

January 2015 Quarterly Strategic Outlook



- › Low inflation to dominate 2015 global landscape as growth diverges
- › Oil presents upside risk for growth but Japan, Europe and China still on watch
- › Bonds and their substitutes show surprising strength in 2014; expect modest reversal
- › Emerging market valuation discount not as large on second look
- › Kiwi needs to adjust further against USD to offset weaker EUR and JPY
- › Global commodity price correction now overdone?

Executive summary

The December quarter and year was a rewarding one for diversified fund investors. Fixed interest produced healthy returns on the back of some softer global activity data, increased asset purchases from the Bank of Japan, a sharp decline in oil prices and associated lower inflation expectations.

Returns from global equities were also generally solid thanks to gains in US and Japanese shares with both markets continuing to experience earnings growth and policy support. Returns from New Zealand shares were strong which coincides with the robust local economy; relatively high dividend yields and a low exposure to commodity stocks also contributed to local market gains. In contrast, a higher commodity exposure held back the Australian market.

Property and infrastructure were the best performing asset classes over the quarter. Given their income characteristics these assets continue to benefit from lower bond yields. A fall in oil prices led a large decline in commodities over the quarter. This was largely due to OPEC's decision not to cut production in the face of slowing global oil demand. The New Zealand dollar moved higher over the quarter, especially against the Japanese yen, euro and Australian dollar as the market priced in central bank easing of one form or another from these regions.

2015 looks set to be characterised by continued 'low-flation' and the battle to avoid deflation. The slump in the oil price has added a further dimension to the inflation story, while at the same time providing a welcome boost to growth in those economies continuing to struggle with weak demand. Global growth is expected to be modestly stronger in 2015, although there are both upside and downside risks.

Oil presents a key upside risk to growth especially in the key oil importing economies. But that will be determined by how much further the oil price falls and where it eventually settles. Downside risks include a sharper property-related slowdown in China and continued sluggish demand in the Eurozone and Japan. When the numbers are in and the dust has settled global growth for 2014 is likely to come in at around 3.3%, the same as last year. In 2015 we expect growth will be slightly higher at 3.5%, followed by 3.7% in 2016.

Global bond yields surprised on the downside in 2014 and this is a major reason why the higher dividend asset classes (property, infrastructure, New Zealand shares) were the top performers in 2014. We expect bond yields to move modestly higher over the next twelve months as the US takes the first small steps toward policy normalisation. Bond purchases by Japan and Eurozone central banks should limit the rise in yields globally.

We also expect the subdued inflation backdrop to be around for some time, so any rate rise in the US this year will be associated with higher growth. This will be positive for earnings growth and share prices given valuations are not overextended. Quantitative easing in Japan and Europe should also support shares in these regions. Nevertheless, global shares entered a flatter and more volatile return profile over the second half of 2014 and we expect this pattern to continue over 2015. A modest increase in bond yields should also result in a modest underperformance by higher yielding shares this year.

We expect the US dollar will follow US rates higher over 2015, and by implication push the New Zealand dollar lower. The recent sharp decline in commodities, while explainable, is now looking overdone given global growth will approach potential this year. Although commodity prices could go lower in the near term we believe the balance of risks have moved to the upside over a medium term horizon.

Our views in summary

Asset class	Near term view	Medium term view	Bias
Global equities	Expect a flatter and more volatile return profile going forward with risk of underperformance if bond yields rise faster than expected.	At current bond yields, valuations are reasonable for this asset class over the medium term.	Neutral
Emerging market equities	Should recover from recent setback but Fed tightening and specific country/currency risks will mean the path will be volatile	EM valuations remain in attractive territory but this is partly due to different sector compositions. Also, the direction of returns will depend on developed markets which are looking fully priced.	Neutral
Australasian equities	Strong domestic economy expected to underpin New Zealand shares despite above average valuations. Improving ex-resource sector earnings growth should support Australia shares.	Australasian shares are reasonably priced given current financial and economic conditions. Expect New Zealand to modestly underperform Australia over the medium term.	Neutral
Listed property and infrastructure	Should track global equities in the near-term with risk of underperformance if interest rates rise faster than expected	Sectors look fully priced. From an absolute perspective, the low real yield environment should provide support over the medium term	Neutral
Commodities	The sharp decline in commodities, while explainable, is now looking overdone given global growth will approach potential this year.	Cyclical lows in a number of commodities suggests upside risk in the medium term.	Overweight
Global bonds	Expect bond yields to move modestly higher over the next twelve months as the US takes the first small steps toward policy normalisation. Bond purchases by Japan and Eurozone central banks should limit the rise in yields globally	Expect low returns given low government bond yields. High NZD carry providing some offset to low market yields.	Underweight
New Zealand bonds	Expect long-end and returns to take lead from US but relatively lower non-US yields could raise demand for New Zealand bonds.	As with global bonds, low yields foreshadow low returns over the medium term.	Underweight
Cash	Cash rates are on hold for an extended period.	Expect similar returns from cash and bonds over the medium term but cash has lower risk of capital loss.	Overweight
Foreign currency	The New Zealand dollar has had a meaningful adjustment but expect more modest declines in the near-term with the high carry providing some support.	The New Zealand dollar remains overvalued against the majors in a long term context.	Overweight

