2014 **Year in review**

A surprise package

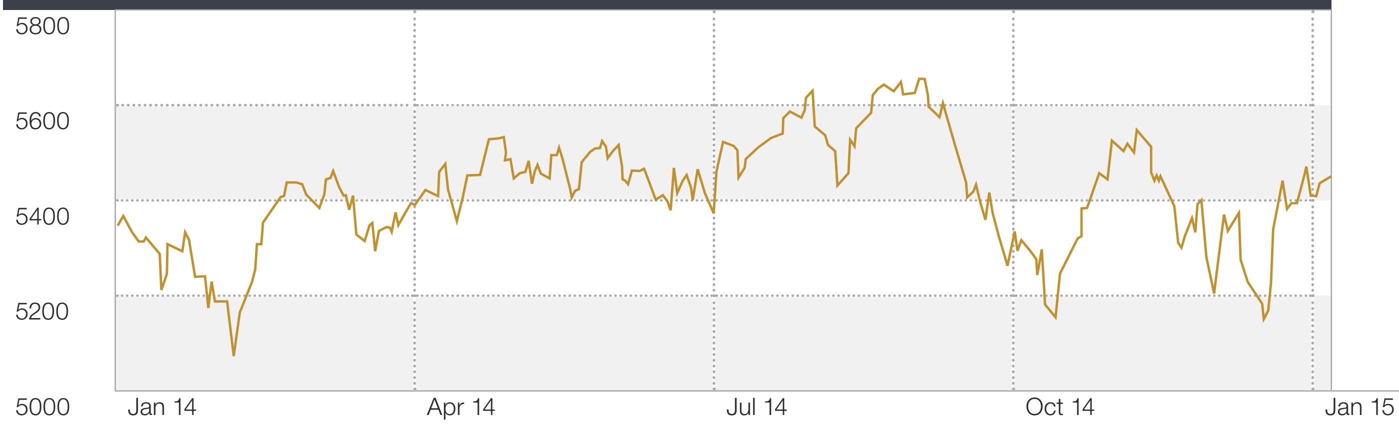
If ever there was a year that proved the benefits of diversification, 2014 was it. Despite all the noise and tumult on global markets, on balance last year was good to local investors. Overseas shares, global bonds and Australian residential property were stand-out performers that more than made up for patchy returns from local shares.

On the world stage it was two steps forward one step back. Global economic growth gathered steam but not as much as expected; the US and China grew strongly but Japan, Europe and many developing nations remained weak; Australia's non-mining economy pushed ahead but the mining sector and shaky consumer confidence were a drag on growth.

Perhaps the biggest surprise of the year was the severity of the fall in commodity prices. While a slowdown in Chinese demand - and hence prices - was expected, no-one predicted near 50 per cent falls in oil and iron ore.

The Australian sharemarket finished the year up just 1.1 per cent, or 5.7 per cent when dividends are included.[i] But averages can be deceiving. The overall market was dragged down by a 19 per cent fall in the resources sector; industrials rose a respectable 8.9 per cent, led by consumer durables and apparel, pharmaceuticals and biotechnology, real estate and healthcare stocks.

Australian stock market (S&P/ASX 200)



Source: www.tradingeconomics.com | Australian stock exchange

Growth solid but patchy

The International Monetary Fund (IMF) predicted growth of 3.7 per cent for the global economy in 2014 but the final figure was closer to 3.3 per cent, a little below the long-term average.

The US and the United Kingdom are performing well, but the rest of Europe and Japan are struggling to revive their economies and are working hard to ward off deflation.

China's growth is moderating as it manages the transition from a construction and investment boom to domestic consumption-driven growth. But amid all the talk of a Chinese slowdown, its economy grew at a still impressive rate of 7.3 per cent last year, contributing close to one third (0.99 per cent) of the world's total economic growth of 3.3 per cent.

The Australian economy grew at a rate of 2.7 per cent in the year to September as the transition from the investment phase of the mining boom to the production phase continued. With the exception of housing construction, non-mining sectors struggled to gain traction despite our low interest rates and falling dollar. As a result, unemployment edged higher from 5.9 per cent to 6.3 per cent.

Australian Key Indices as at 31st December 2014	
GDP annual growth rate*	2.7%
RBA cash rate	2.5%
Inflation (annual)	2.3%
Unemployment rate	6.3%
Consumer confidence index	91.1

*Year to September 30, 2014

Share Market (% Change) January - December 2014	
Australia (ASX 200)	+1.1%
US (Dow Jones)	+7.5%
UK (FTSE 100)	-2.7%
China (SSE Composite)	+52.9%
Japan (Nikkei 225)	+7.1%

Note – Price Indices: excluding dividends

Commodity price wars

The big surprise in 2014 was the collapse in the prices of iron ore, oil, natural gas, thermal coal and copper to five-year lows. Iron ore fell 47 per cent over the course of 2014, oil fell 46 per cent, thermal coal was down 27 per cent and copper 14 per cent.

The commodity price collapse is due in part to falling demand from China, but iron ore and oil are also being squeezed by a price war waged by the big producers to knock smaller, high-cost players out of the market.

