OUTLOOK FOR FINANCIAL MARKETS as at 18/6/2014

THE GLOBAL ECONOMY

- Unemployment has been improving for a while now but still has a way to go.
- Inflation in most countries is low with a few being more concerned about deflation, e.g. Japan.
- Interest rates are very low, even within some of the previously problematic European countries, e.g. Spain, Italy, Ireland etc.
- The savings rate for consumers in most countries is quite a bit higher than it was before the GFC (2007-2009). This probably means that expenditure plans that have currently been deferred by people will at some stage in the next few years be put into action and consumer spending will increase?
- The demand for various resources has softened a bit in recent times and as a consequence commodity prices are lower. As with the previous point I expect demand for many of these commodities will rise at some stage in the not too distant future and their prices will increase as a result.
- Global economic growth is slow, but positive, at the present time. It may stay like this for a year or two, but I expect it will then start to accelerate – Governments of most countries and their central banks are working overtime to try and encourage this.

THE AUSTRALIAN ECONOMY

- Australia was sheltered to a degree from the effects of the Global Financial Crisis (GFC) due to high demand for our mineral resources (mostly from China) and the consequent billions spent in the "development phase". However this appears to have slowed up quite a bit in recent times. There were a lot of people employed and money spent in developing new projects to increase supply of these mineral resources. New projects however appear to be almost non-existent now, although many of those projects started previously have now or will shortly come on-line. So even though commodity prices are currently lower, our export volumes are increasing.
- Unemployment in Australia is higher than a few years ago – 5.8% as compared to low 4%'s a few years back. Hopefully it won't rise much higher than it is now and eventually start to fall again.
- Inflation is under control (between 2% and 3%).
- Interest rates are at record lows (Reserve Bank Cash Rate 2.5% and 10 year Government Bonds at 3.7%) and likely to stay at these levels for a while yet.
- Australian consumers are apparently saving more than 10% of their income at present whereas before the GFC the savings rate was negative. At some point in time I expect the savings rate to decline as people start to "loosen their purse strings" and increase their expenditure on those items they are currently postponing.
- Economic Growth in Australia at present is positive but below our longer term average, i.e. we are growing slowly.
- The $A has been rising of late and while I'm not prepared to make any short term predictions as to where it will go, I do think that over the next few years it will end up lower than where it is now. If so, unhedged $A international investments will generate higher returns than hedged.

SHARES (both Global & Australian)

A few people are suggesting that current share prices are expensive. Others think share prices have plenty of upside left. I personally think that at current interest rates share prices represent fair value on <u>average</u>. Average being the key word here, because the components to achieve this average are comprised of many shares that are cheap to very cheap and a smaller number of mostly very large companies and some mid-size companies that are on the expensive side of things (although I would suggest not excessively expensive in most cases). My firm belief is that while I can't predict short term movements in share prices, the medium and long term outlooks for many of those shares in the cheap to very cheap category is good. The key take out from this is that in setting up your investment portfolios we should target these types of shares and the Fund Managers who do likewise.

PROPERTY (both Listed and Direct, excluding residential)

As with shares, I think at current interest rates property valuations are fair (on average). There are however from time to time opportunities to acquire units in direct property syndicates/funds that seem more attractive than the average. Particularly in the Office, Industrial and Healthcare categories when the buildings are new or near new, well located with Government or other AAA tenants taking the majority (if not all) of the floor space on very long term leases with automatic rental increases each year and starting yields of 7.5% to 8.5% per annum.

FIXED INTEREST (both Global & Australian)

As mentioned above, short term interest rates in most places are at, or close to, record lows. Also long term Government Bonds in many developed countries (USA, UK, Germany, Japan, and Australia) are close to record lows and in my opinion need to be avoided for the time being. I can't make a case for investing in these as there is very little upside but plenty of downside when interest rates eventually normalise (increase towards long term averages). If people are concerned as to where all other investment options are headed then a better option would be to put their money into cash (currently earning around 2.5% to 3% per annum). That said, there are some countries whose Government Bonds appear to be fair to good value – this is where we need specialist Fund Managers who will target these and avoid the former mentioned above. As far as corporate bonds and hybrid fixed interest securities, Asset Backed and Mortgage Backed Securities are concerned there are opportunities for good returns and also those to be avoided. Once again the key is to utilise skilful active management for portfolios containing these types of securities.

OTHER INVESTMENTS

Opportunities for good returns exist in the areas of Infrastructure, Private Equity and Hedge Funds (including Managed Futures).

CONCLUSION

It is easy to make predictions when markets are at extremes. It is much harder when they are somewhere in the middle, which is where I think things are at present. At the moment there are no stand out winners in investment choices. So I think the best approach is to ignore minor short term fluctuations, remain diversified, embrace active management, try to avoid the expensive stuff and target those sound investments that are at reasonable to good prices. This should provide you with good results over the medium and long term.