Global economic outlook

Low inflation to dominate 2015 landscape

2015 looks set to be characterized by continued 'low-flation' and the battle to avoid deflation. The slump in the oil price has added a further dimension to the inflation story, while at the same time providing a welcome boost to growth in those economies continuing to struggle with weak demand. Global growth is expected to be modestly stronger in 2015, although there are both upside and downside risks.

1) Oil's slippery slope

The big story of late 2014/early 2015 has been the dramatic slide in the price of oil. At the time of writing, the price of West Texas Intermediate had slipped close to 55% since the recent peak of mid-2014. The story for 2015 will be where the price eventually settles, and the growth, inflation and monetary policy implications of that.

Oil has not been the only commodity to come under pressure in 2014 with sharp falls in iron ore and dairy prices. All have been due to some combination of supply and demand to varying degrees. Oil has been more a supply than demand phenomenon. That means it will most likely take some form of supply response before we can be confident of any price stabilisation.

To state the obvious, a fall in oil prices is bad for net oil exporters but good news for net oil importers. On balance, we expect lower oil prices to be a positive for global growth as income is freed up from expenditure on petrol at the pump to spend on other consumer items.

Central banks will take an orthodox approach and 'look through' the immediate impact on inflation of weaker oil prices, but they will remain alert to a second round or 'spillover' effects into core inflation. That will be a function of both how low prices go and where they eventually settle and the strength of demand in respective economies. Spillover appears likely to be greatest in economies in which demand is weakest.

But with lower oil prices good for consumer spending and global growth overall, that will help the problem of deficient global demand. It will also lead to a faster closing of output gaps and eventually put upward pressure on inflation.

2) Developed economy growth to remain divergent

In 2014 we saw a divergence in growth opening up amongst the key developed economies. Despite a weak start to the year, the US looked increasingly solid as the year progressed. The UK joined the party during the year too. However, growth remained weak in both Japan and the Eurozone.

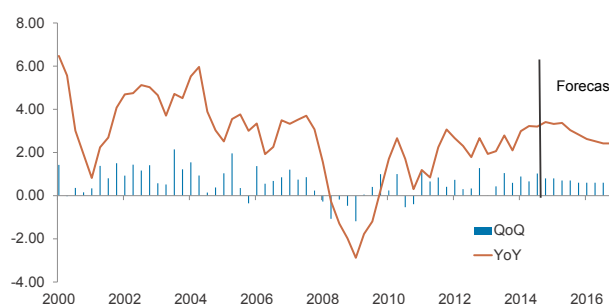
That theme will continue into 2015 with the US and the UK likely to remain the stand-out performers. In the US

we expect above trend growth of 3.5%. Despite continued soft wage growth, increasingly solid jobs gain will underpin robust household spending. However, a stronger US dollar will take the gloss off a touch. We expect another year of 3.0% growth in the UK, although we are less convinced of the sustainability of this pace of growth here than we are in the US.

And of course the New Zealand economy has continued to perform strongly, although recently released revisions to historical data took some of the gloss off the story for 2014. We expect 2014 growth will still show New Zealand as a stand-out performer amongst the OECD with annual average growth of around 3.2%.

New Zealand GDP

% change



Source: Statistics New Zealand and AMP Capital

Into 2015 we expect another solid year of domestic growth of around 3%. Construction activity will remain strong and with business and consumer confidence still at relatively high levels household spending and business investment are expected to make strong contributions to growth this year. Consumption will get an added boost from continued strong gains in employment.

Japan and the Eurozone, while likely to perform better than last year, will continue to lag the stronger performers by a considerable margin. Both are expected to post growth of around 1% this year.

Japan has struggled to recover from the consumption tax hike in 2014 but the lower oil price will provide a significant boost to consumers and businesses this year. Modest increases in both employment and wages will also support consumption.

In the Eurozone the lower oil price will support domestic demand although continued low employment growth will keep overall growth subdued. Lack of structural reform and soft external conditions will also keep business investment subdued. On a brighter note, a weaker currency will provide some gains in competitiveness.

3) 'Low-flation' and the fight against deflation

Global inflation has remained persistently low as large output gaps have persisted. The slump in the oil price over recent months has added another disinflationary dimension and will put further downward pressure on headline inflation around the world.

