

# Australian Share Market: Reading the Roadmap in 2007

Peter Osborne

# Australian equities

A GUIDE TO READING THE ROADMAP

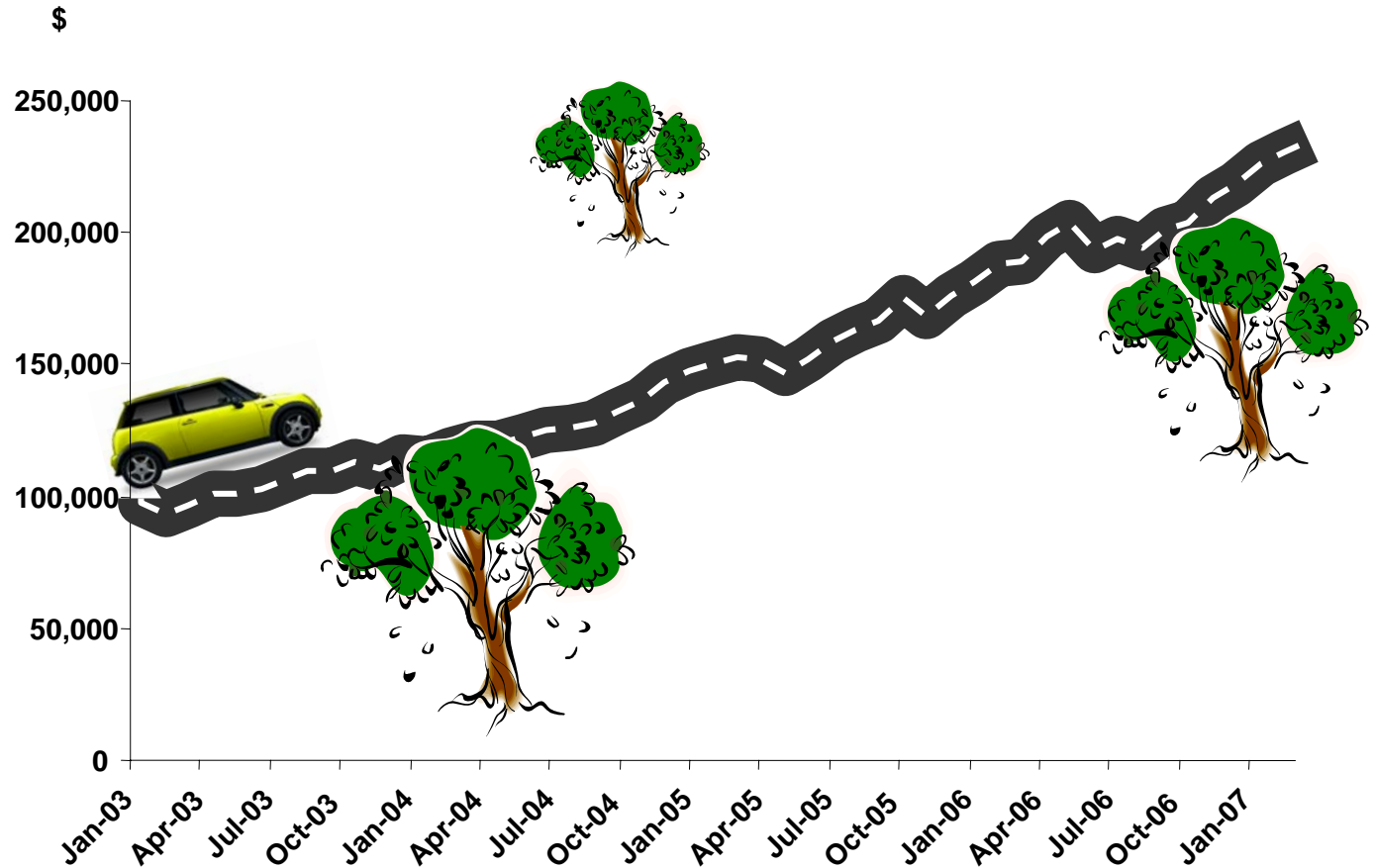


**Presenter**

*Peter Osborne – Head of Economics and Investment Research*



# Stellar performance for Australian equities



# Australian equity returns