



Domestic economic data has continued to surprise on the upside, suggesting that the Australian economy has entered 2010 with considerable momentum. Matthew Sherwood, Perpetual's Head of Investment Market Research examines the 2010 outlook and concludes that the domestic economy is set to experience a strong year of growth, which should represent the early stages of our economy's next golden age and deliver strong returns for investors.

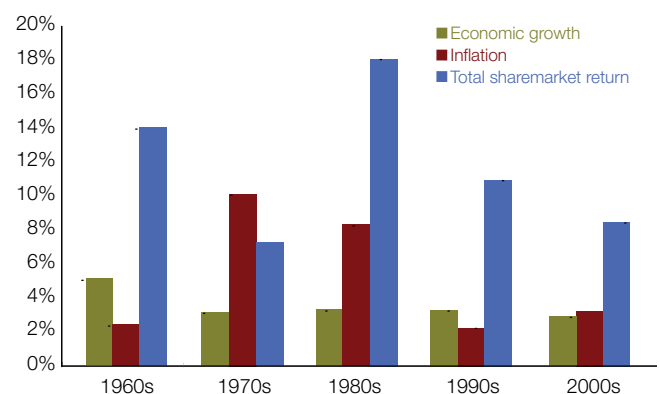
Australians and their sports.....

Australians certainly love their sports. Just as the 2009/2010 test cricket series came to an end, the Australian Tennis Open began. Ten years ago with players like Rafter, Philippoussis and (a young) Lleyton Hewitt around, Australian tennis seemed to be on the rise and that we could look forward to Australians winning the local Grand Slam title. That seems a long time ago, but in the 1960s a local male won the Australian Open title in every year and an Australian women won the title on eight occasions. Indeed, Australian males won 31 of the 40 grand slam men's singles titles that decade and our women won 18 of their possible 40 titles.

Australia's first golden age

Clearly the 1960s was a golden age in Australian tennis (which continued into the early 1970s). However, our tennis players were not the only ones enjoying good times. In fact the Australian economy enjoyed some of its best times in terms of economic growth, inflation and sharemarket returns. In the decade remembered for the Beatles, JFK and the moon landing, Australian economic growth averaged 5.1% (relative to 3% in the subsequent four decades), inflation averaged 2.4% (6%) and the Australian sharemarket returns averaged 14% per annum (11% – see Chart 1). The 1960s boom was underpinned by the rapid growth of the Japanese economy (which averaged 10% per annum during the decade) and its positive impact on the Australian mining sector. In this benign international environment, the consequences of Australia's insular, highly-regulated, over-protective economy did not negatively impact growth, but it did impact our relative economic performance with the domestic economy underperforming the average growth rate of the G7, where growth was robust.

Chart 1: The 1960s was a strong period for investment returns.
Economic Growth, Inflation and Sharemarket Return: Australia (% pa)



Source: Australian Bureau of Statistics, Datastream and Reserve Bank of Australia as at 31 December 2009.

The global economic recovery remains subdued

After shrinking by 2.1% in 2009, the global economy is poised to return to growth of 3% in 2010 (source: USB Australia Limited as at 18 January 2010). This result is primarily driven by the emerging economies (with growth of around 6%) and less so by the advanced economies (around 2%). However, the advanced economy recovery is subdued relative to the 4% average rebound in the five recessions in industrialised economies since 1970. The sub-par 2010 recovery primarily reflects concerns about credit availability and the weak position of government finances and this will also contain global share market returns.

...but global shares are 'priced for perfection'

The MSCI World Index's earnings per share has declined by almost 60% since its market peak, primarily driven by financials. Although the global economy is recovering, the global sharemarket rise since March 2009, has seen markets now 'priced for perfection', particularly in the cyclical sectors (such as basic industrials, capital goods and consumer cyclicals). Given the cost-cutting that listed companies have undergone over the past few years, there is probably not too much more efficiency gains that can be extracted from company operations. Accordingly, the typical listed company will need solid revenue growth to meet analyst forecast and any disappointment would likely represent a drag on market sentiment.

Obama and China

Investor optimism has recently been shaken due to developments in China and the US. In order to prevent another Global Financial Crisis (GFC) President Obama announced in mid-January he would prohibit banks from trading securities on their own accounts and limit bank size. However, the trading of securities and bank size did not cause the GFC. Banks (irrespective of their size) failed or required government bailouts because of either bad lending or exposure to synthetic securities (that were based off these dodgy loans), or both. However, it is impossible to legislate against bad loans and bad judgement, so these policies are more likely reduce bank profits and drag down share prices than prevent another GFC.

