OUTLOOK FOR FINANCIAL MARKETS as at 2/2/2015

Reference Points – Where we are now:

Australia

Reserve Bank official cash rate	2.50 %
90 Bay Bank Bills	2.40 %
3 Year Government Bond Yield	1.94 %
10 Year Government Bond Yield	2.41 %
$A1.00 = $US 0.7781 from $US 0.9412 seven months ago	
$A Trade Weighted Index = 63.9 from 72.2 seven months ago	
S & P / ASX 200 Australian Share Index	5,625

Global

US Federal Reserve Official Cash Rate	0 to 0.25 %
US 10 Year Government Bond Yield	1.66 %
UK 10 Year Government Bond Yield	1.38 %
Japan 10 Year Government Bond Yield	0.28 %
German 10 Year Government Bond Yield	0.31 %

As you can see from the above, interest rates are very low. Some countries at present even have negative short term interest rates i.e. you have to pay the government to keep your money. Even in supposedly financially stressed countries like Spain and Italy interest rates on 10 year bonds are down below 2%. Interest rates at these levels make investments in shares and property more attractive.

Australian share prices have recovered to about where they were on 2/9/14, but are still 17.6% below where they were on 1/11/07. Admittedly a large part of this is due to falls in mineral and energy prices (*oil down below $50 per barrel from over $100, Iron Ore down below $70 per tonne from above $100*) which has caused large falls in the prices for Australian resource shares e.g. BHP is down over 23% since August and Santos is down nearly 50% since then. These type of shares have always had these periods in the past and have always eventually recovered as the demand / supply equation shifts in favour of demand, so I see no reason why this time will be any different. The falls in the prices for resource company shares has had a flow on effect to some other non-resource shares. I can't quite see the logic behind this as lower oil prices should be beneficial to almost all businesses except for oil companies. Lower fuel prices reduces costs for many businesses and puts more dollars in consumer hands.

Perhaps investors are worried that interest rates are about to rise significantly, but I can't see any major shift upwards in interest rates over the near term. Japan and Europe are worried about deflation, they are barely growing at all and are conducting more quantitative easing – money printing. The US has been steadily improving its economy and is now growing at a reasonable rate, but inflation in the US is still low and the Federal Reserve will not want to risk strangling the improvements they have been able to achieve by raising interest rates. Also they are acutely aware that if they raise interest rates this would likely put more upward pressure on the $US and make them less competitive with their trading partners in other parts of the world.

Perhaps investors are worried about Chinese economic growth slowing. A few years ago economic growth in China was above 10% (real / inflation adjusted) and is now around 7% and probably trending down to 6%. But this is 6% on a much much larger base (*i.e. 6% of $200 is a bigger number than 10% of $100*) because China is now a much larger economy than it was as little as 10 years ago. The Chinese are actually targeting a 7% growth rate which they see as much more sustainable than the 10% plus they had a few years back.

Perhaps the recent volatility in share prices is due to the media gaining some traction with their usual negative bent on everything – remember the old saying "steady as she goes sells no papers" and this allows market players such as high frequency traders, chartists, short sellers etc. to take advantage of volatile prices which if combined with index trackers, ETF's and the like cause the price fluctuations to be larger than they might otherwise be.

As I have often said I can't predict short term movements in financial markets because they often appear to happen for completely illogical reasons, but as far as I am concerned the medium to long term case for having some of your money invested in shares (*both Australian and Global*) is still valid.

Having said that and because of the above mentioned short term negative movements that happen in all investment options (*not just shares*), as always, I stress the need to remain diversified with your investment choices. Just before Christmas I had a look at the results achieved from various managed funds we typically use in our client portfolios for the 12 months from 11/12/13 to 11/12/14:

AUSTRALIAN SHARES	Larger Companies	1.18% to 9.29%
	Smaller Companies	(-7.74%) to 12.80%
GLOBAL SHARES	Main Stream	9.55% to 20.0%
	Emerging Markets	7.23%
	Global Resources	(-5.71%)
PROPERTY	Listed Australian	23.17% to 27.07%
	Listed Global	24.72%
	Direct Australian	11.41% to 14.83%
ACTIVELY MANAGED FIXED INTEREST	Global & Australian	4.14% to 9.40%
INFRASTRUCTURE –	Listed & Direct	17.63%
MANAGED FUTURES		16.42%

As you can see there is a sizeable range of results, so by combining them you end up with a good result that whilst not totally predictable does limit the range of overall results – you are not going to achieve what the best investment did, but more importantly you are not going to get what the worst one did either.

In summary then I see reasonable medium to long term value in most sectors with the exception of long term Government Bonds (*issued by Developed Countries*), provided the blend of underlying investments are actively managed with a view towards including more attractively priced, genuinely diversified options in the mix and avoiding as many poor performers as we can.