CAMBRIDGE ASSOCIATES LLC

2012 OUTLOOK
ASIAN MARKET COMMENTARY

Australia: Hang on for the Ride

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Australia: Hang on for the Ride

Aaron Costello & Pete Mitsos

We are neutral on Australian equities and bonds, but still a bit nervous about the Australian dollar. While Australia faces some homegrown challenges, most of the risks emanate from offshore. We see a balance of potential upside—and downside—risks that argue investors should hope for the best, but prepare for the worst and ultimately hang on for the ride.

The year 2011 was a brutal one that reminded us that forces outside of our control can inflict larger-than-anticipated damage. The year began with floods in Queensland, followed by earthquakes in New Zealand and the devastating earthquake and tsunami in Japan. While such events were predictable to an extent (Australia has always had floods, Japan earthquakes), the ramifications were not.

Financial markets have also been buffeted by outside forces, which were known to be brewing, but underappreciated—specifically, the sovereign debt crisis in Europe, deficit brinkmanship by U.S. politicians, and even political uprisings across the Middle East. To some extent, investors just had to go along for the ride.

We expect 2012 will be much the same; on one side, there is the simmering disaster in Europe and a stumbling U.S. economy, while on the other is the potential disaster of a Chinese hard landing. In this commentary, we will cover the outlook for Australian assets, putting recent performance and valuations into context. Overall, we are neutral on Australian equities and bonds, but still a bit nervous about the Australian dollar. While Australia faces some homegrown challenges, most of the risks emanate from offshore. We see a balance of potential upside—and downside—risks that argue investors should hope for the best, but prepare for the worst and ultimately hang on for the ride.

Performance

For Australian equities, 2011 was another negative year, down 14.9% in price terms, although at one point the MSCI Australia Index had tumbled 23% from its 2011 high, breaking the threshold for a bear market.[1] Thanks to a 5.1% dividend yield, total returns were -11.0% on a net basis,[2] the worst annual return since 1990 (excluding 2008's collapse). This follows 2010's -3.5% performance (0.5% in total return).

While Australia underperformed the MSCI World Index (-5.5% total return) for the second year in a row, Australia fared better than most other markets this year, especially the more cyclical markets in Asia (Exhibit 1).

Looking among sectors, the materials sector's -24.0% performance was the largest detractor to overall returns, while financials actually fared relatively well, down 10.4% in price terms, but only -4.7% in total return (thanks to hefty dividends), especially compared to the -18.4% return for financials in the MSCI World Index. Defensive sectors such as utilities and consumer staples were roughly flat for the year in total return terms, while telecoms surged (31.2%) thanks to the resolution of the national broadband network plan between Telstra and the government (Exhibit 2).

[1] All returns are in local currency unless otherwise noted.

[2] Total returns for Australia-based investors will be higher due to franking credits.

Small/mid caps underperformed in 2011, returning -15.4% compared to -10.4% for the large-cap index. Australian small/mid caps also sharply underperformed global small/mid caps, lagging by 700 basis points (bps) (Exhibit 3).

For unhedged foreign investors, the currency impact in 2011 was also mild, with the Australian dollar essentially flat versus the U.S. dollar, albeit with very high volatility. This follows a 14.0 percentage point boost to U.S.-based investors in 2010, and 39.7 percentage points in 2009.

Fairly Valued, Not Cheap

Given two years of negative performance, valuations for Australian equities have improved. However, we disagree with the general consensus that following this year's sharp decline, Australian equities are exceptionally cheap. On a forward price-earnings (P/E) basis, the market does look cheap, trading at 10.3, or 1.8 standard deviations below its post-1994 average. However, this is based on the premise that earnings per share (EPS) will continue to rise (Exhibit 4). While forward estimates have softened recently, they still pencil in 12.5% growth for 2012, with 20.6% growth for mining and metals stocks, according to Goldman Sachs. It should be noted that in early 2008, the consensus also priced in similar growth and earnings levels, only to see forward EPS heavily marked down.

Predicting next year's earnings is tricky in normal times, and especially difficult today. We prefer to value equities based on estimates of sustainable earnings, thereby eliminating the tendency of analysts to fall into the trap of valuing equities on optimistic peak earnings at the top of the market, or depressed earnings at the bottom.

Exhibit 5 shows inflation-adjusted MSCI Australia EPS back to 1969 and our estimate of normalized full-cycle earnings based on our composite metric.[3] While the mining boom saw earnings rise well above our sustainable estimate over 2004–07, the global recession of 2008–09 saw profits collapse well below our composite, only to again rise back above. At face value, our metric says that current EPS are 17% above normalized levels. At the same time, ROE has risen to roughly 1 standard deviation above average, and appears to be peaking.

Given that profits and economies remain cyclical, and that the current cycle is stretched by historical standards (even accounting for the boom in Australian earnings over the past decade), we do not regard equities as cheap. Our normalized P/E metrics show the Australian market as fairly valued at the end of December, trading at P/E ratios of 14. This is down from 18 to 19 times earnings at the end of 2009, or 0.5 standard deviation above average on our composite normalized P/E. During the global financial crisis, Australian equities fell to 13, or 0.6 standard deviation below average. At the 2007 peak, Australian equities were valued at roughly 30 times composite normalized earnings, helping to explain why the market fell over 50% despite an Australian economy that fared relatively well (Exhibit 6).

The relative valuation of Australian equities versus global markets has also improved. Based on our composite normalized P/E, Australian equities moved from a deep discount at the end of the 1990s to 1 standard deviation overvalued on a relative basis by 2007. Australia remained expensive over 2008–09, as equities did not become as cheap as other markets in early 2009, partly explaining why Australian equities have lagged in recent years. However, underperformance over the past two years has now left Australia equities fairly valued versus global

[3] Our composite normalized EPS represents the average of trend-line EPS, return on equity (ROE)–adjusted EPS, and ten-year average inflation-adjusted EPS.

equities (Exhibit 7). Still, we would note that Australia continues to appear pricey relative to European or emerging markets equities, which have been hit harder this year.

Australian small/mid caps, meanwhile, appear fairly valued in comparison to large caps, with the relative price-to-book ratio at its post-1994 average. While small/mid caps are not as expensive relative to large caps as they were near the peak of the last cycle, they are also far from the discounts seen in 2000 and 2008. Relative to global small/mid caps, Australia also seem to be fairly valued, if not slightly cheap (Exhibit 3).

Macro Risks Abound

On the surface, Australian equities appear fairly valued in both absolute and relative terms, based on cyclically adjusted earnings. Normally, this would imply that markets are properly priced for earnings-cycle risks. However, macro risks in the current environment keep us cautious on equities and most risk assets in the near term.

Headline GDP growth for 2011 is expected to be below average, at 1.9%, impacted by the floods in Queensland earlier in the year. However, growth is expected to increase to 3.5% for 2012, meaning that the consensus believes Australia will be the fastest-growing developed economy. Indeed, planned mining sector investment over 2012–14 is expected to underpin growth for the next few years.

However, this expected growth hides a bifurcated economy where the mining sector is booming but the domestic economy is otherwise weak. The strong Australian dollar has choked the domestic manufacturing sector, and while unemployment remains low by historical standards, it is creeping higher as mining-related hiring is not offsetting retrenchment by other employers in both the private and public sectors. Inflation is currently running at 3.5%, but is expected to ease toward 2.7% in 2012 given soft underlying domestic demand (Exhibit 8).

The need to counterbalance the weak domestic sector is arguably why the Reserve Bank of Australia (RBA) lowered interest rates by 50 bps to 4.25% over November and early December (Exhibit 8). The RBA was the first central bank to hike rates in 2009 and is now being proactive in cutting rates as it judges the external environment to pose risks to overall growth.

Bond yields ended 2011 at 3.8% and have dipped below policy rates, resulting in an inverted yield curve that typically signals a slowdown/recession. Futures markets expect the RBA to cut rates to 3.5% by the end of 2012 in response. While we have no direct insights, we think the RBA will continue to be proactive.