Central banks will, in general, remain focused on the degree of spillover into core inflation which will be a function of how low oil prices go and how long they stay low. Risks of spillover also seem likely to be higher in countries where demand is weakest.

In the US the Federal Open Market Committee (FOMC) ended its asset purchase programme towards the end of 2014 as the labour market looked increasingly solid. But even here where growth is running solidly above trend, inflation has remained low as unit labour costs have also remained contained.

The next step for the FOMC in the normalisation of monetary policy is to raise interest rates, but in their own words the Committee can afford to be "patient". With wages benign and early signs the lower oil price is exerting downward pressure on core inflation, we expect it will be the second half of 2015 before we see higher interest rates in the US.

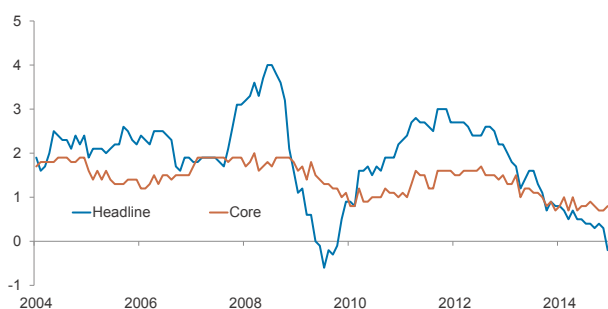
As the FOMC was announcing the end of its asset purchase programme, the Bank of Japan and the European Central Bank (ECB) were busily preparing to fill the global liquidity void.

Core inflation became uncomfortably low and inflation expectations were falling in the Eurozone before the dramatic slump in the price of oil. The ECB stepped up its easing efforts in 2014 with interest rate cuts, including the introduction of a negative deposit rate. It also launched targeted longer term refinancing operations (TLTRO), the take up in the first two tranches of which has been disappointingly low.

As we begin 2015, the Eurozone is in technical deflation and seems the most likely candidate to move into deflation in the true sense of the word. This equates to a more generalised decline in prices, negative inflation expectations and a contraction in demand.

Eurozone inflation

Annual % change



Source: Eurostat

The ECB has stepped up its easing with the announcement of a sovereign asset purchase programme at its January meeting. They will be banking on the expansion of the monetary base, lower yields and greater liquidity support for asset prices to all contribute to stronger credit and GDP growth. A lower exchange rate will bolster inflation and add to competitiveness. However, we remain of the view that quantitative easing by itself will likely prove insufficient to cure everything that ails the Eurozone. As it did in the US, all it really does is buy time.

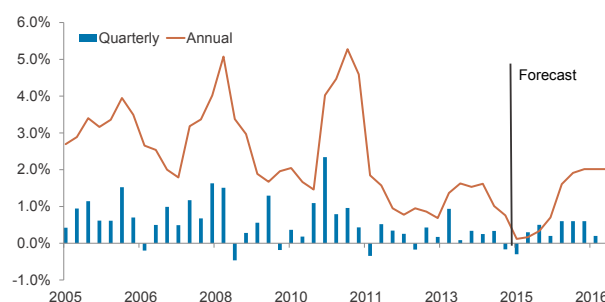
The Bank of Japan unexpectedly announced an expansion of its qualitative and quantitative easing programme in October 2014 given the risk of lower inflation and inflation expectations on the back of the fallout from the tax increase. It seems likely that underlying inflation will improve this year as demand recovers and the lower yen feeds through into higher prices. However, they may feel the need to do more depending on the extent to which lower oil impacts on core inflation and inflation expectations in the near term.

In New Zealand we have been surprised by the continued lack of domestic inflationary pressure despite growth being at a decade high. We put that down to recent strong business investment which has increased the capacity of the economy to grow without generating inflation. Recently strong net inward migration, while adding pressure to the housing market, has assisted in adding to the supply of labour which has kept wage growth in check.

The annual rate of inflation is now below the bottom-end of the Reserve Bank of New Zealand's target band again. It will head lower in March and on our current forecasts is expected to remain below 1% for all of this year. While this may be causing the RBNZ some discomfort, there is not much they can do about it. They can't cut interest rates given the strength in the housing market and signs of rising capacity pressures, even though that is not yet reflected in consumer prices.

New Zealand inflation

% change



Source: Statistics New Zealand and AMP Capital

Where interest rates head from here will not be determined by the price of oil but rather the extent to which the New Zealand economy can continue to grow at an above-trend pace without generating inflationary pressures. That will largely be determined by the extent to which wages respond to continued falls in the unemployment rate. We think that higher interest rates will still be needed, but that is now a story for 2016.