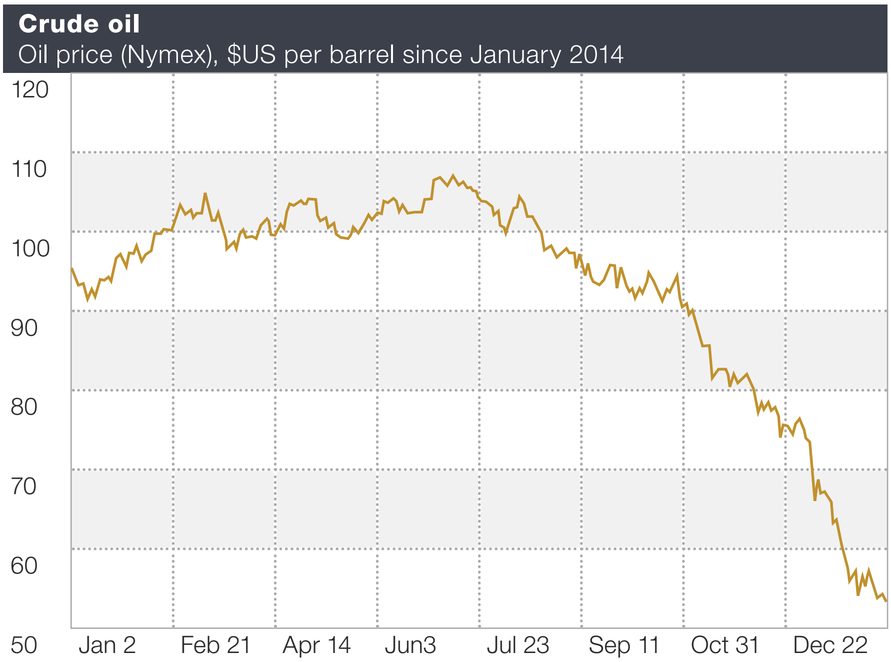
When commodity prices begin to rebound, as most analysts believe they will in 2015, buying opportunities should emerge in oversold resources stocks. Some of the best placed will be Australia's mining heavyweights such as BHP Billiton and Rio Tinto.

Interest rates and inflation

Global interest rates remained on hold in 2014, with rates still close to zero in the US and Europe as a strong upswing in the global economy failed to materialise. The Australian cash rate finished the year unchanged at 2.5 per cent.

Not only has this kept the lid on inflation but it also prolonged the long bull market in global bonds. In a low interest rate world investors have been seeking yield wherever they can get it, pushing up bond prices. As a result, fixed-income assets produced an average total return of 7.7 per cent last year, led by US and German government bonds.[ii]

There are signs though that monetary policy is about to tighten, at least in the US where



Source: Reuters, CommSec

economic growth – at five per cent - was the best in 11 years. The US Federal Reserve declared an end to its policy of monetary stimulus and is expected to begin lifting rates early in 2015.

In Australia, rates are heading in the other direction. Most economists are predicting the Reserve Bank will begin to cut rates in 2015 to stimulate growth. Its job has been made easier by signs of a slowdown in property price growth and a more cautious mood among consumers.

The Westpac-Melbourne Institute Consumer Sentiment Index fell to a three-year low of 91.1 in December, down 13.3 points in a year. The survey's authors concluded that concerns about the economy and job security were weighing on consumers' minds.

A stronger US dollar

The US dollar made large gains against most currencies last year as its economy began to turn the corner. With higher interest rates in prospect, investors began shifting money out of emerging markets into US bonds and shares, pushing up the value of the greenback in the process.

The Aussie dollar lost US7.5c against the greenback in 2014 to finish the year at US82c. The slide is partly due to falling commodity prices but also a symptom of US dollar strength. Whatever the reason, it should give Australia's export industries and our international competitiveness a welcome boost.

The local currency also fell against the New Zealand dollar but rose against the Euro and the Japanese yen.

Australian Dollar
US dollars per Australian dollar since January 2014

Source: Reuters, CommSec

A booming housing market

Property investors were the big winners in 2014 after another strong year on the domestic residential property market. The average total return on capital city dwellings - from capital gains and rental income - grew by 12.2 per cent. This compares with an increase in the total return on shares – from capital gains and dividend income - of 5.7 per cent.

Australian home prices rose by 7.9 per cent, led by Sydney (up 12.4 per cent) and Melbourne (up 7.6 per cent). Prices were up in all capital cities except Canberra (down 0.6 per cent).[iii]

After two years of strong price rises there are signs emerging that price growth is slowing. While dwelling values are still rising, auction clearance rates reduced noticeably in the final two months of the year. At the same time, rental growth is sitting at its lowest annual rate in more than a decade.

According to RP Data: "With value outpacing rental growth, yields continue to shift lower. As at December 2014, gross rental yields were recorded at 3.7 per cent for houses and 4.5 per cent for units."

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The year ahead

Investors have every reason to be cautiously optimistic heading into the New Year. The IMF expects above average global growth of 3.8 per cent in 2015, with the US and the developing nations of Asia driving growth.

Global interest rates are at historically low levels and will remain so even if the US lifts rates as expected.

This low interest, higher growth environment is a very supportive one for shares and property as investors continue their search for returns above the rate for cash and inflation. If some of the heat comes out of the local housing market, as predicted, investors may begin to shift more money into shares.

One of the big lessons of 2014 was the importance of including some exposure to fast growing overseas markets in a diversified portfolio. That will continue to be the case in 2015. What's more, the weaker Australian dollar should also support Australian exporters and companies with offshore earnings.

If you would like to discuss any of the investment themes in this article and their impact on your portfolio don't hesitate to give us a call.

i As measured by the ASX 200 Index, ASX 200 Accumulation Index

ii AFR, 'Best year for global bonds since 2002' by Sridhar Natarajan, p.3, 2-4 January 2015.

iii RP Data, viewed on 5 January 2015, http://www.corelogic.com.au/media-release/capital-city-home-values- rise-by-7-9-in-2014

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