AMP CAPITAL

Where are we in the investment cycle?

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Key points

- While corrections are inevitable, we still appear to be a long way from the peak in the investment cycle.
- Shares are not unambiguously overvalued and on some measures are still cheap, uneven and below trend global and Australian growth is extending the economic recovery cycle, monetary conditions look set to remain easy and investors are far from euphoric.

Introduction

It is now six years since the global financial crisis ended. From their 2009 lows US shares are up 212%, global shares are up 159% and Australian shares are up 91% (held back by higher interest rates, the commodity collapse & the high $A). Despite this, there seem to be constant predictions of a new disaster. This note looks at where we are in the investment cycle.

Time and magnitude

A concern expressed by many it seems is that the cyclical bull market in the influential US share market is now more than six years old and this leaves it (and hence us) vulnerable to a cyclical bear. The next table shows the record of cyclical bull markets in US shares since World War 2. I have applied the definition that a cyclical bull market is a rising trend in shares that ends when shares have a 20% or more fall (ie a cyclical bear market) that takes more than 12 months to be reversed.

Cyclical bull markets in US shares since WW2

Cyclical share bull market, S&P 500	Prior bear market % fall	Total bull mkt, % gain	Duration in months
June 49-Aug 56	-30	267	86
Oct 57-Dec 61	-22	86	50
Jun 62-Feb 66	-28	80	43
Oct 66-Nov 68	-22	48	25
May 70-Jan 73	-36	73	31
Oct 74-Nov 80	-48	126	73
Aug 82-Aug 87	-27	229	60
Dec 87-Mar 00	-34	582	147
Oct 02-Oct 07	-49	101	60
Average	**-33**	**177**	**64**
Mar 09-?	-57	212?	73?

Source: Bloomberg, AMP Capital

The average cyclical bull market in the US has seen shares rise 177% and last 64 months. So far we have surpassed this with shares up 212% over 73 months. While not the longest, some fear this means the US share market is at risk of another bear market. However, there are some points to make in relation to this. First, there is no hard and fast rule regarding the timing of bull and bear cycles so it could be argued that the 19% fall in US shares in mid 2011 was a bear market. This would put the current cycle at a gain of 92% and 42 months duration, which is below average.

Second, global and Australian shares did have a bear market in 2011. As such, for their current bull market since the 2011 low global shares are up 81% over 42 months which is below the average since 1970 of 133% over 55 months. Similarly, Australian shares in the current bull market are up 51% over 43 months versus an average gain of 126% over 47 months. See next table.

Cyclical bull markets in Australian shares since WW2

Cyclical share bull market, All Ords	Prior bear market % fall	Total bull mkt, % gain	Duration in months
Dec 52-Sep 60	-34	146	93
Nov 60-Feb 64	-23	42	39
Jun 65-Jan 70	-20	120	55
Nov 71-Jan 73	-39	57	14
Sep 74-Aug 76	-59	101	23
Nov 76- Nov 80	-23	173	48
Jul 82—Sep 87	-41	421	62
Nov 87-Aug 89	-50	55	21
Jan 91-Feb 94	-32	94	37
Feb 95-Mar 02	-22	89	85
Mar 03-Nov 07	-22	156	56
Mar 09-Apr 2011	-55	63	25
Avg from 1950	**-35**	**126**	**47**
Sep 2011-?	-22	51?	43?

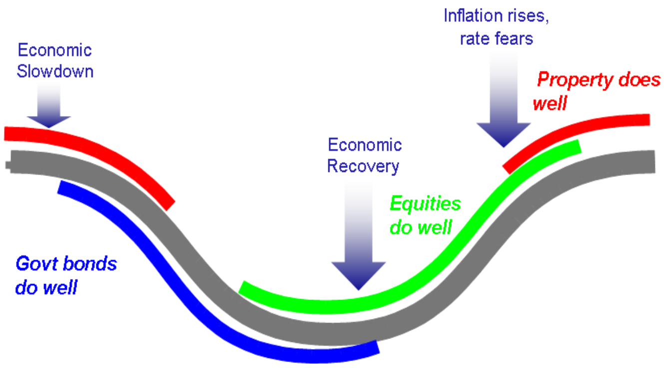
Source: ASX, Bloomberg, AMP Capital

Finally, there is more to bull markets than time and magnitude.

The investment cycle

The next chart shows a stylised version of the investment cycle.

The investment cycle



Source: AMP Capital

A typical cyclical bull market in shares has three phases:

- Phase 1 normally starts when economic conditions are still weak and confidence is poor, but smart investors start to see value in shares helped by ultra easy monetary conditions, low interest rates and low bond yields.
- Phase 2 is driven by strengthening profits as economic growth turns up and investor scepticism starts to give way to some optimism. While monetary policy may start to tighten it is from very easy conditions and remains easy as inflation remains low and so bond yields may be drifting higher but not enough to derail the cyclical upswing in shares.
- Phase 3 sees investors move from optimism to euphoria helped by strong economic and profit conditions which pushes shares into overvalued territory. Meanwhile, strong economic conditions drive inflation problems and force central banks to move into tight monetary policy, which pushes bond yields significantly higher. The combination of overvaluation, investors being fully loaded up on shares and tight monetary policy sets the scene for a new bear market.