We believe the RBA will be proactive because the biggest domestic risk to Australia remains the housing sector. Australia has not had a full-blown recession in 20 years (1992) and avoided economic contraction in 2008 thanks to aggressive monetary and fiscal stimulus. The same fate that met U.S. consumers and the housing market in 2008 was expected to befall the highly indebted Australian consumer and housing market, but Australia managed to dodge that bullet. Yet today, house prices are again weakening, and when combined with falling employment and incomes, a housing-driven debt deleveraging cannot be ruled out.

Still, betting on a housing collapse seems extreme. Given that most homeowners have floating rate mortgages, rate cuts can pass through to households relatively directly (assuming the banks pass them on). While the government has pledged to balance the budget by 2012–13, this fiscal tightening could easily be

reversed, especially in the run-up to the general election in 2013. The good news is that Australia has the monetary and fiscal firepower to fight a sharp slowdown (unlike other developed markets). Yet expecting policy easing to again lift house prices and drive domestic consumption to the same extent as in previous cycles is unlikely.

Thus, Australia remains vulnerable to external shocks. While Australian banks are much less reliant on short-term offshore funding than in 2008 and have reduced leverage, widening credit spreads indicate that a financial crisis in Europe could result in a short-term credit crunch. Australia does not have much direct economic exposure to Europe and the United States, but it does have substantial indirect exposure via trade links to China and Asia.

Indeed, the biggest macro risk is a hard landing in China. Chinese growth is only expected to moderate from 9.1% in 2011 to 8.5% in 2012. However, a much sharper slowdown in the Chinese economy cannot be ruled out, especially in the near term as monetary policy remains tight. Despite a recent policy rate cut, domestic Chinese equities have not rallied as expected, but broken to new lows for this cycle, a worrying signal. While a collapse in China can be avoided amid aggressive policy easing, growth may need to slow sharply first, with knock-on effects for global commodity prices and the Australian economy.

Outlook: Deflation, Then Inflation?

The upshot of this discussion is that if European, U.S., and Chinese growth falter, another growth/deflation scare is likely in store for 2012, which is negative for all risk assets. However, such a scare may prompt coordinated global monetary easing (much like in 2008–09), which will not resolve underlying economic imbalances, but will certainly have an impact on asset markets. And should excessively loose/reflationary monetary policy spur stabilization or even acceleration in growth, an inflation scare may be in store heading into 2013. This is important for Australian assets in several respects.

In the near term, a slowing domestic economy, coupled with external macro uncertainty, will likely keep Australian government bond yields low. At roughly 4% yields, government bonds are overvalued relative to fair value yields of 5% to 6%, but not excessively so. Still, yields have reached levels only briefly touched in early 2009, and are arguably at post–World War II lows. While upside for government bonds is limited, yields could "converge" with developed markets yields at 2% amid a China hard landing scenario.

Perhaps the asset most at risk in the current environment is the Australian dollar. While the Australian dollar rose to 1.10 against the U.S. dollar in 2011 as the RBA tightened rates, the currency has come off the boil and fallen back to parity with the U.S. dollar, although it remains at a level that is still elevated relative to history. The currency is still generally considered overvalued, from 15% overvalued to as much as 40% on some metrics. Although many investors focus on Australia's mining exports, the trade surplus remains cyclical and the country has historically run a current account deficit. At the same time, the Australian dollar has become highly correlated to both equities and commodity prices, and is exhibiting equity-like volatility (roughly 15% annualized).

A global recession that sees another downleg in global risk assets and the RBA aggressively slashing rates to 2008 levels of 3% (or below) could see the Australian dollar fall sharply (Exhibit 9). However, another surge in the Australian dollar cannot be ruled out if such a

growth scare prompts global central banks to launch coordinated quantitative easing, especially if Australian rates offer a yield advantage.

Equities remain vulnerable to further declines in the near term, especially given that valuations are not yet cheap today. However, on a relative basis, Australian equities have tended to outperform global equities amid bear markets (including the 2008–09 bear market and that of 2000–03), although weakness in the Australian dollar generally results in underperformance for unhedged global investors (and outperformance on global equities for Australian dollar investors).

Arguably of greater importance is whether an inflation scare is really in the making. Exhibit 7 shows that Australian equities surged to command premium valuations during the inflation scares of the early 1970s and early 1980s. A similar rise could occur in the coming years. However, these premium valuations ultimately collapsed (meaning such increases are inherently unsustainable). Australian equities spent the 1990s and early 2000s trading at steep discounts to global equities as commodity prices went into secular decline.

Australia is at an important turning point—if the commodity bull market is peaking, perhaps Australian equities are as well from a secular perspective. Today's mining investment boom may lead to tomorrow's glut, as Chinese demand for commodities begins to peak over the coming five years or so (due to structural decline in growth, given demographics and urbanization), which will set the stage for a decline in commodity prices. However, if inflation and a bubble in Asia are in store (amid too-loose monetary policy), Australia may have a few good years left and at some point may become very expensive again on a relative basis. Global and Australian investors should take advantage of any upside overshoot in the Australian dollar and Australian equities over the coming years to diversify into cheaper assets overseas.

Conclusion

Overall, we are neutral on Australia. Domestic economic risks posed by the indebted household sector are balanced at this point given that enough monetary and fiscal firepower remains to provide additional stimulus (unlike in most other developed economies). External risks will matter more in 2012, especially for a stock market and economy geared to global/Asian commodity demand (Exhibit 10).

Australian equities are fairly valued both in absolute terms and relative to global markets, which suggests a neutral exposure is appropriate, especially since Australian equities tend to outperform global equities (after adjusting for the currency impact) during bear markets. Still, Australian equities are not cheap on our metrics, and we see plenty of downside risk, especially if there is a hard landing in China. At this stage, we are also neutral to slightly negative on Australian small/mid caps given average valuations relative to large caps and the fact that small/mid caps, which tend to underperform in down markets, have only just begun to lag. However, we still advocate active management for Australian equities given the concentration of the market, which leaves ample scope for managers to add alpha.

We are also neutral on Australian government bonds, as yields are only modestly overvalued at 3.8%. Given slowing inflation pressures and heighted uncertainty, a sharp rise in yields seems unlikely, and should global or domestic conditions worsen, yields certainly have scope to fall.

In fact, the only Australian asset we are negative/ cautious about is the Australian dollar. The

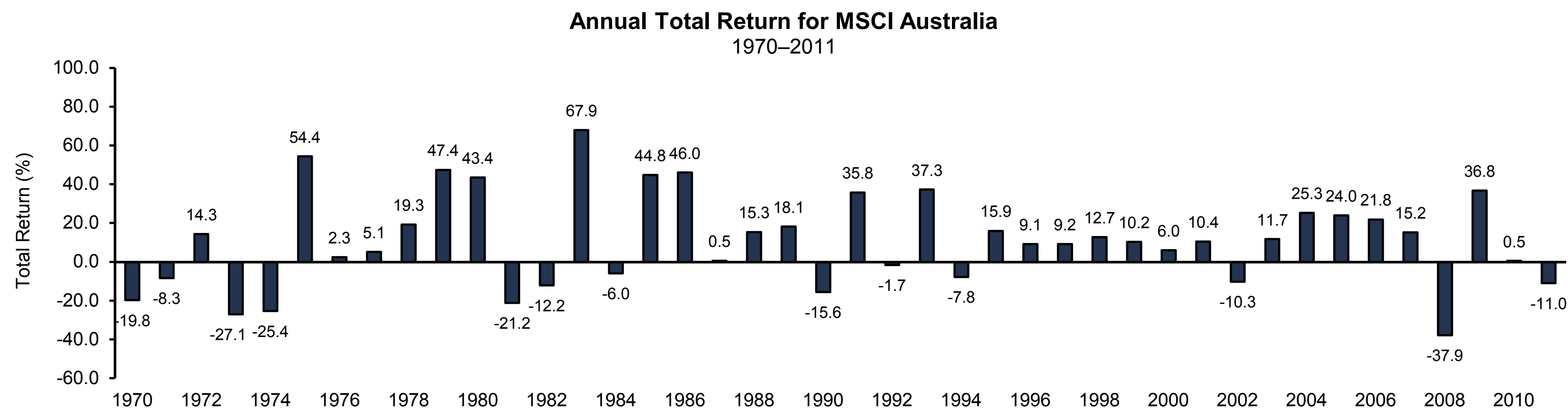
currency appears overvalued, and could fall sharply amid an intensified global growth scare during which the RBA could, if need be, aggressively slash rates to support the domestic economy. Currency volatility poses a sizeable threat for non-Australia-based investors in Australian assets, as hedging remains expensive.