4) BRICs become the BRs and the ICs

Within the BRIC countries (Brazil, Russia, India, China), growth was disappointing in both Brazil and Russia. Lower commodity prices hit Brazil hard and Russia suffered the triple whammy of Ukraine-related sanctions, sharply lower oil prices and sharply higher interest rates to restore ruble stability.

Growth in Brazil will remain low in 2015 as the central bank hikes interest rates to combat persistently high inflation and the government continues to tame its budget deficit. Russia will likely see a deep recession this year with GDP expected to contract -4.0%.

The China slowdown continues despite growth coming in at a slightly better than expected 7.4% in 2014. 2015 will see a continuation of the story of structural headwinds versus cyclical easing measures to support demand through the slowdown. We believe the Government will lower the growth target to 7.0% for 2015 with our forecast assuming they will likely miss the target again, although only by a small margin.

We remain of the view the slowdown in China is positive as a China growing more slowly will ultimately prove more sustainable. The risk is a sharper downturn occurs.

China GDP growth

Annual % change



Source: NBS

Meanwhile, the growth outlook in India remains positive with the new Government implementing a more business friendly environment. India will also be a net beneficiary of lower commodity prices. In addition, lower interest rates will support consumption and investment as the year progresses.

5) With divergent monetary policy here too

In China excess capacity has continued to contribute to falls in prices at the producer level which regained impetus as oil prices fell. Consumer prices also began to soften as the year progressed, prompting the People's Bank of China to cut interest rates at the end of the year. We expect further interest rate cuts in 2015.

The improving inflation performance in India has seen the Reserve Bank of India (RBI) start to cut interest rates in early 2015. The repo rate was cut to 7.75% in January with another 75 basis points (bps) of cuts likely in the next few months. Lower inflation here reflects falling commodity prices but also the Government's supply side reforms. Furthermore, the RBI now has an explicit inflation target.

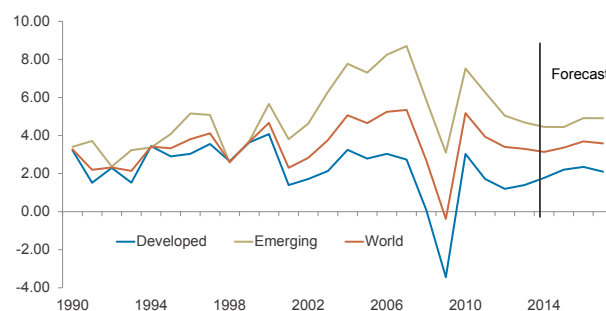
Elsewhere in the emerging world, central banks have been responding in orthodox fashion to their own unique set of circumstances. In Brazil inflation remains problematic despite very low growth. High inflation there is more symptomatic of structural rigidities than it is of excess demand. The central bank has been hiking rates during 2014, but we think they are getting close to peaking. Russian interest rates rose sharply in response to the collapse in the ruble and seem likely to only come down once inflation has peaked.

6) Global growth stronger but risks abound

When the numbers are in and the dust has settled global growth for 2014 is likely to come in at around 3.3%, the same as last year. In 2015 we expect growth will be slightly higher at 3.5%, followed by 3.7% in 2016.

Global GDP growth

Annual average % change



Source: IMF and AMP Capital

Global GDP growth

Calendar year annual average % change

	2014	2015	2016	2017
United States	2.4	3.5	3.2	3.0
Euro area	0.8	1.2	1.6	1.6
Japan	0.3	1.0	1.4	0.6
UK	3.1	3.0	2.8	2.5
Canada	2.5	2.0	2.0	2.3
Australia	3.0	3.0	3.0	2.8
New Zealand	3.2	3.1	2.6	2.3
Developed*	1.8	2.4	2.5	2.3
China	7.4	6.8	6.5	6.5
India	5.5	6.4	7.0	7.0
Brazil	0.1	0.4	1.8	2.6
Mexico	2.4	3.8	4.5	4.5
Russia	0.5	-4.0	1.0	2.2
Indonesia	5.0	5.0	5.5	5.5
South Africa	1.5	2.5	3.0	3.5
Emerging*	4.5	4.2	4.7	4.9
World*	3.3	3.5	3.7	3.7

(*) Averages are PPP weighted average
Source: IMF and AMP Capital

Risks abound, but these are both to the upside and the downside. Oil presents a key upside risk to growth especially in the key oil importing economies. But that will be determined by how much further the oil price falls and where it eventually settles.

Downside risks include a sharper property-related slowdown in China and continued sluggish demand in the Eurozone and Japan.

7) Building a more robust global economic environment

It has now become convention that every year we highlight the need for significant structural reform around the world and reflect on the disappointing progress of the prior year. This year remains no exception.

The problem for both the Eurozone and Japan is that monetary policy alone remains insufficient to restore sustainably higher growth. The good news in Japan is Shinzo Abe has been re-elected Prime Minister with a fresh mandate to fire his third arrow.

