OUTLOOK FOR FINANCIAL MARKETS as at 7/6/2016

It comes as no surprise that investment markets on average (*particularly over the medium to long term*) are significantly influenced by how the local and global economies are performing. At present, in my opinion, it is quite difficult to make a confident prediction as to where things are headed, economically speaking. Digesting copious amounts of commentary and opinion from a wide range of so called experts only leads to further confusion. There are some who are very negative about the outlook, the majority who seem to think progress is being made very slowly and some who are more optimistic.

Some facts to put things in perspective:

Australia

- Even though our interest rates are higher than nearly every other Developed country they are at record lows; the Reserve Bank's official cash rate is 1.75%, 90 day Bank Bills are paying 1.88%, 3 year Commonwealth Government Bonds are paying 1.54% and 10 year Bonds 2.16%, 12 month term deposits with the big 4 banks are paying between 2.05% to 2.45%, investment grade corporate bonds with terms up to 5 years are paying between 2.19% and 3.72%.

- Inflation is low – the latest Bureau of Statistics CPI figure shows inflation at 1.3% p.a.

- The $A is at a more reasonable level than it was a few years ago; $US0.733 verses more than $US 1.05 it was back in 2013. Note however, to put things in perspective, in 2001 it was at $US 0.48. Our exports are now cheaper for overseas buyers than they were a few years ago (*tourism, education, agriculture etc.*) which should help our export and import replacement industries. It should also mean that imports are more expensive, but this hasn't shown up in our inflation figures so far.

- Petrol prices are off their recent lows, but still a decent amount below where they were a few years back.

- Unemployment is at 5.7% nationally, which isn't terrible even if it is larger than the low 4%'s it was prior to the Global Financial Crisis.

- Recently released statistics showed that Australia's real GDP growth for the 12 months to 31/3/16 was 3.1% which is not bad (*if it can be believed*) and better than most other countries – better than the USA, UK, European Union & Japan.

- Australian Government debt to GDP ratio (*40% to 50%*) is still much lower than the majority of Developed nations even if it is quite a bit higher than it was a few years ago. However borrowings on Residential Real Estate in Australia are at very high levels (*some might say extreme levels*) and much higher than most (*if not all*) other countries. This is probably the factor that worries me most about our country's future prospects – whilst I'm not predicting a housing crash, particularly while interest rates are low, you would be a fool to think that it could never happen – it has happened in a lot of other countries – USA, UK, large parts of Europe and China? It happened in Australia after Mr Keating's "Recession we had to have" in 1990 / 91 – Sydney residential prices fell 25% on average and supposedly Westpac was technically insolvent at one stage then, due to an over exposure to residential property.

Global

- Interest rates in the Developed world are lower than Australia's. Japan and some of Europe have negative interest rates i.e. you have to pay their Governments to deposit your money with them. The USA Fed increased their interest rates a few month back by 0.25% p.a. but that was off record lows of 0 to 0.25% which had been in place for some time.

- Inflation in the Developed world is almost non existent. They are more worried about Deflation than inflation.

- Like the USA Fed before them, Japan and the European Central Bank are currently carrying out large scale "Quantitative Easing" programs (*some call this "money printing"*) to try and boost economic growth and employment. I suggest they are also trying to influence currency markets to devalue their currencies and improve their global competitiveness.

- Unemployment is quite low in the USA, UK and Japan (*even though Japan's is higher than it was*), but it is very high in most of Europe.

- Economic growth, while on the lower side of their long term average, is OK at present in the USA and the UK, but barely above zero in Japan and a lot of Europe (*although this does appear to be improving slowly*).

- China's growth has slowed from where it was but it is still above 6% p.a. and on a much bigger base (*due to 10% + growth for quite a few years prior to the last few*).

- The biggest concern for economic forecasters is the level of Government debt in many overseas countries. Some European countries are basically broke (*e.g. Greece*), Japan has a debt to GDP ratio in excess of 200% (*but nearly all of their borrowings are from their own people, so if they had to they could simply print Yen and pay them back*) and the USA's debt to GDP ratio exceeds 100%.

- In my opinion China will succeed in their quest to transition from a construction driven economy to consumer and services driven. The USA's situation is under control and Japan's problem is more demographic and policy driven (*ageing population, low birth rate and some inflexible business rules*) but they will probably muddle through. The European Union situation is more problematic – one currency, the Euro, but separate Governments does not work. Under performing economies don't have the opportunity to devalue their currencies and export / import replace their way out of trouble – if they could their standard of living would drop but it would be easier for their people to find employment and things would eventually improve.

What does all this mean for investment markets (*my opinion*)?

1. Don't invest in developed country Government Bonds – very little to gain (*relying on interest rates falling even further*), with hardly any interest payable and significant downside risk when interest rates eventually rise (*although I don't see that happening to any significant extent any time soon*).

2. It is ok to keep some money short term in cash to invest as and when opportunities arise. The capital value of on call cash is unaffected by rising interest rates.

3. Globally and in Australia there are some opportunities to invest at higher interest rates – carefully selected corporate bonds, some emerging market bonds, structured and syndicated loans and some Australian hybrids, such as the big 4 banks' capital notes and convertibles.

4. Sharemarkets, both Australian and Global, provide some good opportunities and some shares which should be avoided. It is still a stock pickers market at present. Sharemarkets overall range from fair value to some being a bit expensive (*perhaps the USA*). In these markets some of the underlying shares are good value, but some are very expensive.

5. Selected listed and direct commercial property investments, relative to current interest rates are decent value. If interest rates rise by any material amount you would presume that would have a negative effect on valuations, but since I don't see rates rising for a while (*except for some small increases in the USA*) increasing rentals between now and then might more than offset those eventual interest rate rises.

6. Residential real estate – see comments above.

7. Alternate investment options such as Infrastructure, Private Equity, Managed Futures and Special Situations / Event Driven Strategies offer potentially good returns whether or not financial markets are rising or falling and are worthwhile including in investment portfolios not just for their potential returns but equally for their diversification benefits.

The Importance of Stock Picking *(or backing Fund Managers who are genuine stock pickers and not index huggers).*

I was reading a magazine the other day which showed the "Best 100 performed ASX stocks" for the past 3 months to 31/3/16. It also showed each share's performance for the last 12 months;

- 27 of the 100 shares made between 20% and 128% return
- 23 of the 100 shares made between 10% and 20% return
- 34 of the 100 shares made a negative return

A stock picker would try and fill his portfolio with the better performers and avoid the negative ones, whereas an index hugger by default includes both the good and the bad.

It might also be worth pointing out that from the 100 best performed stocks for the 3 months to 31/3/16 only 5 were from the 20 largest listed companies:

	3 month Return	12 month Return
Brambles	11.54%	14.31%
Westfield Corp	9.52%	8.91%
Rio Tinto	6.98%	-(19.19)%
Wesfarmers	4.07%	-(3.01)%
AMP	4.05%	-(10.49)%