yields are over 6 per cent, bond yields are just 4.3 per cent and bank deposit rates are falling rapidly). Nevertheless, just because shares are good value does not mean they have bottomed. But the starting point for recent weakness is more favourable than it was in 2007:

- When Australian (and global) sharemarkets crashed in 2007, it came after a long cyclical bull market that had left price to forward earnings (PE) multiples at 15 times for global shares and 16 times for Australian shares. Earlier this year when shares peaked, the PE was just 12.4 times globally and 13 times in Australia. So shares began the recent slump at relatively modest valuations, implying more limited downside.
- The level of gearing in the sharemarket is far less than it was four years ago because of a sharp decline in margin lending and reduced levels of corporate gearing. This suggests the downside potential for shares should be less than in the GFC, when Australian shares fell 55 per cent and global shares 56 per cent.

The Australian dollar conundrum

The Australian dollar is caught between two conflicting forces. On the one hand, a downturn in the global economy that results in a sharp fall in commodity prices will put more downward pressure on the currency. This is arguably the key risk in the short term now the global growth outlook has become much more uncertain. As such, a fall below parity cannot be ruled out, particularly if the RBA cuts interest rates, as we expect.

However, against this the US dollar, the euro, the British pound and even the Japanese yen all look to be in a race to the bottom on the back of a combination of long-term debt problems, more quantitative easing (a form of monetary policy in the US) and more interest rate cuts (in the case of the European Central Bank).

Gold outlook bright

Gold is likely to remain a key beneficiary (from US-dollar weakness); with US$2000 an ounce set to be breached soon and much higher levels likely over time. Emerging market currencies are also likely to be key beneficiaries, but they suffer from intervention to limit their gains. This leaves the commodity currencies such as the Australian dollar and the Canadian dollars which are likely to benefit as long-term commodity demand remains strong, and they do not have the structural problems faced by the US, Europe, Japan and the UK.

Although the RBA is likely to start cutting interest rates soon, Australian interest rates are likely to remain well above US levels; and over time the impact is likely to be swamped by more quantitative easing in the US, which has the effect of increasing the supply of US dollars. So although the short-term outlook for the Australian dollar is uncertain, in the longer term the outlook is likely to remain up.

About the author

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From ASX

The Russell Investments/ASX Long Term Investing Report assesses the performance of Australian shares against other asset class over 10 and 20 years. It provides useful information for investors wanting a long-term sharemarket perspective.

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