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Review of 2014, outlook for 2015

EDITION 39 – 4 DECEMBER 2014

Key points

> 2014 has been a positive but somewhat constrained and messy year for investors as the global economy remained in a cyclical "sweet spot" despite various threats, but Australian shares underperformed.

> 2015 is likely to see okay but uneven global growth, low inflation and easy monetary conditions. While the US is likely to start gradually raising rates, other countries including Australia are likely to ease monetary policy.

> Against this backdrop the bull market in shares and most growth assets is likely to continue. However, with shares dependent on rising earnings, volatility is likely to be a bit higher and returns okay but constrained.

> The main things to keep an eye on are: when/if the Fed starts to raise rates, Europe, the Chinese property slump, and growth outside of mining in Australia.

2014 – a positive year for investors…mostly

2014 has had its share of worries with a range of geopolitical threats, uneven global growth, the end of quantitative easing in the US, plunging oil and iron ore prices and a debilitating debate about budget cuts in Australia. Yet again, events have conspired to indicate deflation as opposed to inflation is more of a risk. Despite all this it was still a reasonable environment for most assets. Key themes have been:

- **Okay global growth**. Global growth improved a bit to around 3.5%. However, it was uneven, with the US proving to be relatively strong, the Eurozone growth remaining weak, Japan having a tax driven setback, China growing around 7-7.5% and some emerging countries really struggling – notably Brazil and Russia. However, while the uneven nature of global growth has caused consternation it has still been okay, and stronger growth would bring inflation and interest rate worries.
- **The threat of deflation**. Yet again inflation failed to take off as many continue to fear. In fact it remained low or fell in developed countries as excess capacity and falling commodity prices continued to impact.
- **Further global monetary easing**. While the US Fed ended its quantitative easing program, central banks in Japan, Europe and China all eased in the face of sub-par growth and the threat from deflation.
- **Collapsing commodity prices**. Quite clearly the commodity super cycle has turned down as last decade's excess demand for commodities has turned into this decade's excess supply. This is bad for commodity producers but good for most developed countries providing a boost to growth and a dampener for inflation.
- **Rising geopolitical threats**. Conflicts in Ukraine and Iraq, protests in HK and Ebola all hit the headlines causing periodic fear. Maybe it's just an ongoing reality.
- **Flat low rates and subdued growth in Australia**. While non-mining activity improved, the slump in mining investment and poor confidence saw sub-par growth of around 2.5% which in turn saw unemployment drift up. With inflation remaining low the RBA left rates at 2.5%.

The combination of okay but not too hot, not too cold global growth and low inflation meant the global investment cycle remained firmly in the "sweet spot" for investors. But as over the last few years, it was not a simple "risk on" environment. In particular, commodity related trades including the Australian share market were big underperformers.

Investment returns for major asset classes

Total return %, pre fees and tax	2013 actual	2014* actual	2015 forecast
Global shares (in Aust dollars)	48.0	12.1	14.0
Global shares (in local currency)	29.2	10.9	10.0
Asian shares (in local currency)	5.8	7.1	10.0
Emerging mkt shares (local currency)	3.4	7.9	8.0
Australian shares	20.2	3.5	9.0
Global bonds (hedged into $A)	2.3	9.5	3.0
Australian bonds	2.0	8.0	3.0
Global listed property securities	5.8	26.1	9.0
Aust listed property trusts	7.1	21.6	9.0
Unlisted non-res property, estimate	8.8	8.0	9.0
Unlisted infrastructure, indicative	9.0	12.0	10.0
Aust residential property, estimate	14.5	8.0	6.0
Cash	2.9	2.5	2.3
Avg balanced super fund, ex fees & tax	**18.0**	**7.3**	**8.0**

Yr to date to Nov. Source: Thomson Reuters, Morningstar, REIA, AMP Capital

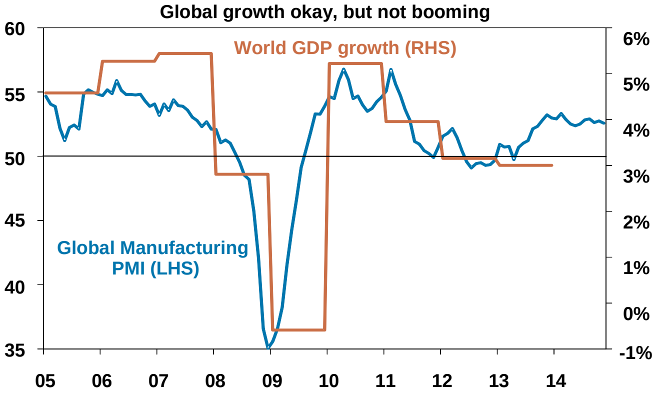
- Despite a few setbacks global shares saw solid returns reflecting the combination of okay global growth and further monetary easing.
- In the developed world US shares outperformed helped by strong profit growth, with Europe lagging.
- While Chinese shares had a strong rebound after a four year bear market and Indian shares did very well, emerging market shares have lagged, as commodity prices fell and political developments weighed in some.
- Commodities performed poorly again as Chinese growth remained constrained and supply surged. Notably the global oil price fell 32% and the iron ore price fell 47%.
- Australian shares, as expected, underperformed again, but performed even worse than expected as the slump in commodity prices weighed with worries about the impact on the economy and foreign investors retreating to the sidelines as the $A fell. Policy uncertainty out of Canberra likely also weighed. While health, utility, telco and financial sectors did well this was offset by a further slump in resources shares.
- Global and Australian bonds performed well as fading inflation and expectations of easier for longer monetary policy pushed bond yields back down.
- Real estate investment trusts and unlisted assets like commercial property and infrastructure had strong returns as investors sought decent sources of income yield in the face of low/falling interest rates.
- Australian residential property had a good year as the recovery in house prices continued on the back of low interest rates. However, gains were narrowly focused in Sydney and Melbourne and slowed through the year.

