



# Annual Outlook

2014: A Transitional Year

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## A transitional year

### We expect 2014 to be a year of transition for the global economy and financial markets.

The Global Financial Crisis (GFC) of 2008/09 was followed by an initial solid rebound in global growth, but then the global economy slowed again, with Europe dipping back into recession and the US struggling through deleveraging. As a result, bond yields fell to historic lows while equities only managed to rise amid quite a degree of volatility.

The coming year will witness closure to this initial phase of adjustment. Better economic growth is anticipated, with a move back towards trend. The extraordinary policy response by major central banks over recent years is finally bearing fruit.

But this has not come without its consequences. Over the past four years, the Fed has purchased close to \$3 trillion of government and mortgage-backed bonds in an effort to kick start the US economy and stimulate better consumption.

As the Fed winds back and ultimately ends its bond buying programme, fixed income markets are likely to remain at the epicentre of this adjustment. But the prospect of rate rises is, in our view, still a couple of years away. Coupled with low inflation, we expect only limited increases in fixed income yields in 2014. While the US economy is improving, it is still well short of a clean bill of health.

On the other hand, after robust returns in 2013, equity markets look set to post further gains, but at a more moderate pace. With low interest rates likely to persist for an extended period, accompanied by low inflation and accelerating growth, the backdrop for equity markets appears largely positive. However, as is often the case, the market has already anticipated the better economic climate in 2014. As such, we believe equities are largely priced for better earnings growth.

Overall for 2014 we anticipate a year of more moderate returns. It won't be without volatility as markets continue to grapple with the persistent and deep government policy interventions that were beyond anyone's expectations just a few years ago. The risks remain but they are changing and slowly diminishing.

As usual, ANZ takes this opportunity to wish all its clients good health, wealth and happiness in the year ahead. We thank you for continuing to be our customers.

#### **Stewart Brentnall**

Chief Investment Officer, ANZ Global Wealth  
Australia and New Zealand Banking Group Ltd

# Economic Overview

## Set for further expansion

2013 will probably mark the lowest point in global growth since 2009, with a cyclical pickup expected in 2014. Although largely driven by healthier G3 growth, a number of emerging economies could also show stable to stronger growth in 2014.

### GDP Growth Forecasts (%)

	2013F	2014F
World	3.0	3.6
US	1.8	3.0
Eurozone	-0.4	0.8
Japan	1.7	1.8
China	7.6	7.2

Source: ANZ Economics & Markets Research. December 2013.

### US: A stronger economy

We expect US Gross Domestic Product (GDP) growth to accelerate to 3.0% in 2014 from 1.8% in 2013, largely due to a diminished drag from fiscal policy (see Spotlight below). Private demand should be underpinned by solid household consumption, a resilient housing recovery and a moderate pickup in business capital expenditure.

## Spotlight

### US: Potential for a virtuous growth cycle

One of the most notable developments of 2013 was the significant tightening in US fiscal policy, including tax hikes. Despite this, the US economy continued to grow.

The US Government started the year narrowly avoiding going over the so-called 'fiscal cliff', seen by commentators as having the potential to drive the economy back into recession. However, the US general government fiscal deficit still managed to decline 2.6 percentage points (from 8.4% to 5.8% of GDP) in the fiscal year ending September 30.

### US General Government Fiscal Deficit (as % of GDP)



Source: IMF.

The fact that the US economy managed to grow as much as it did in 2013 in light of this fiscal retrenchment suggests that the economy has a reasonable amount of underlying momentum. Indeed, this was a key factor behind the Fed's decision at its final meeting for 2013 to commence tapering its QE programme.

Moreover, while the Fed remains concerned over the potential for continued fiscal drag restraining growth over the course of 2014, the deal struck recently by the US Joint Budget Committee will avoid the coming sequester. In fact, it appears that fiscal policy could actually 'add' slightly to growth.



On the household consumption front, we think disposable incomes, in particular, should get a boost from an improving labour market. In addition, deleveraging by the household sector appears mature and appreciating asset prices should provide greater confidence to spend.

We expect some of the factors that have contributed to the low levels of business investment to also diminish next year. In particular, political brinkmanship should ease in 2014, as should household deleveraging.

The key challenge for the Fed in the next few years, along with calibrating its policy setting to the changing economic landscape, will be to more clearly articulate the policy normalisation process. This requires returning the size of the central bank's balance sheet and interest rates to more normal levels, with minimal disruption to activity and financial stability.

### **Europe: A patchy recovery**

The euro zone finally emerged from recession in the second quarter of 2013, although the recovery remains modest. Going into 2014, the outlook for the region continues to look challenging.

On the positives, improving confidence could spur a virtuous cycle of spending and credit. Indeed, the latest bank lending surveys have shown the first upturn in housing demand, albeit from low levels, since 2010. These are grounds for cautious optimism that the core economies will grow at a moderate pace.

On the other hand, growth is likely to remain elusive for many of the peripheral economies with more hard work needed, although the reforms undertaken should eventually lead to enhanced growth prospects for the

entire region over the longer term. Moreover the need for deleveraging in the financial sector could see the supply of credit remain constrained.

A key challenge for the euro zone in the next few years will be to lift aggregate demand in a meaningful way, so as to prevent further disinflation and/or deflation. This may push the European Central Bank (ECB) to ease policy further in the New Year. We believe that a strengthening of the central bank's forward guidance is the only viable conventional policy option left for the ECB, given the potential ineffectiveness of further rate cuts. Other non-conventional measures could include another long-term refinancing operation (LTRO), potentially on the basis that any funds provided to the banks will be lent out to business and households.

### **Japan: Reforms the key to success for Abenomics**

We are forecasting Japanese GDP to increase by 1.8% in 2014. The key for growth and the overall success of Abenomics is a sustained lift in household and business spending. Rising capacity utilisation, negative real interest rates, positive wealth effects as well as government incentives are all potentially supportive of more investment spending.

However, we are not convinced that the central bank will be able to achieve its 2% inflation target by mid-2015, and could come under pressure this year to further expand its asset purchase programme.

