

Back to the 1970s – the return of volatile investment cycles



Key points

- The combination of high private and public sector debt levels in developed countries, extreme swings in monetary policy and greater government involvement in the economy likely mean we have entered a more volatile macroeconomic environment.
- This is likely to result in more volatile cycles in investment markets and more constrained returns from traditional investment markets.
- Investment processes will have to pay more attention to macroeconomic conditions and, as such, will likely become more short-term focused.
- The search for a hedge against constrained returns and greater volatility will likely reinforce increasing allocations to Asia and the emerging world, quality high yield investments and potentially gold.

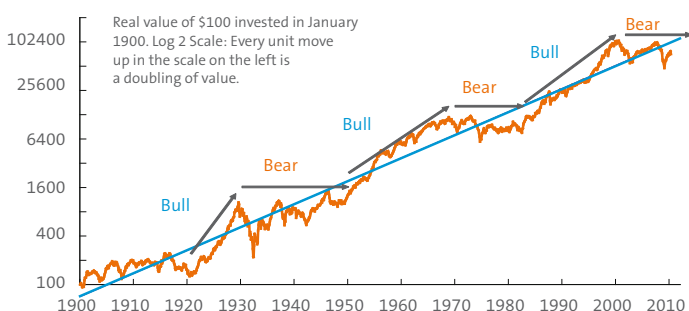
Introduction

Investment markets have become a lot more volatile over the last few years. Much of this of course relates to the global financial crisis and its aftermath. However, there is good reason to believe it is part of a longer term transition from the relative macroeconomic stability that increasingly prevailed from the mid-1980s until a few years ago, to an environment of shorter, more violent cycles like we saw in the 1970s. This has a number of implications for investors¹.

The changing macro backdrop

To understand the current situation we need to understand the prior secular bull market in global shares which occurred from the early 1980s. This was most clearly evident in the US share market, as seen in the next chart.

Long term bull and bear phases in US shares



Source: Thomson Financial, AMP Capital Investors

The secular bull market from the early 1980s was driven by a combination of falling inflation (which allowed shares to rise faster than earnings), de-regulation and smaller government (which helped boost productivity and profits), easy credit, globalisation (which helped keep inflation down and boosted trade), the Information Technology revolution and favourable demographics. These considerations helped drive well-above-average investment returns from 1982. For example, from 1982 to 2000 US shares returned 20% per annum (pa). For many countries, this strength continued into 2007, e.g. Australian shares returned 16% pa over the 1982–2007 period, which was well above its long term average return of 11.8%.

Since the turn of the century and increasingly through the last decade, many of these favourable themes have faded or gone into reverse. In particular:

- the benefit to shares from the shift to low inflation over the last 25 years has run its course;
- the global financial crisis will likely ensure a tighter credit environment for the next decade or so. High household gearing levels made worse by falls in house prices in many developed countries provide both a constraint and a degree of vulnerability going forward (as gearing can accentuate volatility);
- the Great Recession, and the stimulus effort to combat it, have left many developed countries with dangerously high levels of public debt, which is now all too evident in Europe. High public debt levels in many developed countries have left them with little scope to deal with any future downturns and market pressure is already intensifying to cut budget deficits;
- monetary policy in many countries has been forced into extreme swings, which is likely feeding back into the economic cycle;
- the policy pendulum is swinging back to re-regulation and greater government involvement in the economy. Examples of this now abound, with increasing regulation of the financial system globally and the proposed Resource Super Profits Tax (RSPT) in Australia. This will likely adversely affect economic dynamism and productivity growth;
- demographic trends are becoming less favourable as the proportion of the population at peak spending age starts to decline and baby boomers start to retire. Poor population growth in Japan and Europe are additional constraints in these regions; and
- to the extent the world is now becoming more dependent on growth in emerging countries, this will also add to economic volatility. This is because emerging countries are traditionally more volatile, reflecting their greater exposure to manufacturing which tends to be more cyclical than services sector activity.

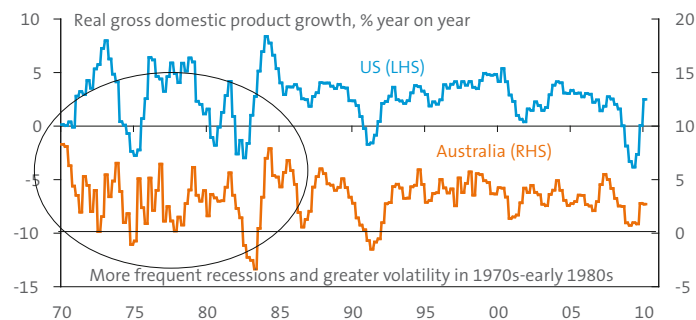
The outcome of these structural forces is likely to be lower average returns from traditional asset classes and a more volatile economic and investment market cycle. The more difficult fundamental backdrop today suggests the medium term trend in US, European and Japanese shares is likely to remain weak and average medium term returns are likely to be around 5–8% pa at best.