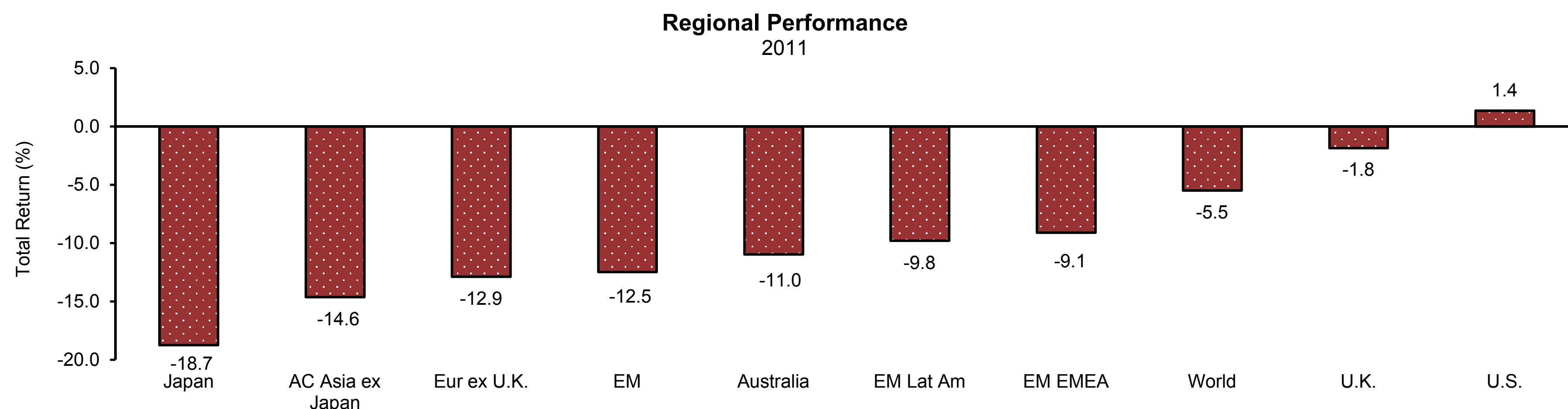
We could be wrong in our global macro assessment, and next year could see global growth stabilize or accelerate and inflation concerns rise, resulting in a sharp rally in Australian equities, the Australian dollar, and perhaps government bond yields. However, for now, we would rather hope for the best, prepare for the worst, and hang on for the ride. ■

Exhibit 1

MSCI Australia Performance

Local Currency





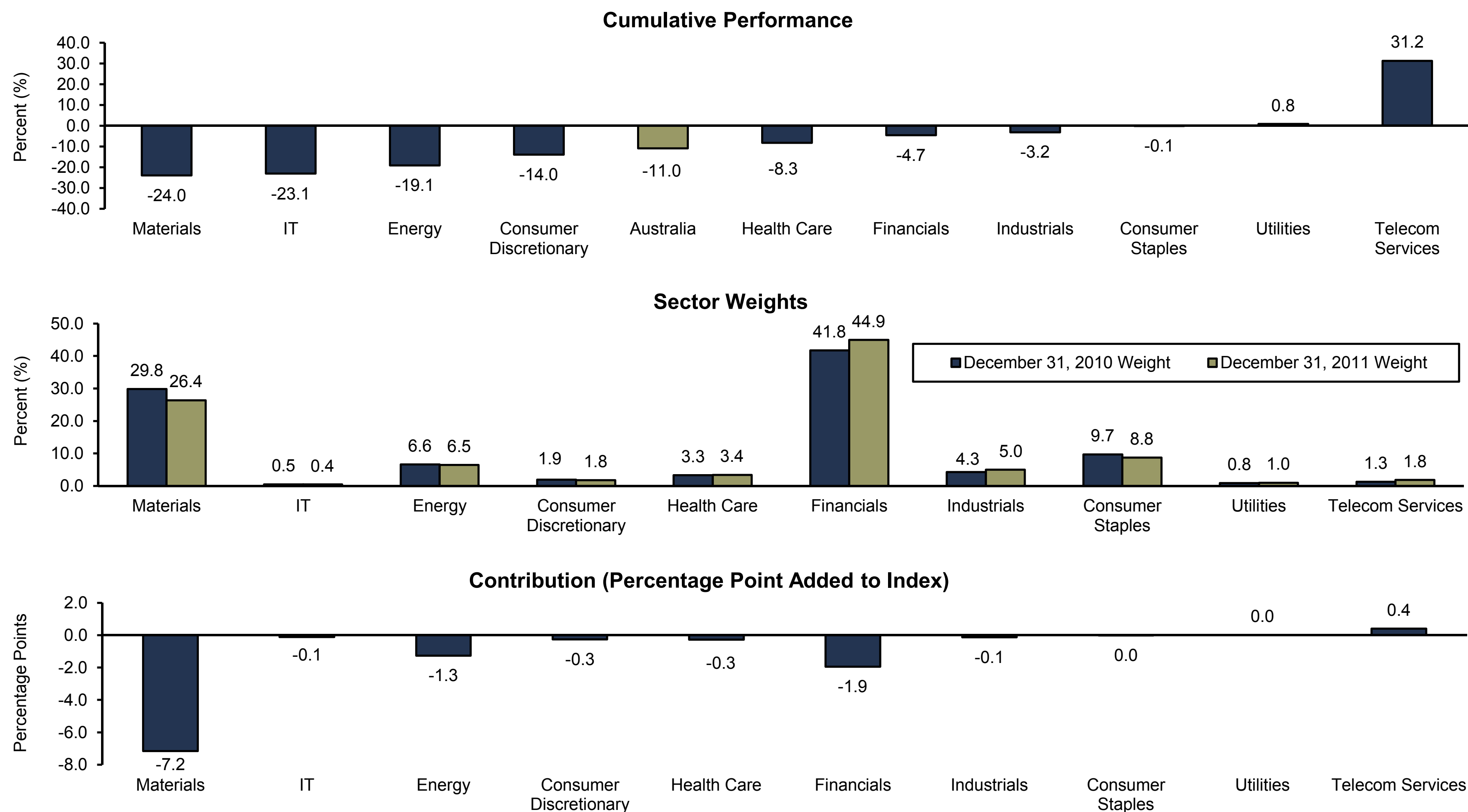
Sources: MSCI Inc. and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.

Notes: Total returns for MSCI developed markets indices are net of dividend taxes. Total returns for MSCI Emerging Markets and All Country indices are gross of dividend taxes. Data for 2011 are through December 31.