In our view, the weak yen has been a major driver behind the uptick in inflation but a sustainable lift in prices will require the government to continue pursuing economic reforms in order to boost productivity and labour force participation, in turn increasing demand and wage growth.

# Economic Overview

## Australia: Managing the transition

While growth in the Australian economy remains below trend and the transition from mining-led growth to other sectors of the economy continues to be a key uncertainty, there are some increasingly clear signs of a potential recovery in the non-mining sector.

For one, building and secondary market activities in the housing sector continue to strengthen. Notably, the positive wealth effect from rising home prices can help to an extent to offset soft household income growth.

The outlook for exports is also very positive as the capacity for new bulk commodities (in particular iron ore) comes on stream. However, below trend growth is likely to keep the unemployment rate close to 6% for some time, with some upside risk.

Against a backdrop of sluggish growth but a robust housing sector and Reserve Bank of Australia's (RBA) clear preference for a lower currency, we expect the RBA to keep the cash rate on hold throughout 2014.

## Emerging Asia: On a firmer footing

Stronger and more even developed economy growth in 2014 will prove to be a key support for Asia in the New Year. While portfolio outflows may follow the commencement of Fed tapering, these should not derail improved economic momentum given the structural institutional and economic changes. More robust policy settings have also been implemented across most economies in the region since the Asian financial crisis of the mid-to-late 1990s.

We view downside risks as being concentrated in Indonesia and India, with their problematic inflation, and 'twin deficits' (combined fiscal and current account deficits). These downside risks could see these two economies slowing amid improving external demand in the rest of Asia.

Political cycles may also interrupt much needed progress on reforms. Over in Thailand, there is the potential for elections to be brought forward.

Meanwhile, on the policy front, we expect monetary policy particularly in the ASEAN countries to tighten against a backdrop of a more synchronised global growth and the beneficial effects of 2013's currency depreciation.

## China: Reforms to chart its course

The reform measures outlined in the third Plenary Session of the 18th CPC Central Committee in November last year were unprecedented and exceeded market expectations. China's top leadership pledged the removal of the privileges granted to state-owned enterprises and other barriers to competition. They also promised to use the market to determine factor prices, accelerate deregulation of interest rates and capital flows, lower curbs on foreign investment, reform the fiscal system, and grant local governments the rights to issue bonds.

These reform measures, if implemented successfully, will result in a more efficient allocation of resources, lifting productivity growth. This could in turn reduce the downside risks in China's economy and help return China to a more sustainable growth path.

That said, the reform package is likely to weigh on China's economic growth in the next one to two years, potentially leading the Chinese government to lower its growth target for 2014 to 7%. With growth roughly in line with China's potential, broader inflationary pressures are likely to remain manageable this year.

However, non-food inflation, especially rental costs, could pick up amid rising property prices, putting some pressure on the consumer price index. Against this background, the central bank is likely to maintain the current policy environment, but will continue to enhance its liquidity management operations, though deleveraging by Chinese commercial banks suggests that liquidity conditions may not improve much.

## Asia Pacific ex Japan GDP Growth Forecasts (%)

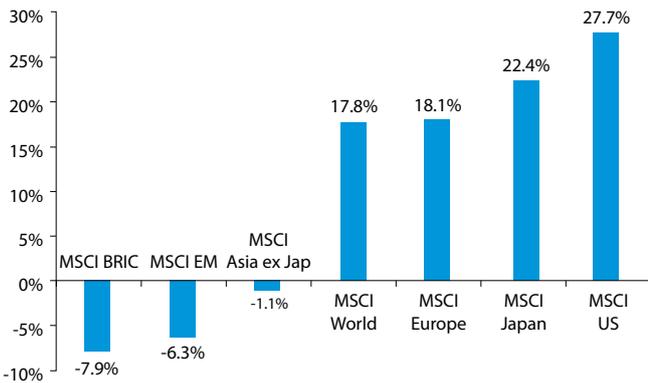
	2013F	2014F		2013F	2014F
Australia	2.4	3.2	New Zealand	2.9	3.2
China	7.6	7.2	Philippines	6.8	6.9
Hong Kong	2.9	3.5	Singapore	4.0	3.2
India	4.7	4.0	South Korea	2.8	3.7
Indonesia	5.7	5.8	Taiwan	2.0	3.6
Malaysia	4.5	5.0	Thailand	2.8	4.2

Source: ANZ Economics & Markets Research. December 2013.

## A positive macro environment

The macroeconomic environment for 2014 is supportive of equity markets. However, neutral valuations and market sentiment call for short term caution, especially in the wake of the Fed's QE programme tapering.

Regional Equity Market Returns (2013)



Sources : Bloomberg and ANZ Global Wealth.

## US: Reasonable valuations

The strong rally since the 2009 trough has seen the US market more than double. However, it is not as stretched as it may first look. US earnings have risen solidly since the end of the GFC, underpinning the market's gains. The market is only 17% higher than the peak reached in 2001, despite earnings having doubled over the same period. This has allowed valuations to fall sharply from their tech bubble induced highs.

More recently, the pace of negative earnings revisions has slowed and expectations for earnings per share (EPS) growth, while a little high, are not unreasonable considering the improvement in US leading economic indicators. Furthermore, in the absence of a sharp downturn in the US economy, earnings are unlikely to pull back from their elevated level any time soon. As a result, the market does not appear overly stretched and we expect positive, but more moderate returns in 2014.

