

## Some simple Australian market analysis

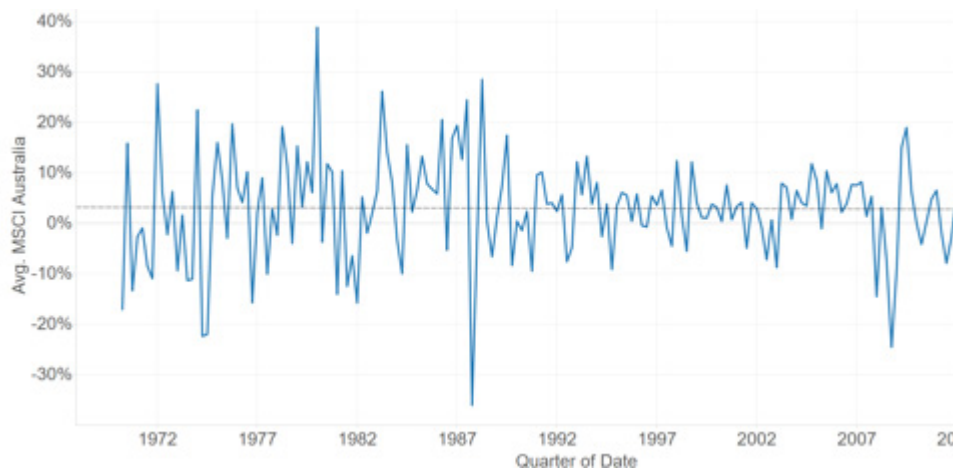
---

Michael Furey | Delta Research & Advisory | 22 February 2016

Like all economies, the Australian economy is always facing significant challenges. Since 1970, there has been the 1973 oil crisis and double digit inflation of the 1970s, the 1980–81 recession, further high inflation of the 1980s, the crash of 1987, the recession "we had to have" in 1991, the Asian crisis of 1998, the global tech crash of 2000 to 2001 and, of course, the Global Financial Crisis. And I'm sure I've missed a few. Following the GFC, and with fair reason, investors have been told to expect low returns. Interest rates are low so investors should expect low equity returns, too. Of course, we never really know how long this is supposed to last and the wiser financial economists will rarely put a timeframe on these issues. But I digress.

The goal of this short paper is to set a baseline for Australian equity market return expectations, using a long(ish) look at a few key measures. I do realise very few believe that past prices can tell you something about the future but – and you knew this but was coming – there is a somewhat remarkable consistency to the trend of the Australian equity market returns over the last 45 years, as shown in Figure 1.

**Figure 1: MSCI Australia GR Index**  
Quarterly returns since 1970



Sources: MSCI, Delta Research & Advisory

Sure, there has been a lot of volatility. But looking through all of that, since the end of 1969 (and that's all the data I have), the trend-line through Australian equity returns is... flat. That is, it is pretty much same as the average return of the Australian equity market

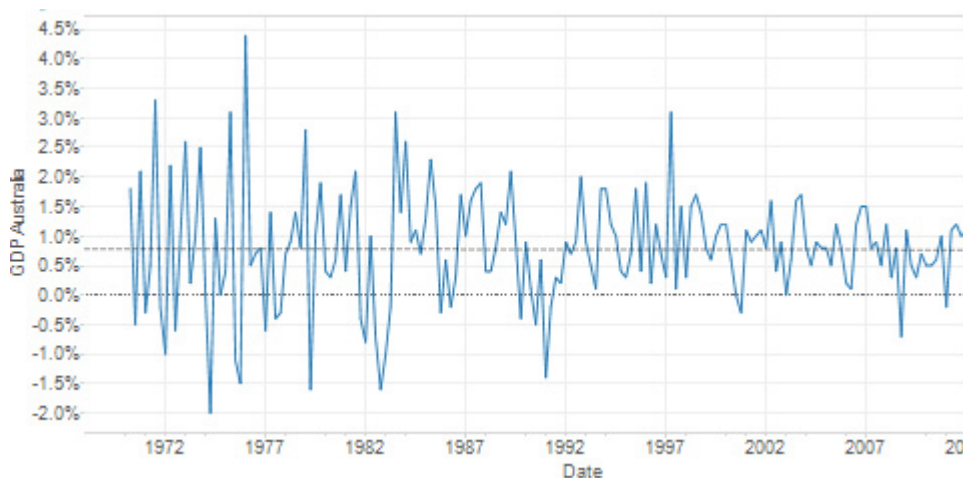
over the period. And when it comes to measuring performance, in my opinion (and in the opinion of many others), using a trend line is a superior method to simple point-to-point return analysis as it reduces starting and ending point biases.

A second observation from Figure 1 is that Australian equity market volatility appears to have been much higher during the late 1970s and 1980s, than afterwards.

So we see varying volatility but a flat trend line for returns.

One of the numerous factors driving equity market success is the state of the economy. Figure 2 shows Australian GDP (seasonally-adjusted) over the same time period (i.e. since the end of 1969). While direct correlations between Australian equity market returns and Australian economic growth may be weak, Figure 2 does suggest two similarities. Firstly, the seasonally-adjusted real GDP trend line (as with the equity market in Figure 1) is flat over the 45 plus year period. Secondly, one again, the 1970s and 1980s were also more volatile than the following period.

