

2013 and beyond – a list of lists

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Key points

- > 2013 is likely to be another good year for investors underpinned by a lessening in tail risks, very easy global monetary conditions and improving global growth.
- > Watch global business conditions purchasing managers' indices (PMIs), European bond yields, Chinese money supply growth, the Australian dollar and Australian housing indicators.
- > Australia will likely continue to grow, but could go through a rough patch as mining investment slows before picking up pace during the second half.
- > There is always a cycle and investors should avoid the crowd. Right now the cycle is moving away from cash and bonds in favour of equities and growth assets.

Introduction

2012 turned out to be a good year. The euro did not break up, the US did not have a double-dip recession, China did not land hard, Australia didn't do anything too bad and the world did not end on 21 December. Rather, the global economy continued to grow and investor returns were strong. Despite the best efforts of some US politicians to go over the fiscal cliff on 1 January, they didn't in the end. This year has started off well and I think it will end well too. As I did a year ago, I thought it would be useful to provide a summary of key views on the economic and investment outlook in simple point form. In other words, a list of lists.

Key themes for 2013

- > Continuing fiscal austerity but moderating in Europe and picking up in the US.
- > Ultra easy global monetary conditions with open-ended quantitative easing in the US, Japan effectively doing the same, more monetary easing in Europe and very low interest rates in Australia.
- > Diminishing risks of a euro break-up and a further fading of the Eurozone financial crisis, largely thanks to European Central Bank (ECB) action but also ongoing support for peripheral countries.
- > Global growth of around 3.25%, up from around 3% in 2012 led by an improvement in the US and China.
- > Continued low inflation thanks to spare global capacity.
- > Occasional bouts of market volatility but against a rising trend for share markets as global growth improves helped by reasonable valuations, easy monetary conditions and a likely swing in investor flows from 'safety' to focusing a bit more on 'growth'.

Key risks for 2013

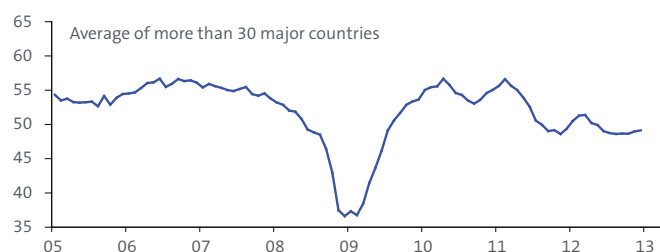
- > US politicians fail to agree on long-term budget savings and a debt ceiling increase leading to more US ratings downgrades adversely affecting US confidence.
- > The European recession deepens resulting in social unrest and renewed concerns of a break-up of the euro.
- > China's growth improvement proves fleeting.
- > The key cyclical non-mining sectors of the Australian economy fail to respond to lower interest rates leading to a hard landing for growth and weaker profits.

- > Global growth surprises on the upside leading to a mass investor switch out of bonds and a sharp rise in bond yields, destabilising the global economy.
- > Factor X. All of the above (except maybe the last point) are well known worries.

Five key indicators to watch

- > Global business condition indicators or PMIs - as these will give a good guide as to whether global growth will pick up a notch. So far so good.

Global manufacturing conditions indicators (PMIs) appear to have bottomed



Source: Bloomberg, AMP Capital

- > The spread to German bond yields for Italy and Spain - a further narrowing would be a good sign.
- > Chinese money supply growth – it should trend sideways.
- > The Australian dollar is a good indicator of global growth – if it stays strong things are okay globally. So far so good.
- > Australian housing-related indicators – a good guide to whether lower interest rates are gaining traction.

We all know about US public debt woes, but here's five reasons to be optimistic on the US

- > The housing sector (the trigger of the global financial crisis) is recovering.
- > Private sector deleveraging is well advanced. Private debt is down, household wealth levels are up.
- > America is going through an oil and gas production boom thanks to shale fracking. US oil production is at a 20-year high. This means less reliance on the Middle East, cheaper energy and a jobs boost.
- > Manufacturing is having a renaissance with numerous companies switching production to the US thanks to cheap energy, low unit labour costs, the low US dollar, etc.
- > The US remains the centre of the tech boom/innovation.

Seven reasons why Europe tail risk is fading

- > The ECB has removed bank funding issues via cheap loans to banks.
- > The ECB has declared the euro "irreversible" and backed this up with a program (the Outright Monetary Transactions [OMT] program) to buy bonds in countries that ask for help and commit to reforms. And investors believe it.
- > The European Stability Mechanism (ESM) bailout fund is up and running.
- > Europe now has a fiscal compact focused on reducing and converging budget deficits.
- > Europe is on track for a banking union with a single regulator.
- > Despite much angst and delays Europe has bent over backwards to keep Greece in the euro.
- > The constant trend over the last three years by European Union leaders has been to "more Europe, not less".