exceptional

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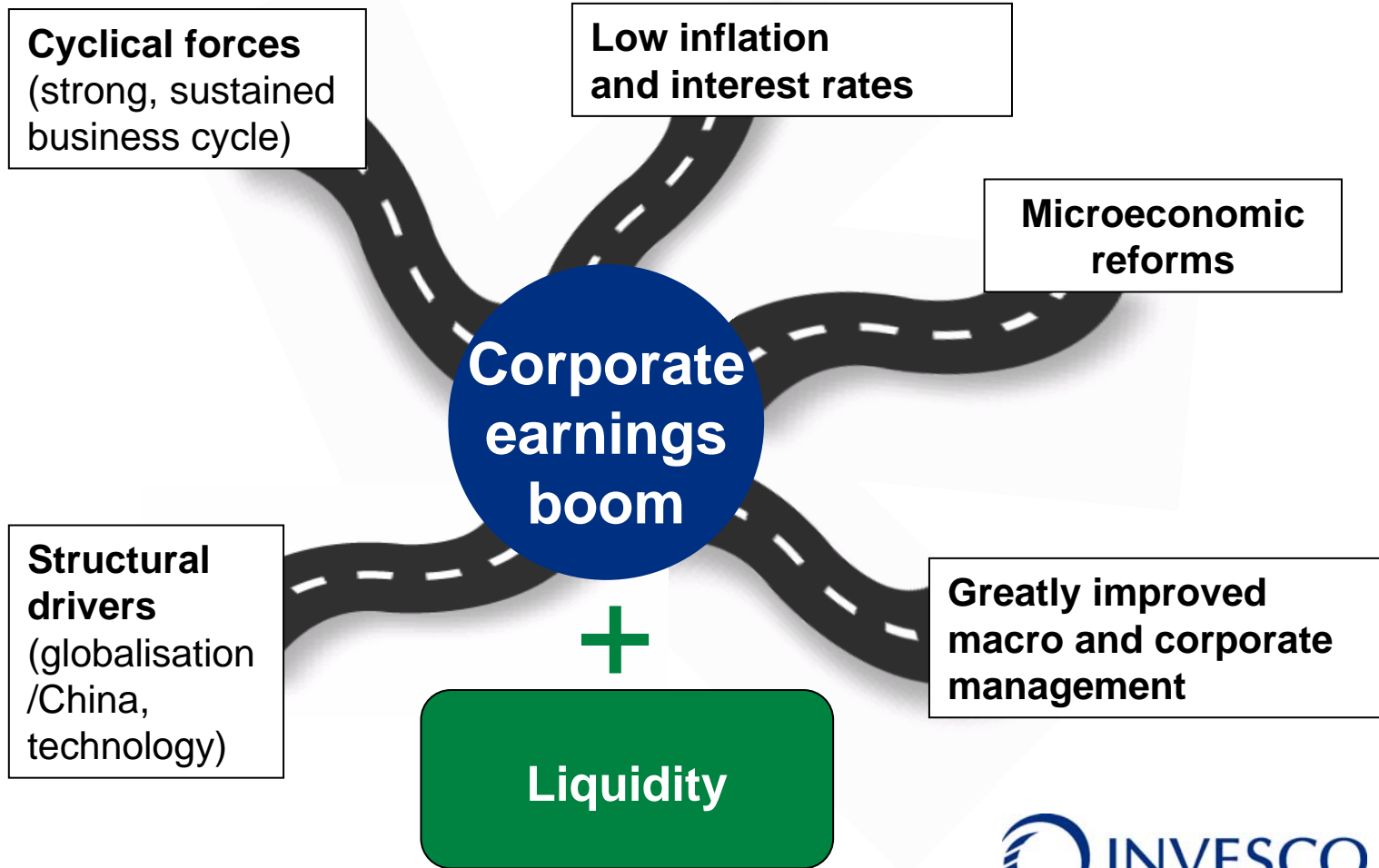
- Average total return over past four years 22.4%
- Total return over past four years 124%
- Australia has outperformed global market by 34% since 2003
- Corporate earnings growth and profit share at historical highs

