OUTLOOK FOR FINANCIAL MARKETS as at 3/3/2017

AUSTRALIAN SHARES

DATE	S&P/ASX 200 AUSTRALIAN SHARE PRICE INDEX
31/10/2007	6,754
4/03/2009	3,166
28/04/2015	5,949
1/08/2016	5,587
9/11/2016	5,157
2/03/2017	5,777

Australian share prices (as measured by the S&P/ASX 200) are still nearly 15% below where they were almost 10 years ago, (just before the GFC – Global Financial Crisis). They have risen an average of 7.5% per annum since their low point after the GFC (March 2009), however they are still nearly 3% below where they were nearly 2 years ago. More recently they went through a down phase from early August 2016 till early November 2016 (down an average of 7.7%) before recovering more recently to now be up 3.4% on where they were 7 months ago. However the recent movements have been far from uniform, as big rises over the last 12 months (after a selloff in January 2016) have come via the resources sector (materials, energy and related industries) which are up 40% to 50% over the last 12 months. The improvement in Resources was after a terrible preceding 5 years, e.g. BHP is up 79% on where it was in January 2016 but still down 47% on where it was around March 2011 and Woodside is up 24% on where it was in January 2016 but still down 35% on where it was around March 2011. Perhaps a lot of these rises have simply been a combination of improved oil, iron ore and coal prices together with a recognition that the market (from a longer-term valuation perspective) got too carried away in the previous down period and prices were just being restored to more sensible levels. The banks have also done OK of late, e.g. Commonwealth Bank was $69.50 on 13/9/2016 and is now $83.86, however it was $85.50 on 28/12/2015 and $95.80 on 16/3/2015. The performance of a lot of the other sectors over the last 6 months has been negative.

WHERE TO FROM HERE?

My base case is that the Australian economy will muddle along, continuing to grow but at lower than long term averages, that inflation will stay largely under control and that consequently Australian interest rates aren't going to change much (if any) over the next couple of years and will remain low. This hopefully will prevent a residential property price crash and consequent unpleasant consequences for the banking sector. Australian consumers have just about reached the limit of their borrowing capacity so I don't expect to see much growth in sales for quite a few businesses (however there are always exceptions). That said, dividend yields are in a lot of cases well above interest rates available for fixed interest investing so I expect selected Australian companies will be well supported by investors – there are still large amounts of money being contributed into superannuation and record amounts of cash being held waiting to be invested when confidence improves.

As always, I believe it is important to be highly selective in choosing which shares to invest in and not just follow the herd, take a medium to long term view, be patient and remain diversified.

GLOBAL SHARES

USA

Their economy seems to be growing at a reasonable rate; the official unemployment rate is low (although some workers are underemployed – part time or casual only); inflation is still a bit below their target levels; the $US is strong; but interest rates are still barely off their record lows. Donald Trump's presidency has now started and he says he is going to increase spending on infrastructure, reduce taxes and cut Government "Red Tap". This is expected to boost economic growth but also inflation and Government debt. The US Federal Reserve (the Fed) were already looking to raise interest rates towards more normal levels in 2017 and 2018 and increasing inflation can only encourage this process. However, 2 things will restrict the extent to which they might raise interest rates:

1. They don't want high rates when the Government has higher debt levels; and
2. Higher rates will mean a higher $US which they don't want because it will impact the competitiveness of their exporters and make imports more attractive.

The "Canary in the Coalmine" however is to what extent Donald Trump carries through his threats to reduce the opportunities for free trade. Let's hope his advisers and his Republican Party colleagues keep him under control.

So, my guess is US interest rates might be increased by say 1% over the next year. This would normally be a negative for share prices but seeing as how these increases are expected they have probably mostly been priced into where shares are positioned now. That said, I believe the prices of quite a few US shares are expensive, but because of the scale of their market there are still many opportunities for good gains.

EUROPE

The economic performance of many European nations has been improving – slowly. The ECB (European Central Bank) has been conducting extensive quantitative easing to keep interest rates very low (in some cases negative) which helps support economic growth and share prices. However, 'populist' political parties have been gaining ground (due to substantial numbers of the population being disaffected with how their Governments have performed over the last decade) and general elections in France, Germany, The Netherlands and maybe Italy in the next 12 months could see populists come to power and decide to remove their countries from the European Union. Who knows how that would play out in the short term, although in my opinion it might be beneficial for many, longer term, as I don't think the Union has benefitted too many countries except for Germany.

Share prices in Europe would seem to me to be similar to elsewhere – some expensive but opportunities for good gains still exist if you pick the right companies.

JAPAN

Doesn't have Europe's problems but the Bank of Japan is also conducting massive Quantitative Easing in order to keep interest rates and the Yen low. Japan's biggest problem is its rapidly aging population which makes it difficult for them to achieve decent economic growth – less workers and tax payers per head of population and older people spend less. However, shares in some Japanese companies are still worthwhile, particularly those who have strong export performance on the back of better products (mostly technology based).

EMERGING MARKETS

Plenty of good prospects at cheap prices, but also some to avoid and the whole category can sometimes be volatile over the shorter term.

FIXED INTEREST (Australian & Global)

Not much change to prior outlooks. Avoid long term Government Bonds issued by countries from the Developed World (Australia, USA, Europe, Japan). Some Corporate Debt is reasonable. Fixed interest portfolios need to be selective with their investments and actively managed.

PROPERTY

Not much change to prior outlooks. Regarding commercial property, look for reliable and sustainable long term leases, with quality tenants, good yields (6% per annum plus), with contracted annual rental increases (as per the leases). Not all property fits this description so we need to be selective. With listed property funds avoid those that trade at too high a premium to the valuations of their underlying properties. As I mentioned above, I hope Australian residential property prices won't fall, but given that these prices (particularly in NSW and Victoria) have increased at a rate well above rental increases and people's incomes, I seriously can't see how they can keep increasing – hopefully they stay where they are for a few years so rents and income can catch up. I fear if they continue to increase at the current rate then we are in for a "crash" (maybe like 1990/91 – 25% falls), with consequent flow on effects to some other parts of our economy.