

2012 and beyond – a list of lists

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Oliver's Insights



Key points

- > 2012 is likely to be a better year than 2011.
- > Watch European bond yields, Chinese money supply growth and the US Institute for Supply Management (ISM) index.
- > The emerging world remains in good shape.
- > Even if the world does spiral into recession (which is unlikely), Australia will likely continue to grow.
- > The A\$ will remain strong on a medium-term basis.
- > Medium-term returns are likely to remain constrained and volatile.
- > There is still a cycle and investors should focus on assets providing decent and sustainable yields.

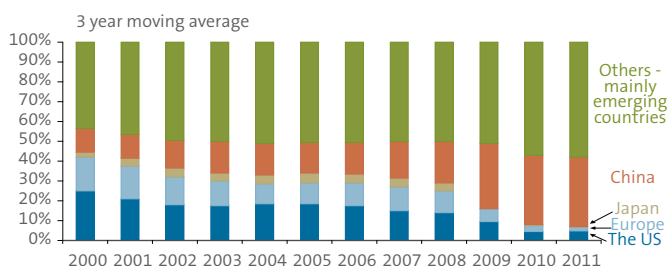
Introduction

I was determined that, after writing endlessly about Europe last year, my first note this year would not be on Europe. In fact, this note takes a different tack to normal Oliver's Insights. I thought it would be useful to provide a summary of key views on the global economy and investment outlook in simple point form, both from a 2012 and a medium-term perspective. In other words, a list of lists. So here goes.

Key themes for 2012

- > Fiscal austerity and de-leveraging in Europe and the US.
- > Monetary reflation with quantitative easing in Europe, the US, the UK and Japan, and rate cuts in the emerging world and Australia.
- > The emerging world to again account for most global growth.

Contribution to global growth - rising role of emerging countries



Source: IMF, AMP Capital Investors

- > Global growth of 3%, 1% in advanced countries, 5% in emerging countries and 3% growth in Australia.
- > Falling inflation and price deflation in some areas thanks to plenty of spare capacity.
- > A volatile first few months in markets on continuing European woes, but then improving market conditions and returns as

markets start to anticipate the next economic upswing helped by attractive valuations and easy monetary conditions.

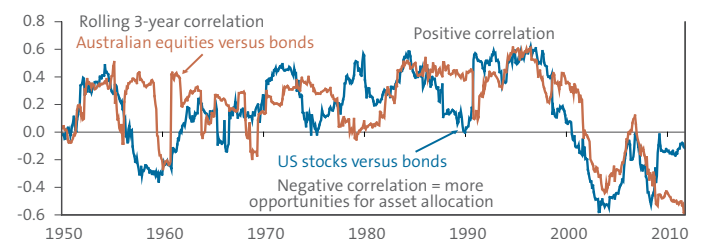
Key risks for 2012

- > Europe fails to reflate sufficiently or in time, resulting in a deep recession and possible break up of the euro.
- > The US fails to extend payroll tax cuts and expanded unemployment benefits.
- > China eases too late to prevent a property crash and hard landing in growth.
- > Tension regarding Iran leads to a surge in oil prices.

Four key indicators to watch

- > The spread to German bond yields for Italy, Spain and France - a further narrowing would be a good sign.

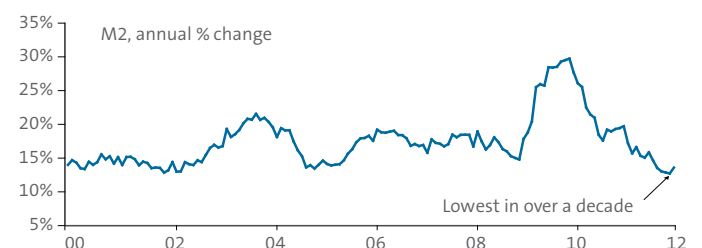
Italian, Spanish and French bond yields have been stabilising relative to German bond yields



Source: Bloomberg, AMP Capital Investors

- > Chinese money supply growth recently bounced off a decade low, but should improve if policy makers continue to ease.

