Australian shares hit record highs – is the decade long underperformance versus global shares over?

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Key points

> The long time taken for Australian shares to regain their 2007 high and their underperformance compared to global shares this decade reflects a combination of payback after their strong performance last decade, tighter monetary policy, the strong $A into 2011, the slump in commodity prices and property crash phobia.

> High dividend payouts are not to blame.

> While the Australian share market is at risk of a short-term pull back it's likely to be higher on a 6-12 month horizon and its period of relative underperformance compared to global shares is likely at or close to an end.

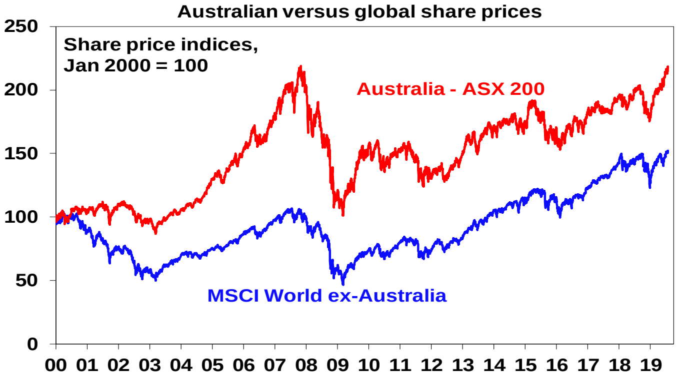
Australian shares back to their 2007 high…at last!

After nearly 12 years the Australian share market is above its November 2007 pre-Global Financial Crisis (GFC) high. The All Ords index surpassed it last week and the ASX 200 has done so this week. Basically, the Australian share market is looking through short-term uncertainties around the economy and focussing on lower interest rates and bond yields making shares relatively cheap, the likelihood that policy stimulus will ultimately boost growth, high iron ore prices boosting mining companies and a positive global lead. But why has it taken so long? Is the break out sustainable? And is the relative underperformance of Australian versus global shares over?

Why has it taken so long?

12 years is a long time to make a new high. US shares made it back to their 2007 high in 2013 and global shares did so in 2014. See the next chart. Since the March 2009 GFC low, Australian shares are up 118%, versus a 222% gain in global shares in local currency terms and a 347% gain in US shares.

Australian versus global share prices



Source: Bloomberg, AMP Capital

So why has the Australian share market underperformed global shares since the GFC such that it's taken far longer to regain its 2007 high? There are basically five reasons:

- Payback for its huge outperformance last decade – Australian shares go through periods of relative out performance and underperformance versus global shares. This can be seen in the next chart that shows the value of Australian shares relative to global shares. After underperforming global shares through the 1990s tech boom during which Australia was seen as "old economy" it came roaring back during the resources boom last decade resulting in a huge outperformance. This is also evident in the previous chart – whereas global and US shares just made it back to their 2000 tech boom high by 2007 Australian shares more than doubled in value. This meant that the 2007 high for Australian shares was a much higher high than for global shares which really just spun their wheels last decade. So, the poor relative performance of Australian shares this decade is payback for their huge outperformance last decade. So, it's naturally taken longer for Australian shares to get back to their pre-GFC high.

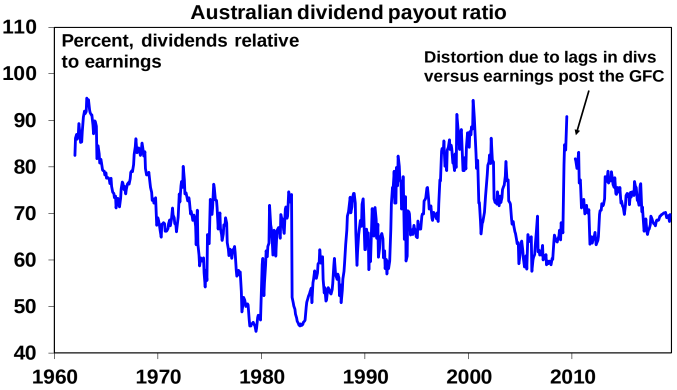
Australian share prices relative to global share prices

Source: Thomson Reuters, AMP Capital

- Tighter monetary policy for much of the post GFC period – whereas the US, Europe and Japan had near zero interest rates and quantitative easing, Australia has had much higher interest rates (until just recently) and no money printing. In fact, the relative underperformance really started in October 2009 when the RBA started to raise interest rates post GFC which was not followed by other major developed countries. See the previous chart.
- The surge in the $A to $US1.10 in 2011 – this reduced the competitiveness of Australian companies from which the damage can take a long time to reverse even though the $A has fallen to around $US0.70 in the last four years.
- The slump in commodity prices from 2011 – this weighed heavily on resources shares into 2006. US, European and Japanese shares have a lower exposure to resources.
- Property crash phobia – foreign investor fear of a crash in Australia's relatively expensive housing market has been a constant theme. Therefore, many stayed away.

Are high dividends holding Australian shares back?

An often heard view is that Australian companies are not investing because shareholders are demanding high dividends, and this is causing poor earnings growth and share market returns. This is unlikely. The dividend payout ratio (ie dividends relative to earnings) is in line with its historic norm. And it's mainly resources stocks that have boosted payouts since the GFC – but it's been hard to argue they should ramp up investment so soon after the mining investment boom.



