Investment Spotlight

ANZ Wealth Chief Investment Office

November 2017

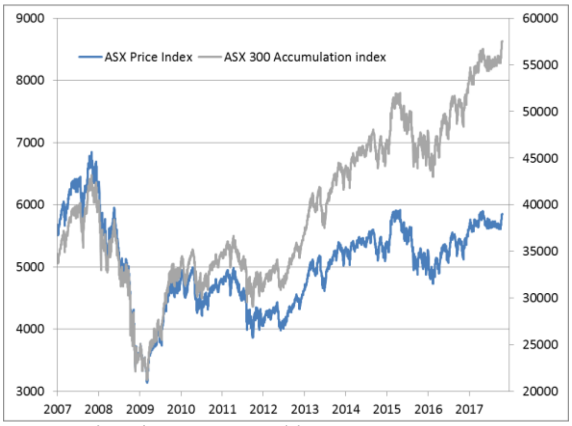
The ASX's lost decade: is an end in sight?

On November 1 it is 10 years since the peak in the Australian share market. With the S&P/ASX 300 price index 14% below its record high, this equals the longest period in the past century for the share price to fail to revisit its previous peak. Is this about to change? Read on for more.

10 years since the peak in the ASX

On November 1 it is 10 years since the peak in the Australian share market. Currently the S&P/ASX 300 price index remains 14% below its record high, equalling the longest period in the past century for the Australian share price index to remain below its previous peak. Even following the Great Depression (5.5 years) and the 1987 stock market crash (6 years), the market revisited its peak at least sometime within the subsequent decade. The longest period was 14 years in the late 19th century following a great property boom and bust. While the total return index (i.e. including dividends) stands 33% above the 2007 peak, the annualised nominal return of only 3% p.a. is one of weakest decade rolling periods that we have experienced. This is an unusual period.

Table 1: ASX – price & total return indices



Source: Bloomberg, ANZ Wealth

What's gone wrong?

The key driver of this disappointing trend has been earnings. While the United States S&P 500 index has soared to be 65% above its 2007 high, supported by a 30% rise in earnings per share (EPS), the ASX's EPS is still 19% below the 2007 peak. The major driver of this weakness has been Resource sector earnings, which is 40% below the level of 10 years ago, reflecting the collapse in commodity prices – for example iron ore has suffered a 67% fall in the past decade, closely followed by coking coal of 43%. Earnings for the market excluding Resources is also below its 2007 peak, but only by 14%.

Chart 2: The share market & earnings

Source: Thomson Reuters Datastream, ANZ Wealth

Trend earnings have slowed markedly

The Australian share market has experienced three distinct phases over the past two decades. If we focus on the 10 years preceding the China commodity boom and the GFC period (1993 to 2003), trend earnings growth was 6% p.a. (Chart 3). In the China commodity price boom phase, earnings exploded upwards, more than doubling in four years. Subsequent to this earnings fell with the onset of the GFC and the resulting lower commodity prices, capital raisings and weaker economic activity. If we had remained on the 1993-2003 trend, earnings would have risen sufficiently to put the market beyond the 2007 peak (Chart 3), but this hasn't happened.

What is the real trend in earnings?

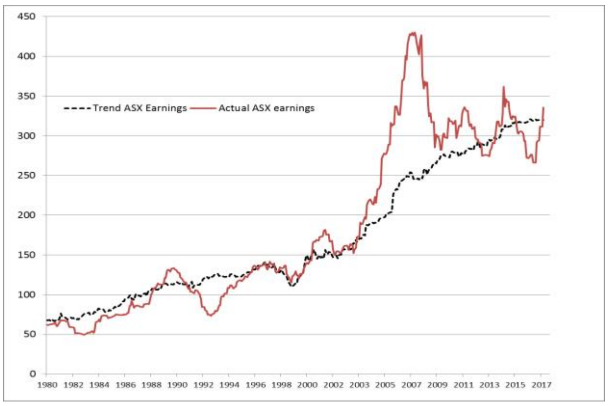
The global economy and markets have changed significantly in the wake of the GFC, so the trends that were evident - an emerging commodity

Chart 3: The ASX and trend earnings

Source: Thomson Reuters Datastream, ANZ Wealth

ravenous economic giant (China), debt fuelled growth in the developed economies and lax financial regulation – are no longer the case. To work out what is the real underlying earnings power of the market in this environment, its best to focus on balance sheet variables. In particular, we look at the book value of equity (BVoE) and the return on equity (ROE) to calculate potential earnings for the Australian share market.