## Spotlight

### Global: Disparate earnings growth

Post-GFC earnings in the US have outpaced all other major equity markets

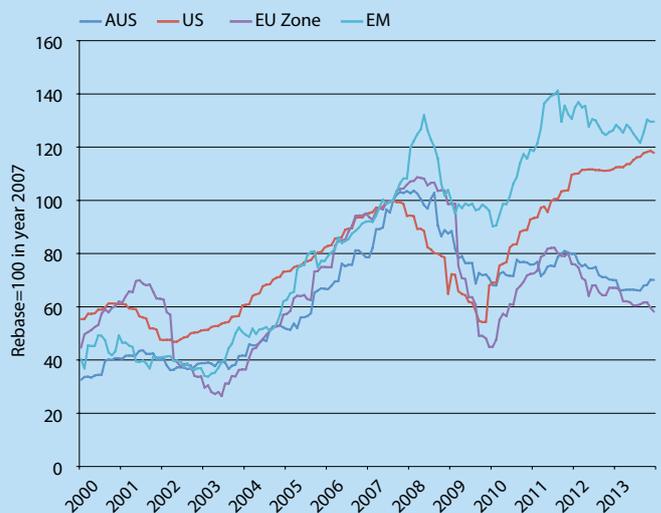
The US equity market recovery has stood out as the strongest relative to its peers. Since its March 2009 low, the S&P 500 has risen 168%, compared to the MSCI Europe Index, which has climbed by less than half this amount (66%), while Emerging Markets have risen by 100%.

While the impact of QE on US asset prices readily comes to mind when attempting to rationalise the difference, a close look at earnings helps to make better sense of the performance differential.

As the chart shows, US earnings per share have risen to 18% beyond their pre-GFC peak. In contrast, European earnings are still 45% below their 2007 high and only up 33% from their 2009 low.

The Emerging Markets, despite their initial rapid rebound in both earnings and the market, have gone backwards since 2010. For these and other markets such as Australia, after a period of strong re-rating, further advances now require actual earnings growth, and not just a forecast.

Trailing EPS



Sources: Thomson Financial Datastream and ANZ Global Wealth. December 2013.

# Equities

## Europe: Benefitting from recovery

Despite the recovery in the past 12 months, there is still room for upside in European equities in 2014. Firstly, a decline in equity risk premium is in prospect if macro-economic and financial conditions continue to improve as expected.

Also, earnings expectations are very modest which means valuations based on forward earnings multiple are cheap if earnings growth in the region recovers in line with better economic growth. Although earnings revisions are still negative, the trend is now upward.

Business confidence in Germany has improved significantly, and there have even been signs of tentative improvement in peripheral countries. The economic recovery is also gaining significant traction in the UK despite meaningful government spending cuts.

## Japan: Mixed valuations

The Abe Government's economic policies to end deflation are bearing fruit. Leading indicators are improving with earnings revisions only recently off a five-year high. However, with the Topix having risen more than 45% last year, valuations are now looking mixed. Current earnings expectations may already be reflecting the prospect of stronger growth and a weaker yen.

After the rapid gains of 2013, a more measured rise is expected in the coming year as the once off boost from the initiation of reflationary policies transitions to questions over the sustainability of an end to deflation.

## Australia: Earnings growth required

Over the long term, the market is expected to benefit from a pickup in earnings growth as the economy responds to the RBA's stimulatory monetary setting and a lower AUD. Industrial sector downgrades have eased significantly with earnings growth expectations of 8% over the next couple of years. Moreover, the cyclically adjusted Shiller PE measure still remains below average suggesting further upside in the medium term. That said, much of this good news, for the moment at least, is priced in.

## Emerging Markets: A mixed bag

Emerging markets suffered another year of underperformance in 2013, weighed down by Fed taper talk and slowing growth momentum. In 2014, we see scope for modestly stronger earnings growth, helped by already weakened currencies and continued demand from the developed economies.

However, with the onset of Fed tapering, this picture is appearing somewhat clouded. Tightening financial conditions and high levels of corporate and household debt are a cause for concern in selected economies.

Macro-economic weakness and heightened political uncertainty in Thailand, Indonesia, India and Brazil also imply that investors are likely to be more discerning.

On balance, given cheap valuations and light investor positioning, we believe that longer-term investors may want to take advantage of bouts of volatility to gradually build some exposure within the emerging markets over the course of the year.

We continue to favour Asia ex Japan within the emerging markets for its better fundamentals. The Asian region is more leveraged to developed market growth, and may also benefit when reforms in Japan and China bear fruit. On the other hand, we shy away from the more commodity-dependent markets such as Russia and Brazil, given our more cautious commodities outlook.

## 2014 Equity Market Outlook

Market	Outlook
Global	Positive
US	Positive
Europe	Positive
Japan	Positive
Australia/New Zealand	Positive
Emerging Markets	Neutral

Source: ANZ Global Wealth. December 2013.

## Asia and Emerging Markets in Detail

### China: No quick fixes

Liquidity conditions are likely to remain tight in China in 2014. While further bank deleveraging and industrial rationalisation will be beneficial for the economy in the long term, they are likely to be a dampener on growth in the near term, which could in turn weigh on earnings in the New Year. Meanwhile, the road to reforms is long and has only just begun.

Although the market does not appear expensive and could potentially re-rate over the longer term as China's financial and growth risks are seen to moderate, we stress that volatility could be high in the medium term. On the other hand, companies involved in healthcare, insurance, railway/construction as well as pollution control may enjoy policy support, and thus fare better.

### India: Less pessimistic

We enter 2014 feeling less pessimistic about India's growth outlook as recent activity indicators suggest that growth may be bottoming out. We are also heartened by the recent improvement in India's current account dynamics. Although higher diesel prices will continue to exert upward pressure on inflation, favourable base comparisons may provide some offset.

Given these factors, we expect one more 25 basis points hike, after which the RBI is likely to stay on hold in order to give growth a chance to pick up. A market friendly election outcome in 2014 could also help lift animal spirits and spur a much-needed revival in investment spending. However, as the market appears fairly priced, we would look to gain exposure at better entry levels.

#### Taiwan: A better first half

We remain slightly positive on the Taiwanese market going into 2014. Historically, Taiwan's earnings are highly correlated to developed market growth. As such, we look forward to a market underpinned by improving global growth momentum, rising tech demand, and easy domestic monetary conditions. That said, the market is not cheap and given the current low approval rating for the incumbent KMT party, the upcoming municipal elections could see the rise of political uncertainty in the second half of the year.

