Plenty of surprises, good and bad, await investors in year ahead

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MY experience, from a half-century of investing, has taught me big shifts in expectations for economic growth or inflation can impact powerfully on investment markets. Here are some expectations for economic conditions that may be significantly revised — some several times — during 2015.

1. US economic growth may well exceed the average of expectations now priced into shares and interest-bearing assets in the US and around the world. That's because the spending power of US households will get a boost from the recent drop in petrol prices and there's a pick-up in business investment other than in oil and gas. This would, if it eventuates, strengthen the prospect the Fed will — by midyear — have taken the first step towards normalising the US cash rate. But growth at a stronger-than-expected rate would also challenge the capacity of the Fed to convince investors it can deliver a "patient" program of increases in the cash rate — a fresh bout of uncertainty in money markets would develop in the US and elsewhere. Stronger US economic growth would also likely be accompanied by higher US bond yields and a further rise in the US dollar.

2. For several years, a dominant view in investment markets has been that failures among property developers and shadow banks will soon cause a hard landing for the Chinese economy. Recent monetary easings in China — initially specific to property but followed by an across-the-board cut in interest rates — may have reduced the risk of recession more than investors generally have yet recognised. If investors come to accept China will avoid the much-predicted slump, commodity markets may shake off some part of their heavily negative sentiment. But a worthwhile rebound in commodity prices, particularly for oil and iron ore, would likely await significant cutbacks in global oversupply.

3. In Japan and the eurozone, economic prospects are more uncertain — and troubling. Both central banks are committed to huge programs of purchases of bonds, financed by printing money, as they seek to avoid sustained deflation and kickstart their economies. The consensus view on these economies, correctly, is highly cautious. Deep deflation will likely be avoided, but inflation and economic growth are expected to be negligible in 2015. In both cases, structural flaws are holding back better economic performance.

4. Over the next few years, cash rates around the world are likely to remain well below levels investors once saw as "normal". In 2015, at least, the hunt for yield is likely to continue to be a force in investment markets — encouraging investors in Australia to continue favouring shares that pay attractive (and preferably rising) dividends.

5. In most countries, inflation is likely to remain subdued — even negligible — this year. But long-dated bonds are now priced for many years — even a decade or two — of inflation at extremely low rates. James Paulsen of Wells Capital Management asks two pertinent questions investors should continue to address: "How would US bond yields react if the accommodative policies recently employed about the globe successfully boost international economic growth and calm fears of a deflationary spiral? How quickly and aggressively would US bond investors rush to re-establish a yield buffer against potential inflation in the US?"

6. The Australian economy seems set to have a lacklustre year in 2015, with GDP growth of between 2 and 2.5 per cent. National income — a better measure of economic wellbeing because it allows for changes in the terms of trade — is likely to be about unchanged over the coming 12 months. House construction and infrastructure are the brighter spots as mining investment falls away sharply.

If core inflation looks like moderating further, or unemployment rises above 6.5 per cent, the Reserve Bank would likely cut the cash rate. That said, I'd put a lower probability on the cash rate being reduced to 2 per cent than is now priced into fixed-interest markets. The prospects are the Australian dollar will weaken further, particularly against the strengthening US dollar. But the current account deficit is narrowing more than seems generally appreciated, and with capital inflow, especially from China, likely to be strong, the exchange rate is unlikely to settle at a level as low as that wished for by many exporters and businesses competing with imports.

7. For two to three years up to last October, investment markets were — on all the objective measures of volatility — unusually calm and stable. At times in 2015, investors will likely have to cope with wide volatility, in particular as major changes occur in market expectations for economic growth and inflation. Also, many asset markets — especially bond markets, but also US shares (the S&P 500 index closed at record levels on 50 days last year) — have become highly priced and are vulnerable to bad news. Geopolitical issues, especially relating to Islamic State and the economic crisis in Russia, could add to swings in sentiment and market prices.

Putting it all together, the prospects are this will be a challenging year for investors. My guesses are shares will deliver a positive but modest return this year, but on medium- and long-dated bonds, negative returns are in prospect.

Sensible diversification is important and so is stock selection.

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