

The 'Twilight Zone'



Even though it defies financial theory, every decade since the 1950s has had a prolonged period where Australian (and global) share prices have risen despite declining earnings. Matthew Sherwood, Perpetual's Senior Manager Investment Market Research, discusses whether we have recently entered one of these 'Twilight Zones' and finds that even though recent economic data has surprised significantly on the upside, caution is still warranted.

Introduction

It was once written that if you are ever short of an idea for a science fiction show, then simply watch an episode of the 'Twilight Zone'. This show was a mixture of self-contained fantasy, science fiction and suspense, often concluding with an unexpected twist. Even though the strange circumstances in each episode were described in the opening and closing narrations in a cryptic and dramatised manner, the show often was quite confusing. On many occasions you couldn't understand how the characters had entered the 'Twilight Zone' and didn't really have an idea of how they would get out of it. The phrase 'Twilight Zone' has gained so much notoriety in recent decades that when variables are not behaving in an expected manner, or people have unorthodox views, they are said to be in the 'Twilight Zone'. This phrase has been used extensively to discuss unusual behavior in the arts, politics, sport and financial markets.

What is the 'Twilight Zone'?

When economic growth turns negative, investors need to negotiate two key turning points with respect to their investment strategy. The first occurs when share prices trough and decouple from declining earnings. This stage sounds counter-intuitive and defies basic financial theory and during this time, sharemarkets get so cheap that investors are willing to look through the cycle and purchase stocks irrespective of the near-term earnings outlook. As markets don't go down (or up) in a straight line it is near impossible to immediately distinguish the start of these unusual periods as it only becomes apparent with the benefit of hindsight.

The 'Twilight Zone' is full of contradictions; share prices rise even through dividends are being cut and declining earnings suggests investors should be cautious, but rising sharemarkets suggest that a more aggressive strategy could be appropriate. The second turning point occurs when the earnings trough and begin to recover. These two stages are symbiotic in that one cannot occur in a sustained way without the other, but they hardly ever occur together and can be several years apart.

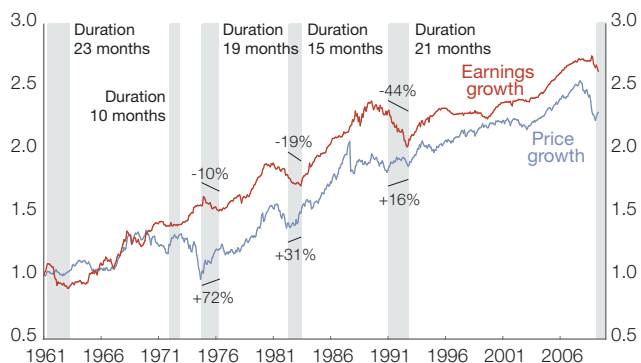
Previous episodes

Investors may be experiencing an unusual sensation at present as earnings are declining, a frustratingly tepid economic recovery is at least six months away, but all major sharemarkets have rallied over 20% since early March 2009. Australian investors have experienced a 'Twilight Zone' episode every decade for the past 50 years. The first occurred between 1961 and 1963, where the Australian sharemarket rose by 7% and earnings declined by 28%. This was the longest episode, even though the decoupling between earnings and prices was small relative to other periods. The largest disparity between price and earnings growth occurred in the mid-1970s, when prices rose by 72% as earnings declined by 10% (over a 19 month duration, see Chart 1).

The 1970s was the only decade to have two 'Twilight Zone' episodes reflecting the impact of extreme monetary and fiscal expansion, which initially boosted household disposable income, but provided little support to business capital spending. As a result, the Australian economy experienced high growth and then sizable recessions as government spending was subsequently constrained, which foreshadowed the recessions in 1972, 1975 and 1977. Following this, in the early 1980s prices rose 31% and earnings declined by 19% (15 months) and in the 1990s the Australian sharemarket rise by 16% even though earnings declined by 44% (21 months).

Chart 1: The Australian sharemarket has had a 'Twilight Zone' episode each decade

Australian Sharemarket: Earnings and Price Growth (Index, log scale, January 1961 = 1)



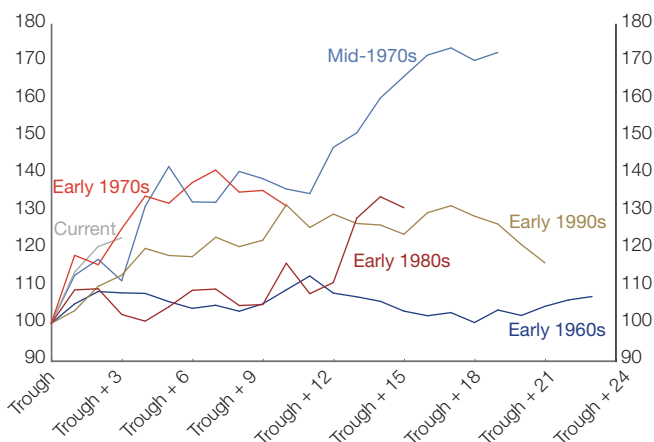
Source: Citigroup, IRESS and UBS Australia Limited as at 21 May 2009.