Exhibit 2

Sector Performance Attribution for MSCI Australia

January 1, 2011 – December 31, 2011 • Australian Dollar

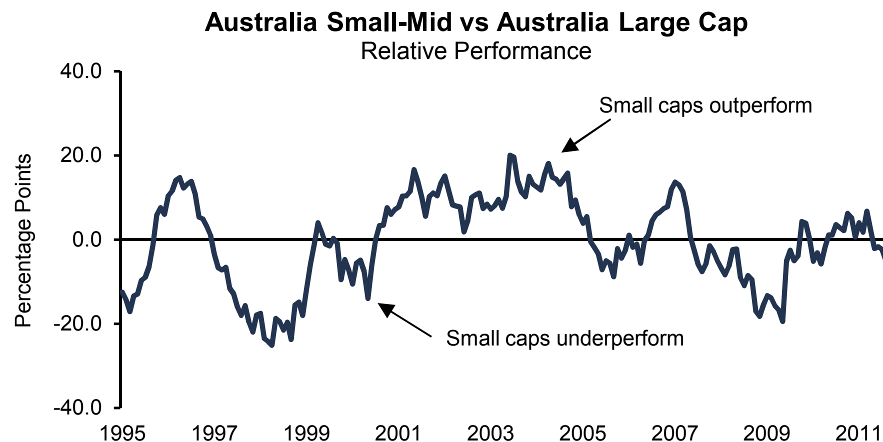


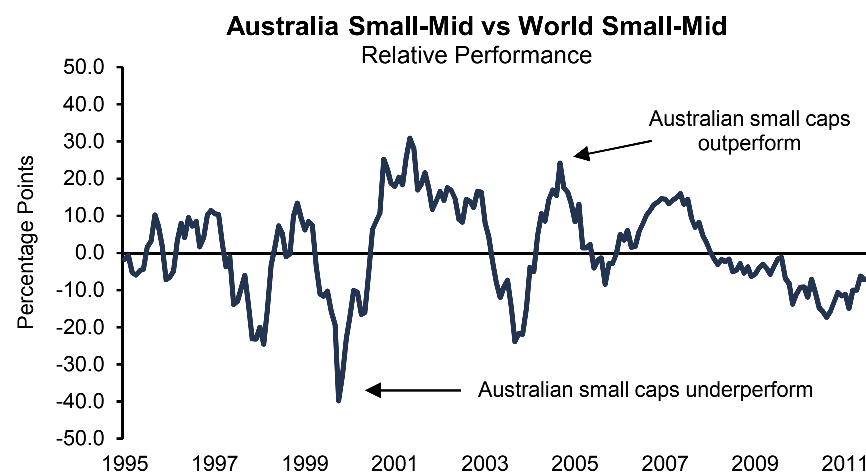
Sources: MSCI Inc. and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.
Notes: Contribution represents the sector's percentage point addition to the MSCI Australia Index return of -11.0%. Sector contributions are calculated by multiplying the sector's December 31, 2010, weight by its cumulative local currency return from January 1, 2011, to December 31, 2011. Percentages may not total due to rounding. Performance is measured by net total returns in Australian dollars.

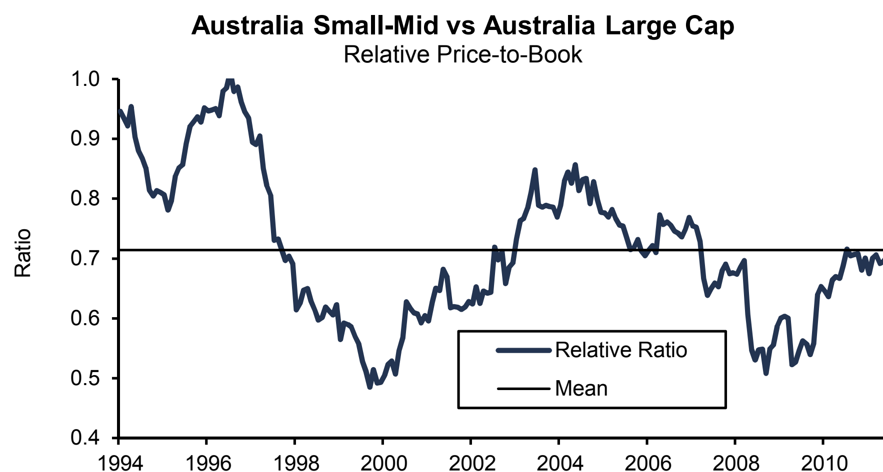
Exhibit 3

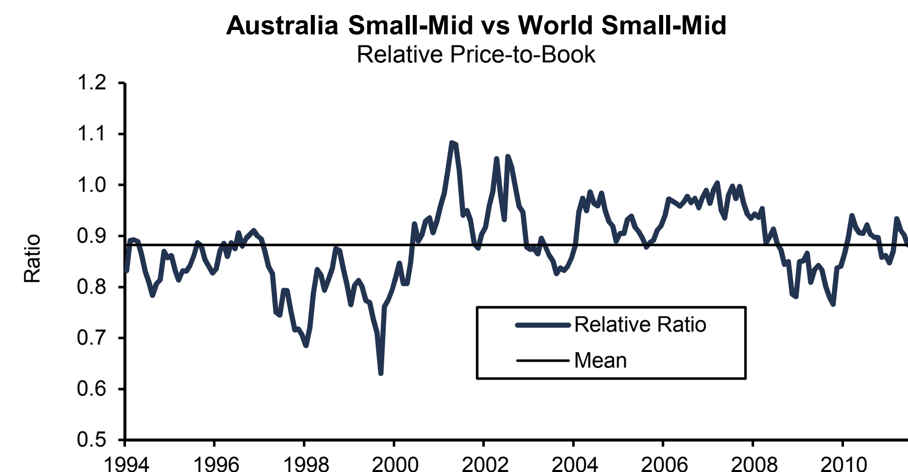
MSCI Australia Small Caps: Rolling 12-Month Relative Performance and Valuation

June 30, 1994 – December 31, 2011 • Local Currency







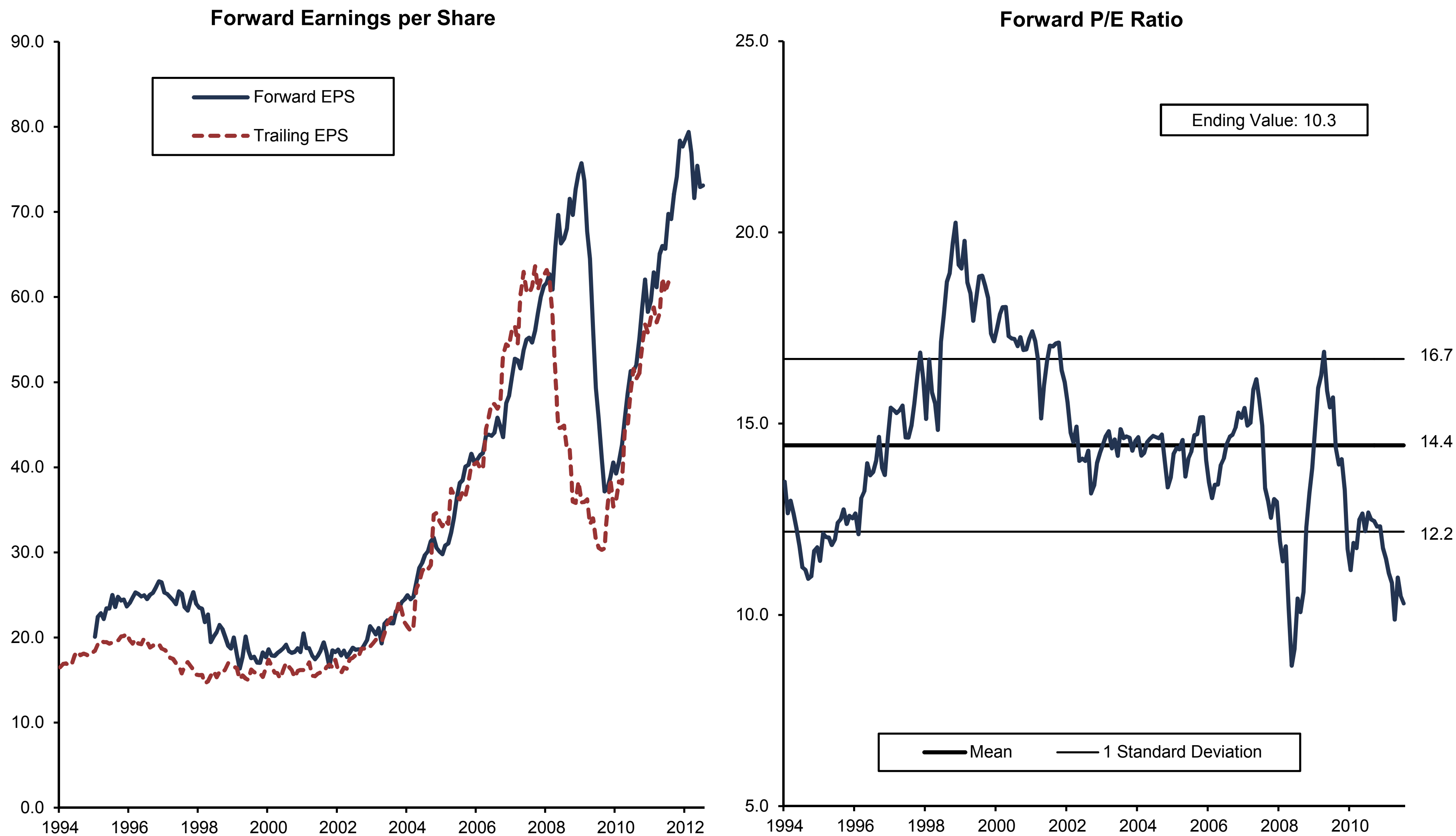


Sources: MSCI Inc. and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.
Note: Relative performance graphs show the percentage point difference between the rolling 12-month total return of each index in local currency terms and begin May 31, 1995.