#### Korea: Domestic demand may surprise on the upside

We are slightly positive on the Korean market. The economy should benefit from the global recovery given Korea's key role in the Asian supply chain with continued developed market growth expected to bode well for Korea's technology, auto and shipbuilding sectors.

On the domestic front, further government reform to support the housing market could lift domestic consumption and improve the earnings profile of domestic-related sectors. While further yen depreciation could be a risk to our view over the New Year, our currency strategists do not see the yen weakening significantly from current levels.

#### Hong Kong: Subdued

The outlook for the Hong Kong market is subdued in the face of tighter liquidity and the potential for hot money flows out of the country. Residential property prices are expected to correct in 2014, presenting an earnings risk for the property sector. The negative wealth effect from the decline in property prices can also be expected to dampen domestic consumption.

#### Singapore: Prefer cyclical sectors

Growth will likely be tempered by tightening financial conditions and the continued transformation of the economy to a more productivity-driven growth model, as foreign labour inflows slow. Inflation is expected to pick up as pent up costs are finally passed on to consumers, while the continued tightness in the labour market may drive wages up more aggressively. Similar to Hong Kong, a softer property market may weigh on the sector as well as on domestic consumption. We prefer exposures to cyclical sectors that have strong linkages to the improving G3 growth profile.

#### ASEAN: Caution warranted

We expect the ASEAN markets to underperform in 2014. Not only do valuations continue to look expensive relative to its other Asian counterparts, growth also appears challenging with higher interest rates expected in the Philippines, Indonesia and Malaysia. In addition, the THB and IDR are deemed to be vulnerable to renewed portfolio outflows while political uncertainties are likely to persist in Thailand throughout the early part of the New Year.

There are also a number of notable sector variations. Over in Indonesia, election-related spending could lend a boost to domestic-related sectors during the year. Meanwhile in Malaysia, the outlook for property developers and banks could be hurt by the government's cooling measures and moderating consumption growth.

#### Brazil: Earnings risk

The consensus forecast of 16% for earnings growth in 2014 appears aggressive against a subdued outlook for commodities and domestic growth. Rising costs pressures, higher interest rates and a stronger USD are further headwinds for earnings. Meanwhile, fiscal underperformance has undermined investor confidence with currency volatility seen as a key risk for foreign investors. Policy uncertainties arising from the upcoming Oct 2014 presidential election further warrant a cautious view.

#### Russia: Neutral outlook

While valuations are cheap, the outlook for the economy and earnings is subdued. Granted, there has been increasing political pressure on the government and central bank to adopt more pro-growth policies. However, the fiscal rule implemented recently, together with the central bank's ongoing transition to inflation targeting, severely restrict the scope for both fiscal and monetary stimulus. The gradual erosion of Russia's external surplus has also weakened the fundamentals of the rouble.

#### 2014 Asian and Emerging Markets Outlook

Market	Outlook
Asean	Negative
China	Neutral
Hong Kong	Neutral
India	Positive
South Korea	Positive
Singapore	Neutral
Taiwan	Positive
Brazil	Negative
Russia	Neutral

Source: ANZ Global Wealth, December 2013.

# Fixed Income

## A lower interest rate world

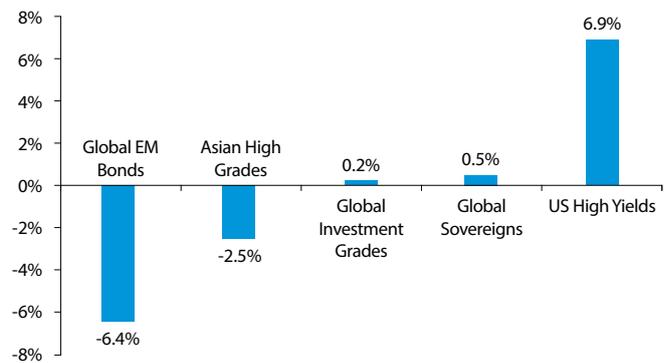
While the Fed's QE programme may be coming to an end, we expect low rates to persist in the major economies.

### US: The end of QE

With the Fed's tapering of QE underway, 2014 is likely to witness an end to its unprecedented open-ended bond buying programme. QE is the third key facet (along with the Fed Funds rate and forward guidance) of the Fed's current monetary policy strategy to return the US economy to health following the GFC.

However, the end of the bond buying programme is one thing. Raising interest rates, the Fed's traditional way of implementing policy, is another thing entirely. The Fed's guidance for future interest rate movements points to the need for a further significant improvement in the unemployment rate and inflation close to its 2% objective. This suggests a move higher in the Fed Funds rate may still be a couple of years away.

Global Bond Market Returns (2013)



Sources: Bloomberg and ANZ Global Wealth. Returns are as of 20 December and are unhedged, in USD terms. Past performance is not a guarantee of future returns.

## Spotlight

### Bond Bubble?

If it is true that QE has pushed asset prices into bubble territory, then the most obvious area of potential trouble is where the Fed has been most active, namely 10-year bonds.

While US 10-year Treasury bond yields are around their lowest level in the past century, as the chart shows, there are two points worth noting. Firstly, interest rates have been on a declining trend over the past three decades as inflation has steadily fallen. In other words, the low level of rates we have now is not just because of the Fed's QE operations. Secondly, yields in the US have picked up from their low point in mid-2012 of 1.4% and now stand just below 3%.

A good way to anchor your thinking about what level US 10-year bond yields should be over the longer term is the level of nominal GDP growth. While in the pre-GFC period this was close to 5%, given weaker trends in demographics and productivity growth, we now believe this is closer to 4%.

If this is correct, it means that while yields are low they are not too far from what looks to be a reasonable average level, and not low enough now to be called a bubble. Currently being below this fair value level appears justified, if one considers the still weak nature of the recovery, significant excess capacity in the labour market, the headwinds still apparent from high debt levels and the low inflation rate.

US 10-year Treasury Bond Yield (%)



Sources: Bloomberg and ANZ Global Wealth. December 2013.