In the Eurozone reform progress has been greatest in the periphery (under duress) while some of the larger economies remain serial non-reformers. In that respect, Italy and France are likely to remain a significant drag on Eurozone growth for the foreseeable future. The concern this year is that the lower currency, following further easing by the ECB, provides

another reason for lack of progress on more meaningful action to boost competitiveness.

As we have said right from the start, the need for structural reform is not just a developed economy phenomenon. Brazil, Russia (growth there was slowing well before the Ukraine crisis erupted) and India again get singled out for special mention. Prime Minister Modi in India is making good progress while President Rousseff has a fresh opportunity in Brazil.

More generally, we continue to worry about fiscal sustainability in many countries. The near term implication of that is the option of debt-fueled growth to support demand is not an option in many countries. And while global imbalances have been improving recently, we worry about the sustainability of the improvement.

8) Politics and geopolitics

Politics was always going to prove fascinating in the post GFC-world, especially in the developed economies as people adjust to lower living standards, particularly in the Eurozone. At the same time, growing middle-classes in the key emerging economies seem likely to demand more from their politicians, particularly in the form of social services such as health and education.

In the Eurozone austerity fatigue and high unemployment has seen the rise of anti-austerity and anti-Europe political movements in recent times risking voter backlash against the ruling elite. That was going to make elections in Spain and Portugal later this year very interesting and potentially unsettling for markets, even before the snap election was called in Greece.

Politics will also be interesting in the US this year. While there are no elections there, the Republicans will be looking to use their majorities in both houses of Congress to assert their dominance only to have their aspirations vetoed by the President. The President himself will look to get through some of his own agenda by use of his executive powers. It's a potential shambles.

Finally, geopolitical tensions remain high as the Russia/Ukraine conflict continues to play out. Syria and Iraq also remains a hot spot and terror alerts remain high around the world following recent events in France.



Bevan Graham
Chief Economist

Asset strategy

Bonds and their substitutes show surprising strength in 2014

The December quarter and year was a rewarding one for diversified fund investors. Fixed interest produced healthy returns over the quarter on the back of some softer global activity data, increased asset purchases from the Bank of Japan, a sharp decline in oil prices and associated lower inflation expectations.

Returns from global equities were also generally solid thanks to gains in US and Japanese shares with both markets continuing to experience earnings growth and policy support. Emerging market equities were flat over the quarter with gains in Asia offset by declines in Latin America and Europe.

Returns from New Zealand shares were strong which coincides with the robust local economy. Relatively high dividend yields and a low exposure to commodity stocks also contributed to local market gains. In contrast, a higher commodity exposure held back the Australian market.

Property and infrastructure were the best performing asset class over the quarter. Given their income characteristics these assets continue to benefit from lower bond yields

A fall in oil prices led a large decline in commodities over the quarter. This was largely due to OPEC's decision not to cut production in the face of slowing global oil demand.

The New Zealand dollar moved higher over the quarter, especially against the Japanese yen, euro and Australian dollar as the market priced in central bank easing of one form or another from these regions.

Asset class	Quarter	Year
Cash and fixed interest		
NZ Cash	0.9%	3.4%
NZ Bonds	3.0%	7.8%
Global Treasuries	3.6%	11.8%
Global Aggregate	3.2%	11.1%
Domestic and global shares		
NZ Shares	6.0%	17.5%
Australian Shares (AUD)	3.1%	5.6%
Global Shares (local)	3.3%	9.8%
Emerging Markets (local)	0.0%	5.2%
Real assets		
NZ Listed Property	10.0%	24.2%
Global Property	13.1%	30.2%
Global Infrastructure	7.2%	24.1%
Commodities	-11.7%	-15.2%

Currency	Quarter	Year
NZD (MSCI weights)	2.5%	-0.6%
NZD / AUD	7.2%	3.8%

Global bond yields surprised on the downside in 2014 and this is a major reason why the higher dividend asset classes (property, infrastructure, New Zealand shares) were the top performers in 2014.

We expect bond yields to move modestly higher over the next twelve months as the US takes the first small steps toward policy normalisation. Bond purchases by Japan and Eurozone central banks should limit the rise in yields globally.

We also expect the subdued inflation backdrop to be around for some time, so any rate rise in the US this year will be associated with higher growth. This will be positive for earnings growth and share prices given valuations are not overextended. Quantitative easing in Japan and Europe should also support shares in these regions.

Nevertheless, global shares entered a flatter and more volatile return profile over the second half of 2014 and we expect this pattern to continue over 2015. A modest increase in bond yields should also result in a modest underperformance by higher yielding shares this year.

