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Rising Temperatures

Rising interest rates, a surging oil price and a housing downturn has put heavy pressure on the economy. Despite this gloom and doom, the market is booming.

Story James Dunn Illustration Christopher Nielsen

There is no question that the Australian share market has been a lucrative place to be invested for the past three-and-a-half years. Since the invasion of Iraq in March 2003 kicked off a prolonged rally, the Australian market has more than doubled: the All Ordinaries Accumulation Index – which incorporates dividends as well as price gains – has returned 112 per cent. Given that, according to research house Andex Charts, the market has returned an average of 13.1 per cent a year – assuming dividends reinvested – since 1950, the market has effectively been running at more than double its average long-term performance track record. What has powered the market over that time has been a fortuitous combination of surging commodity prices, driven by the voracious Chinese – and to a lesser extent, Indian– demand for raw materials, and the resultant strong earnings growth of Australian miners. With many commodity prices rocketing to more than two standard deviations beyond their long-term averages, Australian miners have been busy making hay in the sunshine.

Strike It Rich

The extent of this profit bonanza is starkly illustrated by two companies' reports for the year ended June 30. BHP Billiton lifted its profit by more than $5bn to $13.7bn – the first time the reported profit figure of an Australian company has run into 11 figures. Less impressive in absolute terms – but even better in comparative terms – was zinc miner Zinifex, which racked up a four-fold increase in net profit to $1.1bn, on the back of a 60 per cent surge in revenue to just over $3bn. That followed a four-fold profit increase last year: Zinifex's maiden profit in 2003- 04 was $54m, showing just what a hugely profitable time it has been for miners. Australian resources companies lifted their earnings by more than 60 per cent on average in 2005-06, following a 79 per cent profit surge in the 2005 financial year and a 43 per cent rise the year before.

Nothing Lasts Forever

Although the resources stocks make up only about one-quarter of the market by capitalisation, they have made a much larger contribution to the market's total profits. The profit growth of the resources stocks helped the market – the ASX 300 stocks – to an average profit rise of 20 per cent for the financial year, following 28.5 per cent in 2004- 05 and 17.4 per cent the year before. But there are signs that the party may soon be over, with the market's reliance on resources companies for profit growth exposing it to a slowdown. Andrew Quinn, managing director of boutique investment research house Wren Research, which collates brokers' earnings forecasts, says it could hardly get better for investors than the past three financial years. Profit growth over that period for the Australian market has averaged 19.1 per cent compound, he says, compared to the average earnings growth of 9.3 per cent a year since 1975." "Clearly, over the past three years, the profit performance has been running well above the long-term average, driven by strong resources earnings. That can't go on forever, and it won't. On our numbers, the market is looking at average profit growth in the 2006-07 financial year of 7.9 per cent, which will be a seven-year low," he says.

Slow But Steady

Hans Kunnen, head of investment research at Colonial First State, says things "aren'tgoing to be as spectacular" on the sharemarket in the near term as they have been since 2003 – but that investors "would have to be greedy" to expect the conditions of the past couple of years to continue. "We've had good earnings growth on the back of strong economic growth, says Kunnen. The Australian economy has enjoyed 15 consecutive years of expansion, with an average growth rate of 3.7 per cent. The global economy has averaged 3.8 per cent growth over 30 years. That's a good base for companies to make money. In the US, earnings growth has run at double-digit pace for 17 quarters in a row; in Australia, it has been closer to 18 per cent." This rate of earnings growth will slow as global economic growth eases, says Kunnen. "The global economy is not stopping, but it will probably grow a bit slower than it has in the past two years. This means that earnings will probably grow a bit slower than they have in the past two years – but let's face it, that period has seen outstanding pace," says Kunnen. "Sharemarket returns will slow as earnings slow, but investors have to remember that the markets have done very well in the face of what have actually been severe headwinds. You've had rising interest rates globally, a surging oil price and in the US, a housing downturn that is putting fairly heavy pressure on the economy. Given all that, you'd have to say that the markets have done very well."