Share prices during stage one

Overall, the average 'Twilight Zone' lasts for 18 months and in this time prices rise an average 32% and earnings decline by 20%. Australian equities have bounced harder in the past 12 weeks than at the beginning of other episodes other than that in the early 1970s (see Chart 2). This possibly reflects the much larger peak-to-trough decline (-55% between November 2007 and March 2009) than previous periods. The only larger decline was in the mid-1970s (after the first oil shock, where the market declined 59%), which experienced a similarly strong rebound in the early stages.

Chart 2: The current market rally is high relative to other 'Twilight Zone' periods

Australian Sharemarket Returns During the 'Twilight Zone' (Index)



Source: Citigroup, IRESS and UBS Australia Limited as at 21 May 2009.

Are Australian investors currently in the 'Twilight Zone'?

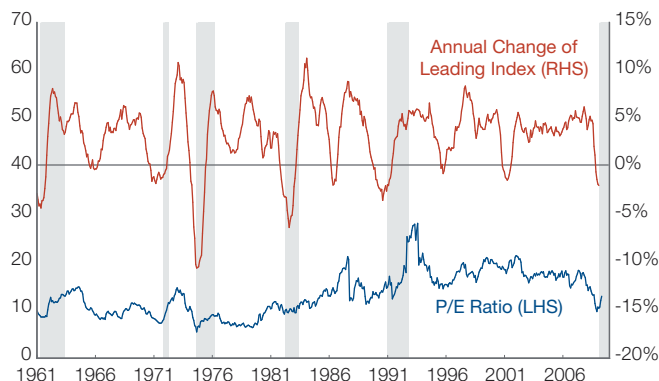
Considerable evidence is mounting that investors entered the 'Twilight Zone' in March 2009. Firstly, if share prices have declined enough to discount further drops in earnings, then valuations should be quite low. The Australian sharemarket's price-earnings ratio hit a 25-year low in December 2008 (at 9.6 times earnings), which was well above the 'Twilight Zone' levels seen in the 1970s (around 7x), at parity with the 1980s and below that seen in the 1990s (12.3x). Declining earnings and rising share prices means that the market exits the 'Twilight Zone' with a considerably higher P/E ratio than when it entered, and the current cycle has not disappointed with the P/E ratio already up 33% (to 13 times) in four months (see the bottom line in Chart 3).

Lead indicators need to turn upwards

Another characteristic of these episodes is the improvement in lead economic indicators. Every 'Twilight Zone' witnesses the Leading Economic Index recovery from low levels (see top line in Chart 3). This suggests that green-shoots are important and investors seem to be focused on these statistics right now rather than continued negative news-flow in corporate Australia. These green shoots include signs of a strong turn around in the domestic housing market, rising commodity prices and that the labour market and exports have been considerably more resilient than expected.

Chart 3: Large growth in the Leading Economic Index and market valuations

Leading Index of Australian Economic Activity and Market Valuation (% change, X)



Source: Citigroup, IRESS and UBS Australia Limited as at 21 May 2009.

Economic growth in Asia is on the improve

The Westpac Melbourne Institute Leading Index of Australian Economic Activity examines a wide range of economic data (including overtime worked, US industrial production, commodity prices, productivity, share prices, corporate profits and dwelling approvals) and has historically given a good lead on turning points in earnings. Although the recent result is comparable with Australia's previous recessions in the 1960s, 70s, 80s and 90s, more pre-emptive monetary and fiscal policy suggests the current downturn is likely to be less damaging than earlier ones. Recent economic data suggests that China's \$US750 billion stimulus package has underpinned a sharp economic recovery, which could support future Australian export activity. Industrial production and exports have also picked up in other Asian economies and data has improved in the US and Europe, but is still indicative of negative economic growth.

Is it time for a pullback?