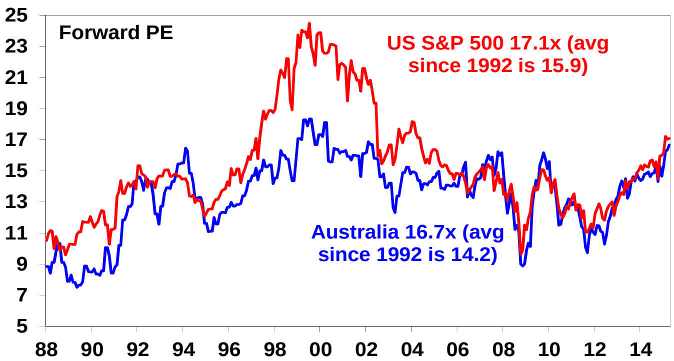
Typically the bull phase lasts three to five years. But it varies depending on how quickly recovery precedes, inflation rises and extremes of overvaluation & investor euphoria appear. As a result “bull markets do not die of old age but of exhaustion”.

Current point - not there yet

So the big question is: are we at or near “exhaustion” for the cyclical bull market in shares? The best way to look at this is to assess market valuation, economic growth and inflation pressures, monetary conditions and investor sentiment.

- Share market valuations are mostly okay. Sure, measured in isolation against their own history shares are no longer dirt cheap. In fact, forward price to earnings multiples in the US and Australia are above long term averages.

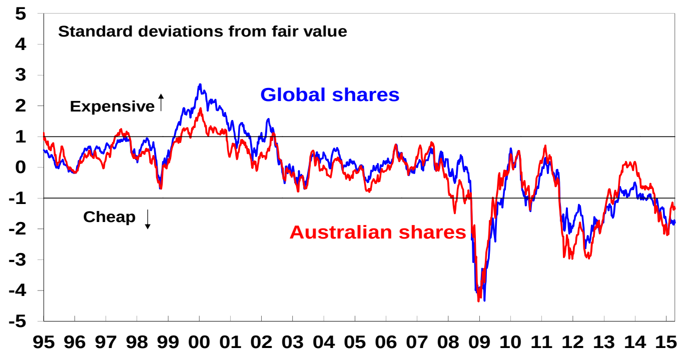
US & Australian forward PEs are above long term averages



Source: Thomson Reuters, AMP Capital

However, once the gap between share market earnings yields and bond yields is allowed for, shares still look cheap (next chart).

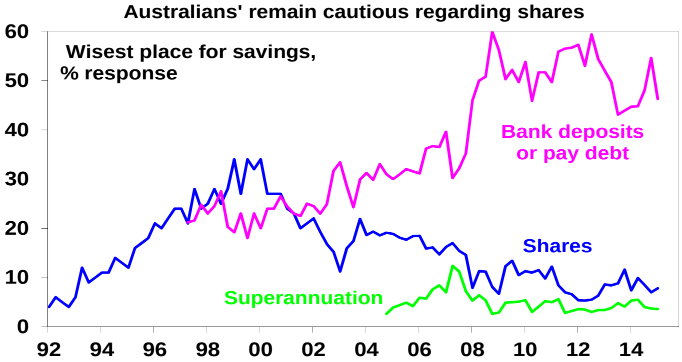
Share market valuations



Source: Bloomberg, AMP Capital

- The global economy is continuing to grow at an okay pace. While growth is constrained by past standards, a constrained and slower recovery is a longer recovery. Year after year has seen growth remain below longer term trend levels globally and in Australia. However, there is a silver lining – spare capacity globally remains significant. This means we are a long way from the sort of inflation and debt excesses that precede cyclical downturns.
- Global monetary conditions look set to remain easy. Continued spare capacity and the lack of inflationary pressure has seen global monetary conditions ease not tighten this year. And the Fed's first interest rate hike is rightly getting pushed out in response to the dampening impact of the strong $US. So a 1994 scenario where aggressive interest rate hikes pushes bond yields sharply higher and threatens shares still looks a long way off.
- Finally, while investor optimism is up it’s a long way from euphoria. In the US investor flows are still going into bond funds, not shares, and measures of investor sentiment are in the middle of their normal ranges. In Australia sentiment towards shares as a wise destination for savings remains low and more investors still prefer bank deposits.

Australians' remain cautious regarding shares



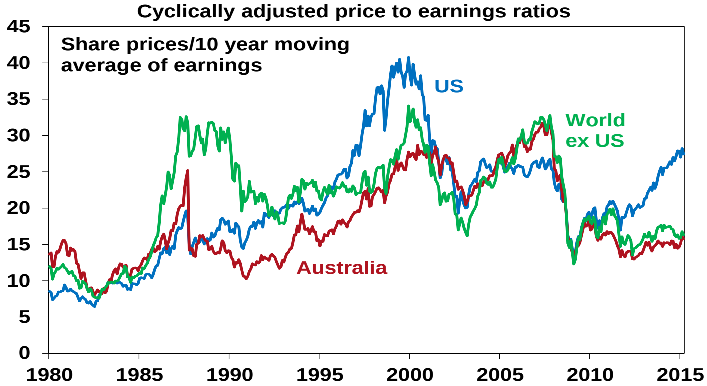
Source: Westpac/Melbourne Institute, AMP Capital

So from a broad brush perspective we are not seeing the signs of exhaustion that come at cyclical peaks and so the cyclical bull market in shares looks like it has further to go.

Global divergences

Finally, for those who like to follow the Shiller or cyclically adjusted PE, while US shares are expensive on this measure most other major share markets are actually cheap because they have lagged the US over the last six years. In other words there are plenty of opportunities for investors outside the US.

Cyclically adjusted price to earnings ratios



Source: Global Financial Data, AMP Capital

Investment implications

First, while corrections should be anticipated – with Greece and the Fed being potential triggers – we appear to be a long way from the peak in the investment cycle.

Second, while the US shares register as expensive on some metrics this is not like 2000 when all markets were expensive.

Finally, while Australian shares should do okay this year better opportunities still lie abroad where the slump in commodity prices is not a drag on growth but rather a positive.

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