Investment Spotlight

ANZ Wealth Chief Investment Office

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10 years since the GFC: How much longer can the cycle last?

August 2007 is considered by many to be the start of the Global Financial Crisis. Ten years on and following sustained strength in share markets and economies since 2009, it's worth reflecting on just how much longer the current expansionary phase can continue. Read on for more.

10 years since the GFC

On 9 August 2007 French bank BNP Paribas froze US $2.2 billion of money-market funds. Many consider it to be the event that marked the start of what we now know as the Global Financial Crisis (GFC). Over the next 18 months we saw share and credit markets tumble, and the world economy experienced the worst recession since the 1930s.

Ten years on, and following sustained strength in share markets and economies since 2009, it's worth reflecting on just how much longer the current expansionary phase can continue.

If we look at the United States (US), the current share bull market and economic recovery is approaching the decade-long run of the 1990s (see Table 1). The annualised return for the S&P 500 has also been very strong despite slower economic growth. Long bull markets in shares have been a feature over the past three decades, compared to the volatile 1970s and 1980s that faced shocks from higher oil prices and inflation.

Table 1: US Market & Economic Cycles

Expansions	Since GFC	2000+	1990s	1980s	1970s
Market					
Length of expansion	34 quarters	26 quarters	40 quarters	8 quarters	10 quarters
Average annual real return over expansion	15.3%	14.0%	17.1%	22.8%	12.3%
Economy					
GDP cycle length	34 quarters	30 quarters	40 quarters	18 quarters	15 quarters
Average annual growth	2.1%	2.3%	3.4%	4.2%	4.0%

Note: The table shows the average length of recovery in the US share market and economy by decade.
Source: Bloomberg, ANZ Wealth

How much longer can it go on?

To get a guide to the longevity of the current upward phase of markets we have put together a check list of indicators (Tables 2 and 3) that have historically flagged an approaching end to a bull market in shares and recession. Invariably, these indicators illustrate that the end of a bull market is typically marked by a combination of imbalances and excessive confidence.

Valuations and sentiment far from stretched

Current valuations overall are less extreme than previous market peaks. While global share market price earnings (PE) ratios are above average, across a range of measures valuations are still well below that reached in 2000 and, for some measures, 2007. Bond markets are not indicating an imminent market peak either. The yield curve is still positive while credit spreads are low and have not begun to rise which typically happens as a downturn approaches.

Table 2: Cycles Compared: 2000, 2007 & now; Valuations & Sentiment

Valuations	Mar-00	Oct-07	Now
Trailing PE	33	17	21
Forward PE	24	14	16
Dividend Yield	1.3	2.1	2.4
CAPE	48	30	23
Global ERP	1.0%	3.3%	4.0%
US HY Bond Spread	600bp	600bp	400bp
US IG Bond Spread	175bp	175bp	110bp
Yield Curve (10y minus 2y)	-0.5%	0.0%	0.9%
Sentiment	**Mar-00**	**Oct-07**	**Now**
AAII	53	50	34.6
Margin Debt	80%	46%	13.6%
Global Equity Fund Flows	$300bn	$50bn	$198bn

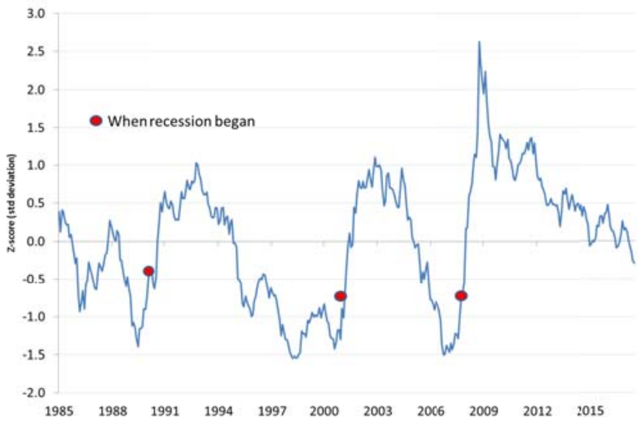
consistent with investment cycle peak
consistent with approaching investment cycle peak
consistent with ongoing investment cycle

Note: CAPE is a Cyclically Adjusted Price Earnings ratio that uses a 10 year average of earnings, not current earnings, to value the share market
Sources: Citi Research, Bloomberg, ANZ Wealth

A useful way to look at overall valuations is to combine various measures into a single measure of risk premiums. There are three risk premiums we focus on that compensate investors for different investment risks: term premium (the risk of an uncertainty outlook for short-term interest rates), credit premium (risk of default), and equity premium – the compensation for bearing the risk of ownership. Chart 1 shows market pricing of these risks relative to the risk free rate (that is, cash).

