

FM Financial Update: Sept 2020

NEWSLETTER

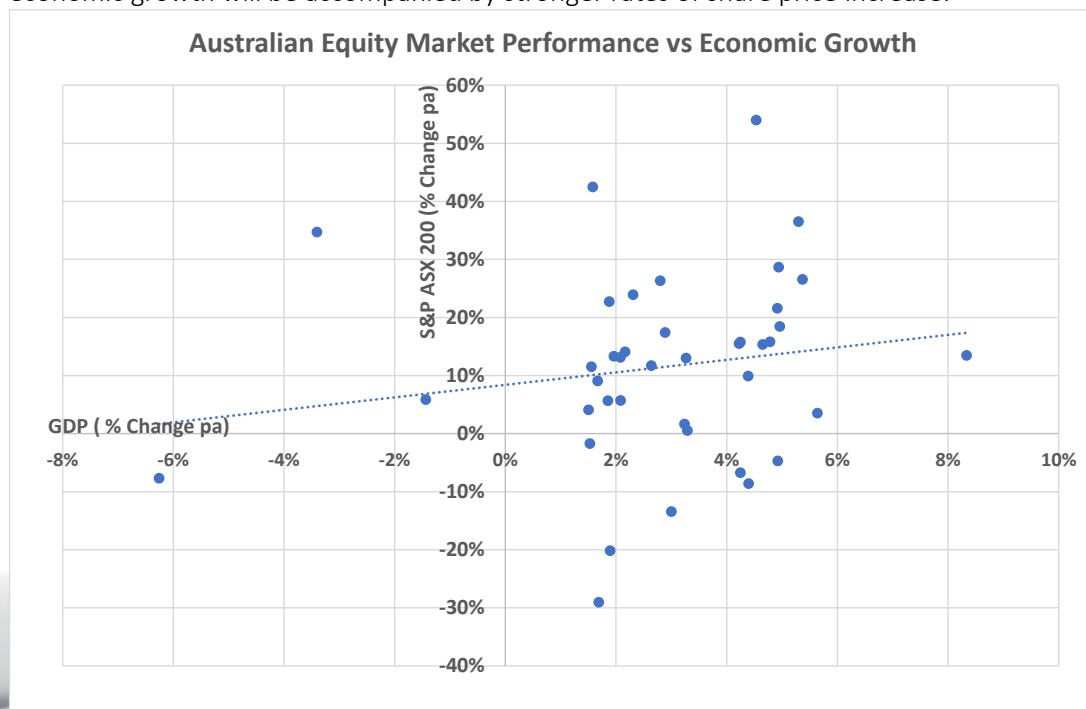
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Share market performance in recessions **September 2020**

The release of National Accounts data for the June quarter confirmed that Australia’s record run of recession avoidance has come to an end. With June being the second consecutive quarter of negative economic growth, Australia, like most of the world, has entered a technical recession. For Australia, the remarkable run of largely uninterrupted economic growth since 1991 has ended.

Theoretically, recessions and economic downturns should be seen as bad news for share market investors. Share prices are clearly linked to company earnings over the longer term, and company earnings are influenced by the general state of the domestic and global economy.

However, on examination of past data it is difficult to discern any relationship between economic growth and share market performance. The chart below plots the percentage change in the S&P ASX 200 Accumulation Share Price Index against Australia’s real economic growth rate for each financial year since 1980. As indicated, there appears to be a high degree of randomness in the relationship between changes in economic growth and share prices, although the dotted line representing the “line of best fit” does imply a marginally positive correlation overall i.e. there is a slightly higher likelihood that periods of high economic growth will be accompanied by stronger rates of share price increase.



Source: S&P ASX 200 Index, ABS, Plain English Economics.

The above chart also highlights there have been some periods of negative or low economic growth that have coincided with quite strong equity market returns. This is further explored in the table below, which details the 6-years out of the last 40 that have had the lowest rate of economic growth, highlighting the share market movement in these 6 years as well as the preceding and following year:

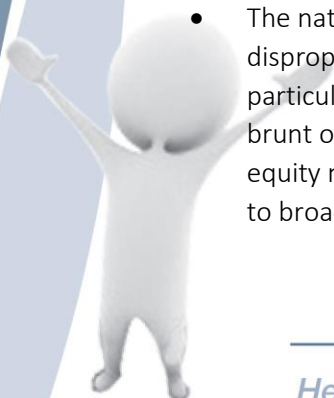
Share markets in years of lowest economic growth				
Year End June	Economic Growth	Equity Market Change		
		Year of Downturn	One Year After	One Year Before
1983	-3.4%	35%	13%	-29%
1991	-1.4%	6%	13%	4%
1990	1.5%	4%	6%	4%
2003	1.5%	-2%	22%	-5%
2019	1.6%	12%	-8%	13%
1986	1.6%	42%	54%	37%
Average	0.2%	16%	17%	4%

Source: S&P ASX 200, ABS, Plain English Economics.

In the last two periods of recession, 1991 and 1983, the Australian share market produced positive returns. More broadly, the average share market gain in the 6-years of weakest economic growth has been 16%. Over the past 40 years, the share market annual gain has averaged 11.5%. Hence, share market performance in the years of weakest economic growth has been well above average. Additionally, the table

shows that the Australian share market has performed well in the year following a period of poor economic growth as well, with an average gain of 17%. The table does suggest that share markets may at times be predictive of economic cycles, with share market gains averaging just 4% in the year prior to the period of weak economic growth. The data above implies historically there has been a significant disconnect between economic and share market performance. Clearly there are signs of this disconnect playing out currently with global share markets reaching record highs despite economies around the world experiencing the deepest economic downturn since the Great Depression. There would appear to be some specific reasons why share market performance may be even more disconnected to this current economic downturn than in previous cycles as discussed below:

- As the economic downturn was triggered by a pandemic, share markets have shown a willingness to “look through” short term earnings weakness on the basis that the downturn may be relatively short lived and less structural in nature than other periods of economic decline.
- Financial markets have been supported by unprecedented levels of central bank liquidity provision as well as a strong publicly stated commitment to the maintenance of low interest rates. As a result, investors may be willing to purchase equities at higher prices (relative to earnings) than would have otherwise been the case.
- The nature of the current downturn is such that it appears to be having a disproportionate impact on businesses that are not listed on the stock exchange. In particular, restaurants and other small businesses involved in hospitality are bearing the brunt of the downturn. These types of businesses are not heavily represented on the equity market. In contrast, mining companies, banks and large retailers have been able to broadly remain profitable through this period.



In summary, there are a multitude of determinants of share market performance and it is too simplistic to assume that a recessionary environment will result in equity market weakness. It is this complexity of share market valuation that makes it so difficult to predict. The fact that share markets have rallied so strongly in recent months despite the onset of recession only serves to highlight why a long term perspective should be taken to investing. The most positive aspect of the analysis discussed above is shown in the chart on page 1, where it is clear there have been far more positive than negative years of share market performance. This is the one statistic that has been enjoyed by those investors willing to hold equities for the long term.

Important Information

The following indexes are used to report asset class performance: ASX S&P 200 Index, MSCI World Index ex Australia net AUD TR (composite of 50% hedged and 50% unhedged), FTSE EPRA/NAREIT Developed REITs Index Net TRI AUD Hedged, Bloomberg AusBond Composite 0 Yr Index, Barclays Global Aggregate (\$A Hedged), Bloomberg AusBond Bank Bill Index, S&P ASX 300 A-REIT (Sector) TR Index AUD, S&P Global Infrastructure NR Index (AUD Hedged).

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