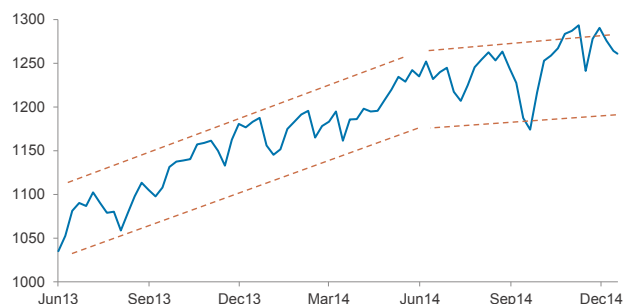
We expect the US dollar will follow US rates higher over 2015, and by implication push the New Zealand dollar lower. The recent sharp decline in commodities, while explainable, is now looking overdone given global growth will approach potential this year. Although commodity prices could go lower in the near term we believe the balance of risks have moved to the upside over a medium term horizon.

Equities

Global shares entered a flatter and more volatile return profile over the second half of 2014. A higher valuation multiple is the main reason the return profile is flatter. Global share prices have been rising faster than earnings over the last few years and this could not continue indefinitely.

The return profile is more volatile (wider) due to uncertainty regarding the first rate hike from the Fed, a return of euro zone deflation worries, the ongoing slide in China property market and the recent slump in oil prices. We expect this share price pattern to continue over 2015.

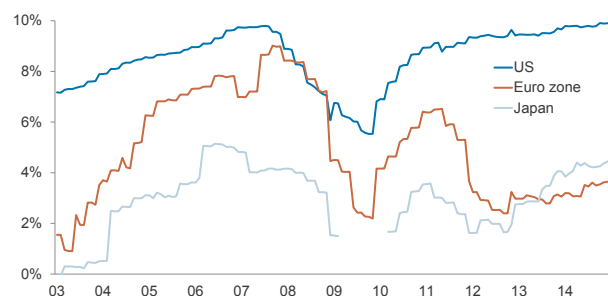
Global shares – expect flatter and more volatile returns in 2015



Source: Bloomberg, AMP Capital

Earnings should continue to rise over the course of 2015 supported by improving growth. Low inflation will hold back revenue growth to some degree, however. Elevated profit margins in the US doesn't leave much room for improvement on that front, but margins are lower outside of the US so there is opportunity for catch-up elsewhere.

Global profit margins



Source: Bloomberg, AMP Capital

Equity valuations are reasonable across the major asset classes. Emerging markets are undervalued but this is partly due to a larger exposure to low-valuation sectors such as financials and a smaller exposure to high-valuation sectors such as healthcare.

Adjusting for this reduces the emerging market (EM) discount to developed markets (DM) from 33% to 23% (based on price/book). EM typically trades at an 11% sector adjusted discount to DM to compensate for the higher volatility associated with emerging market returns. So the genuine EM discount relative to history is closer to 12%.

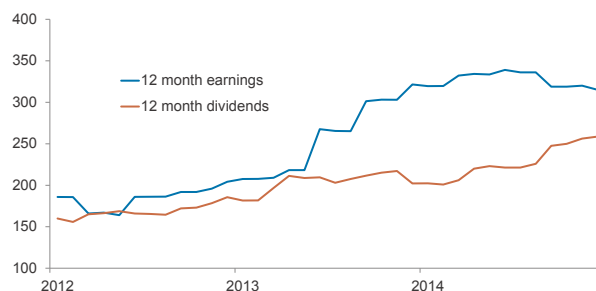
Emerging v developed share market valuation

Unadjusted EM/DM discount	-33%
Sector adjusted EM/DM discount	-23%
Historical sector adjusted EM/DM discount	-11%
Genuine EM/DM discount	-12%

Source: AMP Capital

The search for yield theme continued to benefit New Zealand shares over the December quarter and year. While NZX 50 earnings growth decelerated towards the end of the year, companies continued to raise dividend payouts, taking annual dividend growth to 28%.

NZX 50 earnings and dividends



Source: Bloomberg, AMP Capital

There is room for further lifts in payouts, given the earnings growth experienced over the last two years. This should continue to support the market over 2015 though a double digit total return for the fourth year in a row looks something of a stretch. Especially given economic growth peaked in 2014 and bond yields are expected to rise over the course of this year.

Dividend growth also supported the Australian market over 2014, but to a lesser extent than New Zealand. Dividends grew 7.8% over 2014, a touch less than earnings growth of 7.2%.

With Australian share prices rising only 1.1% (for a total return of 5.6%) over the year, valuations moved back into modestly undervalued territory in 2015. The mining and energy sector will face earnings headwinds this year but profits from the other sectors should continue to grow thanks to easier monetary policy, the strong housing market and the lower Australian dollar. We should expect a better year from Australian shares in 2015.