Seven implications of Japanese reflation, under new Prime Minister Abe

- > The Japanese yen is likely to fall another 10-20%.
- > Japanese shares are likely to perform well.
- > A stronger Japanese economy.
- > Japan will no longer be a drag on global growth.
- > Easier monetary policies in Japan will add to ultra easy global monetary conditions.
- > Yen weakness will put more pressure on competitor countries, notably Korea and Taiwan, to ease.
- > Further fuel to the carry trade of borrowing cheap in Japan and investing in currencies like the Australian dollar.

Four reasons the emerging world remains in good shape

- > Low public and private debt levels.
- > Low per capita income levels = huge potential for further catch-up in living standards and hence urbanisation and industrialisation.
- > Inflation has fallen allowing easy monetary policies.
- > Generally sensible economic management.

Australian growth is likely to slow initially as mining investment slows, but here's six reasons not to be bearish on Australia

- > Low interest rates will boost demand more from the 40% of households with a mortgage than it will suppress it from those relying on bank interest reflecting the net indebtedness of the household sector and the greater spending variability of the former.
- > Interest rates may still fall further.
- > There is significant pent-up demand, e.g. for housing.
- > A slower mining sector will allow for the economy to become better balanced.
- > Our trading partners are in good shape, and China's growth appears to have bottomed.
- > The Australian dollar will fall if need be, providing a buffer.

Reasons why the Australian dollar is likely to remain strong on a medium-term view

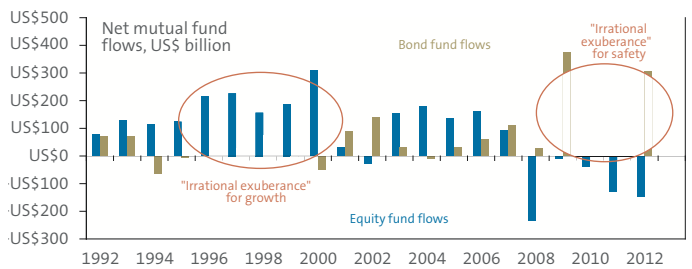
- > Commodity prices are likely to remain strong on the back of emerging world industrialisation.
- > Quantitative easing will increase the supply of US dollars, yen and euros relative to the supply of Australian dollars.
- > Safe-haven buying of Australian bonds as its one of only a few countries with a 'stable' AAA credit rating.
- > However, low Australian interest rates and softer Australian growth as the mining investment boom slows will likely constrain the Australian dollar. So while I expect the Australian dollar to remain strong I don't expect a new surge higher.

Reasons to be cautious of sovereign bonds

- > Bond yields are near record lows which means low returns if yields are unchanged or worse if they rise as investors would then suffer a capital loss.
- > If global growth improves it will bring forward market expectations for the start of monetary tightening and push bond yields higher.

- > Huge inflows into bond funds/outflows from share funds ("irrational exuberance" for safety) in recent years suggest a huge risk of reversal once confidence improves. This would be bad for bonds.

Huge US investor flows into bonds, out of equities



Source: Bloomberg, AMP Capital

Why investment markets will remain volatile over the next few years, albeit less so than they have been

- > Excessive public sector debt levels in Europe, the US and Japan and ongoing fiscal austerity will create occasional bouts of volatility.
- > Extreme monetary policy settings, e.g. zero interest rates and quantitative easing, will be a source of volatility when changes occur.
- > Social unrest is high and politics remains polarised (e.g. the tea party in the US and the tensions between economic rationalists and populists in Europe).
- > Greater reliance for global growth on emerging countries which are usually more volatile.
- > This all results in a continuing favourable environment for dynamic asset allocation strategies.

What should investors consider? (Thanks in part again to my friend Dr Don Stammer)

- > The cycle lives on – times of gloom eventually give way to boom and vice versa. There is no such thing as a new era, new paradigm or new whatever.
- > The power of compound interest – regular investing of small amounts can compound to a big amount over the long term.
- > Buy low and sell high – starting point valuations matter. The lower valuations thrown up by market weakness provide opportunities for long-term investors.
- > Focus on investments providing decent and sustainable cash flows – dividends, distributions, rents – as they are a good guide to future returns, a good buffer in volatile times and provide good income.
- > Invest for the long term but for those with a short-term horizon, such as those close to or in retirement, consider investment strategies targeting desired investment outcomes whether in the form of a targeted return or cash flow.
- > Avoid the crowd – at extremes the crowd usually gets it wrong. And in recent times the crowd has piled into cash and sovereign bonds, which are unlikely to be the best place to be over the next five years or so.

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