Exhibit 4

MSCI Australia Forward Earnings Estimates and Price-Earnings Ratios

June 30, 1994 – December 31, 2011

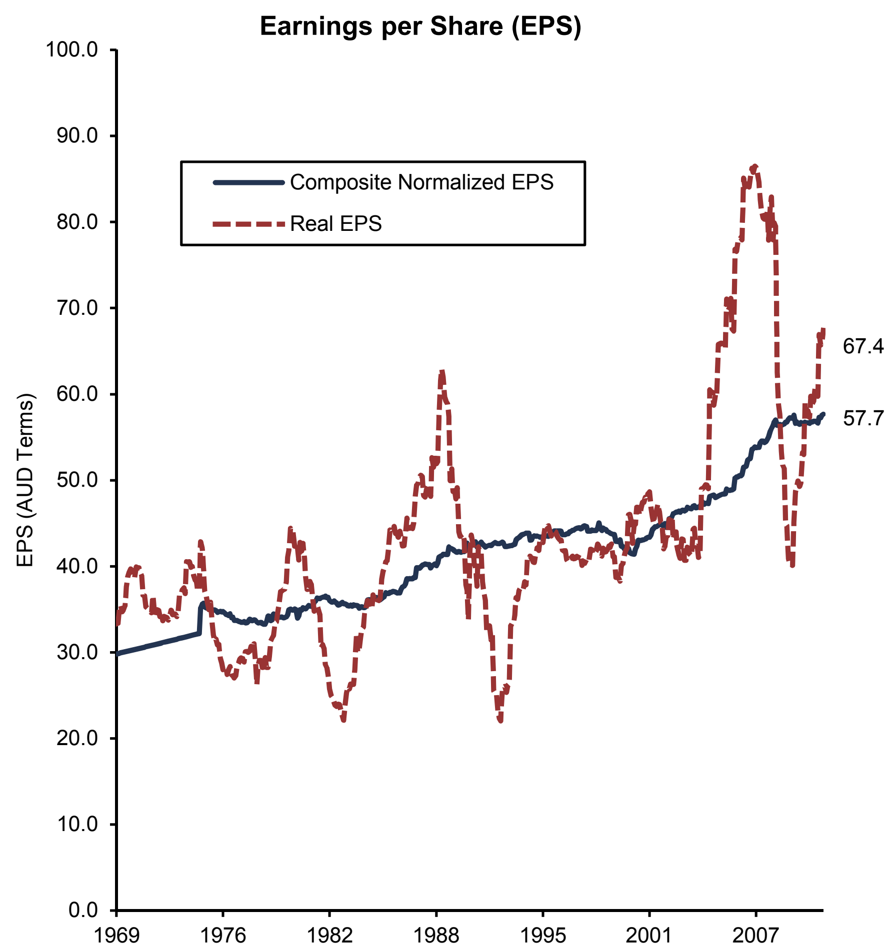


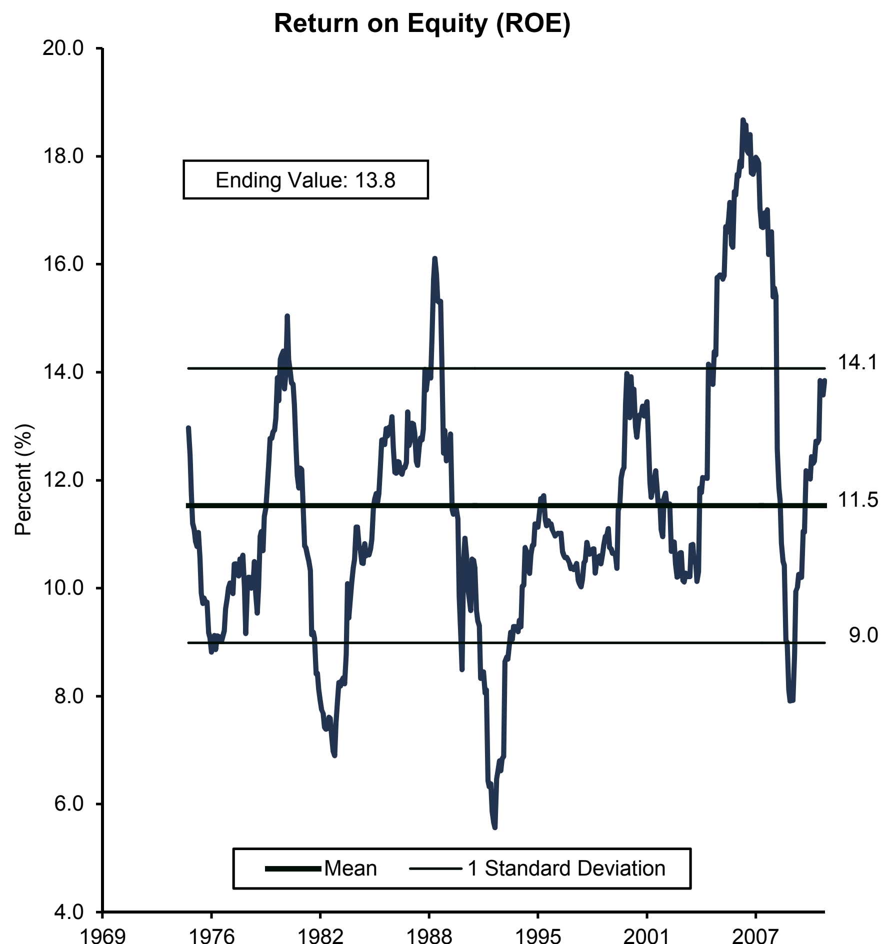
Sources: FactSet Research Systems and MSCI Inc. MSCI data provided "as is" without any express or implied warranties.
Note: Forward earnings per share are graphed leading by 12 months.