A Bumpy Road

However, the strength of corporate profits – and the resultant sharemarket returns – does not mean that investors have had it all their way since 2003. It has been far from one-way traffic: the Australian market has endured several mini-slumps in that time, most recently a 9.8 per cent fall – almost qualifying for the 10 per cent threshold regarded as an official correction – in May-June 2006. Before that, the market fell by 6.7 per cent in October 2005 and by 7.5 per cent over March–May 2005. Although there was no official correction, it certainly felt like it at the time. But, investors being only human, it was hard to remember last year's twin slumps when the end-of-year gain stood at 18 per cent. The regular speed-bumps encountered by the market arose from the flipside of the commodity boom and global economic growth. When economies are growing, inflation becomes a factor, and it has definitely returned to the fore in 2006. Since June 2004, the Fed has lifted US interest rates 17 times – by 0.25 per cent at a time – to reach 5.25 per cent at the time of writing, to curb inflation. The rising interest-rate environment in the US has been reflected around the world. Since December 2001, eight rises of 0.25 per cent have taken the official Australian rate to 6.25 per cent at time of writing, with the most recent alteration coming in November 2006. The Australian rate has shown far greater stability: over that period, it stayed on 4.75 per cent for 17 months, on 5.25 per cent for 16 months and on 5.50 per cent for 14 months. As a rule, stock markets don't like rising interest rates. When interest rates rise, there are two major effects on the stock market: first, money moves from shares to bonds, which become more attractive compared to shares, and secondly, borrowing costs for companies go up, effectively lowering profits. Stock markets also don't generally like a rising oil price, because of its unavoidable impact on companies' operating costs – whether as energy or feedstock – and thus, profits. By right, oil's surge from $US18 ($A24) a barrel in November 2001 to almost $US80 ($A107) a barrel in July 2006 should have practically derailed the world economy. After all, proportionally tamer rises in the 1970s, 1980s and 1999-2000 led to recessions or sharp growth slowdowns in the developed countries. Certainly, as each round number milestone – $40, $50, $60, $70 – passed on the great oil surge of the 2000s, economists talked of the threat to world economies. Instead, the global economy has handled the oil rise much better than expected: Kunnen says it could do this because the rise was demand-based, not the kind of supply shock that caused previous spikes. "There's plenty of oil, so the price couldn't hold at $80, because demand was wound back. It's the same thing we saw in most of the other commodities: there was a heavy speculative element that had leveraged the price upward, and when those bets were cut, the price came off rapidly. Since oil was at $US80, and the market was saying 'get ready for $US100', it has slipped almost one-quarter in price." Kunnen expects prices to stabilise around $US55 ($A73) a barrel. "I get the feeling that OPEC will defend $55. They will turn off the taps sooner rather than later, because they have funding problems themselves, and they got used to good prices. In real terms, $55 is not stunningly high. They've now structured themselves for ongoing solid prices – not $80, but I think that $55 would meet their needs and ours."

Slow News Is Good News

Craig James, chief equities economist at Commonwealth Securities, expects oil prices to settle around $US60-65 ($A80-$87) a barrel, which he expects to be a plus for world economies. "Global demand remains healthy, new supply has come on to the market and the price has come down to a level that is positive in a medium/longer-term sense for energy producers," he says. "The fall in gasoline prices in the US has been positive for retail- and transport-focused areas. This has positive implications for inflation, and for keeping the Federal Reserve Board on the interest-rate sidelines." The US economy has definitely slowed, says James, but importantly, it has slowed to a more sustainable rate. "That's not necessarily bad news for the share market if it means the growth is more sustainable. The thing that investors have to keep a watch on – whether in Australia or the US – is the slowdown in the US housing sector. Provided it's a soft landing scenario, there's no great cause for concern, but a harder landing would affect wealth levels and consumer spending. "But perhaps we're moving into a 'Goldilocks' situation, where economic growth is not too hot, not too cold; oil prices aren't the same sort of influence; and provided the Chinese economy continues to grow at a healthy rate, that's going to be good news for the resources sector, because it is still enjoying prices that are much higher than they were a year ago." Over the September quarter, says James, investors shifted away from mining and energy stocks to sectors of the market offering greater earnings, such as the banks and the consumer-staples stocks (Woolworths and Coles Myer). "I think that rotation has run its course. Resources are unlikely to go gangbusters from here. I think the lower oil price will be good news in terms of inflation and consumer spending, but consumers aren't going to be spending like there's no tomorrow. It's still more the essential forms of spending that will do best. We think that the banks, particularly here in Australia, will benefit from the continued strength of business borrowing," he says. •

