



## 2015 – a list of lists regarding the macro investment outlook

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EDITION 2

### Key points

- > 2015 should be another reasonable year for investors reflecting okay growth and easy monetary conditions, but expect a bit more volatility.
- > Watch global business conditions indicators, US wages, Spanish and Italian bond yields, the ECB, the Chinese property market and confidence readings in Australia.
- > The investment cycle still favours growth assets over cash and bonds.

### Introduction

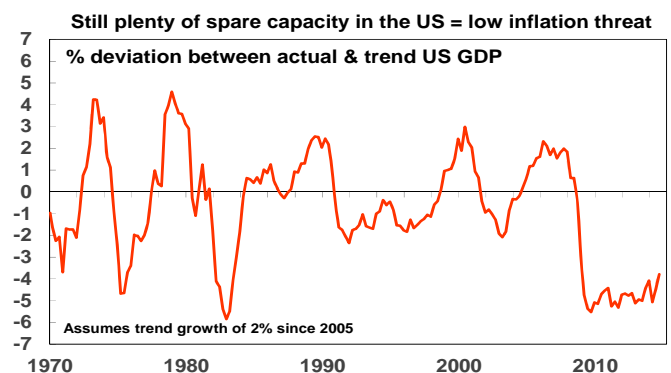
2014 saw good returns for diversified investors as the global economy continued to grow and monetary conditions remained easy, but a combination of uneven global growth, worries about deflation, plunging commodity prices, soft growth in Australia and geopolitical concerns meant returns were uneven across asset classes. Balanced super funds look to have had returns of around 9%, which is pretty good after the double digit returns of the previous two years. This note provides a summary of key insights on the global economic and investment outlook in simple point form.

### Four lessons from 2014

- Turn down the noise – despite talk of recessions & crashes encouraging you to head for cash, returns were good.
- Markets lead economies – this was most evident in China where fears of a hard landing intensified, but Chinese shares gained 50% after a four year bear market.
- Surging inflation still MIA – an inflation take-off has been a common fear for years but remained as distant as ever.
- Diversification and active asset allocation are critical – the uneven return environment (with more underperformance by Australian shares) provided a reminder of the benefits of diversification and dynamic asset allocation strategies.

### Key themes for 2015

- Okay but uneven global growth of around 3.5%, with the US being the world's locomotive, Europe and Japan lagging and China running around 7%. Global growth continues to help earnings, but it's a long way from overheating.
- A continuing secular downtrend in commodity prices in response to excess supply.
- Low inflation, with the threat of deflation, on the back of global spare capacity and falling commodity prices.



Source: Bloomberg; AMP Capital

- Continuing sub-par real growth in Australia of around 2.5-3% in response to falling mining investment, the commodity price slump and budget cutbacks but with improved momentum by year end helped along by non-mining activity.
- Easy monetary conditions with the US starting to gradually raise rates mid-year, but on going easing in Europe, Japan, China and Australia. The RBA to cut the cash rate further.
- A further rise in the \$US and corresponding weakness in the Euro, Yen and \$A, with the \$A falling to around \$US0.75.
- Further gains in shares, but with increased volatility and with global shares outperforming Australian and emerging market shares.

### Key risks for 2015 – there's always something!

- Concerns about Fed rate hikes could trigger share market weakness, possibly with higher bond yields.
- The slump in oil prices could trigger problems in energy producers, eg energy companies, Russia, Arab countries.
- A return of the Eurozone crisis if ECB quantitative easing is not enough, deflationary pressures intensify or in response to political problems (eg, in Greece or Spain).
- China's property slump could trigger a hard landing there.
- The loss of national income from lower commodity prices and the continuing unwind in mining investment could overwhelm the fledgling pick up in non-mining activity resulting in much weaker Australian economic growth.
- Bubble trouble – the ongoing search for yield and returns could set off a bubble in various assets.
- More geopolitical flare ups – eg, ISIS/terror threat.
- Factor X – there is always something from left field.

### Six indicators to watch

- Global business conditions indicators (or PMIs) – these have been averaging around reasonable levels.

- Wages growth in the US as a guide to how quickly the Fed may move on rates – so far it remains low.
- The spread of Italian and Spanish bond yields to German bond yields – a good guide to whether the Eurozone crisis is continuing to fade. So far so good.
- The ECB's balance sheet – it should start to rise with QE.
- Chinese property prices – for signs of stabilisation.
- Confidence indicators in Australia – these are a good guide to the state of non-mining activity and need to improve.

#### Four reasons why low inflation/deflation is more likely than a surge in inflation

- Sub-par growth means there is still plenty of spare capacity, which means ongoing low pricing power.
- The fall in commodity prices is still feeding through.
- The consensus is still for higher bond yields (& the crowd is often wrong).
- A strong \$US will import low inflation into the US.