In addition, with the US economy still in a healing process, high debt levels providing a headwind to demand and an ageing population constraining potential GDP growth, the level at which the Fed Funds rate eventually settles is likely to be well below previous expectations of what is a normal rate. That is, not only is the Fed Funds rates likely to be kept near zero for some period yet, but the pace of the ascent once it begins may be moderate and only to an historically low rate.

We believe the recent rise in bond yields has moved this asset class closer to a neutral valuation, discounting the end of the QE programme. While the medium-term trajectory of yields will be higher, we look for more of a grind than a rapid adjustment, with yields trading in a range. The Fed will try to cap any aggressive move up as the economy still appears vulnerable to rates significantly higher than where they already are.

This is where forward guidance becomes critical. Ultimately the Fed's ability to exit its ultra-easy monetary policy will be dictated by the state of the US economy. As long as inflation remains low (2% or lower) and inflation expectations stabilise around a similar level, the Fed will be able to take their time.

### Europe: Continued stimulus

While the Fed will set the tone for global fixed income markets, domestic conditions will also be critical for the other major markets. Continued QE by the Bank of Japan (BoJ) and the potential for further stimulus by the ECB could also help contain yields.

In Europe, the risk of deflation continues to loom given the region's high unemployment rate and the relatively weak economic recovery. Given the risks, the ECB may well ease policy again and strengthen its forward guidance to further underwrite the economic recovery and stave off further disinflation. With inflation well below the ECB's 2% target and the region's potential growth deteriorating as the population contracts, interest rates are on a sustainably lower path. We see limited upside to yields in 2014 given the still considerable risks facing the fledging recovery.

### Australia: Rates on hold

In absolute terms, current yields still appear expensive from a historical perspective. However, with the neutral cash rate having moved lower on the back of wider lending spreads and the headwinds still faced by the domestic economy, the current low level of official interest rates may be sustained for longer than the market expects.

We view the current level of bond yields as around fair value given the outlook for US yields and domestic economic conditions. While global yields may grind higher, this backdrop favours some renewed rate convergence of Australia to low global yields.

### New Zealand: Leading the way on policy tightening

We expect New Zealand sovereign bonds to outperform other G10 sovereign bonds. The short end of the New Zealand yield curve is currently pricing in 125 basis points of hikes to December 2014. While we recognise there is some upside risk to the outlook for growth and inflation in NZ, the moderate pace of growth elsewhere in the world suggests that the RBNZ will not be overly aggressive in their tightening velocity. To our mind, the current market pricing is unlikely to come to fruition.

### Emerging Markets: Favour Asian corporates

As tapering begins in earnest, we expect to see further outflows from emerging market bonds in 2014 and a further widening of credit spreads. That said, we believe that selective opportunities would emerge within the complex, as valuations become more attractive.

In particular, Asian corporates could experience less stress relative to their emerging market peers. Fundamentals appear more resilient, and could improve further as developed economies heal and export demand picks up. The stabilisation in China's growth profile is also expected to have a positive impact on the region. At the same time, Asian fixed income has the added benefit of domestic-based investors, who tend to be more optimistic over the region's outlook. Meanwhile, the moderately stronger economic outlook suggests that inflation pressures are likely to remain manageable in Asia with the possible exceptions of India and Indonesia.

### 2014 Fixed Income Outlook

Market	Outlook
Global	Neutral
US	Neutral
Europe	Neutral
Japan	Neutral
Australia	Positive
New Zealand	Positive
Emerging Markets*	Neutral

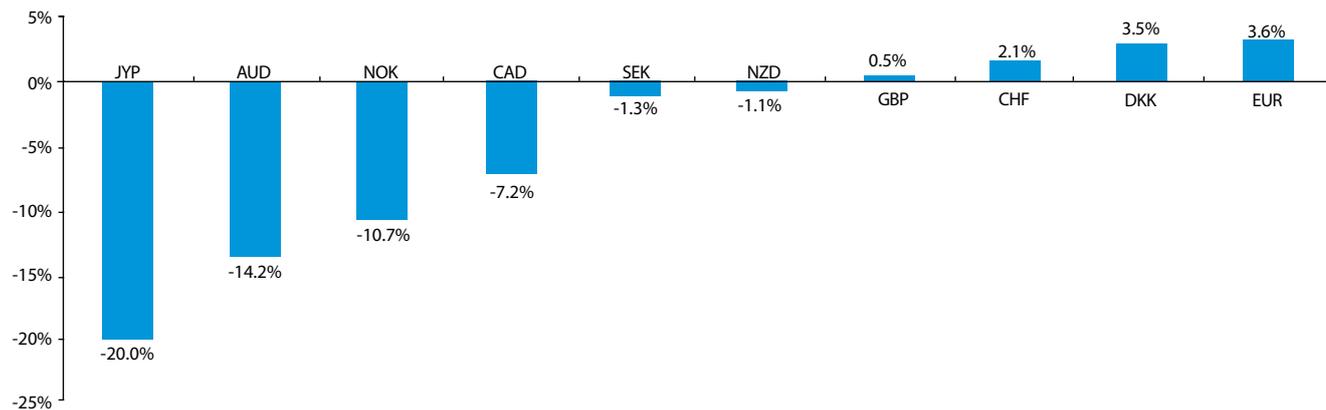
Source: ANZ Global Wealth. December 2013. \*USD-denominated.

# Currencies

## Selective USD strength

Despite a recovering US economy and the start of tapering, the US dollar is expected to rally only against selected currencies. Declining tail risks and strong demand should help the euro and renminbi stay firm in 2014.

G10 Currency Returns (2013)



Sources : Bloomberg and ANZ Global Wealth. Returns are as of 20 December 2013 and against the USD. Past performance is not a guarantee of future returns.

## Spotlight

### RMB: A currency for the future

While much remains to be done before the renminbi (RMB) can become a global reserve currency, the gears have been set in motion.

