John Murray
Managing Director
Perennial Value

Could the stockmarket rise significantly over the course of 2014?

Perhaps the first point to make is that, in talking to investors about this, they believe that it is a big ask given the market's strong rise over the past year or so. That view is probably more perception than reality as the market has in fact barely risen 10% (total return) over the past year at the time of writing. In itself, this return, when measured against the long term average rate of return delivered by the Australian stockmarket of around 12%, suggests that the stockmarket could deliver a double-digit return over the next twelve months.

Nonetheless, stockmarkets are ultimately driven by earnings growth and earnings growth, in turn, is ultimately driven by broader economic growth. Stockmarkets are also driven by expectations and I wish to address both of these issues.

The Case For A Stronger Economy

In discussing the outlook for the Australian economy, investors generally seem to be quite pessimistic. To the contrary, compared to say six months ago, there are a number of economic indicators which point to a stronger economy over 2014.

From a global perspective, the source of global growth is switching back to the advanced economies. The US appears to have achieved a level of self-sustaining growth while Japan and the European Union also appear to be heading in the right direction. China's exporters are likely to benefit from increased demand in the advanced economies and Australia would be an indirect beneficiary of China's growth.

Domestically, the key issue is the growth transition away from the massive resources investment spend towards the non-mining sectors of the economy, essentially represented by the eastern seaboard. It can be said with more confidence compared to last year that this transition is happening. Indeed, the Australian economy is on track to achieve its 23rd consecutive year of uninterrupted economic growth, in itself quite a remarkable achievement. There are a number of key drivers which should underpin this growth in 2014 including a record low cash rate, an upturn in the housing market and increased consumer spending and confidence. When one places these drivers against the backdrop of substantially improved household and corporate balance sheets and a more synchronised recovery in the advanced economies, Australia appears well positioned for the future.

The cash rate currently stands at a record low of 2.5% and this has successfully stimulated the economy. Low interest rates have increased housing demand through improved affordability, resulting in rising house prices. This encourages construction activity and also has the effect of boosting wealth and improving sentiment. Targeting residential construction is an effective policy as it is the most suitable sector to employ those leaving a job that was created by mining investment. Fundamentally this sector is also well positioned as the lift in population growth provides a favourable demographic demand for new housing. Additionally substantial pent-up demand has accumulated over recent years as the sector has had to compete with the mining sector for labour and material. The upturn in this sector now looks entrenched and will add substantially to GDP growth through a multiplier effect on other industries such as retail.

The low interest rate environment has also had other stimulatory effects on the broader economy by putting downward pressure on the Australian dollar and encouraging non-mining capex. The drop-off in mining investment is likely to be offset by increased volumes of resource exports as the lower currency provides much needed relief for exporters and import competing sectors. Service exports including tourism and education are growing whilst there are some early indications that the lower currency has redirected some offshore spending back onshore. The downside of a lower currency is rising inflationary concerns through increased imported inflation.

Public finances as well as the financial system remain in good shape, whilst household and corporate balance sheets are substantially stronger than before the 2008-09 financial crisis. This will support the economy as it experiences slightly below trend growth that will cause the unemployment rate to rise further. Despite this, Australia's unemployment rate is relatively low when viewed from a global perspective. Further, whilst rising unemployment will remain a headlining issue, job numbers have always been a lagging indicator of future economic activity.

In summary, Australia does appear to be in the early stages of successfully transitioning away from mining investment led growth. Globally, the major developed world economies are continuing their recovery in a synchronised fashion and, in turn, this will provide further support to the domestic economy.

Expectations

Just as investors are arguably too cautious about economic growth, it appears that they are also quite pessimistic about corporate earnings growth looking forward over the next year or so. Earnings growth forecasts in general are positive yet still only single digit.

In an environment of weak revenue growth, it has been the aggressive 'cost-out' push by Australian corporates which has underpinned recent earnings growth. This cost-out theme will continue throughout 2014 and, at the time of writing, has once again emerged as a key theme in the February reporting season. What has also emerged is a significant number of outlook statements pointing to improving volume and revenue growth rates particularly from housing, construction and retail-related companies. This is new news and has been absent from company commentaries for a number of years.

Conclusion

The case for a stronger domestic economy which can successfully transition away from the resources investment boom to a stronger eastern seaboard is growing. Should this continue to play out then company revenues should grow. When marrying this with the ongoing 'cost-out' push, then it is possible that earnings growth could well exceed current very low expectations. This scenario would most likely push the Australian stockmarket to considerably higher levels than is currently the case over the next year or so.