Investment insight

Where to for share returns?

3 April 2014

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The outlook for returns depends on company profits and central bank policies.

While share markets have performed extremely well in recent years, the outlook for share returns from here depends crucially on what happens to profits, and the actions of the major central banks.

Central bank policies have supported share prices and economic growth

As the worst of the global financial crisis recedes into the distance, investors have enjoyed remarkable gains in share prices, both here in Australia and globally. Extraordinary policy measures adopted by the world's major central banks – most notably the US Federal Reserve (the Fed) – have provided enormous support to share prices across the world. Short-term interest rates close to zero and historically low bond yields (helped by the Fed's bond buying) have encouraged investors into higher risk assets, such as shares, in search of higher returns.

The actions of central banks have also contributed to stronger economic growth, and therefore an improvement in corporate profits, in recent years. This has been particularly important given that the other arm of macroeconomic policy – fiscal policy – has largely been working in the opposite direction.

Company profits haven't kept up with share prices

Table 1 shows just how far share prices and earnings per share (EPS) have risen since the first quarter of 2009, the worst of the GFC. And to provide a little more perspective, the table also shows trailing price to earnings ratios (PE) for each market. Those ratios have also risen since 2009, as gains in corporate profits have not kept pace with rising share prices.

Table 1: Share prices have risen dramatically since the GFC

	US	Eurozone	Japan	Australia	EME#	World
PE Q1 2009	12.2	8.5	14.8	11.5	8.8	10.4
Price change*	19.7	12.1	12.0	9.0	13.3	15.7
EPS growth*	8.1	-2.2	9.0	-1.3	5.9	5.2
PE end 2013	19.8	16.2	16.8	18.4	12.1	16.4

Source: Datastream.
* Annualised percentage change from the first quarter of 2009 to the final quarter of 2013.
# Emerging markets equities.

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Taken at face value, PE ratios at the end of 2013 suggested that world share markets were fully valued at best, and in some cases overvalued. However, elevated PE ratios may well be justified if markets are simply doing what markets tend to do, ie, price in the likelihood of further gains in corporate profits, perhaps underpinned by stronger sales revenue growth than the world has seen in recent years.

Will corporate profits keep rising?

Just how likely are further gains in corporate profits? The answer depends on where you look, whether you think demand growth is poised to accelerate, and the level of corporate profit margins across markets.

Chart 1 shows net profit margins for the major global markets based on the Datastream total market indices for each country.

There are several conclusions we can draw from the chart.

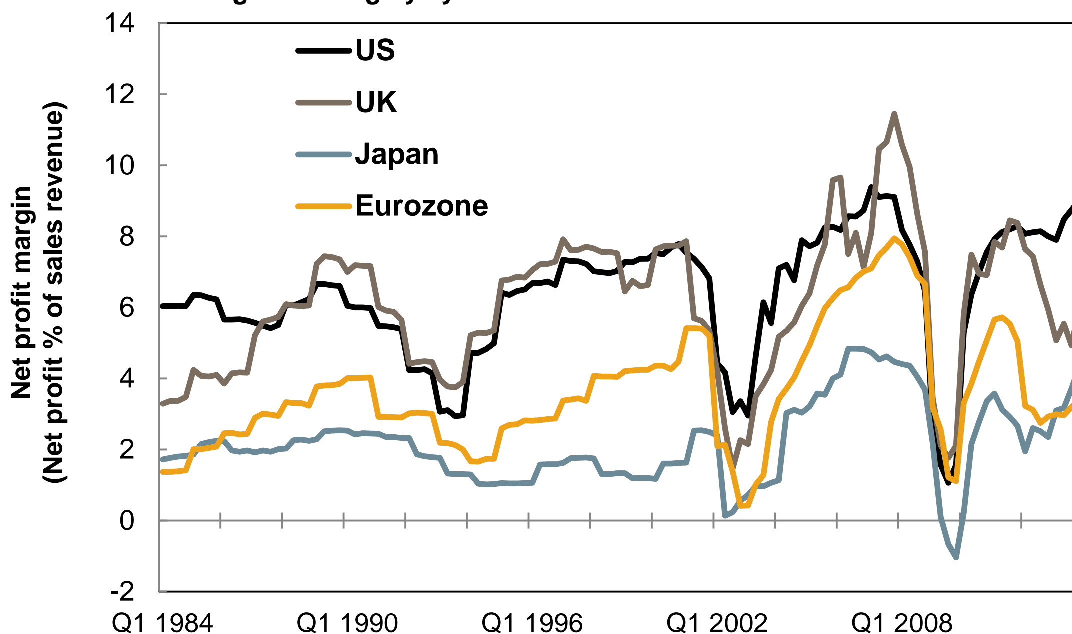
The first is that over time, margins are very cyclical and tend to revert to some kind of average level. High profit margins encourage an expansion in capacity, which competes away excessive margins. Where high profit margins reflect high unemployment and therefore subdued labour costs, that advantage diminishes as labour markets improve and the bargaining power of labour increases. This is an important point, and one we'll return to.

The second is that while margins in the US and in Japan are at or close to historic highs, margins elsewhere (the UK and eurozone) are not.

This pattern also appears in economy-wide measures of profitability, such as the share of corporate profits in GDP. In the US, this is at an all-time high, while profit share in the UK and Europe is much lower. There seems to be scope for margins to expand in Europe and the UK, if and when economic growth improves. Certainly, the economic data from those economies have taken a clear turn for the better over the past year.