# Not unprecedented but more fundamentally based

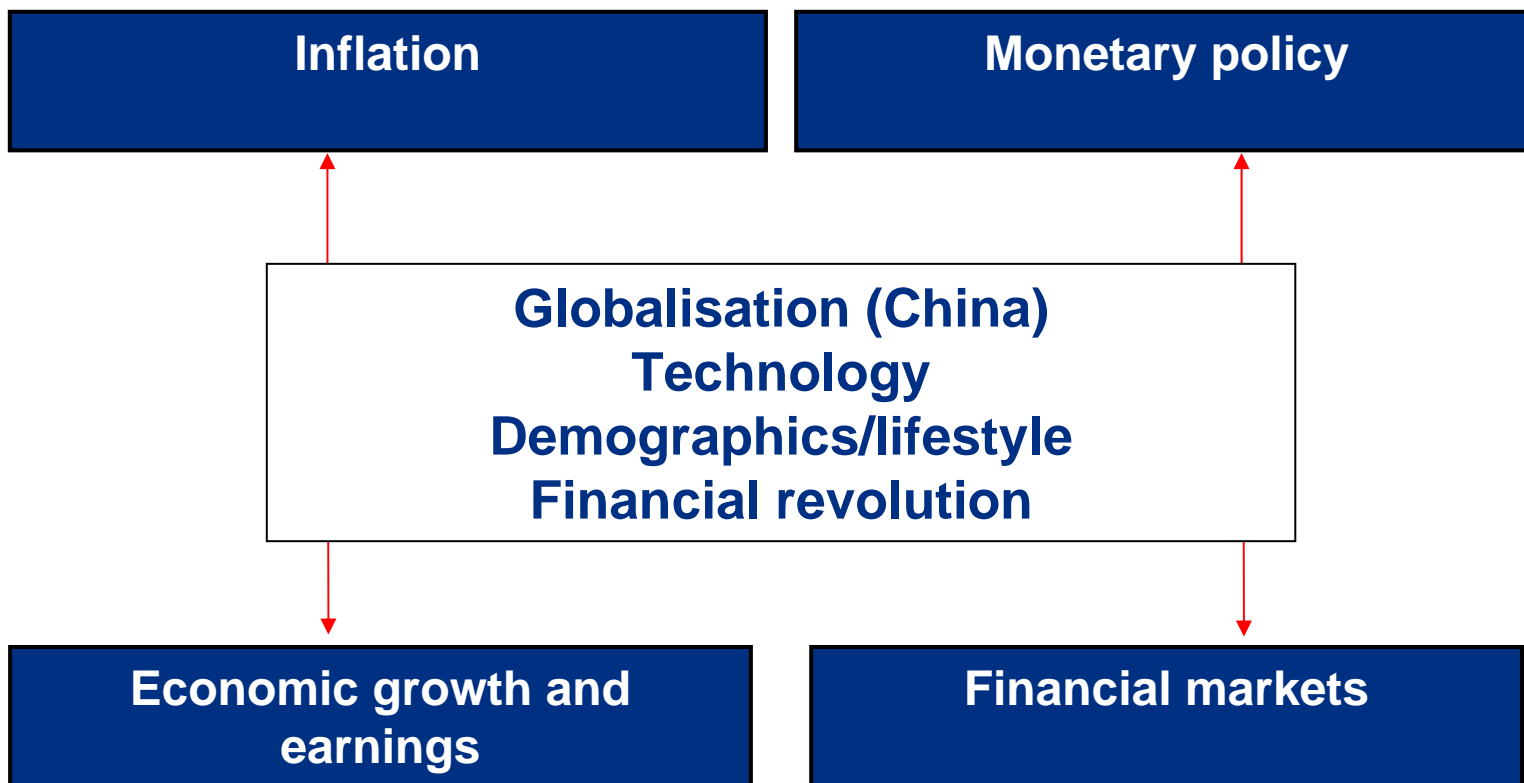


Source: Morgan Stanley, ABS, Datastream INVECO