#### Five reasons to be optimistic on the US and \$US

- US Congress has been more constructive since the Tea Party was sidelined after the 2013 debt ceiling debate.
- Low energy and labour costs have led to a renaissance of US manufacturing.
- The post GFC deleveraging process has come to an end and rising wealth is supporting consumer spending.
- The US budget deficit has fallen to around 3% of GDP.
- The Fed looks set to raise interest rates at a time when other central banks are still easing policy (good for \$US).

#### Three reasons why China will see growth around 7%

- Potential growth is trending down from 10% pa plus last decade to around 6% pa by 2020 as the population slows and the easy gains of industrialisation are over, but...
- Mini-stimulus measures over the last year or so highlight the Government has no tolerance for a collapse in growth.
- Chinese inflation is very low (with producer prices deflating) indicating plenty of scope for further monetary easing.

#### Four reasons for optimism about Europe

- Eurozone shares are relatively cheap.
- The ECB is stepping up quantitative easing.
- Greece is a short term threat, but there is less threat of contagion now as Portugal, Ireland and Spain are now all stronger and defence mechanisms in Europe are stronger with a bailout fund, a banking union and an aggressive ECB.
- The lower and still falling Euro will provide support

#### Four reasons not to despair on Australia

- Interest rates are at generational lows and likely to fall.
- The fall in the \$A is removing a major drag on growth.
- There are signs of life in non-mining sectors of the economy: dwelling construction, retailing, tourism, higher education and manufacturing is also likely to see a boost.
- Stronger export volumes (from resource projects) will provide a partial offset to lower commodity prices.

#### Four implications of the commodity price downtrend

- Favour advanced countries (where commodity users dominate) over emerging countries.
- Favour Asia (commodity users, economic reformers) over South America and Russia (commodity producers, reform resisters) when investing in emerging markets.
- Favour global shares over Australian shares, as the trend in commodity prices has gone from a tailwind last decade to a headwind this decade for Australia.

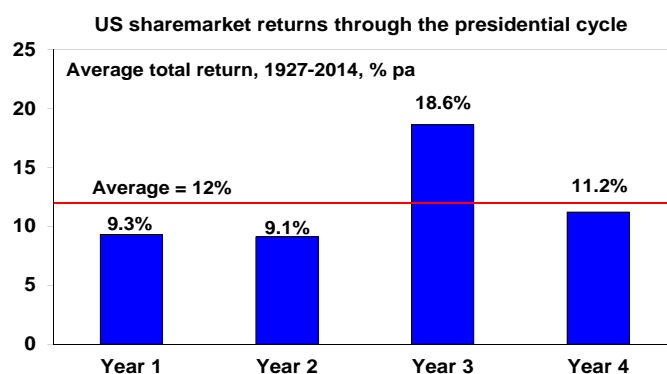
- Favour the \$US over the \$A, with the latter likely to fall to around \$US0.75.

#### Five reasons pointing to the risk of a share market correction in the first half of the year...

- Uncertainty around the impact of plunging oil prices on energy producers is likely to get worse before it gets better.
- Uncertainty about a Greek exit from the Euro and Eurozone deflation may also get worse before they get better.
- The last time the Fed started to raise rates (in mid-2004) saw a weak first half 2004 in US shares.
- Given the parallels between now and second half of the 1990s (stronger US, weaker rest of world, falling commodity prices), it is noteworthy that as the bull market back then continued volatility picked up.
- Shares are no longer dirt cheap and there is a greater dependence on earnings.

#### ...but five reasons why the trend in shares likely remains up

- Share valuations are still okay, particularly against the reality of low bond yields and interest rates.
- Global growth is continuing and this should help profits.
- As there are more consumers of oil than producers the lower oil price will ultimately be positive for growth & shares.
- Monetary conditions globally and in Australia are very easy and likely to get easier still as while the Fed may start to tighten other central banks are still easing.
- US shares which set the scene normally do well in the third year of the Presidential Cycle (which it is now) and in the fifth year of each decade. Since the 1880s all years ending in five (ie 1885, 1895, etc) have seen US shares rise.



Source: Bloomberg, AMP Capital

#### Eight things investors should always remember

- The power of compound returns – saving regularly in growth assets can grow wealth substantially over long periods.
- The cycle lives on – markets cycle up and down and we need to allow for it.
- Starting point valuations matter – so buy low and sell high.
- Focus on investments providing sustainable and decent cash flows – not financial engineering.
- Invest for the long term where possible.
- Avoid the crowd – because at extremes its invariably wrong.
- Accept that it's a low return world to avoid disappointment – low nominal growth & lower bond yields and earnings yields mean lower long term returns. When inflation is 2.5% an 8% return is pretty good.
- Always diversify and consider active asset allocation to enhance returns/protect against falls in market values.

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