Exhibit 5

MSCI Australia Fundamentals

December 31, 1969 – December 31, 2011



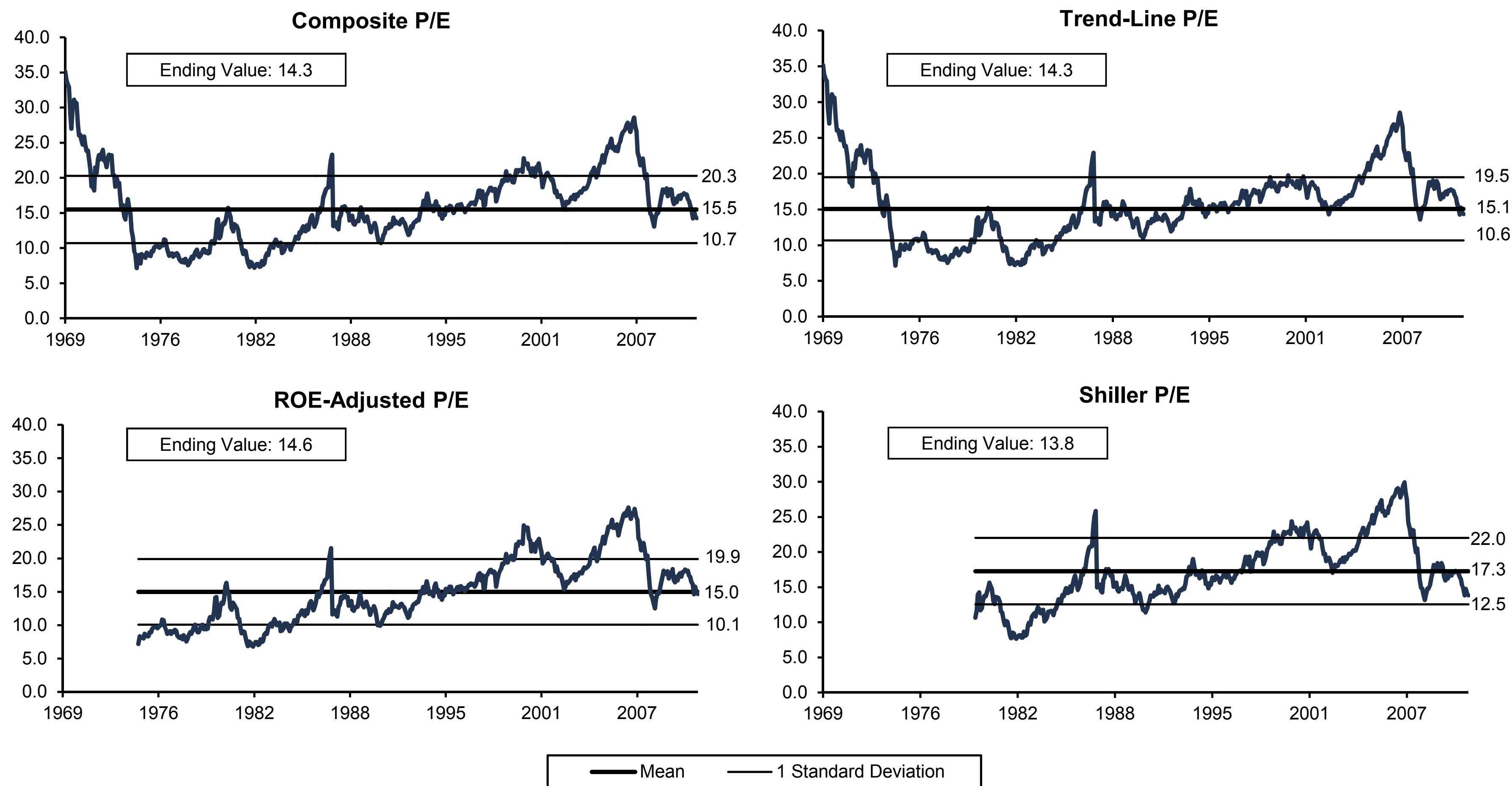


Sources: MSCI Inc. and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.
Notes: The composite normalized earnings per share (EPS) is the simple average of three normalized earnings metrics: ten-year average real earnings (i.e., Shiller earnings), trend-line earnings, and return on equity (ROE)–adjusted earnings.The ROE-adjusted price-earnings (P/E) ratio is the current trailing P/E ratio multiplied by the ratio of the current level of ROE to its historical norm. Shiller P/E is calculated by dividing the current price level by the ten-year average of inflation-adjusted EPS. Trend-line P/E ratios compare current stock prices to the level of earnings predicted by long-term real earnings growth based on a simple linear regression. ROE data begin in December 1974.

Exhibit 6

MSCI Australia Price-Earnings Valuations

December 31, 1969 – December 31, 2011



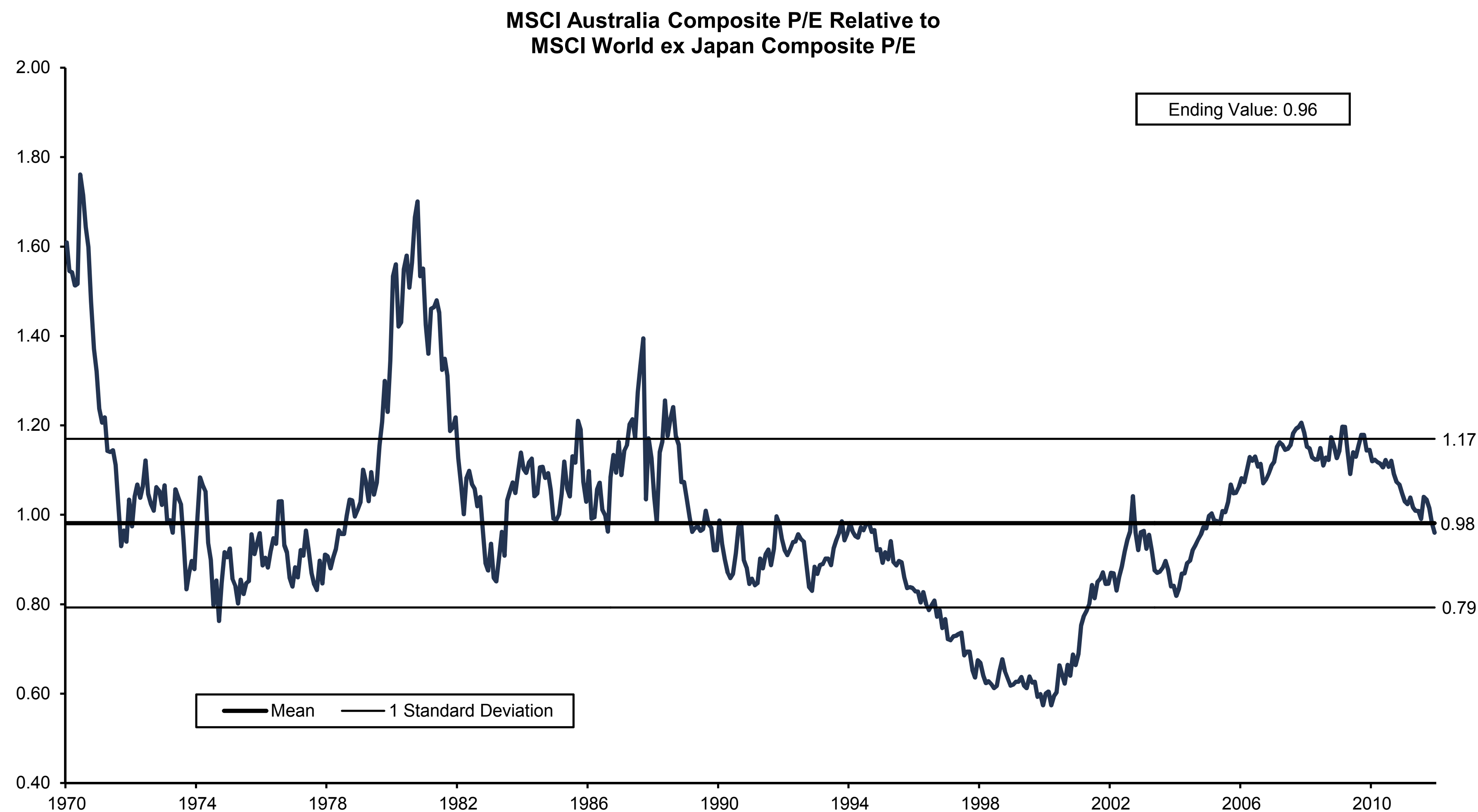
Sources: MSCI Inc. and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.

Notes: The composite normalized price-earnings (P/E) ratio is calculated by dividing the inflation-adjusted index price by the simple average of three normalized earnings metrics: ten-year average real earnings (i.e., Shiller earnings), trend-line earnings, and return on equity (ROE)–adjusted earnings.The ROE-adjusted P/E ratio is the current trailing P/E ratio multiplied by the ratio of the current level of ROE to its historical norm; data begin December 1974. Shiller P/E is calculated by dividing the current price level by the ten-year average of inflation-adjusted EPS; data begin November 1979. Trend-line P/E ratios compare current stock prices to the level of earnings predicted by long-term real earnings growth based on a simple linear regression. Mean and standard deviation calculations begin January 1972.