# Macro 'roadmap' to recent equity returns



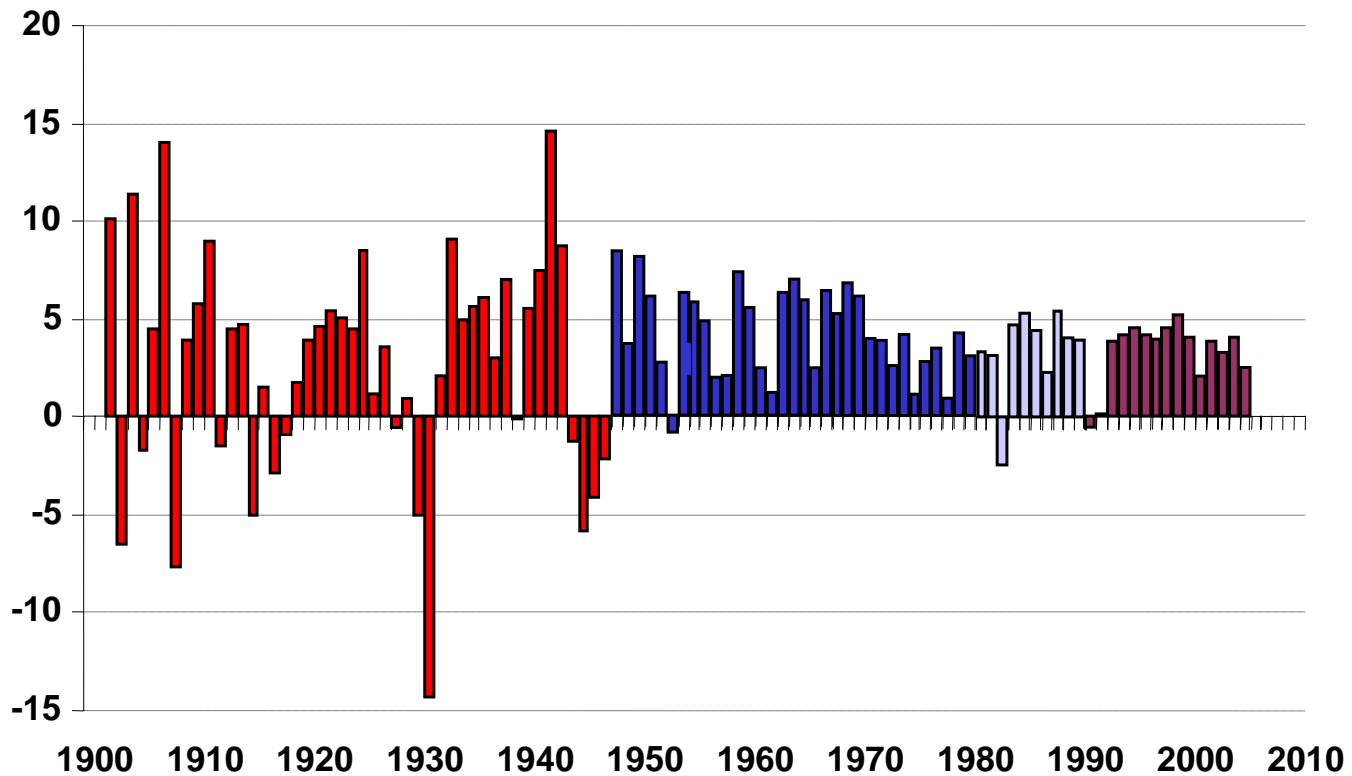
# 'Structural' economic and market drivers important