1. These themes were first referred to in "Where are we in the short and long term share cycles", Oliver's Insights, June 2009.

The combination of still high private sector debt ratios, dangerously high public debt levels and the need to unwind very easy monetary policies (together with greater government intervention in the economy) will also likely result in a more volatile economic and financial cycle. There is also likely to be a positive feedback loop now underway where greater economic and investment market volatility has fed into investor skittishness, which is in turn adding to volatility.

In many ways, developed countries may have now come full circle and are going back to the shorter and more extreme cycles of the 1970s (see next chart).

Back to the 1970s



Source: Thomson Financial, AMP Capital Investors

The 1970s was of course a very constrained period for share market returns (see the first chart).

Investment implications

This is all likely to have a number of implications for investors. First, buy and hold or momentum-based strategies may be less successful (or less acceptable for many investors) in the more volatile environment we have now entered. As we noted in a recent report, asset allocation is expected to be more important and more valued going forward.

Second, a more volatile economic and financial environment is likely to result in a higher cost of capital and a reduction in its availability as investors and lenders demand compensation for greater volatility and uncertainty in underlying earnings and a perceived higher risk of default.

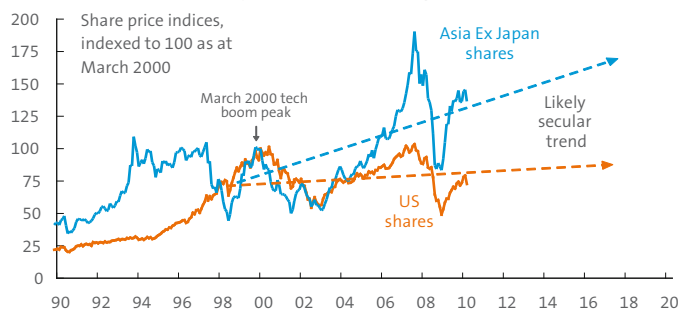
Third, the more volatile and less certain economic environment is likely to result in share markets trading on lower price-to-earnings (P/E) multiples than has been the case over the last decade or so as investors potentially demand a higher risk premium to compensate for greater uncertainty, resulting in shorter investment horizons. This may be worth one or two points off P/E multiples, but in the absence of a return to 1970s inflation levels is unlikely to justify a return to single digit P/E multiples. Over the last decade, the forward P/E multiple on Australian shares has averaged 14.5 times, and this would suggest the average going forward might shift down to around 13 times.

Also, the macroeconomic environment will be far more important for the management of equity, property and corporate debt portfolios than has been the case from the early 1990s onwards until recently, when economic upswings were long and relatively steady and recessions were mild and tended to be many years apart.

In addition, investors will need to accept lower average returns from traditional investment markets. This is simple mathematics flowing from relatively low starting point yields, constrained prospects for earnings growth in traditional markets and little likelihood that P/E multiples will be able to steadily expand as they did over the 1980s and 1990s. Lower average returns have already been evident for traditional global shares over the last decade.

Finally, investors need to consider investing more in markets which don't suffer to the same degree from high debt levels and demographic constraints as most developed countries do, e.g. Asian and emerging markets. It's worth noting that while US shares have been in a long term bear market since 2000, the trend in Asian shares has been strong. This is likely to continue. Thanks to Australia's trade links to strong growth in Asia, better demographics and a better public debt situation, the medium term return from Australian shares is likely to be somewhere in between the strong gains from Asian shares and the more constrained trend in the US (assuming we can resolve the impasse over the proposed RSPT). Quality high yield investments and potentially gold are also worth considering as a hedge against increased cyclical volatility.

The secular trend is likely to remain stronger for Asian shares



Source: Thomson Financial, AMP Capital Investors

Conclusion

The combination of high private and public sector debt levels in developed countries, extreme swings in monetary policy and greater government involvement in the economy likely mean that we have entered a more volatile macroeconomic environment. This in turn is expected to result in more volatile cycles in investment markets and more constrained returns from traditional investment markets. The search for a hedge against constrained returns and greater volatility will likely reinforce increasing allocations to Asia and emerging country shares and bonds, quality high yield investments and potentially gold.

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