Exhibit 7

Composite Normalized Price-Earnings Ratios: MSCI Australia Versus MSCI World ex Japan

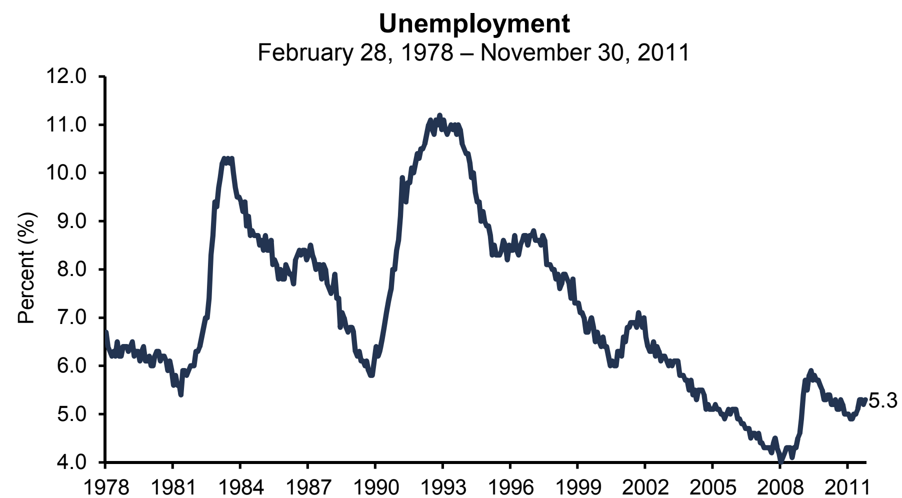
January 31, 1970 – December 31, 2011

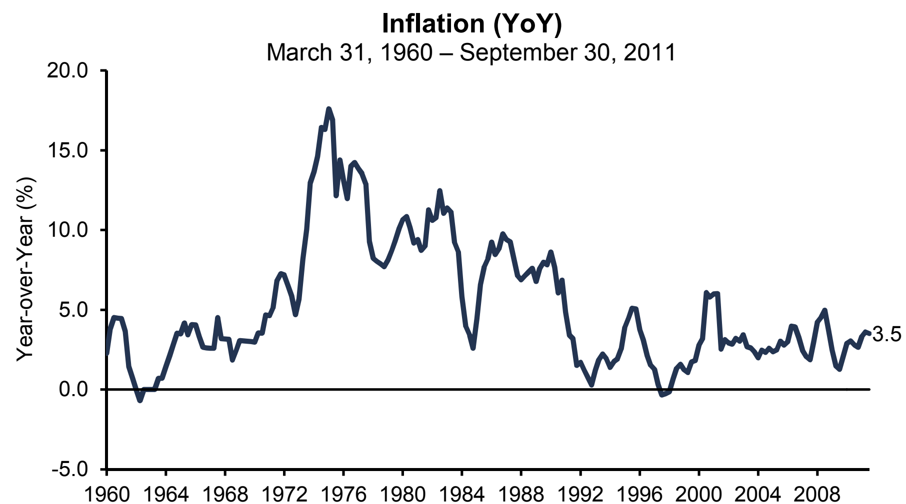


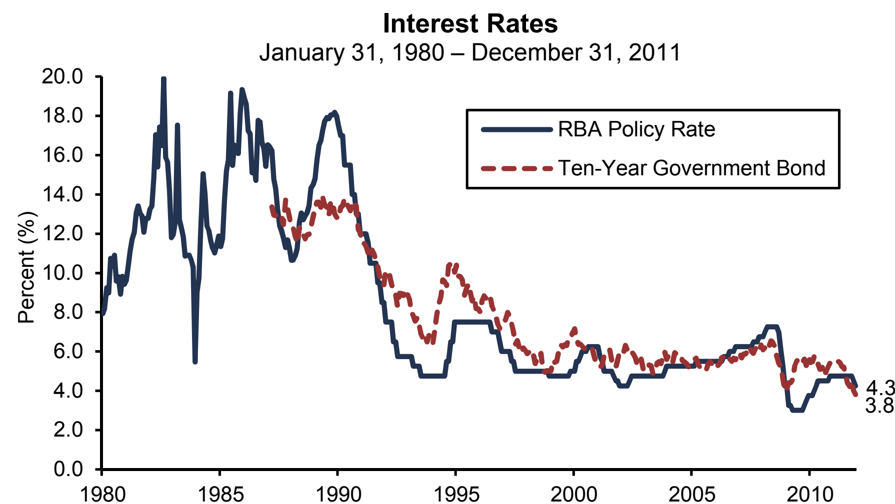
Sources: MSCI Inc. and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.
Notes: The composite normalized price-earnings ratio is calculated by dividing the inflation-adjusted index price by the simple average of three normalized earnings metrics: ten-year average real earnings (i.e., Shiller earnings), trend-line earnings, and return on equity—adjusted earnings. All data are monthly. Mean and standard deviation calculations begin January 1972.

Exhibit 8

Australian Economic Indicators





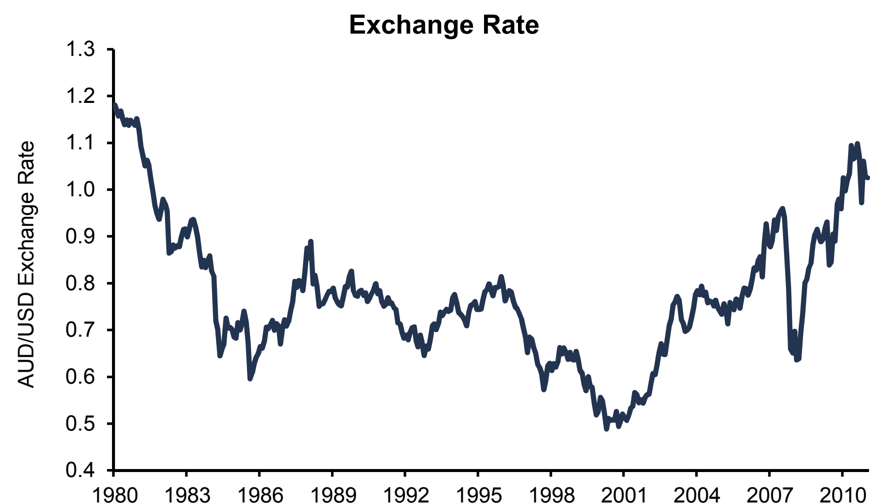


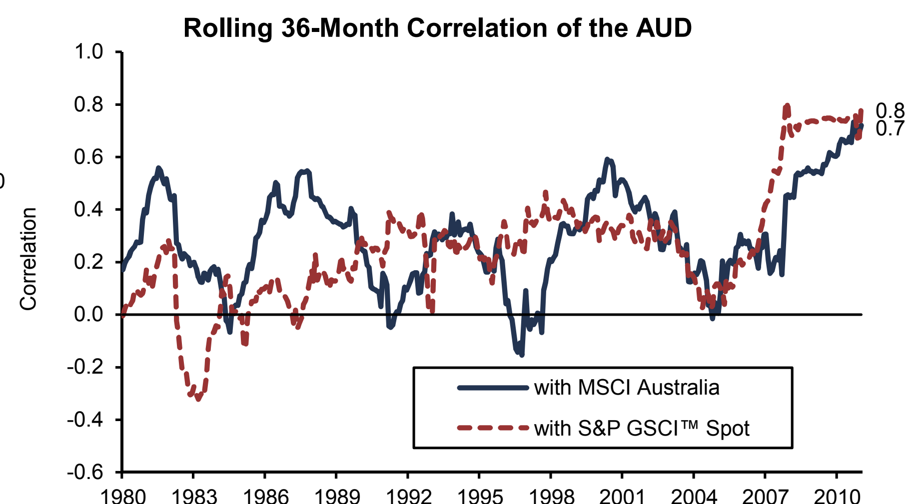
Source: Thomson Datastream.
Notes: Unemployment and interest rate data are monthly. GDP and inflation data are quarterly.