ASX 200 earnings and dividends



Source: Bloomberg, AMP Capital

Bonds

Global bond yields surprised on the downside in 2014. Lower inflation expectations and softer economic activity helps explain much of the decline in yields last year.

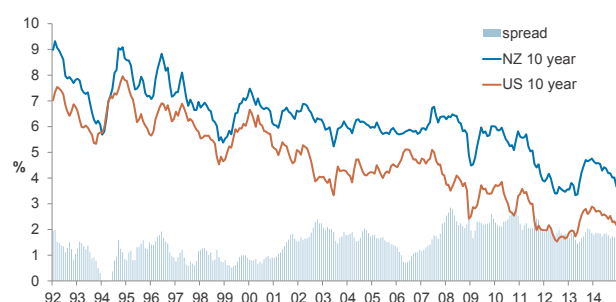
Region	2014 year end level (annual change)					
	10yr bond yield		10yr inflation expectations		Economic activity (PMI)	
United States	2.17	(-0.86)	1.68	(-0.55)	53.9	(-1.1)
Eurozone	0.54	(-1.39)	1.15	(-0.61)	50.6	(-2.1)
UK	1.76	(-1.26)	2.58	(-0.54)	52.5	(-4.5)
Japan	0.33	(-0.41)	0.76	(-0.33)	52.0	(-3.2)
New Zealand	3.67	(-1.05)	1.68	(-0.28)	57.7	(+1.3)

Source: Bloomberg, AMP Capital

The domestic picture was something of an exception. Ten year government yields declined more than 1% for the year, yet long term inflation expectations were down less than 0.3% and economic activity (as measured by the BNZ PMI) was actually a touch higher at the end of the year than at the beginning.

This is largely because New Zealand's relatively higher yields continue to look attractive in the global low yield environment. The spread between New Zealand and US ten year government bonds was 1.5% at year end, in line with the long term average. The spread has been higher over much of the last decade, partly because of quantitative easing in the US which has now come to an end. With the US set to hike rates this year the ten year NZ-US spread could go below 1.5%

New Zealand minus US 10yr government bond spread

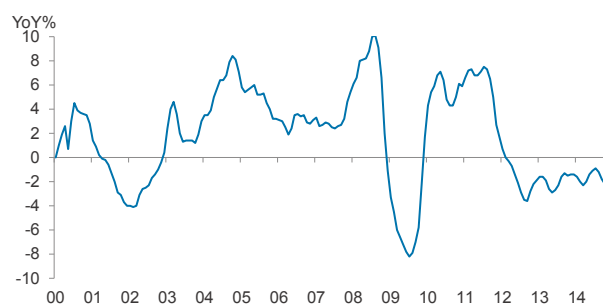


Source: AMP Capital

Looking at the drop in global inflation expectations over the year, there is much more to it than the recent plunge in commodity prices. Global production cost inflation was already very low as illustrated by negative output prices in the modern-day workshop of the world.

China producer price inflation remains in negative territory and the trend towards positive inflation has broken down.

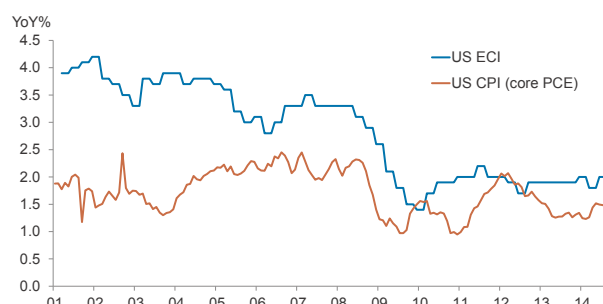
China producer price inflation



Source: Bloomberg, AMP Capital

Global employment cost inflation also remains sluggish. The US employment cost index (ECI) has ticked up recently but only to 2.2%. Assuming non-inflationary employment costs (ie productivity) is around 1.5% over the long run then a CPI target of 2.0% corresponds to a 3.5% ECI target. There is still a way to go to get to that. We expect employment cost inflation to remain low over 2015 given spare capacity in labour market plus competition from technology and globalisation.

US employment cost inflation versus consumer price inflation



Source: Bloomberg, AMP Capital

We expect bond yields to move modestly higher over the next twelve months as the US takes the first small steps toward policy normalisation. Bond purchases by Japan and Eurozone central banks should limit the rise in yields globally.

Global credit spreads moved higher over the recent quarter but are only 0.2% above long term median levels, so investors shouldn't expect global credit spreads to provide much protection against rising treasury yields. Like last year, we expect longer term domestic bond yields to take their lead predominantly from the US bond market.

