

Review of 2013, outlook for 2014

EDITION 39 – 31 DECEMBER 2013



Key points

- > 2013 has turned out to be another good year for investors as various threats faded and the global economy remained in a cyclical "sweet spot" of improving growth, low inflation and low interest rates. This resulted in solid overall returns.
- > 2014 is likely to see improving growth globally and in Australia and with inflation and interest rates remaining low this should provide a positive backdrop for growth assets even as bond yields gradually continue to drift higher. However, with shares no longer dirt cheap and dependent on rising earnings, volatility is likely to be a bit higher and returns a bit more constrained.
- > The main risk to keep an eye on is a sharp sell in bond yields perhaps on Fed tapering or much stronger growth.

2013 – another good year for investors

2013 was notable for what did not happen: the US did not go off the fiscal cliff or default on its debt and the much feared inflation lift off failed to materialise; the euro did not fall apart despite a few scares involving Italy, Cyprus, etc; China did not hard land despite reports of "ghost cities" and claims of massive debt; and Australia did not have a recession despite the mining slowdown. What did happen was mostly positive:

- Global growth stabilised around 3% with leading indicators improving. US and Japanese growth was moderate, the Eurozone returned to growth and Chinese growth stabilised around 7.5%. Most importantly forward looking indicators of global growth, notably business conditions PMI's, moved higher.
- Inflation remained low or fell in developed countries as excess capacity continued to impact. Japan saw inflation return but only at a very low rate.
- While the US Federal Reserve generated mid-year uncertainty in flagging plans to taper its quantitative easing program, global monetary policy remained highly stimulatory and in fact became more so with Japan announcing a massive quantitative easing program and Europe cutting interest rates further.
- In Australia, the Reserve Bank cut the official cash rate to 2.5% as growth remained sub-par at around 2.3%. A change of Government provided a modest confidence boost, but the key development was the upswing in the housing sector followed by other indicators suggesting interest rate cuts are getting traction.
- The biggest surprise on the downside globally was the worse than expected performance of emerging market countries with several – notably Brazil, India and Indonesia – facing a deteriorating growth/inflation trade-off, not helped by years of backsliding on economic reforms. In fact all three countries raised interest rates.

The favourable combination of an improving growth outlook and low inflation meant the investment cycle remained firmly in the "sweet spot" for investors. But while a chase for yield continued on the back of low interest rates, it was not the simple "risk on"

environment that many had become used to. Returns for the major assets are shown in the next table.

Investment returns for major asset classes

Total return %, pre fees and tax	2012 actual	2013 actual	2014 forecast
Global shares (in Aust dollars)	14.1	48.0	18.0
Global shares (in local currency)	15.5	29.2	14.0
Asian shares (in local currency)	18.4	5.8	14.0
Emerging mkt shares (local currency)	17.0	3.4	9.0
Australian shares	20.3	20.2	12.0
Global bonds (hedged into \$A)	9.7	2.3	3.0
Australian bonds	7.7	2.0	2.5
Global listed property securities	26.7	5.8	8.0
Aust listed property trusts	33.0	7.1	8.0
Unlisted non-res property, estimate	8.0	8.8	8.0
Unlisted infrastructure, indicative	12.8	9.0	10.0
Aust residential property, estimate	2.0	10.5	8.0
Cash	4.0	2.9	2.7
Avg balanced super fund, ex fees & tax	13.3	18.0	10.0

Source: Thomson Reuters, Morningstar, REIA, AMP Capital

- Despite a mid-year correction on Fed taper concerns global shares saw very strong returns as threats receded, the global economic outlook improved and monetary conditions remained ultra-easy.
- Japanese shares shot the lights out (returning 49% to November) as Abenomics swung into gear followed by the US and then Europe. Emerging market shares lagged, particularly outside Asia, as commodity prices fell, growth slowed a bit and inflation proved problematic in some countries, necessitating monetary tightening.
- Commodities performed poorly as Chinese growth moderated and supply rose.
- Australian shares had solid returns but they were constrained by soft growth and another year of poor returns for resources stocks on periodic China fears.
- Unlisted assets like commercial property and infrastructure had solid returns, but listed real estate investment trusts slowed reflecting their sensitivity to rising bond yields and after 30% or so returns last year.
- Australian residential house prices had a good year as low interest rates sparked a recovery & talk of a bubble.
- Global and Australian bonds performed poorly as government bond yields rose on the back of better growth prospects resulting in capital losses for investors at a time when low yields barely offset the losses.
- Cash returns were poor reflecting record low RBA interest rates. This saw bank term deposit rates fall.
- The \$A fell on soft commodity prices and RBA rate cuts.
- The strong returns from shares and unlisted assets drove solid returns for balanced superannuation funds.

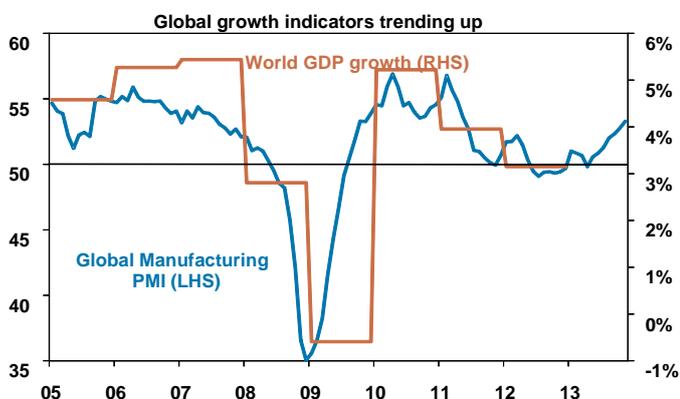
2014 – still in the sweet spot

While there are still plenty of doomsayers around, we remain cautiously optimistic regarding the growth outlook. First, the cyclical pattern since the 1970s of major recessions every 8-10 years (mid 1970s, early 1980s, early 1990s, early 2000s, late

2000s) with modest growth slowdowns in between suggests we remain in a positive part of the cycle. The 2012-13 global growth slowdown has cleared the way for a continuation of the global recovery for the next few years which should help underpin growth assets.