The pace of the RMB's recent internationalisation has surprised even the hardest of sceptics. As of 2013, 24 global central banks had bilateral currency swap agreements with the People's Bank of China.

The scope for foreign investors to buy Chinese assets has also widened with the expansion of programmes such as the QFII and RQFII, both enabling greater foreign investment in China's stock and bond markets. Also underway are the government's experiments with floating deposit interest rates and full convertibility of the RMB exchange rate.

These developments, coupled with last year's shutdown of the US government, have led investors to wonder if and when the RMB will be able to rival the greenback's reserve currency status. After all, China now accounts for about 10.4% of global exports and 9.4% of global imports, well in line with the US's figures of 8% and 12.3% respectively. Historically, currencies of major global trading nations have tended to become reserve currencies.

However, reserve currency status would also require the liberalisation of China's capital account and the

development of deeper financial markets. While these feature in the government's long-term reform plans, they are unlikely to happen in a hurry, given the need to manage increased exchange rate volatility. This means the internationalisation of the RMB remains a work in progress.

Capital Account Liberalisation Likely to Increase RMB Volatility



Sources : Bloomberg and ANZ Global Wealth. November 2013.



## **USD: Selective strength**

While we continue to anticipate a somewhat stronger US dollar (USD) in 2014, the trend is likely to be selective, rather than uniform. The forces that had prevented a broad-based USD rally in 2013, namely low interest rates and a wide US basic balance deficit, are likely to remain in play in the New Year.

Therefore, despite a recovering US economy and a shift towards Fed tapering, the dollar is likely to be only selectively strong. In particular, while the greenback is expected to show its strength against the Australian dollar, Indonesian rupiah, Malaysian ringgit and Thai baht, it looks likely to underperform the euro and British pound.

## **EUR: To remain firm**

Market expectations for a weaker euro hinge on the need to provide some offset to disinflationary pressures and support growth. While we sympathise with this view, we do not think it follows that the euro will necessarily depreciate over the coming year. Firstly, we do not believe that an absence of growth is simply an exchange rate problem. In fact, to pursue a policy of exchange rate depreciation would risk progress on the reform agenda.

Secondly, we believe that German resistance will prevent the ECB from embarking on significantly more aggressive policy easing. Finally, reduced tail risks mean the eurozone is likely to continue to attract capital inflows. We expect to see a gradual appreciation in the euro for 2014. The banking assessment conducted by the ECB is a key development in the New Year. With banks providing about 70% of the euro area's financing, any moves to nurse the banking sector back to health is likely to also help support the region's recovery.

## **JPY: Looking to global drivers**

Domestic factors are unlikely to have the impetus to drive further yen depreciation in 2014. After all, the current level of the currency appears to be broadly consistent with the relative size of the BoJ and the Fed's balance sheets. Meanwhile, with the BoJ's asset purchase programme not scheduled for completion until early 2015, the odds of further monetary stimulus appear low in the near term.

As such, global drivers look set to determine the yen's trajectory. On this front, the market may start to price in higher global interest rates along with the recovery in the core economies. This would be negative for low yielding currencies such as the yen. Hence, while a substantial depreciation is unlikely, a move to 105 versus the USD appears achievable.

## **AUD: Any bounces likely to be shallow**

The Australian dollar (AUD) entered 2014 having corrected much of its valuation overshoots. Notably, 2013's decline from above parity down to around USD90c has eradicated much of the currency's over-valuation relative to metrics such as commodity prices and terms of trade.

However, financial flows could determine how the currency evolves from here. We note that foreign ownership of the Australian government bond market is maturing. Having reached 80% in early 2012, these flows are likely to deteriorate going forward. Against this backdrop, we believe that any bounces in the AUD are likely to be shallow, as higher levels attract fresh selling.

# Currencies

## NZD: Short-term support

We remain comfortable with our view of gradual New Zealand dollar (NZD) depreciation over 2014, driven by portfolio diversification flows returning to core currencies. Bouts of concern over risk and improving sentiment towards the US dollar are other potential reasons why the Kiwi might get knocked off its perch.

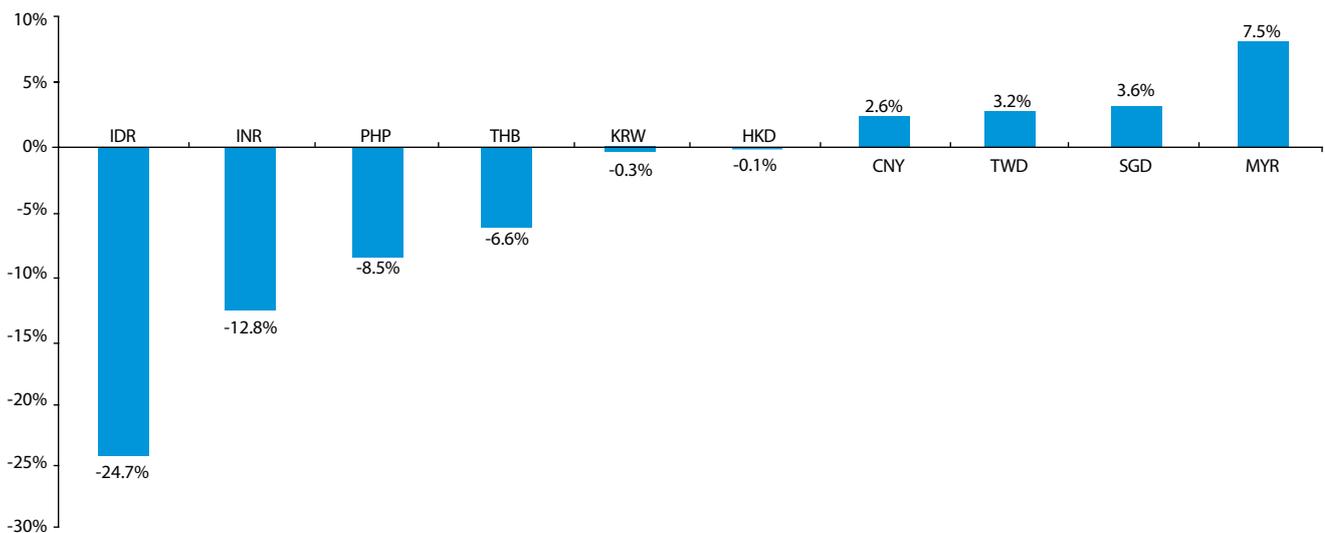
However we acknowledge that there are reasons to be relatively optimistic in the short term. High interest rates, attractive bond yields, reasonable growth prospects and low levels of government debt are reasons to expect the NZ dollar to remain at elevated levels throughout 2014. While many of these factors are well known, market sentiment and timing expectations are still shifting, thereby providing some scope for upside surprises.