# Our economic growth strongest since Federation

Australian real GDP growth, 1901 - 2006

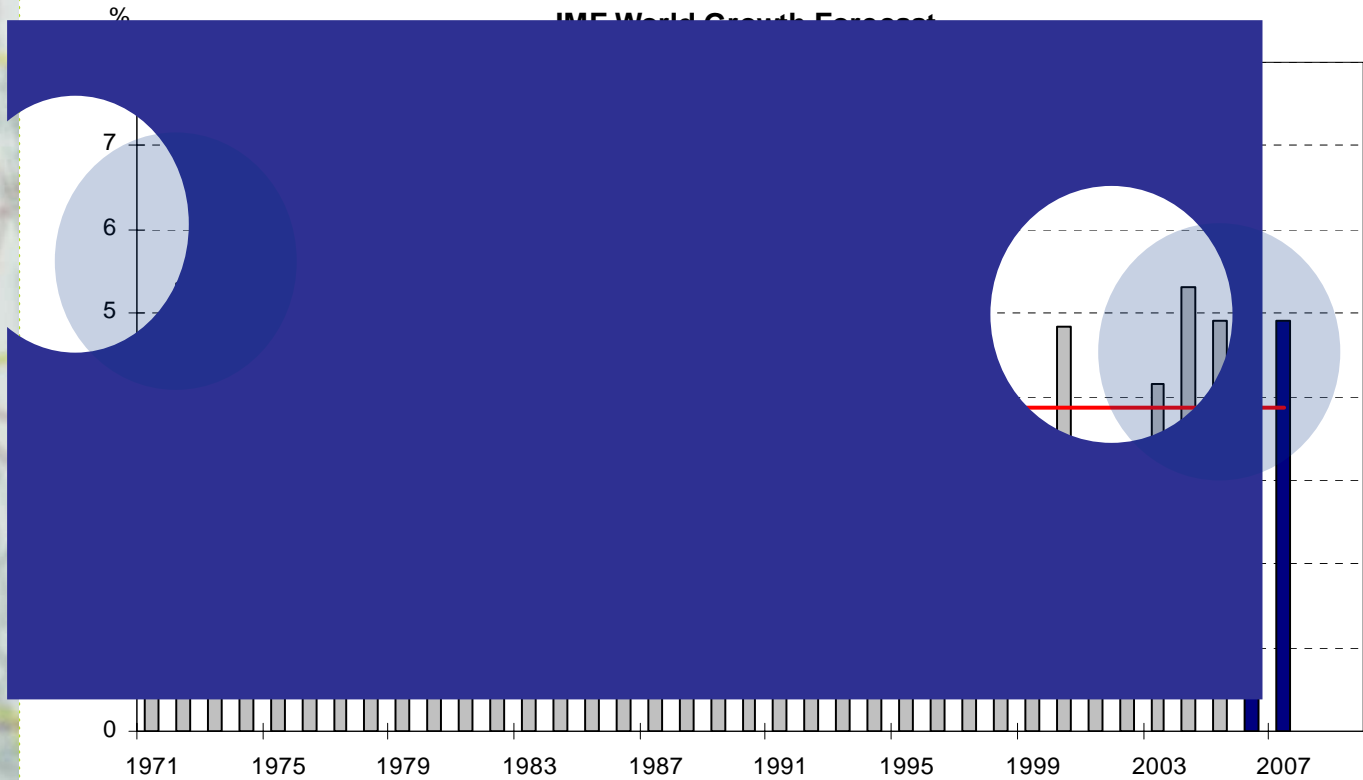
GDP % - chg year



Source: ABN-AMRO, ABS, INVESCO

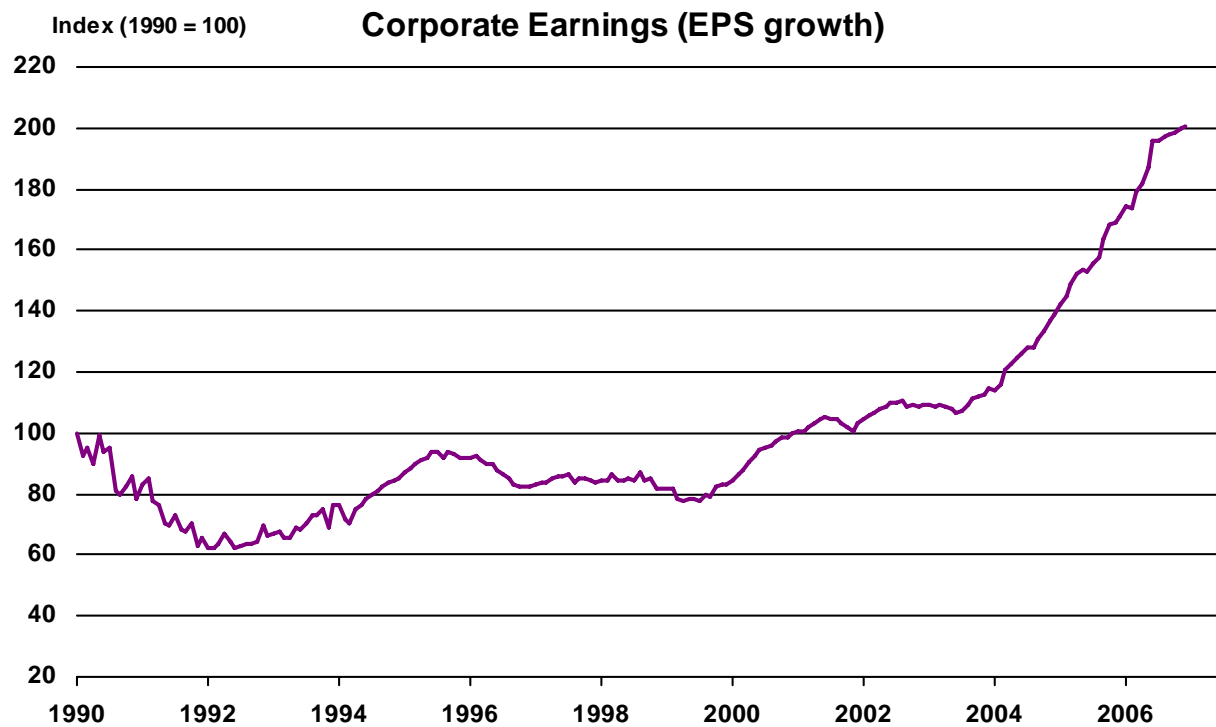


# World growth stronger and more synchronised



Source: IMF, INVESCO

# Profits explosion – earnings driving returns



Source: UBS, INVESCO

# It's the 'Earnings' not the 'PE' driving returns

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	S&P/ASX 200	Mining
Price change	40.0%	61.5%
P/E change	-3.5%	-4.5%
'Earnings' change	43.5%	66.0%

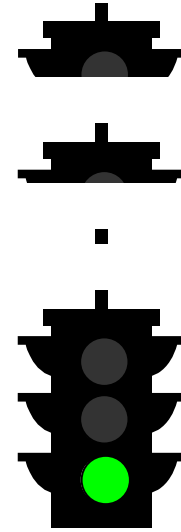
All data refers to the two years to December 2006.

Source: UBS, INVESCO