Meanwhile, markets have been rattled by the news that China is trying to restrain credit growth. By telling some banks to pull their lending in, the Chinese government is not trying to slow the economy down; indeed the Chinese Premier has stated that ample credit growth will be maintained. Instead, these measures are aimed at mopping up excess liquidity, restraining some excesses and lowering credit risks, all of which are large positives for sustainable growth. At this stage, these developments do not appear to be game-changing, but they highlight how fragile market sentiment is.

Interestingly stocks in sectors such as healthcare, consumer staples and utilities have lagged the recovery, but appear more attractively priced and tend to have more stable earnings and appear to be more cost-efficient way of gaining access to any recovery with the added bonus of some downside protection.

Australia is about to enter its next golden age

There appears to be little doubt that there will be two very powerful forces in the next few generations that will dominate global economic growth. During this period, the aging global population will negatively impact growth, whereas China's and India's (and other emerging economies') industrialisation and urbanisation will positively impact activity. China's and India's increased demand for raw materials appears likely to represent the start of a golden age for the Australian economy underpinned by strong investment, exports and population growth, which will help to keep demand strong and unemployment very low.

Indeed the December 2009 labour market report (which indicated that the economy has created 135,000 jobs in the past four months, with unemployment down to 5.5%) indicated that the domestic economy has entered 2010 with considerable momentum. These numbers indicate that Australia's most pressing

economic problem is not a collapse in demand or a large number of unutilised labour, but how to manage the excess demand from renewed China-led export boom.

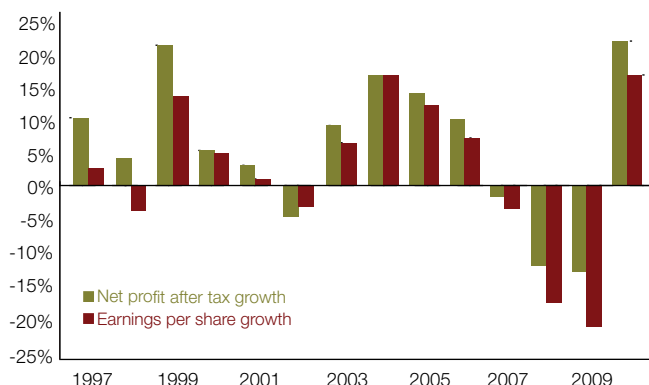
The Australian market outlook – the February reporting season is key

With Australian sharemarket valuations now above average on a forward-looking basis, companies will have to deliver on earnings growth and as such, the upcoming February 2010 reporting season is key. The balance of risks for the upcoming reporting season is tilted to the upside. In recent months, analysts have made modest upgrades to their earnings forecasts, but more are required given the significant improvement in Australian and global economic conditions. Australian listed company revenues are rising (reflecting a stronger economy) and costs remain contained which suggest the reporting season is expected to be an operating leverage story.

Overall earnings growth is expected to be quite strong (albeit from a low base), but this will be heavily diluted by the large-scale equity raisings undertaken over the period (see Chart 2). The difference between earnings growth and earnings per share growth in 2009 is expected to be the largest on record, but earnings are forecast to recover and total earnings per share for 2010 is forecast to be around its highest level in the past 15 years.

Chart 2: Higher earnings will be diluted by equity issuance

Australian Calendar Year Earnings and Earnings Per Share Growth:



Source: UBS Australia Limited as at 21 January 2010. 2010 is a forecast.

What is the largest risk to the Australian sharemarket's 2010 outlook?

Despite the positive earnings backdrop, the risks for Australian stocks are elevated for firms with weak balance sheets, low operating leverage and high levels of overseas earnings (given the large appreciation of the Australian dollar). In addition, from a macro perspective one risk that could be quite important in 2010 is rising bond yields.

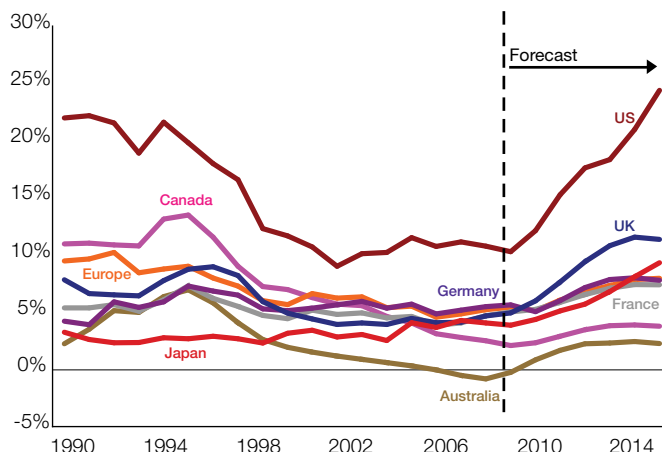
Why would bond yields rise in 2010?

a. Advanced economy government debt continues to rise

Record government deficits have occurred in most countries (excluding war times) over the past year. Unfortunately these budget positions are not expected to return to surplus over the Budget estimates in almost every country, other than Australia. Indeed the US is not forecast to return to surplus for at least the next 10 years. Like an over-leveraged company, one problem with carrying too much debt is that it can very quickly drain cash-flow (see Chart 3).¹ Unlike spending programs that can be reduced or cut (albeit with some political pain), coupon payments to bond holders are non-discretionary, irrespective of total tax revenue. If investors perceive some risk of default, they will seek higher yields in compensation for bearing this perceived risk. Although the likelihood of a US or UK default is extremely low, that alone will not prevent bond yields from rising as the risk of this development occurring has clearly risen. Accordingly, government debt in high indebted countries runs the heightened risk of being downgraded.