**Figure 2: Seasonally-adjusted real Australian GDP**  
Quarterly since 1970



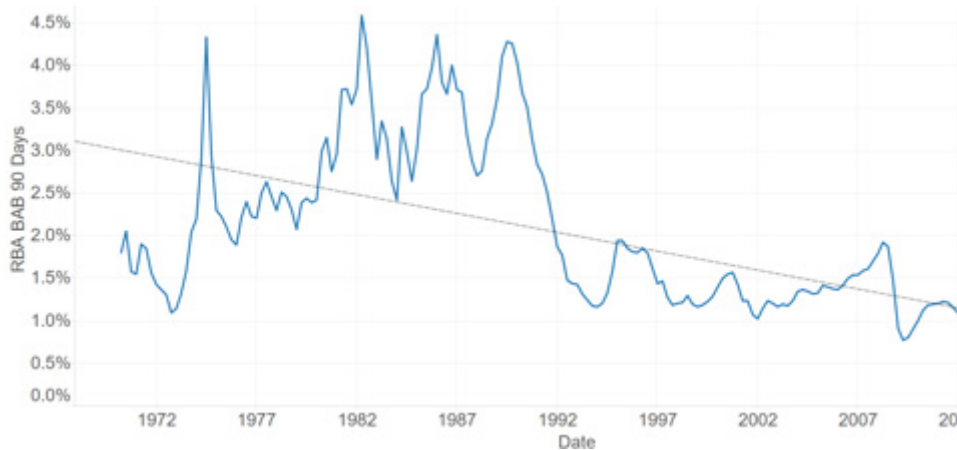
Sources: ABS, Delta Research & Advisory

While GDP and equity market returns have shown flat trends (albeit with volatile volatility), there is one financial market that has changed significantly – interest rates.

Figure 3 shows quarterly returns of the RBA Bank Bill 90 Day Index since 1969. This time, there is no sign of a flat trend and little doubt the trend is downwards, and significantly so. But this comes as no surprise. The high inflation of the 1970s and 1980s resulted in high interest rates. Over the last 25 years we've seen lower inflation provide the Reserve Bank of Australia with the scope to reduce rates in order to deal with ongoing maintenance of

economic growth and employment. Corresponding with this, is once again the same volatility pattern – high volatility in the 1970s and 1980s and a significant reduction since.

**Figure 3: RBA Bank accepted bills 90 days**  
Quarterly returns since 1970



Sources: RBA, Delta Research & Advisory

When forecasting long run equity market returns, valuation is typically a very important factor, along with many other metrics (depending on who you ask). I don't intend to address those here. As mentioned, the intention of this short paper is to set a baseline for Australian equity market expectations that can be expanded and improved.

The above trend analysis suggests a real possibility that average equity market returns may continue to trend sideways. Certainly, 45 years of data (as much as I have) isn't a bad start. I believe the main question around what equity markets will do starts with the future trend of inflation – which means the RBA plays a key role, given its key operating philosophy is that it can contribute to Australian economic prosperity by setting the cash rate to meet an agreed inflation target.

So if inflation stays low, so too will interest rates and – déjà vu – we may continue to see what has been happening more recently. If on the other hand we experience higher inflation, interest rates will rise which may increase equity market volatility as the denominator of valuations are placed under pressure.

There is, however, one inflationary scenario not captured in the Australian economy and financial markets since 1969 and it is rarely talked about, at least in the Australian context. That is deflation. There is definitely a complacency in Australia which is probably due to the fact it has been so long since Australia actually had a technical recession. While deflation is not a high probability scenario, Australia does face numerous challenges that don't rule deflation out altogether: Australia's economy is transitioning to new economic drivers as

the resources investment boom is over; the Australian population is ageing; Australia has amongst the highest levels of household debt in the world; and, this is accompanied by a residential property market that many argue is in a bubble at least in the largest markets of Sydney and Melbourne.

A severe bursting of this bubble accompanied by deflation (as seen in Japan, Spain and other burst property bubbles) would mean the above scenarios of sideways trending equity markets and economic growth would not apply. Interest rates don't have far to fall before reaching the zero bound and then the only market mechanism left would be further weakening of the Australian dollar.

So, the simple baseline scenario for long run return expectations to build from is:

- **Continued contained inflation** – a continuation of the long-run trend in Australian equity market returns and similar volatility as the last 25 years, plus continued low interest rates;
- **Higher inflation** – a continuation of the long-run trend in Australian equity market returns accompanied by much higher volatility than currently, plus much higher interest rates; or,
- **Deflation** – a sharp decline in the current Australian equity market returns accompanied by high volatility plus hitting the zero interest rate bound.

Or, something completely unprecedented!



*Michael Furey is Managing Director of [Delta Research & Advisory](#), which specialises in providing independent, conflict-free investment research and asset consulting services to dealer groups (AFSLs), financial planners, and self-directed investors. He has worked in the financial planning industry since 1999, both in research and financial planning roles.*

---