## Asia: Divergent performances

Fed tapering its asset purchase programme is expected to drive divergent performances among Asian currencies in 2014. Strong US data will likely be negative for Asian currencies, while dataflow from the region looks on balance to be relatively lacklustre and lacking evidence of a genuine pickup in export performance. In our view, renewed portfolio outflows will put current account deficit countries under the spotlight again, with the Thai baht and Indonesia rupiah looking the most vulnerable.

On the other hand, steps taken by rupee policymakers to improve the current account deficit and tackle inflation will ultimately be positive for the currency. Over in China, strong trade surpluses, higher yields and steps to further internationalise the renminbi will likely elevate demand for the currency.

Asian Currency Returns (2013)

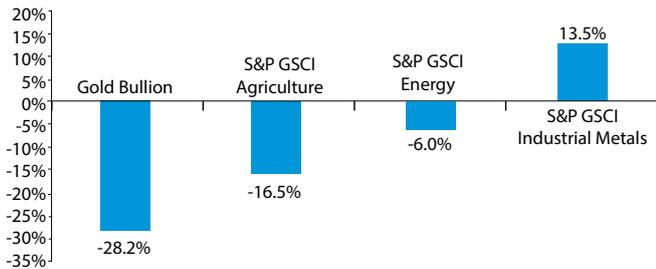


Sources : Bloomberg and ANZ Global Wealth. Returns are as of 20 December 2013 and against the USD. Past performance is not a guarantee of future returns.

## Cautiously optimistic

While we see commodity markets moving cautiously out of a two-year bear market, we are not expecting a broad-based rally. Global growth and demand fundamentals suggest that performances are likely to be skewed towards energy and base metals.

Commodity Returns (2013)



Sources : Bloomberg and ANZ Global Wealth. Returns are in USD. Past performance is not a guarantee of future returns. As of 20 December 2013.

### Oil: One of the better performers

We expect oil prices to be supported by more positive demand side dynamics in 2014. For one, the global economy is showing encouraging signs; in particular, the disproportionate improvement in developed market activity is likely to be supportive of oil markets. In addition, there is greater comfort surrounding China's demand outlook, further boosted by the need to build strategic reserves.

## Spotlight

### The shale revolution creates winners and losers

The US shale boom is set to reshape the global energy market in the coming decades with important ramifications for the US economy going forward.

US natural gas and oil production has jumped over 30% since 2005, a spectacular reversal from almost zero growth in the previous 40 years, thanks to shale gas. While shale gas is not a recent phenomenon, having been extracted in the US since 1825, large scale production only began in earnest in the 1970s.

However, over the years, the combination of favourable government policies, unique US land ownership laws and technological advances has made shale gas the most significant contributor towards the total primary energy mix in the US over the last decade. By 2030, natural gas is expected to become the number one energy source for US consumers.

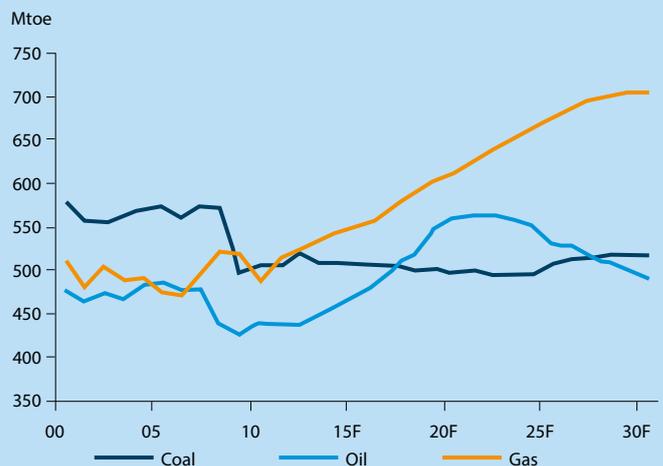
This has important ramifications for industries as well as the US economy. For one, oil and coal consumption will probably decline in favour of this cleaner and potentially cheaper fuel source. Industries that are big direct consumers of natural gas, such as the producers of petrochemicals and fertilisers, are likely to be big beneficiaries. Energy-intensive users such as the aluminium and steel producers are also likely to gain from lower energy costs, as will businesses in general. Overall, this could lift the cost competitiveness of US manufacturers.

On the other hand, energy suppliers to the US, namely South American and Middle East suppliers may turn out to be the biggest losers. In fact, rapidly rising domestic oil production already has the potential to halve US oil

imports as early as 2020. This would represent significant import savings, considering that crude oil is the single largest US import, accounting for about 14% of total imports in 2012.

While this is undoubtedly dollar positive in the longer term, we note that it will probably take another two decades for the US to be self-sufficient in energy. In the meantime, high capital expenditures and infrastructure constraints may stand in the way of bringing new capacity on stream.

US Energy Production



Sources: IEA, BP Statistics and ANZ Commodity Strategy. August 2013.

# Commodities



On the supply front, the return of supplies from Iran and Libya following sanctions and protest-led disruptions in 2013 could result in an overhang in the Brent market. However, with Saudi Arabia still holding the lion's share of OPEC spare capacity, a more disciplined export response including supply caps could be forthcoming.

## **Base metals: Stronger demand**

We are generally positive on the outlook for base metals as confidence around Chinese demand improves. Copper will dictate overall base metal sentiment and has the propensity to rebound if large short positions are forced to unwind.