1 This concept is discussed further in Perpetual Perspective, 'Is Government Debt the next Sub-prime?', November 2009, pages 1-3.

Chart 3: Government debt continues to drain Budget revenue
Percentage of Budget Revenue Used To Fund Bond Payments



Source: International Monetary Fund, Macquarie Equities and Perpetual Investments as at 18 December 2009.

b. Central banks may not have inflation under control

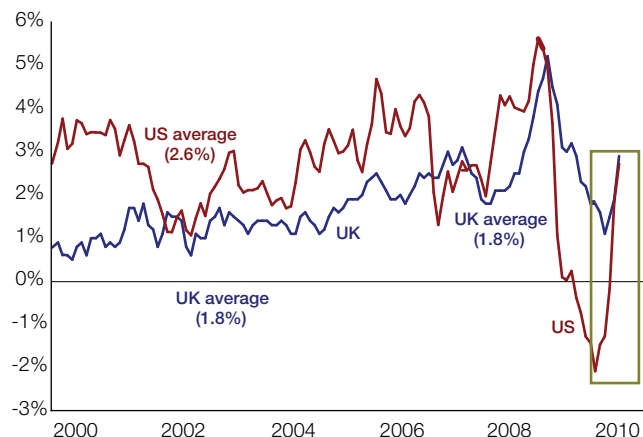
Most central banks expect inflation to remain low reflecting the easing in capacity pressures and slower wages growth. However US and UK inflation has recently been rising at an uncomfortable pace. For example, Britain's December inflation rate rose from 1.9% to 2.9% (see Chart 4), with core inflation (at 2.8%) at its highest level since records began in 1997. There are some unusual factors driving the move, which can be viewed two ways; firstly, the drop in the consumption tax, oil prices and the currency in late 2008 had artificially deflated inflation and it is now returning to where it otherwise would be.

Alternatively, these negative factors are starting to roll off the annual rate and its effect is likely to be a one-off. Indeed the Bank of England's Governor (King) stated his expectation that inflation will lift markedly in the first half of 2010 before coming back down. That may happen, but when you've had the Central Bank printing press on 24/7 for over a year, and have a cash rate with a zero in front of it, you would not want to be wrong as the consequences could be fairly dire. If this rise continues bond yields would be expected to rise, which will hinder an already fragile economic recovery.

c. Australia's growth should be well above trend

With the Australian economy set to record fairly strong growth in 2010, this is likely to prompt the Reserve Bank of Australia to progressively return rates to at least neutral levels, and more likely, above-trend levels throughout the year. This will place additional domestic pressure on local bond yields and may lessen the relative yield attractiveness of Australian equities to bonds.

Chart 4: US and UK Inflation is on the rise
Annual Change in Headline Inflation: US and UK (%)



Source: UBS Australia Limited as at 31 December 2009.

Implications for investors

Despite an improved economic outlook, the global recovery is likely to be more subdued than the post-1970 average. This is likely to be a headwind for stocks that are priced for perfection, particularly in advanced economies with high government debt (which account for the vast majority of the MSCI World Index). Consequently, investors might need to realign their portfolio and reduce risk by increasing their exposure to companies with more sustainable business models who can achieve higher earnings and dividend growth in an environment characterised by subdued economic conditions and rising bond yields.

In contrast, the Australian economy seems poised to enter a new golden age of strong growth underpinned by higher exports and investment. However, the associate rise in earnings will partially be offset by rising official interest rates and bond yields. Consequently, it is very important to manage portfolio risk from an earnings and a valuations perspective. Even though Grand Slam winners usually change every year (other than Nadal at the French Open and Federer at Wimbledon), the pedigree of stocks which deliver risk-efficient investment returns over the long run has not changed. Indeed quality companies at attractive valuations not only provide investors with exposure to rising sharemarkets, but also downside protection for when unforeseen events (like the GFC) occur and this is highly unlikely to change.

Matthew Sherwood
Head of Investment Market Research
Perpetual Investments

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Adviser Services 1800 062 725
Investor Services 1800 022 033
Email investments@perpetual.com.au
www.perpetual.com.au