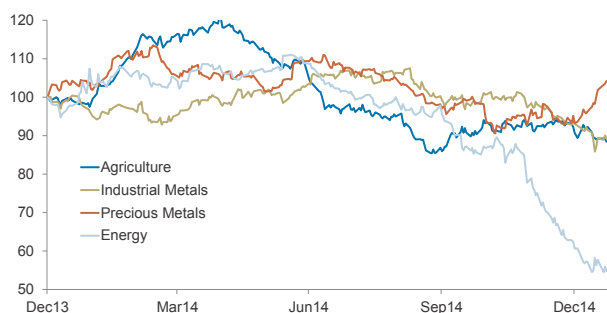
Real assets

Property and infrastructure were the best performing asset classes over the quarter and year. Given their income characteristics, these assets continue to benefit from lower bond yields.

These sectors look fully priced following recent performance and higher valuations suggest lower returns going forward absent further declines in bond yields. From an absolute perspective, an extended low real yield environment should provide support over the medium term.

A fall in oil prices led a large decline in commodities over the quarter. This was largely due to OPEC's decision not to cut production in the face of slowing global oil demand.

Commodity prices



Source: Bloomberg, AMP Capital

Broad commodity prices have declined 25% from the end of April to December. As a result, commodity prices are at five year lows and the commodity risk premium (commodity versus cash return) is negative on a 10 year horizon. Given the higher risk of holding commodities versus cash, we expect some mean reversion in commodity prices on a medium term horizon.

Elevated supplies and sub trend economic growth are the main reasons why commodity prices are at cyclical lows. We expect the global economy to grow close to potential this year. At the same time we expect the current level of commodity prices, if sustained, will begin to impact supply growth. There is already evidence of significant capex reduction across the energy and industrial commodity sectors.

We believe a rising US dollar is the main negative risk for commodity prices this year. China's property slowdown is another risk but the recent cut in interest rates (and the likelihood of more) reduces the threat of a significant correction. While commodity prices could go lower in the near term we believe the balance of risks have moved to the upside over a medium term horizon.

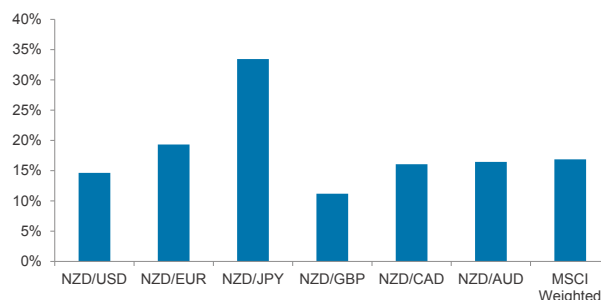
New Zealand dollar

Following a sharp fall in the September quarter, the New Zealand dollar (NZD) rose 2.5% over the December quarter on a MSCI weighted basis. The NZD rose only 0.2% against US dollar but gained 9.5% against the Japanese yen, 4.6% against the euro and 7.2% against the Australian dollar as the market priced in central bank easing of one form or another from these regions.

The NZD remains well down on the July 2014 peak of 88 cents against the US dollar and we expect further weakness

against the US dollar this year, supported by US rate hikes and NZD overvaluation.

NZD dispersion versus long term fair value

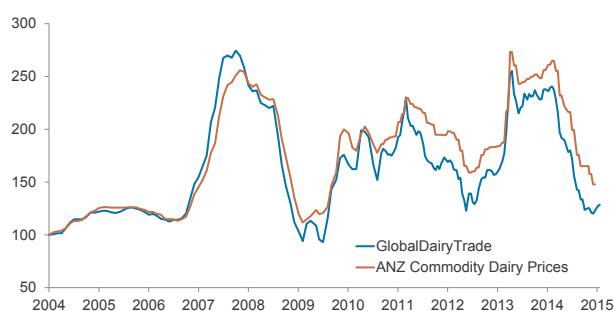


Source: AMP Capital

However NZD moves against the other currencies are harder to pick. The Bank of Japan and ECB will not be raising rates for the foreseeable future and both central banks are expected to undertake significant asset purchases over the next two years. Meanwhile, the ongoing slide in energy and metal prices has raised the chance of a rate cut from Reserve Bank of Australia this year.

The latest Fonterra auctions suggest New Zealand dairy prices may be bottoming. Nevertheless, the decline in dairy prices to date points to further declines in New Zealand's terms of trade and weakening trade balance over coming quarters. Given the likelihood of further weakness in the yen and euro this means the NZD needs to fall further against the USD to improve our trade and current account balance over the medium term. A 70 cent NZD/USD would greatly assist this process.

New Zealand dairy prices



Source: AMP Capital

Overall we expect a gradual depreciation in the MSCI weighted NZD this year but a global shock would likely lead to a sharper adjustment.



Keith Poore
Head of Investment Strategy

Contact us

If you would like to know more about how AMP Capital can help you, please visit ampcapital.co.nz or call us on 0800 400 499

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