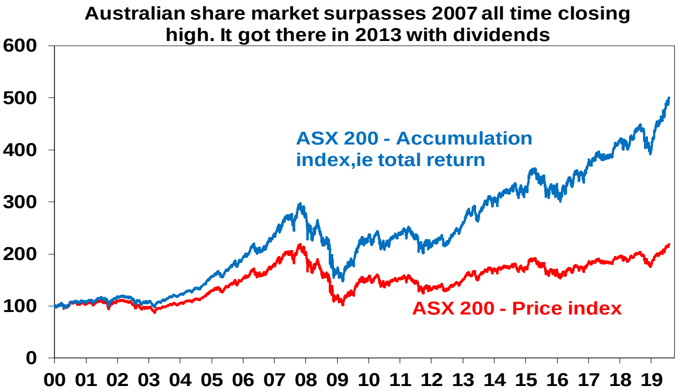
Source: Bloomberg, Global Financial Data, RBA, AMP Capital

The real reasons for the lack of investment by non-mining companies are likely to be post-GFC caution, wariness after getting smashed through the mining boom by the high $A, spare capacity & competitive pressures, uncertainty about demand and too-high investment hurdle rates.

More fundamentally, Australia's high dividend payouts are healthy from a long-term perspective: high dividend payouts mean less risk of poor investment decisions from retained earnings, they are indicative of corporate confidence about future earnings and they indicate earnings are real.

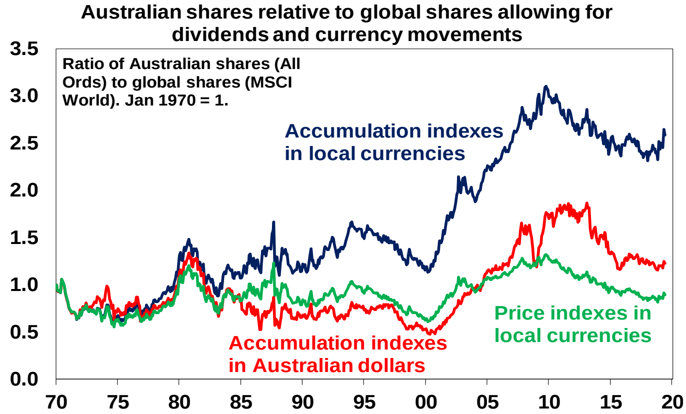
2007 high was reached in 2013 with dividends

In fact, because Australian shares pay relatively high dividend yields (around 4.1%) compared to global shares (2.5%) they should be included in comparisons of Australian with global share market returns. Once dividends are allowed for (ie looking at the accumulation index, or total returns) the Australian share market surpassed its 2007 high in 2013.



Source: Bloomberg, AMP Capital

The next chart compares the relative performance of Australian to global shares since 1970 in terms of: relative share price performance in local currency terms (green line); relative total returns ie with dividends added in (blue line); and relative total returns with global shares in Australian dollars (red line). A rising ratio means Australian outperformance and vice versa. Several things stand out. First over long periods of time and when dividends are allowed for Australian shares have had better returns than global shares. Since 1970 Australian shares have returned (capital growth plus dividends) 10.4% per annum compared to 8.3% pa for global shares in local currency terms. The falling $A over this period has enhanced the return from global shares to 9.9% pa but they still slightly underperformed Australian shares. Second, the swings in the relative performance of Australian shares are apparent if dividends and currency movements are allowed for or not - in particular in the big outperformance last decade and underperformance this decade. Since October 2009 Australian shares have returned 8.4% pa compared to 10.4% pa from global shares in local currencies or 12.5% in Australian dollar terms (as the $A fell).



Source: Thomson Reuters, Bloomberg, AMP Capital

What's the outlook?

Is the break out by the All Ords and ASX 200 to new highs sustainable? Going through past bull market highs after a long period below can attract investors into the market so it could push on for a bit. But after such a huge run – the market is now up 21% year to date – its vulnerable to a short-term correction: we are coming into a seasonally weak part of the year; the August earnings reporting season could result in volatility; and there are various risks in relation to trade wars, tensions with Iran and soft economic data. However, the combination of low bond yields which means that the share market is comparatively cheap, monetary easing by the RBA and other central banks and a likely pick up in global growth by year end and Australian growth next year point to even higher share prices on a six to 12 month horizon.

In terms of the Australian share market's valuation, its price to 12 month ahead consensus earnings multiple of 16.5 times is above its long-term average, but shares are known to trade on higher PEs when inflation and interest rates are low. In fact, the gap between the forward earnings yield of 6.1% and the 10 year bond yield of just 1.2% is well above average making shares relatively cheap.

Is the secular underperformance of Australian shares versus global shares over? So far this year Australian shares have outperformed global shares and the various comparisons in the last chart have hooked higher. Several of the factors that drove the relative underperformance this decade are fading:

- Much of last decade's outperformance has been reversed. Payback has happened albeit it could still go further.
- The RBA is easing more aggressively.
- The surge in the $A to $US1.10 of 2011 has reversed making Australian companies more competitive.
- The commodity price slump from their 2008-2011 highs (depending on the commodity) looks to be over.
- Finally, the risks of a property crash dragging banks and the economy into recession may be receding.

The Australian dollar is still likely to fall a bit and it makes sense to maintain a decent exposure to global shares for portfolio diversification reasons. But with many of the negatives for the Australian share market fading it's hard to maintain a strong case against it versus global shares.

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