# The roadmap in 2007 – watching the signals

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- Growth
- Inflation and interest rates
- Earnings
- Valuations
- Liquidity
- Investor risk aversion



# Global economic outlook – mid-cycle slowdown

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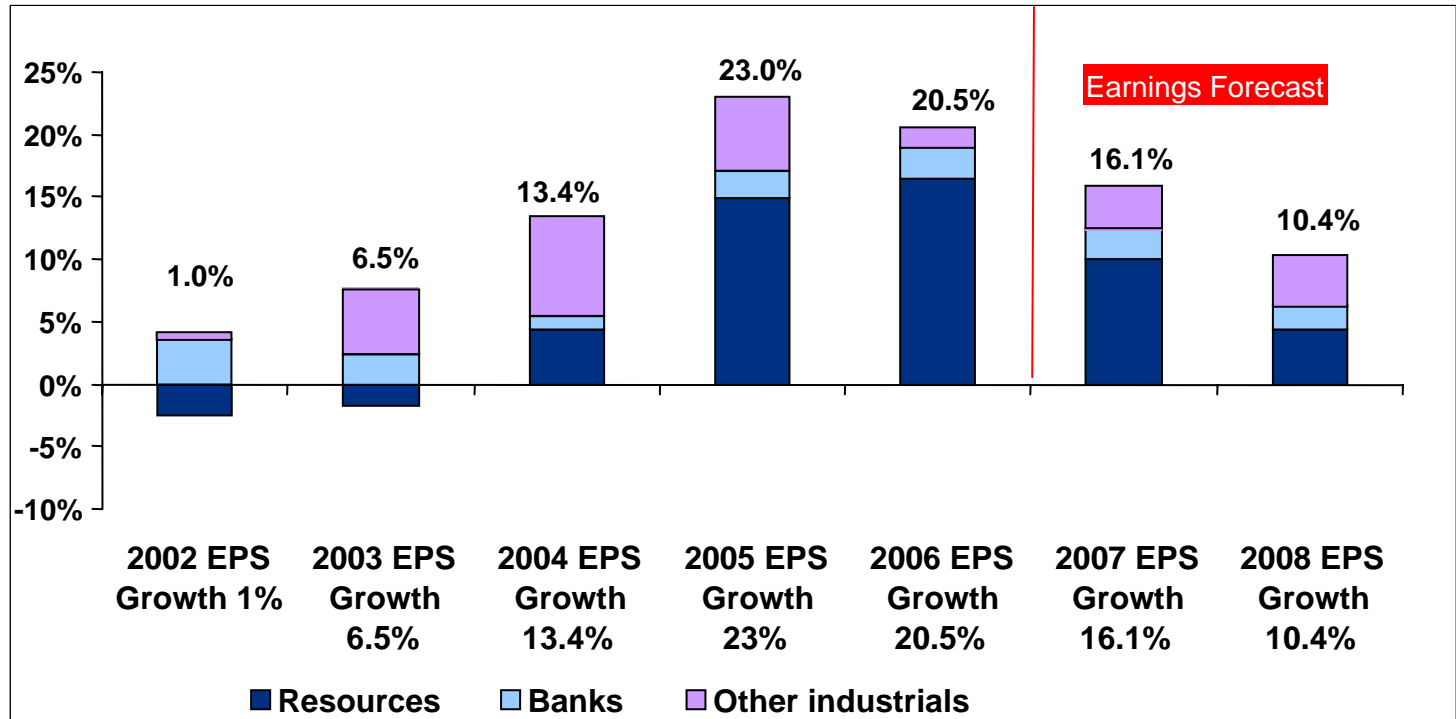
- Global economy transitioning through its peak growth period
- Greater breadth and synchronisation of global growth
- Base case is fairly stable inflation and interest rate environment
- Global policy settings/fundamentals = mid-cycle slowdown
- Key global economic risks (higher global inflation; deeper slowdown in the US)