That's all well and good, except that the US remains the 800 pound gorilla in global shares, accounting for around 40% of the world by market capitalisation. US margins have widened for a number of important reasons, both structural (such as the rise in importance of the relatively high margin technology sector) and cyclical (extraordinarily low interest rates and the impact of high unemployment on labour costs).

Chart 1: Profit margins are highly cyclical



Source: Datastream, MLC Investment Management

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Outside these reasons, US profit margins have been boosted by a relentless focus on cost control by US firms and lower energy prices courtesy of the North American shale gas boom. The widening in margins has been critical to the profitability of US firms, particularly during a period when revenue growth has remained somewhat subdued, in keeping with the generally anaemic state of global demand.

The fact that 40% of the global shares universe is priced at a premium price earnings multiple, at a time when sales revenue growth is modest, suggests the best news on corporate profitability just might be behind rather than in front of us. This should be a cause for concern for investors.

Will share market returns be affected?

Is this the kind of concern that is likely to pressure returns from US (and global) shares in the short term? Possibly, but downward pressure on margins may be some time coming.

Usually, tighter monetary policy in response to building inflationary pressure triggers a fall in margins. Why? Because the inflationary pressure tends to manifest itself in rising labour costs, tighter policy weakens sales revenue, and firms find themselves unable to reduce costs fast enough – at least in the short term. However, despite a substantial fall in the US unemployment rate, the labour market is not strong enough to produce the kind of wage pressures that would trouble the Fed.

And despite the fuss over the decision to start 'tapering' the Fed's quantitative easing program, US monetary policy is set to remain extraordinarily loose for some time. Not only could this push out the next policy-induced recession, but persistently low interest rates still provide an incentive for investors to seek higher returns in share markets.

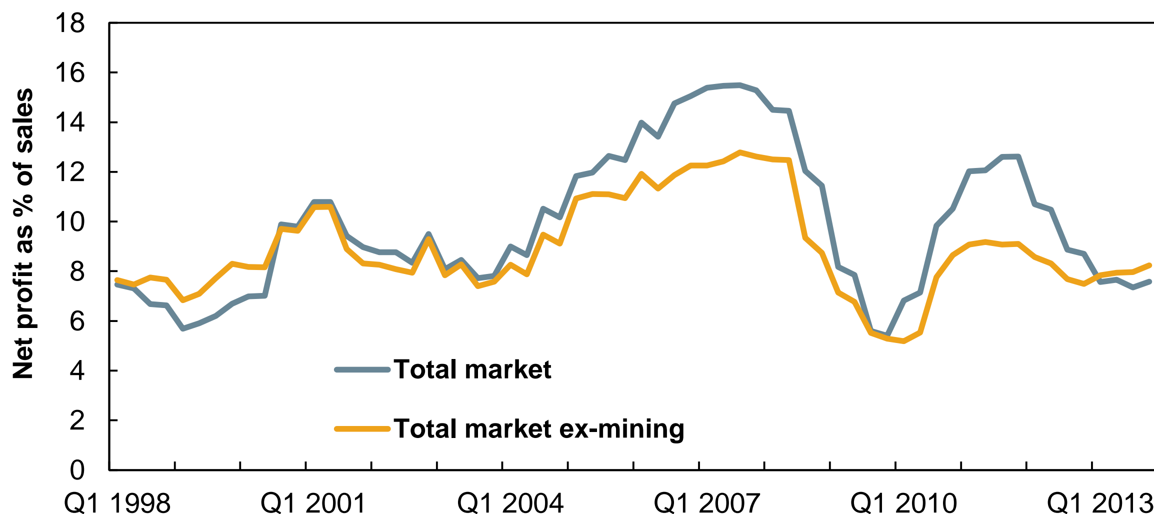
In other words, the usual 'cyclical' culprits responsible for lower profit margins and weaker returns from shares may not show up any time soon.

If this scenario plays out, then US share market returns could remain pretty solid, despite signs that the market is overvalued. As history has shown many times, markets can remain overvalued for some time, particularly if liquidity conditions remain supportive, as they still are now. Asset allocators relying solely on valuation nearly always have to be patient – as do their clients.

What about future profit margins for Australian companies?

Chart 2 shows the profit margins of Australian listed companies since 1998, both for the total market, and for the market excluding the mining sector.

Chart 2: Australian margins aren't high by historical standards



Source: Datastream, MLC Investment Management

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Margins are far from excessive at this point, and there has to be at least some chance of a widening in margins as the non-mining economy continues to improve in response to much easier monetary policy and a decline in the Australian dollar.

While that improvement is still largely a forecast rather than a reality, there are signs in economic data that it is under way.

Leading indicators of housing activity, such as home loan and new building approvals, have picked up, and some key business surveys show an improvement in confidence and reported business conditions. However, it's still uncertain whether this recovery is going to be robust enough to offset a decline in the level of mining investment over time.

Conclusion

For investors, the debate over the future of corporate profitability, and how that outlook could vary from country to country, is just one of a number of uncertainties in the outlook for investment returns.

Future returns from shares may turn out to be quite reasonable, at least for the next few years, but this may well be the kind of environment in which being in the right markets, and in the right stocks and sectors, is going to be more important than ever.

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