Second, global monetary conditions will likely remain very easy. As a result of the 2012 growth slowdown, coming at a time when the world had not really fully recovered from the 2009 recession, spare capacity remains immense and so inflationary pressures are low. As a result while the Fed is moving to slow its quantitative easing program, the Fed Funds rate is set to remain near zero out to 2015. Japan and Europe may even see more monetary easing.

Third, the drag on growth from fiscal tightening is receding from around 1.3% of GDP in 2013 to around 0.7% of GDP in 2014. This is particularly the case in the US where fiscal drag will shrink from 2.3% of GDP to 0.6% of GDP and in the Eurozone where it will fall from 1.1% of GDP to 0.3% of GDP. In other words, the big fiscal tightening in Europe (believe it or not Greece is on track for a primary budget surplus this year) and the US is largely behind us.



Source: Bloomberg, AMP Capital

Reflecting this:

- Global growth is likely to pick up a notch to around 3.5% from 3% in 2013, ranging from 1% in the Eurozone, 1.5% in Japan, 3% in the US and 5% in the emerging world with China at 7 to 7.5%.
- Inflation is likely to remain benign on the back of significant spare capacity.
- Interest rates are likely to remain low, although towards the end of 2014 there may be more talk of when the Fed will start to raise interest rates and Fed tapering could cause bouts of uncertainty.
- The improving global growth back drop at a time of constrained costs is likely to see earnings growth pick up.

For Australia, the combination of a housing recovery, gradually improving confidence, a pick-up in non-mining investment and stronger global growth are expected to result in growth pushing up to around 3% by end 2014. At the same time inflation is likely to remain benign and the RBA is expected to keep the cash rate on hold at 2.5% ahead of a possible rate hike later in 2014 which will likely see the cash rate end the year at a still low 3%.

So what will it mean for investors?

The backdrop of improving growth but still low inflation and interest rates is positive for growth assets. But returns may be a bit more constrained and volatile than we saw in 2013.

- Shares are likely to continue to push higher as the global recovery picks up pace driving strong earnings growth & interest rates remain low supporting an ongoing investor switch from cash and bonds into shares. But after the rapid gains of the last two years shares are no longer dirt cheap but around fair value. As a result returns are likely to be more constrained and volatile as they will be more

dependent on earnings growth. Relatively high levels of investor sentiment readings and various technical indicators highlight the risk of a correction in the next few months, before the broad rising trend resumes.

- In terms of regions, for shares we favour: Europe (which is cheap and may see more monetary easing), Japan (which may also see more monetary easing) and parts of North Asia including China (which are also cheap) over the US (which is fair value and may be constrained by Fed tapering) and emerging markets generally (which are cheap but messy and may suffer as the Fed tapers).
- Australian shares are likely to perform well as profits pick up and interest rates remain low, but will probably lag global shares as there is somewhat better value globally. We expect the ASX 200 to rise to around 5800 by end 2014. Bombed out cyclicals like resources and industrials that underperformed over the last year are likely to outperform with interest though remaining in yield plays.
- Commodity prices are likely to receive a boost – while they are in a long term downswing their poor performance since 2011 (they have lost 8.5% year to date) has left them undervalued and unloved and they are likely to receive a boost from better global growth.
- The gradual uptrend in sovereign bond yields is likely to continue as global growth continues to improve and investors switch to riskier alternatives. Corporate debt remains a better bet for those after income.
- An ongoing chase for yield and reasonable fundamentals should drive solid returns from income yielding commercial property and infrastructure.
- 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 falling below 4%.
- The downtrend in the \$A is likely to continue – but a sharp fall is unlikely as RBA jawboning and Fed tapering will be offset by improving Australian growth and slightly stronger commodity prices. Expect a fall to \$US0.86.

What are the risks?

Beyond the risk of a short term correction in shares, there are three key “risks” for investors. First, shares could continue to surge higher as the strong returns of 2012 and 2013 reinforce fund inflows. It’s interesting to note that the US share market year to date is up 26%. The last five years in which it was up 26% or more, saw average gains in the subsequent year of 16% as the strong return attracted inflows. This of course would be a nice risk (while it lasts).

Second, a combination of Fed tapering, a faster growth acceleration and/or a pick-up in inflation could prompt a sharp back up in bond yields which would pressure yield plays and shares. Finally, on the flip side global growth could remain sluggish or deteriorate threatening deflationary pressures. This would be good for sovereign bonds and possibly bad for growth assets.

Another US debt ceiling standoff with Congress could cause uncertainty, but looks unlikely given the mid-term elections.

In Australia, the main risk is that the non-mining sectors fail to pick up pace leading to a sharper slowdown in growth rather than the upswing to 3% growth we are expecting. This could see the RBA cut the cash rate to 2%.

Investment implications

2014 is likely to see more volatility than seen in 2013 with more constrained returns. But overall it should be positive for investment markets as global growth picks up a bit and monetary conditions remain ultra easy.

Dr Shane Oliver
Head of Investment Strategy and Chief Economist
AMP Capital