# Australia – slower growth in 2007

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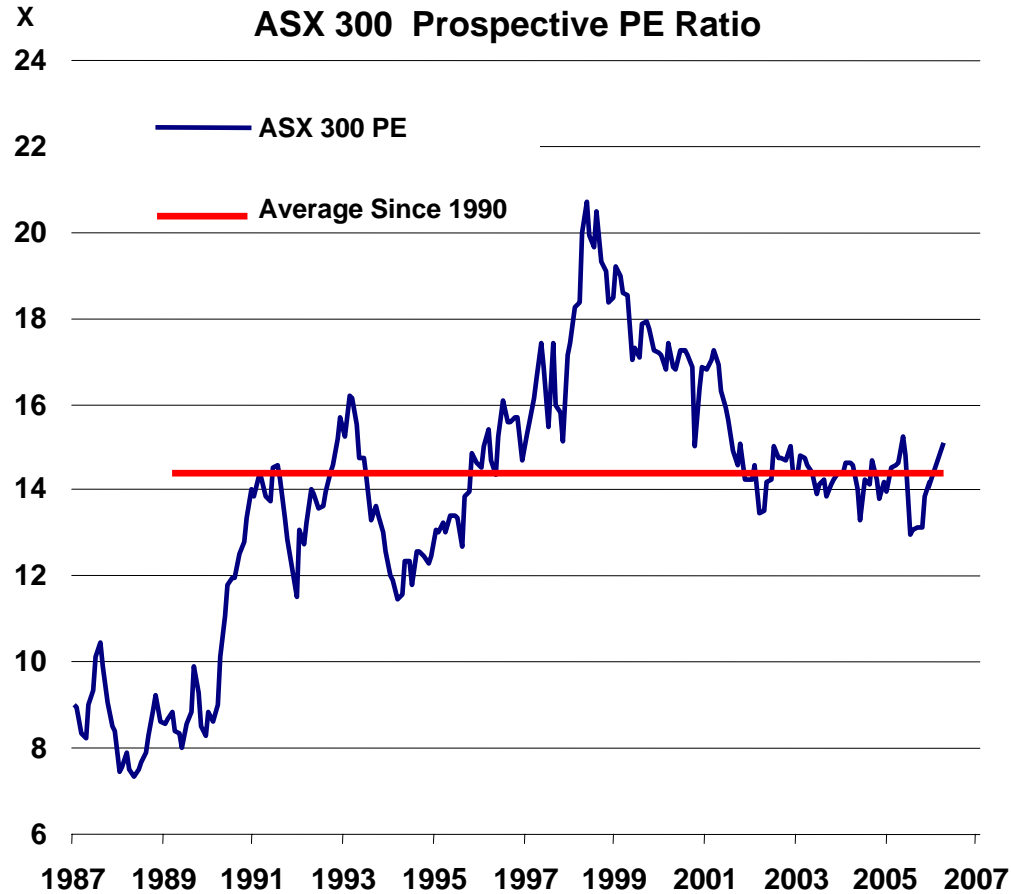
- Slower but still healthy growth in 2007
  - 2006 rate hikes (75bp) to slow demand in 2007
  - Housing recovery subdued, consumers more constrained
  - Drought cuts rural production (~ 0.75% of GDP)
  - Investment cycle maturing
  - US economy transitioning to lower growth rate
  - Inflation set to moderate in 2007
- Key risk to Australian economic thesis that demand and growth are stronger than expected (3%+)