Chinese money supply growth



Source: Bloomberg, AMP Capital Investors

- > The US ISM manufacturing index - downturns in mid-2010 and mid-2011 both inspired false "double-dip" alarms.
- > The A\$ is a good indicator of global growth - if it stays up things are okay. So far, so good.

Five reasons why the emerging world is in reasonably good shape

- > Low public and private debt levels.
- > Low per capita income levels equal huge potential for further catchup in living standards and hence urbanisation and industrialisation.
- > Inflation is falling, clearing the way for more monetary easing.
- > The monetary transmission mechanism still works.
- > Generally sensible economic management.

Seven reasons why, if the world does go into recession, it would be unlikely in Australia

- > There's a long way to go to zero for interest rates. Roughly 85% of mortgages are variable rate and hence households get a huge boost to spending power as rates fall.
- > Low public debt by global standards means scope for fiscal stimulus if necessary.
- > The A\$ will fall if need be, providing a buffer.
- > Corporates have low gearing and are cashed up.

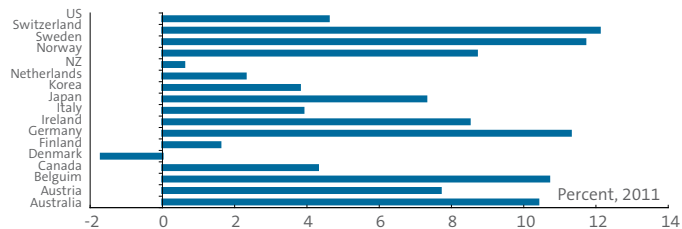
Australian corporate sector gearing is low, cash is up



Source: RBA, AMP Capital Investors

- > Households have high savings rates which provide a buffer.

Household saving rates - Australia near top of OECD



Source: OECD, AMP Capital Investors

- > The mining investment boom provides resilience.
- > Our trading partners are in reasonable shape.

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

- > Commodity prices are likely to remain in a long-term uptrend on the back of emerging world industrialisation.
- > Australian interest rates are likely to remain well above US, EU and Japanese interest rates.
- > Quantitative easing will increase the supply of US dollars, euros, pounds and yen relative to Australian dollars.
- > Safe haven buying of Australian bonds - as one of only several countries with a "stable" AAA credit rating.

Why medium-term (5-10 years) economic growth in advanced countries and investment returns will be constrained and volatile

- > Private sector de-leveraging in advanced countries has a way to go, which will be a headwind for growth.
- > Excessive public sector debt levels in Europe, the US and Japan and ongoing fiscal austerity.
- > Extreme monetary policy settings, e.g. zero interest rates and quantitative easing, can inspire extreme market volatility when changes occur.
- > The easy gains from 1980s and 1990s disinflation are over, and deflation (e.g. Japan over the last 20 years) or rising inflation (as in the 1970s) would be bad for shares.
- > Social unrest is on the rise and politics is becoming more polarised (e.g. the tea party in the US and the 'occupy movement').
- > The policy pendulum is swinging back to the left with less growth-friendly policies (tax the rich, reregulate markets, trade barriers, etc) after the economic rationalism of Thatcher, Reagan and Hawke/Keating.
- > Greater reliance for global growth on emerging countries which are usually more volatile.

What should investors consider in the current environment (partly inspired by my friend Dr Don Stammer)?

- > The cycle lives on - history tells us that times of gloom will eventually give way to boom and vice versa.
- > The power of compound interest – regular investing of small amounts can compound to a big amount after 20 years plus.
- > Buy low and sell high – starting point valuations matter, and the lower valuations thrown up by market weakness over recent years provide opportunities for far-sighted 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 – just as the crowd got it wrong piling into the 'Japanese miracle' in 1989 (with Japanese shares falling for the next two decades), the 'Asian miracle' of the mid 1990s (which turned into the Asian crisis of 1997-98), the 'tech boom' of the late 1990s (which turned into the tech wreck of 2000-03), the credit and US housing booms of mid-last decade (which turned into the global financial crisis), it might also find that the dash for cash of the last few years will ultimately prove to be wrong over the next five years or so.

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