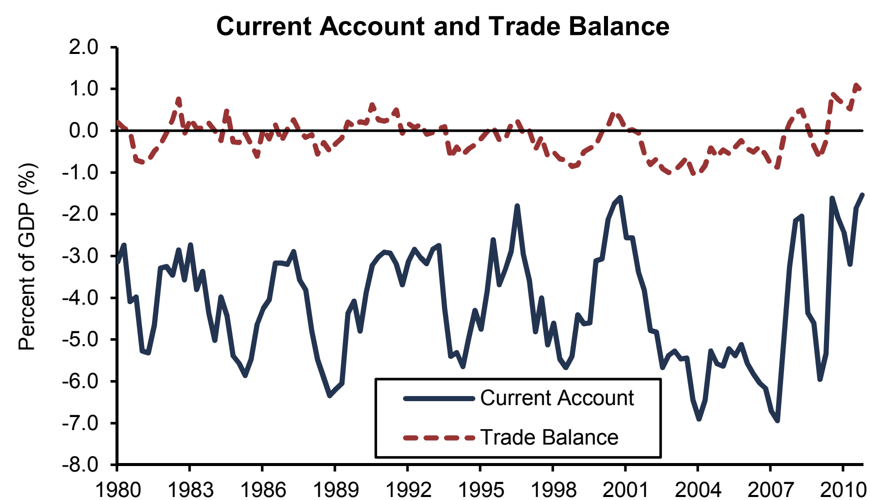
Exhibit 9

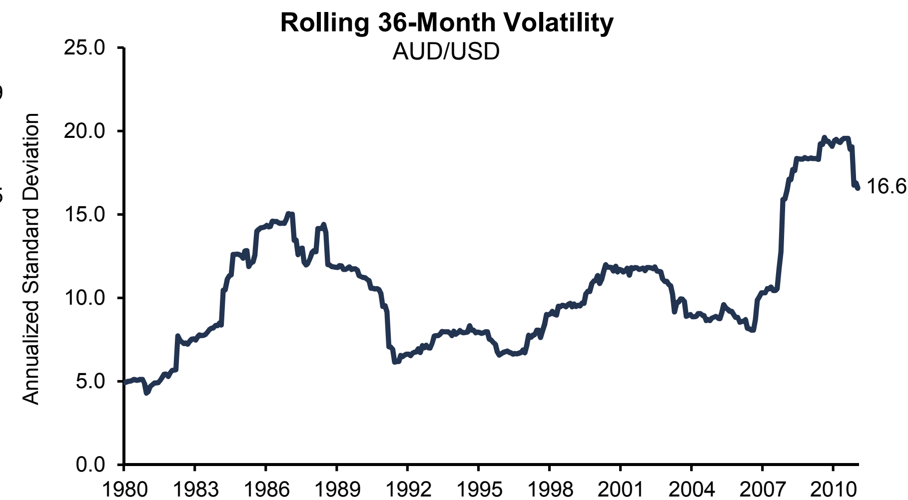
The Australian Dollar

December 31, 1980 – December 31, 2011







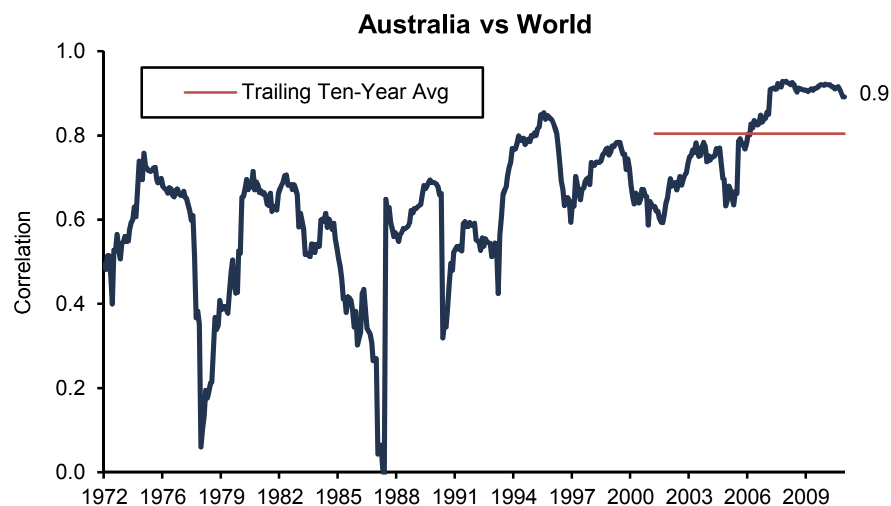


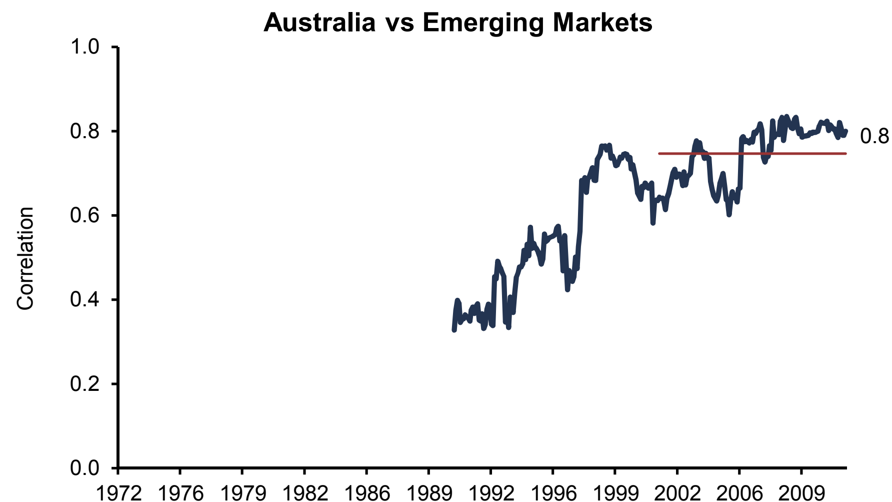
Sources: OECD, MSCI Inc., and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.
Note: All data are monthly except current account and trade balance, which are quarterly and through third quarter 2011.

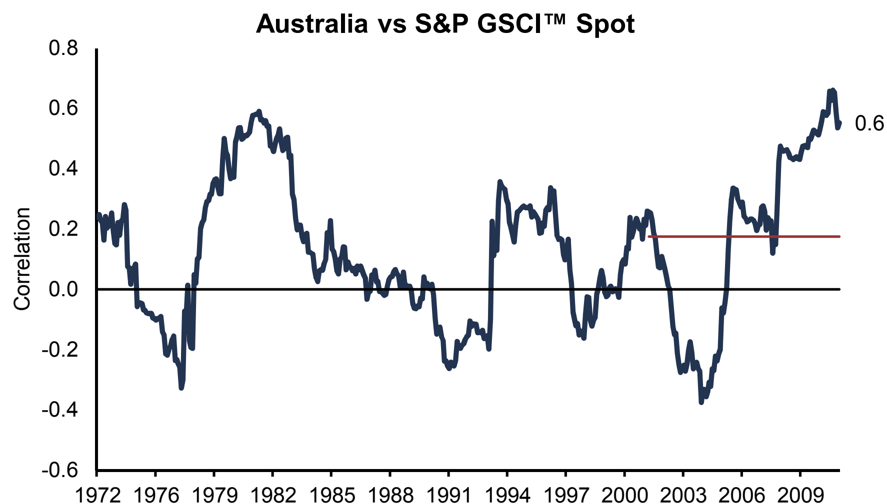
Exhibit 10

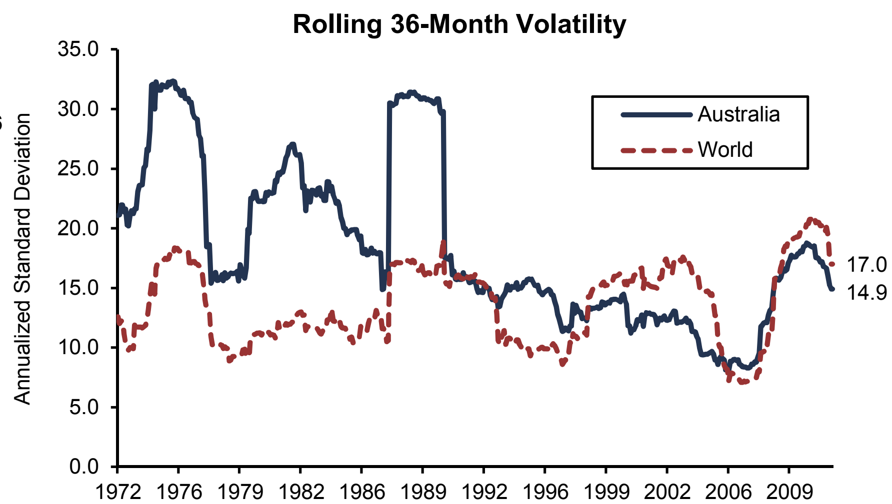
MSCI Australia Rolling 36-Month Correlations and Volatility

December 31, 1972 – November 30, 2011









Sources: MSCI Inc. and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.
Note: Data are based on monthly price returns in local currency for each region.