OUTLOOK FOR FINANCIAL MARKETS as at 4/9/2017

Australian Shares

Over time the value and therefore ultimately a company's share price should be a reflection of the profits and gains they make – taking into account whether or not they retain the profits and reinvest them in their businesses, pay them out as dividends or some combination of the two. Predicting company profits into the future is not an exact science and is very difficult to get right most of the time. The world we live in has many twists and turns, some of today's most profitable companies didn't exist 30 years ago and some companies that were market leaders 30 years ago have gone out of business or shrunk considerably in size. Businesses that are able to continually adapt successfully to ever changing circumstances are the ones most likely to continue to grow and prosper.

My unsurprising view is that there are many Australian companies that fit into both categories (companies that will grow profits and companies that will end up in decline) and everything in between. Unfortunately, a large number of Australian investors (*including many institutional investors*) tend to "follow the herd" and buy or sell the same shares that others do – they follow the index causing expensive shares to become even more expensive and cheaper shares to become even cheaper relative to their true worth. This often happens over shorter periods of time (a year or less) until something acts as a catalyst (*historically many different things*) and reverses the whole process. This does not end well for the herd. From the second half of 2016 following the index has worked reasonably well for Australian Share investors, but my feel for the situation is that this trend is now starting to reverse and investors are starting to pay more attention to company fundamentals. Longer term company share prices eventually gravitate towards their true worth.

So I think it is still worthwhile having a cautious exposure to Australian Shares, being very selective in which companies to own. The best way to get this exposure in my opinion is to use Fund Managers who are good stock pickers, don't allow the index to interfere with their stock selections and have the qualifications, experience and resources to implement a logical longer term focused investment philosophy. Ideally these managers have a proven track record at outperforming in down markets, just in case one of those catalysts mentioned above causes a sell-off e.g.

- North Korea and / or Middle East.
- Significant Terrorist Attacks.
- Rising Interest Rates, caused by the Fed raising US rates and as a consequence increasing debt defaults – debt levels are at all-time highs for Australian households.
- Australian Residential Property Price falls.
- Italy votes in one of their Anti-European Union Parties at their next election.
- A Chinese "Hard Landing".
- Political gridlock in any number of countries.

I say "cautious" because the vibes I get from the many financial articles I read are quite diverse – everything from boom times to an Australian recession and as a consequence some not insignificant price falls. Ignoring short term fluctuations I tend to lean towards some good gains to be had from carefully selected stocks. After all, Australian share prices are still 4% to 5% below where they were two and a half years ago and 11% to 12% below where they were nearly 10 years ago. This gives me some comfort that if there are share price falls they shouldn't be too large and if history is any guide, share prices will eventually exceed their previous highs by a considerable margin.

OUTLOOK FOR FINANCIAL MARKETS *(Cont'd)* as at 4/9/2017

Global Shares

Some of the same comments I made with regard to Australian shares apply to global shares. The 2 big differences are:

1. The global opportunity set is much larger - Australia accounts for less than 2% of publicly listed companies available to invest in globally.
2. The currency effect on unhedged global investments. In my opinion at present the $A is overvalued against many other countries and if it falls back to what I believe is fairer value then unhedged overseas investments will make extra gains. For example, if say the $A falls from $US 0.79 to $US 0.72 then unhedged $US investments will get you an extra 9.7% return.

That said, US shares on average appear to be the most expensive in the world, but if you drill down further you would find many US companies are still good value. The reported level of the US market gets dragged high due to some of the mega companies like Facebook, Apple, Amazon, Netflix etc.

Australian Property

Commercial property investments both listed *(on the ASX)* and directly held, in many cases seem to present reasonable investment opportunities generating 5% to 10% p.a. returns. As with the comments made above regarding shares, it pays to be selective when deciding which properties to invest in. As far as Australian residential property is concerned *(based on most valuation metrics)* prices seem excessive in many cities, particularly Sydney. There has been some commentary in the financial press suggesting we are in for a residential property price crash, whilst at the same time there are others who believe nothing much will change. My hope is that prices will just move sideways for quite a few years so the reality *(rents, peoples' incomes and debt levels)* can catch up to where prices are.

Fixed Interest

My opinion hasn't changed for some time. Interest rates in Australia and Globally are still barely above record lows in most countries. The Australian Reserve Bank's official cash rate is still 1.5% p.a., 12-month Australian Bank term deposits are still in the region of 2% to 3% p.a. and official interest rates in most other developed economies are even lower than Australia's. So steer clear of long term Government bonds issued by Developed Country Governments.

There are some OK options in corporate debt and some emerging market bonds but these need to be carefully selected and actively managed to obtain the best results.

Other Investments

There are still opportunities for good gains from private equity, infrastructure and hedge fund investments.