



2014 NEWS UPDATE

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The year ahead...

Good evening. This is always a good time to take a fresh look at the economic and investment landscape, and how this might impact on your financial well being going forward.

Of course, 2013 turned out to be a very good year for investors in well-diversified portfolio as the threats of the last few years receded and global growth prospects improved - the US didn't have a fiscal crisis, the Eurozone continued to stabilise, Japan recovered, Chinese growth stabilised and Australia saw signs that low interest rates are actually starting to help the economy. This note, produced by Dr Shane Oliver, provides an annual 'list of lists' - a summary of key views on the global economic and investment outlook in simple point form.

The key themes for 2014:

- Continued very easy monetary conditions (low interest rates). While the US Federal Reserve 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 easing in Europe and Japan.
- Reduced 'fiscal drag' in developed 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.

The 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.
- 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 (technical):



- Global business indicators (or PMIs) - these have been drifting higher, auguring well for improved global growth, but not (thankfully) a global boom.
- Wages growth in the US as a guide to how quickly inflation will pick up there, and so when & how 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 and 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:



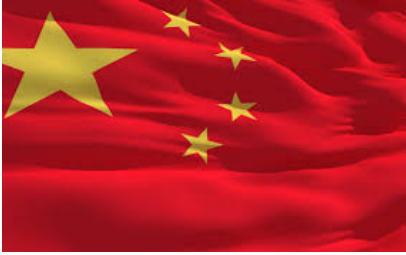
- The US budget deficit has collapsed from over 10% of GDP in 2010 to below 4% of GDP.
- The bi-partisan budget deal announced in December signals reduced political risk in the US and suggests increasing the debt ceiling, which will be required around March, is unlikely to be a major problem.
- The housing sector continues to recover.
- Private sector de-leveraging appears to have run its course with debt levels down and 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.

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.
- Money supply growth is running at a 14 year-high.

Five reasons why Chinese growth will remain around 7% to 8%:



- The authorities don't want to see a return to 10% plus growth as it 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.
- A house price crash is also unlikely. 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.

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.
- 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).
- A housing construction recovery is underway with, e.g. building approvals around past cyclical highs.

Strong Australian building approvals point to a strong housing construction cycle



Five reasons why share returns might be a bit more volatile:

- 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.
- The rising trend in bond yields could occasionally pressure share markets in some sensitive sectors, like high yielding financials and utilities.
- Short-term investor sentiment is 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 (i.e. 1991,

1995, 1997, 1998 & 2003) saw average gains of 16% in the subsequent year as the strong returns attracted inflows.



Reasons to remain cautious on 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 (i.e. interest rate hikes), which could push bond yields higher (which would negatively impact on bond fund performance).
- 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 towards growth. The outflows from bond funds will only serve to drive bond yields higher - not a good thing.

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 amount 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 bonds and this is turning out not to be the best place to be invested.

Wishing you health and happiness for 2014 - and as always, don't hesitate to call us if you need help.

Warm regards,



Rick Maggi

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Important Information

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Ideas worth spreading...



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