Chart 1 indicates that the combined risk premiums are close to the average of the past three decades. Within the measure equity and term risk are close to average, while credit spreads are now narrower than normal. We based this approach on analysis by JP Morgan that found similar results but was based on a longer time series. The combined risk premium needs to fall further (ie risk is underpriced) before the reversal that ultimately signals a bear market and recession is at hand.

Chart 1: Market risk premiums - total



Source: JP Morgan, Thomson Reuters Datastream, ANZ Wealth

Sentiment indicators are positive but not at an extreme level that suggests excessive exuberance and that a market peak is imminent (Table 3). While global equity inflows have been strong, New York Stock Exchange data on the growth in margin debt data remains relatively subdued at 14% growth, whereas 50% is a typical market peak level flagging exuberance. Individual investor market sentiment, as measured by a survey by the Association of American Individual Investors, (AAII) is only at average, not an elevated level.

However, there are emerging signs of risks in high debt / low unemployment. Corporate behaviour indicators only have one indicator flashing red – net debt of the US corporate non-financial sector. The reading of 1.9x earnings puts debt above the previous two cycles. But other indicators such as capex, mergers & acquisitions (M&A) and initial public offerings (ie IPOs, or share market floats) remain restrained. These are consistent with what we found for individuals with share margin debt; so far there is not the typical surge characteristic of an approaching cycle end.

Table 3: Cycles compared: 2000, 2007 & now; Corporate behavior & Economic

Corporate Behaviour	Mar-00	Oct-07	Now
Global Capex Growth (YoY)	8%	11%	3%
M&A (Previous 6m as % of Mkt Cap)	6.1%	4.2%	2.3%
IPOs (Previous 12m as & DM Mkt Cap)	0.7%	0.4%	0.2%
Net Debt/EBITDA (US ex Fins)	1.8x	1.4x	1.9x
Global ROE	12.2%	16.1%	10.9%
Economic	**Mar-00**	**Oct-07**	**Now**
US Lending Standards	33.9	19.2	-3.9
US Unemployment Rate	4.0%	4.7%	4.3%
US Core Inflation	2.4%	2.2%	1.7%

consistent with investment cycle peak

consistent with approaching investment cycle peak

consistent with ongoing investment cycle

Sources: Citi Research, Bloomberg, ANZ Wealth

For **economic indicators,** the current US unemployment rate of 4.3% is flashing red, suggesting end of cycle risks from high inflation and tight monetary policy. But our lending standards indicator (a high reading is tight, low is easy) suggests we are far from this point with banks supportive of the expansion and markets. And inflation remains below 2% and not threatening to go much higher anytime soon.

Conclusions

While the current investment and economic cycle has been lengthy, we don't see enough typical signals yet to suggest that an end is imminent. So for now we continue with our strategy of growth assets at benchmark. Valuations still have further to go if history is to repeat, sentiment is far from exuberant and corporate behaviour (M&A, IPOs and capex) is restrained. However, there are risks beginning to emerge as US corporate debt has risen and low US unemployment flags rising inflationary risks.

But every cycle is different and so we also need to keep an eye on what may be different this time. In terms of financial and economic risks, at the top our list is China due to its increased indebtedness since the GFC. With the increased importance of emerging markets, including China over the past decade, it may well be the source of the next major market shock, although there are no signs of this at present.

Mark Rider, Chief Investment Officer

Mark is responsible for delivering an overarching investment strategy, including asset allocation, investment themes, investment manager and product selection and monitoring for ANZ Wealth in Australia. Before joining ANZ in 2013, Mark spent 15 years at UBS and 10 years at the Reserve Bank of Australia, making him a well-recognised and respected member of the Australian investment community.