- Cash rates and bank term deposit returns were poor reflecting record low RBA interest rates.
- The $A fell against the $US on commodity price falls and a resurgence in the $US. However, it rose against the Yen and Euro as both ramped up monetary stimulus.
- Balanced superannuation funds had solid returns, albeit constrained compared to the previous two years thanks to the softer performance from Australian shares.

2015 – still in a global sweet spot

As always there seems to be plenty of calls for global recession in the year ahead based on everything from quantitative easing to demographics. However, there remains good reason for cautious optimism.

- Leading indicators of global growth including business conditions PMI's point to continued reasonable growth.



Source: Bloomberg, AMP Capital

- While this growth is likely to remain uneven between countries, which can be unnerving, it does mean we are a long way from global overheating associated with excessive growth in credit, inflation etc. In many ways the current environment is a bit like the mid to late 1990s where US growth was good but subdued conditions elsewhere kept inflation and interest rates relatively low.
- Falling commodity prices in response to a positive supply response are adding to this. Recall the oil price falling to $US10/barrel in 1998. It could conceivable now fall to $US40/barrel.
- As a result monetary conditions are set to remain relatively easy as major central banks seek to head off deflationary pressures.

In short, the next global recession looks to be a long way off – maybe not until later this decade in accordance with the cyclical pattern that has prevailed since the 1970s of major recessions every 8-10 years: mid 1970s, early 1980s, early 1990s, early 2000s, late 2000s, later this decade?

Reflecting all this:

- Global growth is likely to remain around 3.5%, ranging from 1-1.5% in the Eurozone and Japan, 3.5% in the US and China at 7%.
- Inflation is likely to remain benign on the back of significant spare capacity and weak commodity prices.
- Global interest rates are likely to remain low, with the US starting to raise rates gradually from mid-year, but continuing monetary easing in Europe, Japan and China. Europe is likely to expand its QE program and China is likely to cut its benchmark lending rate to around 4.5%.

For Australia, non-mining activity is likely to continue to pick up pace but in the face of falling national income and subdued confidence this will likely require further monetary stimulus in the form of a lower $A and a further RBA interest rate cut. If this occurs then improving conditions in sectors like housing construction, consumer spending, tourism, manufacturing and higher education should see GDP growth move up to around 3%. At the same time inflation is likely to remain benign. The RBA is expected to cut the cash rate to 2.25% early in the year with a 50% chance of another cut in the June quarter.

Implications for investors?

The continuing sweet spot combination of okay global growth, but still low inflation and easy money is positive for growth assets. But an eventual rate hike by the Fed and ongoing geopolitical flare ups are likely to cause volatility.

- Global shares are likely to continue to push higher as global growth continues and monetary conditions remain easy. But shares are no longer dirt cheap and so are dependent on earnings growth. This and the ongoing debate about when the Fed will start to raise rates is likely to lead to a more constrained and volatile ride.
- For shares at present we favour: Europe (which is still cheap, unloved and likely to see more monetary easing), Japan (which will see continued monetary easing) and China (which also remains cheap) over the US (which may be constrained by a Fed rate hike) and emerging markets generally (which are cheap but messy).
- Australian shares are likely to pick up pace as interest rates remain low and growth continues to rebalance away from resources, but will probably lag global shares again as the $A remains under pressure and commodity prices remain in a long term downtrend. Expect the ASX 200 to rise to around 5800 by end 2015.
- Commodity prices may see a bounce from very oversold conditions, but excess supply for many commodities is expected to see them remain in a long term downtrend.
- Very low bond yields point to a soft return potential from sovereign bonds, but it's hard to get too bearish in a world of too much saving, spare capacity & low inflation.
- Commercial property and infrastructure are likely to benefit from the ongoing search by investors for yield.
- Australian house prices are likely to see a continued upswing on the back of low interest rates.
- Cash and bank deposits are likely to continue to provide poor returns, with term deposit rates running around 3%.
- The downtrend in the $A is likely to continue as the $US trends up and reflecting the long term downtrend in commodity prices and Australia's relatively high cost base. Expect a fall to around $US0.75. However, the $A is likely to be little changed against the Yen and Euro.

What to watch?

The main things to keep an eye on in 2015 are:

- when/if the Fed starts to raise interest rates (as history shows the first rate hike can cause volatility);
- whether Europe can avoid sustained deflation & the ECB ramps up its quantitative easing program (I think it will);
- a possible Greek election early in the year as a threat to whether it remains in the Euro (although the risk of contagion to other countries is likely to be minimal now given ECB action);
- the Chinese property slump;
- whether non-mining economic activity continues to pick up in Australia. A failure to do so could see even more aggressive RBA rate cuts;
- ongoing geopolitical flare ups; and
- whether the search for yield and return in the face of ongoing low interest rates sets off a bubble in equity markets. This might be nice – but only while it lasts!

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