

2014 – a list of lists

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Key points

- > Thanks to improving growth and very easy monetary conditions, 2014 is likely to be another year of good returns for investors, albeit a bit slower than in 2013.
- > Watch global business conditions indicators, wages growth in the US, European bond yields, Chinese lending growth and Australian consumer related indicators.
- > Australian growth is likely to pick up a bit thanks to stronger housing investment and consumer spending.
- > Right now the investment cycle is still moving away from cash and bonds in favour of equities and growth assets.

Introduction

2013 turned out to be a very good year for investors in well-diversified portfolios as the threats of the last few years receded and global growth prospects improved. The US did not have a fiscal crisis, the Eurozone continued to stabilise, Japan recovered, Chinese growth stabilised and Australia saw signs that low interest rates are starting to help the economy. As a result, the global economy was in a sweet spot of stabilising/improving growth, but low & falling inflation and very easy monetary conditions, all of which proved very favourable for equity markets. This note provides an annual list of lists - a summary of key views on the global economic and investment outlook in simple point form.

Key themes for 2014

- Continued very easy monetary conditions. While the Fed is slowing its quantitative easing program, significant spare capacity and low inflation will see interest rates remain low globally and in Australia, with the possibility of even further monetary easing in Europe and Japan.
- Reduced fiscal drag in OECD countries as austerity slows down in the US and Europe.
- Global growth of around 3.5%, up from 3% in 2013, led by improvement in the US and Europe.
- A pick up in Australian growth to around 3% by year end as housing and consumption recovers and export volumes improve, partly offset by a further slowdown in mining investment and budget cutbacks
- While share market volatility may increase and returns may slow, returns should still be good as shares and growth assets generally remain underpinned by an improving growth outlook, easy monetary conditions, a continued rotation in investor flows from "safety" to "growth" and as shares are still not expensive.

Key risks for 2014

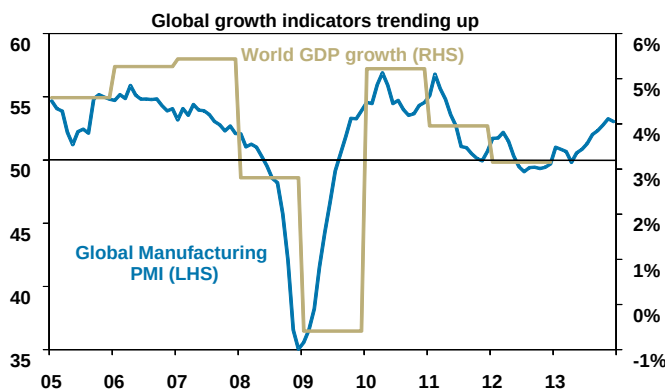
- Too much exuberance. After the strong run in share markets of the last two years, short-term investor confidence is at levels often associated with corrections.
- Bond yields could surge higher and destabilise growth assets. This could occur in response to stronger than

expected growth and/or inflation and/or an accelerated switch out of bond investments by investors.

- The Eurozone crisis could return as growth there remains low and with bank stress tests due later in the year.
- China's growth stabilisation could prove fleeting.
- The pick-up in non-mining sector growth in Australia may not be strong enough to offset the slowdown in mining investment and budget cutbacks in the May budget.
- Factor X - something can always come from left field.

Five indicators to watch

- Global business conditions indicators (or PMIs) - these have been drifting higher auguring well for improved global growth but not (thankfully) a global boom.



Source: Bloomberg, AMP Capital

- Wages growth in the US as a guide to how quickly inflation will pick up there and so when & how quickly US monetary tightening will occur - so far it's still very low.
- The spread to German bond yields of Italian and Spanish bonds - a good guide to whether the Eurozone crisis is continuing to fade. So far the news remains very good, with the spread continuing to contract.
- Chinese lending and money supply growth - it should trend sideways.
- Australian consumer spending related indicators, like consumer confidence & retail sales, as these are a good guide to whether the benefit of interest rate cuts are flowing on from housing to the broader economy.

Seven reasons why the US is in good shape

- The US budget deficit has collapsed from over 10% of GDP in 2010 to below 4% of GDP.
- The bi-partisan budget deal announced in December signals reduced political risk in the US and suggests increasing the debt ceiling, which will be required by around March, is unlikely to be a major problem.
- The housing sector is continuing to recover.
- Private sector deleveraging appears to have run its course with debt levels down & household wealth rising.
- The energy boom is continuing leading to cheap gas and electricity and less reliance on Middle East oil.

