

OUTLOOK FOR FINANCIAL MARKETS (5/12/2013)

FIXED INTEREST – AUSTRALIAN & GLOBAL

	90 Day Cash	10 Year Government Bonds
Australia	2.59% pa	4.31% pa
USA	0.24% pa	2.83% pa
German	0.24% pa	1.81% pa
UK	0.52% pa	2.90% pa
Japan	0.15% pa	0.62% pa

These rates are low by historical standards and likely to stay so for the foreseeable future – at least until inflation becomes a problem which will probably only happen once global economic growth picks up to well above where it is at present and causes global excess capacity (labour, resources, plant and equipment) to be used up.

At these rates long term government bonds for developed countries are not attractive investment propositions. Selected other countries and some corporate interest paying securities look to be far better value (paying around 5% to 7% per annum).

THE AUSTRALIAN DOLLAR

It is obvious the Reserve Bank and the Government would prefer the \$A to fall in value against some of our main trading partners. I believe this will happen at some stage over the next few years. If this is correct then from an investment perspective it will result in extra gains being achieved by unhedged global investments.

SHARES

I read a lot of articles regarding sharemarkets and where they are positioned. For as long as I can remember there are always some commentators who will suggest share prices are too high for any number of reasons and those that suggest they are good value at current levels. One reason I have read of late for why prices are too high is because they have risen quite a bit over the last couple of years. What do they expect? You will always get that result if you choose to measure things starting at a low point (e.g. March 2009 or October 2011). Much of the upward shift in prices from a low point can be explained as simply a recognition prices had fallen too far and a significant portion of subsequent price rises are just getting things back to where they should have been anyway. If you pick a high point to start from you can often get a negative return. So where is a fair point to measure share price movements from? In my view you should measure from peak to peak or trough to trough, i.e. measure the result over a full cycle. If you do that, then current share prices (on average) could well be regarded as being on the low side of fair value. Over a full cycle total average returns from Australian shares should be around 9% to 11%:

Inflation	2%	to	3%
Real Growth in Profits (in excess of inflation)	3%	to	6%
Dividends	3%	to	5%
<u>Less</u> Share portfolio costs			(1%)
	<u>7%</u>	to	<u>13%</u>

Returns from various global sharemarkets should reflect similar returns (adjusted for risk). If we assume that we are currently at a peak (which I don't believe we are), then the results would be as follows:

From Previous Peaks	Australian	Developed World (excl. Australia)	Emerging Markets
31/10/2007 to 30/11/2013 (6 years & 1 month)	1.03%	2.36%	0.44%
31/3/2000 to 30/11/2013 (13 years & 8 months)	8.40%	2.37%	8.49%
30/11/1972 to 30/11/2013 (41 years)	10.64%	8.34%	n/a

The results this century so far are well below where they might normally be – the Global Financial Crisis and its after effects have been the main reason for this. At some stage in the next few years I believe we will enjoy a sustained period of above average returns – needed to restore average returns some way towards the more normal long run averages.

Another argument I hear to suggest that Australian share prices are high is that the P/E Ratio (that is, Share Price Divided by Earnings per Share) has risen from around 11 (low point) to 14.5 (lower is cheaper). But as suggested above, the majority of the rise is in my opinion is simply restoring prices back to more normal levels – the long run average P/E Ratio for the Australian sharemarket is around 14 and there have been occasions when the level has been more like 18 to 20. A P/E Ratio of 14 is the equivalent of earnings per share of 7.14% which when compared to current interest rates looks quite attractive – currently a Commonwealth Bank Term Deposit pays 3.4% per annum and produces no capital growth.

In conclusion, I believe current share prices (Australian and Global) on average represent reasonable value and by being selective with the shares we choose we can acquire better value, because an average of "reasonable value" is comprised of components that are both good and not so good.

PROPERTY

AUSTRALIAN COMMERCIAL (OFFICE, RETAIL & INDUSTRIAL)

- ASX Listed - Fair value on average; not cheap but except for a few, not expensive either.
- Direct - Current prices are fair to good (for buyers), but you need to be selective.
 - Look for blue chip tenants on long leases starting with net income yields of 7.5% to 9%, with annual rental increases.

AUSTRALIAN RESIDENTIAL

There have apparently been some improvements in selling prices of late (probably fuelled by the low interest rates we have at present) but I'm not sure further increases are sustainable because there are simply not enough people who can afford to pay these prices.

GLOBAL

For most people the only realistic way to gain exposure to global property markets is via global sharemarket listed property vehicles. At present these present a mixed bag of opportunities – some good ones and some others that appear expensive to me. The key here is to be selective, so we suggest using property fund managers whose approach is to try and pick the best and avoid the overpriced or riskier offerings, as opposed to just buying some of everything (such as an index fund would do).