The trend of previous 'Twilight Zone' episodes suggest that the market maybe due for an extended pullback before resuming its climb just before the start of stage two. If history is any guide, investors waiting for the market to find a new low before buying might be disappointed as only the early 1990s 'Twilight Zone' episode gave back a sizable part of the gains before the earnings recovery. At that time the market rose 32% in the 10 months to October 1991, before declining 12% in the subsequent 11 months. All other episodes had price declines of less than 5% between the share price trough and the start of stage two.

A recalibration of risk

The market rise to date has been underpinned by the possible passing of the maximum point of risk in relation to the global financial system and the global economy, which has prompted investors to recalibrate risk premiums in financial markets. However, investors need to be cautious. Recessions associated with financial crises have typically been more severe and longer lasting than recessions associated with other shocks such as oil price rises. The financial crisis typically follows a large build up of debt which has been used to purchase overvalued assets. Consequently, a key reason recessions associated with financial crises are so much worse is that households need to cut discretionary spending for many years to boost savings and repay debt. Similarly, corporations need to boost dwindling profits to strengthen balance sheets, and capital spending continues to decline after the recession trough.

... but a much slower recovery over the next five years

Recoveries from financial crisis-induced recessions are associated with weak consumer and business spending and tightness in the supply of credit to new borrowers. The current global downturn is also highly synchronised, which when combined with a deep financial crisis, underpins a very rare combination in the post-WW2 period. In the next five years, the recovery in the US (1.5% growth per annum in the next five years), Europe (0.5%), Japan (-0.2%), UK (1.0%) and Australia (2.3%) is likely to disappoint any market bull.

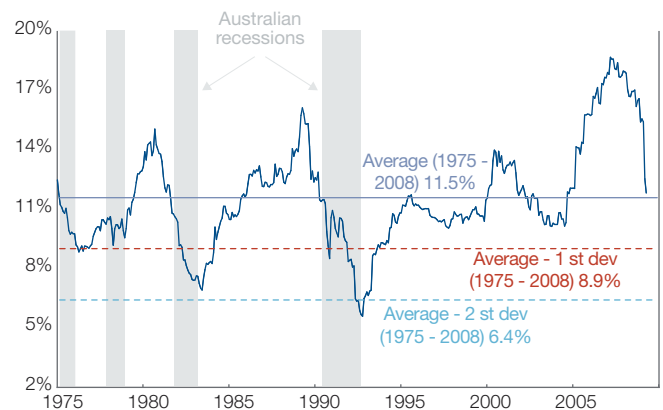
... and this will impact earnings growth and returns

Investors should not think that just because things at present appear slightly better, that all risk has now passed and the market is on an unstoppable rise back to its peak and beyond in a short period of time. The Australian corporate sector has clearly entered a considerably more difficult trading period than has been evident for the best part of two decades. The recovery over the five years post the economic trough is likely to be frustratingly tepid and this is likely to have a constraining impact on corporate earnings growth and market returns. It is expected that earnings will continue to decline going forward as return on equity remains well above its usual recessionary level (see Chart 4). However, investors are unlikely to experience the sharp earnings rebound that was experienced after the recession in the early 1980s as economic growth will not be supported by historic events like financial market deregulation. It is likely that earnings growth will be similar to the

decade after the 1980s, where return of equity declined from its (then) record high and remained below average for most of the next decade.

Chart 4: Australian Earnings are likely to decline more and remain lower

Return on Equity: Australian Sharemarket (%)



Source: UBS Australia Limited as at 30 April 2009.

Implications for investors

There is tremendous change underway in the global economy and global sharemarkets and although sentiment is slightly better than earlier in the year, heightened risk remains. The sustained stress on household and corporate balance sheets and a likely weak recovery should constrain earnings growth and investment returns, even though the market could drift higher in the prevailing 'Twilight Zone'. However, investors might be cautious in this environment as the length of the current market downturn (19 months) is considerably shorter than during Australia's two other financial crisis; the 1890s property crash (39 months) and the Great Depression (25 months).

Even though a combination of less dire macro-economic data and credit markets could outweigh the near-term earnings growth outlook, stock selection is likely to be of critical importance to investors. People should be wary of companies with high debt, opaque business models or that have highly cyclical earnings. Conversely, a diversified portfolio of companies with strong cashed-up balance sheets, higher earnings certainty, sustainable dividend growth, dominant market positions and reasonable valuations should be able to withstand these murky times, irrespective of whether the 'Twilight Zone' lasts for a short period of time or considerably longer.

Matthew Sherwood
Senior Manager, Investment Markets Research
Perpetual Investments

**For further information speak with your
Financial Adviser**

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Further information

Adviser Services 1800 062 725

Investor Services 1800 022 033

Email investments@perpetual.com.au

www.perpetual.com.au