Chart 4: Trend & actual EPS

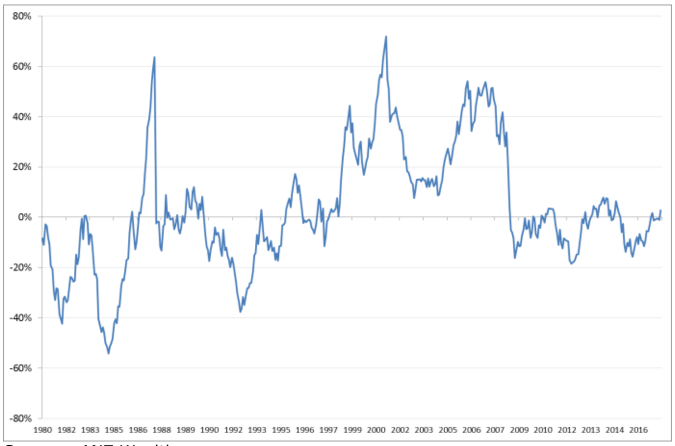


Source: Thomson Reuters Datastream, ANZ Wealth

Chart 4 shows the outcome of this calculation. Two trends are evident. Firstly, after a surge in growth during the 2000's, the pace of growth has slowed – in the past three years our measure of trend earnings growth is only 1%, versus 10% in 2003 to 2007 and 3% in 1993 to 2003. This slowdown reflects weaker growth in the BVoE, in part due to the high payout ratios that Australian companies are paying – their preference is to payout profits rather than retain to invest for future growth. The second trend that is evident (see Chart 6) is that the ROE has collapsed back from the 2007 peak.

If we use this estimate of trend earnings, along with an average PE ratio for the period, we estimate that the Australian share market is currently around fair value (Chart 5). It's notable that in previous market peaks -1987, 2001 and 2007 – the market typically has been at least 50% overvalued. It is not the case this time. In terms of underlying earnings power, we estimate trend EPS is now 26% higher than in 2007.

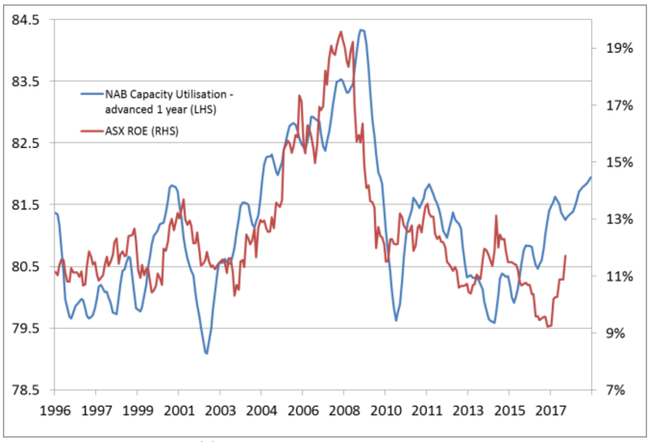
Chart 5: ASX: Deviation from fair value



Sources: ANZ Wealth

The market currently lies only 14% below the November 2007 peak of 6,845. With this well below previous periods of market overvaluation, it suggests the market is within striking distance of the 2007 peak.

Chart 6: ASX EPS & the economy



Sources: NAB, ANZ Wealth

The way it can get there is by two avenues – earnings move above trend and the PE ratio rising. Stronger earnings look a good prospect. A stronger economy generates better earnings growth, and Chart 6 shows that with the capacity utilisation of the economy rising solidly in recent years, a rise in ROE, and therefore EPS, is not an unreasonable expectation. With market consensus at around 5% for the year ahead, further upside on the market looks possible.

Mark Rider, Chief Investment Officer

Mark is responsible for delivering an overarching investment strategy, including asset allocation, investment themes, investment manager and product selection and monitoring for ANZ Wealth in Australia. Before joining ANZ in 2013, Mark spent 15 years at UBS and 10 years at the Reserve Bank of Australia, making him a well-recognised and respected member of the Australian investment community.