# Corporate earnings – is double-digit growth sustainable?



Source: Macquarie Bank, INVESCO

# Equity market valuations (PEs) creeping up

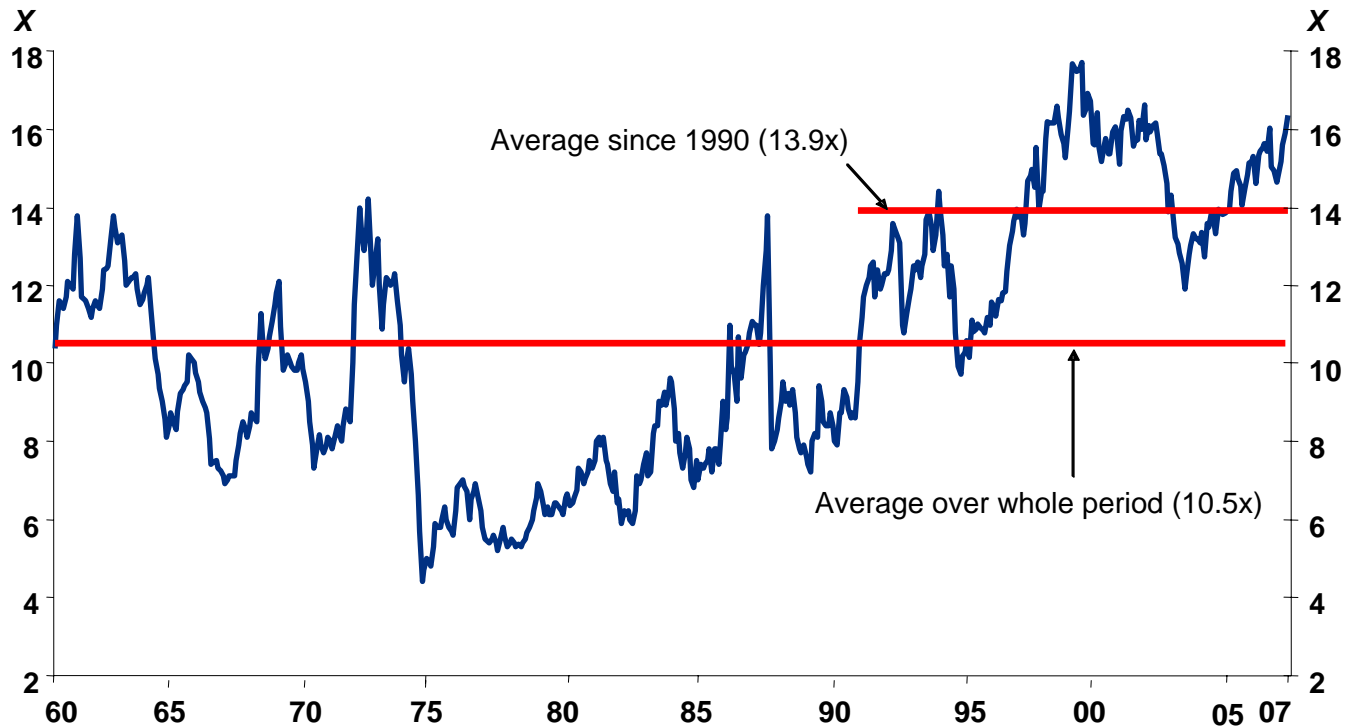


Source: GSJBW, INVESCO



# Industrial valuations – amber light flashing

**All Industrials (ex NWS)  
1 yr forward rolling PER**



Source: Macquarie Bank, INVESCO

# Liquidity positive but potentially dangerous

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- Powerful sources of liquidity
  - Mandated superannuation
  - Future Fund cashed-up and ready
  - Private equity funds lifting participation in market
  - Corporate balance sheets cashed-up, under-gearred
  - Accommodative credit conditions
  - Adds up to highly favourable demand-supply balance for equities



# Watch investor risk aversion

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- Investor risk aversion has been extremely low but could quickly change on:
  - A rise in inflation and interest rate expectations
  - Unexpected growth shock
  - Negative earnings surprise or weaker EPS momentum
  - Deteriorating valuations
  - High profile credit default or tighter credit environment



# Summary and conclusions

- Cyclical and structural growth drivers still positive
- Low stable inflation the key – watch carefully
- Corporate earnings cycle has peaked but...
- Reasonable earnings growth ahead
- Corporate fundamentals positive
- Valuations (PEs) creeping higher, particularly ex resources
- Liquidity conditions highly favourable
- Potential for liquidity/valuation bubble in 2007



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