However, our preferred exposures are lead and zinc – two markets that have not seen meaningful supply investment in the past two to three years. On the other hand, aluminium and nickel are likely to underperform given rising Chinese smelter output and large inventory overhang. That said, the outlook for the latter could improve if persistently weak margins force capacity closures.

## **Bulks: Divergence expected**

Thermal coal is expected to be the best bulk performer in 2014, as prices come off a low base against a tighter supply backdrop. Notably, supply discipline appears to be kicking into key producing markets of China, the US, and to a lesser degree Indonesia.

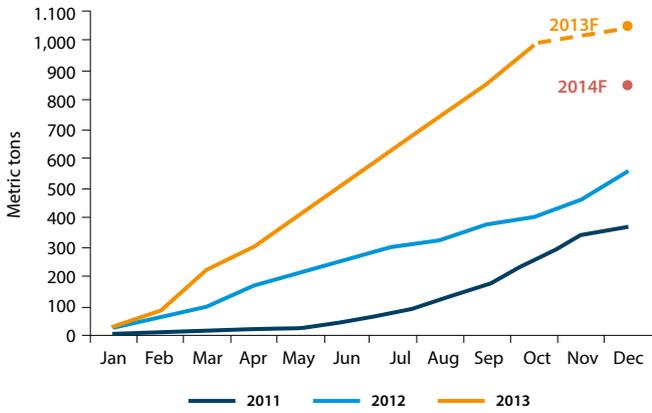
On the other hand, iron ore and coking coal markets will probably be more tied to Chinese steel prices. In the absence of stronger supply discipline in China, prices here are likely to struggle to move higher. In fact, iron ore is our least preferred bulk commodity exposures for 2014, falling off a very high base in 2013, with large new expansion in Australia iron ore output expected to further weigh on prices.

## **Precious metals: Relatively lacklustre**

Precious metals are likely to underperform in 2014, although prices may bottom out by the end of the first quarter. In the short term, the expected winding back of the Fed's asset purchase programme poses a headwind for gold prices, although demand fundamentals could re-assert themselves in the second half of the year. On this front, Chinese demand for physical gold is a key support factor for the market as Indian consumers continue to be affected by the Reserve Bank of India's (RBI) import restrictions. We expect China's gold imports to remain robust in 2014 at 900mt, the second highest on record.

Within the platinum group metals (PGMs), a global shortage of palladium is expected to persist with minimal sales from Russian stockpiles and a stabilisation of physical ETF holdings. Against a backdrop of higher US and European auto sales, this should keep palladium prices elevated relative to other precious metals. Meanwhile, platinum prices are likely to stay choppy amid the ever present threat of industrial action from key producer South Africa.

China Cumulative Gold Imports



Sources : Bloomberg and ANZ Economics & Markets Research, December 2013.

### Agriculture: Greater stability

After two years of extreme volatility in prices, we expect a period of greater stability for agricultural markets in 2014. With supply conditions improving across the complex, food prices are expected to track sideways over the course of the year. One exception could be in wheat where low stockpiles leaves the market particularly vulnerable to any supply disruptions in 2014. In addition, we believe that conditions are in place for China to embark on a large scale wheat import programme – China’s wheat stockpiles are low and domestic prices are trading within a fraction of their all-time high. This could present some upside surprise for wheat prices in the New Year.

# Forecasts

## Policy Rates (%)

	Current	Dec-14
US	0.25	0.25
Eurozone	0.25	0.25
Japan	0.10	0-0.1
UK	0.50	0.50
Australia	2.50	2.50
New Zealand	2.50	3.50
<b>Emerging Asia</b>		
China	6.00	6.00
HK	0.50	0.50
India	7.75	8.00
Indonesia	7.50	7.50
Malaysia	3.00	3.50
Philippines	3.50	3.75
South Korea	2.50	2.75
Taiwan	1.875	2.000
Thailand	2.25	2.25

Sources: ANZ Economics & Markets Research, relevant central banks and Bloomberg. As at 20 December 2013.

## Foreign Exchange Rates

	Current	Dec-14
<b>Majors</b>		
A\$/US\$	0.89	0.87
NZ\$/US\$	0.82	0.75
US\$/¥	104	105
€/US\$	1.37	1.42
£/US\$	1.63	1.69
<b>Asian currencies</b>		
US\$/CNY	6.07	5.98
US\$/IDR	12214	12200
US\$/INR	62.0	66.0
US\$/KRW	1061	1100
US\$/MYR	3.29	3.35
US\$/PHP	44.5	44.0
US\$/SGD	1.27	1.29
US\$/THB	32.6	33.0
US\$/TWD	29.9	30.5

Sources : Bloomberg and ANZ Economics & Markets Research. As at 20 December 2013.

## Commodity Prices

	Unit	Current	Dec-14
<b>Base metals</b>			
Aluminium	US\$/lb	0.79	0.90
Copper	US\$/lb	3.29	3.60
Nickel	US\$/lb	6.52	7.50
Zinc	US\$/lb	0.92	0.99
Lead	US\$/lb	1.00	1.07
<b>Precious metals</b>			
Gold	US\$/oz	1203	1450
Platinum	US\$/oz	1332	1702
Silver	US\$/oz	19.41	23.8
<b>Bulk metals</b>			
Iron Ore	US\$/t	132	120
Coking Coal	US\$/t	139	170
Thermal	US\$/t	84	92
<b>Energy</b>			
WTI Nymex	US\$/bbl	99	104
Brent	US\$/bbl	112	112
<b>Agriculture</b>			
Corn	US\$/bu	433	480
Wheat	US\$/bu	614	670
Soybeans	US\$/bu	1319	1160
Sugar	US\$/lb	16.5	17.0
Cotton	US\$/bu	83	77
Milk Powder	US\$/t	5000	3900

Source: ANZ Economics & Markets Research. As of As of 20 December 2013. Forecasts are average prices for the quarter.

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