- The US manufacturing renaissance is continuing thanks to low labour costs, cheap energy and the low \$US with companies switching production back to the US.
- The US remains the centre of the tech boom and innovation.

Four signs Abenomics is working in Japan

- Inflation is running at 1.5% up from -0.1% a year ago.
- Wages growth is stabilising.
- The ratio of job vacancies to applicants is at a six-year high.
- M2 money supply growth is running at a 14 high.

Five reasons why Chinese growth is likely to remain around 7% to 8%

- The authorities don't want to see a return to 10% plus growth as it is seen as unsustainable, but...
- Premier Li has indicated a floor to tolerable growth (to avoid rising unemployment) of 7% to 7.5%.
- Inflation remains benign at around 1.5% to 2.5% suggesting little need for aggressive monetary tightening.
- A debt crisis is unlikely. Public debt to GDP is up due to strong growth in local government debt, but at 56% of GDP it is manageable for a high-growth, high-savings country and well below US, Japanese & Eurozone levels.
- Nor is a house price crash likely. House prices have seen solid growth but this largely reflects a lack of supply of housing that most Chinese need rather than bubble-like conditions & the authorities appear to recognise this.

Five reasons not to be too bearish on Australia

- Trade is likely to steadily boost growth as resources export volumes pick up in the years ahead (after all the investment and helped by a stronger global economy). Exports to China are growing 55% year on year.
- Slowing mining investment will allow a more balanced economy after the unbalanced "two speed economy" years.
- Interest rates are at generational lows.
- The falling \$A is providing a boost to growth.
- A housing construction recovery is underway with, eg building approvals around past cyclical highs.

Strong Australian building approvals point to a strong housing construction cycle



Source: Bloomberg, AMP Capital

- There are signs of life in consumer spending with retail sales looking stronger, consumer confidence off its lows, household wealth up and the savings rate very high at around 11% (meaning it has scope to fall a bit to provide a boost to consumer spending growth).

Five reasons why share returns might be a bit more constrained and volatile this year

- After two strong years, shares are no longer dirt cheap meaning the easy gains are behind us and we are now more dependent on rising earnings coming through.

- Improving growth and Fed tapering will bring with it occasional worries about a faster removal of monetary stimulus in the US.
- The rising trend in bond yields could occasionally pressure share markets and high yield sensitive sectors, like financials and utilities, in particular.
- Short-term investor sentiment measures are very bullish, which is bearish from a contrarian perspective.
- The second year of the four-year US Presidential cycle has seen below average returns historically.

...but four reasons to still expect good returns

- While shares are no longer dirt cheap, share valuations are not expensive either.
- Improving global (and eventually Australian) economic growth will help drive stronger profits.
- Global and Australian monetary conditions will remain very easy, with sub 4% term deposit rates in Australia driving investors in search of higher returns elsewhere.
- The near 30% gain in the US share market in 2013 augurs well for another decent year. The last five years that saw 26% or greater gains in US shares (ie 1991, 1995, 1997, 1998 & 2003) saw average gains of 16% in the subsequent year as the strong returns attracted inflows.

Reasons to remain cautious sovereign bonds

- Despite the rise in sovereign bond yields in 2013, yield levels remain low pointing to low medium-term returns from bonds.
- If global growth improves as expected, it may bring forward expectations for the start of monetary tightening, which could push bond yields higher.
- The "great rotation" - the huge inflows into bond funds since 2008 are only just starting to reverse as investors start to unwind an "irrational exuberance for safety" in favour of a greater balance to towards growth. This can in part be a response to poor bond returns themselves, but the outflows from bond funds will only serve to drive bond yields higher.

What should investors always remember?

- The cycle lives on - times of gloom eventually give way to times of boom and vice versa.
- The power of compound interest - regular investing of small amounts in growth assets can compound to a big amount over the long term and make up for the volatility often caused by investment cycles.
- Starting point valuations matter a lot for subsequent returns - so buy low and sell high.
- Focus on investments providing decent and sustainable cash flows such as rents, dividends or interest - this is particularly important as investor gloom gives way to optimism.
- Invest for the long term as far as possible, but those with a short-term horizon should consider investment strategies targeting investment goals whether it be for cash flow or a retirement nest egg.
- Avoid the crowd because, at extremes, the crowd is invariably wrong. In the aftermath of the GFC, the crowd piled into bank term deposits and sovereign bonds and this is turning out not to be the best place to be invested.

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