

Investment market update

Key themes for the next financial year

As we have now entered the 2015 financial year we thought this would be a good time to share key themes which we think will shape the market in the new year:

Australian interest rates lower for longer:

Given economic growth in Australia remains below trend, we now expect interest rates will remain low for the next two years. We expect inflation will continue to soften and perhaps leave the door open for the RBA to reduce interest rates further. This would be very good for equity markets, particularly yield driven stocks. Term deposits are delivering around 3% compared to the grossed up yield of the major banks at around 7%.

USA increasing interest rates:

With economic data continuing to improve over the last year, we think the US Federal Reserve could increase interest rates by the end of 2014. Generally, rising interest rates have a dampening impact on equity market returns. In our view, this could provide short term volatility to the downside.

Australian housing market to remain strong:

With interest rates at record lows in Australia, we believe house prices may continue to move higher in the short term. We are also seeing large amounts of foreign investment into the property market, in particular Chinese buyers of Sydney units. With the banks competing aggressively for new home loans this should support short term property price increases. However at current levels most property prices are high and we may see little long term capital growth for areas like Sydney and Melbourne.

Company earnings:

Earnings growth in the Australian share market remains low with a raft of profit downgrades in recent months across a number of sectors. The market's expectation of 8% earnings per share (EPS) growth for the next year appears a little high and if companies report below market expectations this could provide short term volatility to the downside.

Lower returns:

Investors can thank supportive central bank policy settings (i.e. low global interest rates and the printing of money) for another year of good returns from growth assets such as shares. The charts on the right hand side show the price movement from USA and Australian sharemarket markets with returns around 10-12% for the past year. We believe these returns are unlikely to be repeated in the next 12 months, because valuations of stocks are considerably higher now and earnings may not meet expectations.

One Year Chart of the Australian Share Market



One Year Chart of the USA Share Market



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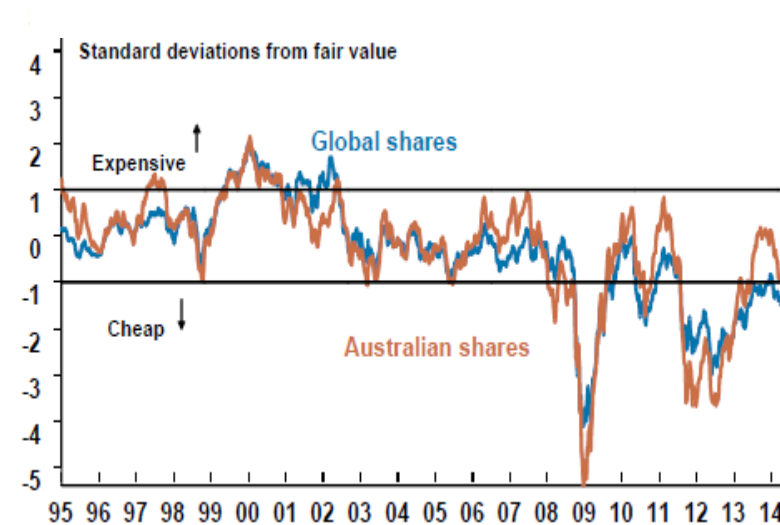
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Market outlook for the new financial year

- Global economic indicators have been gradually heading higher. US growth is rebounding from its March quarter soft patch, Japan seems to be weathering its April sales tax hike pretty well, European growth remains slow but at least it is continuing and Chinese growth appears to have bottomed after slowing earlier this year with various mini-stimulus measures helping.
- In Australia, a likely softening of some of the measures in the Federal Budget to allow it to pass through the Senate combined with continuing low interest rates, strong housing construction activity and strong resource export volumes should see the economy back on track by year end.
- Global and Australian monetary policy remains easy and is likely to remain so for some time yet.
- There is no sign of the investor exuberance usually seen at major market tops. Various surveys show that investor scepticism towards shares remains high. The mountain of money that built up in bond funds in the US has yet to fully reverse. In Australia, investors still generally prefer bank deposits over shares and the share of cash in the superannuation system remains double pre-GFC levels.
- Numerous possible triggers for a correction exist including: a continued run of stronger US economic data raising concerns about an earlier Fed rate hike; risks around Ukraine and Iraq; maybe a return of worries about Europe on the back of European Central Bank stress tests and independence referendums later this year in Scotland and (possibly) Catalonia. And in Australia, we need to see confidence levels pick up. We still seem a fair way from a major market top in shares. As such, the cyclical bull market in shares likely has further to go over the medium term.
- The Australian dollar has remained stubbornly high for longer than we expected. This may continue in the short term however events such as rising interest rates in the US may see the dollar fall considerably from its current levels, at around \$0.94.

Share market valuations



What does the above graph mean?

It shows the gap between earnings yields on shares vs current bond yields.

This is a proxy for the excess return shares offer. At current levels shares would normally be seen as expensive however when compared to bonds and cash they still remain very attractive which supports our positive medium to long term view of investment markets.



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Our favourite investment quotes:

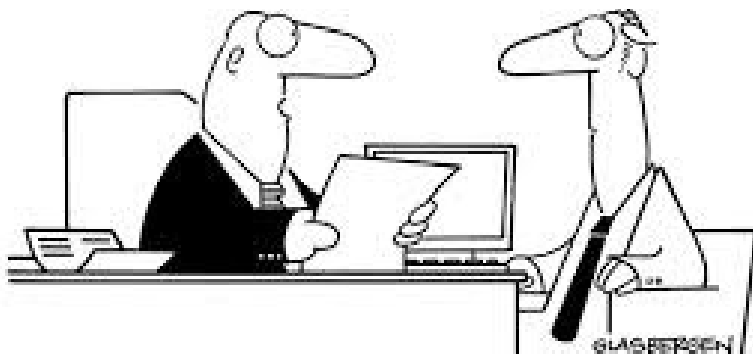
"Bull markets are born on pessimism, grow on scepticism, mature on optimism and die of euphoria."

"It's not what you own that will send you bust but what you owe."

"How many millionaires do you know who have become wealthy by investing in savings accounts?"

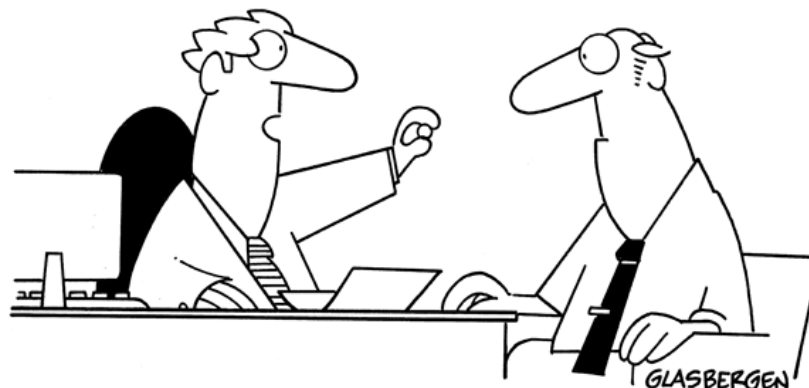
"Investing should be like watching paint dry or watching grass grow. If you want excitement...go to Las Vegas."

Our favourite investment cartoons # 1:



"The good news is, that nobody will ever hate you for being rich"

Our favourite investment cartoons # 2:



"If a stock goes sour and leaves a bad taste in your mouth, try one of these – they are InvestMints!"

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