OUTLOOK FOR FINANCIAL MARKETS (7/3/13)

AUSTRALIAN SHARES

The last Outlook I wrote *(4/12/12)* suggested that over the next 5 years Australian shares could on average generate returns of 20% p.a. or more, noting that the actual timing of these gains over shorter periods was harder to predict and no doubt would be subject to some random periods where share prices fall, often referred to as volatility. Since this last Outlook was prepared, Australian share prices as measured by the S & P / ASX 200 index *(which is dominated by the larger companies)* has risen by 13.6%. The bulk of these gains can be attributed to the big 4 banks, Telstra, CSL and a few other large companies *(Woolworths, Wesfarmers etc.)*. Some medium size and smaller companies have done well also but they are in the minority. There are quite a lot of companies whose share prices have not gained much and / or fallen, particularly in the resources sector. There are a few commentators in the financial media now suggesting that share prices have risen a bit too far too quickly and whilst this may be a fair comment for a few companies, I don't believe it applies to the majority. Even after the recent price rises the big 4 bank's dividends *(including franking credits)* still equate to 7.25% to 8.45% p.a. of their current share prices, which is considerably more than those same banks are paying on term deposits *(3.0% to 4.2% for 12 month terms)*. Australian share prices still have to rise a further 33% just to get back to where they were at the end of October 2007 despite many companies being in better financial shape and more profitable. So my view is that while the price of some companies shares are not as cheap as they were, they still represent good value in a lot of cases. As always, we believe it pays to be selective in which shares you buy *(or your Fund Manager buys)* and which shares are sold. My comment that gains, possibly in excess of 20% p.a., over the next 5 year period *(as suggested in my last Outlook 4/12/12)* still stands – certainly the last 3 months have been a good start to that scenario.

GLOBAL SHARES

The USA

Currently the financial press is focusing on the fact that the index for USA share prices has reached a record high. Sounds impressive doesn't it? That is until you realise that current share prices are only about the same level they were over 5 years ago and in fact no higher than they were 13 years ago. That's right, 13 years without any capital gain. Does that sound normal to you? Admittedly there have been problems in the wake of the Global Financial Crisis (GFC), sub-prime mortgages, housing prices collapsing, government debt etc., but things appear to be improving in the US.

1. Interest rates *(including borrowing rates)* are very low *(the Fed's cash rate is 0.25% p.a. and 10 year government bonds are yielding less than 2%)* and likely to stay that way for some time.

2. The $US is lower and some of their exporters and import replacement industries are doing better. In fact some large US companies have brought production facilities back to the US from offshore in recent times *(reversing the trend that has been the norm over the last couple of decades)*.

3. Due to changes in technology *(Fracking)* the US now has access to vast reserves of natural gas and petroleum at much cheaper prices. Some say the US could become energy self sufficient by 2020. Access to cheaper energy is providing a boost to US manufacturing and their economy in general.

4. Housing in the US is finally improving. The number of sales, the prices and number of new home starts are all increasing. This trend should provide a powerful boost to the US economy.

5. Unemployment has slowly improved, down from a post GFC high of 10% to below 8%. The "participation rate" has also been improving. It still has a way to go but it is headed in the right direction.

6. Company balance sheets have strengthened and US companies are sitting on record levels of cash and lower levels of borrowings. The household sector in the US has also reduced their borrowings. It's only the Government whose debt has been increasing and this seems to be what gets all the attention, particularly the squabbling between the Democrats and the Republicans over how to go about reducing their debt *(higher taxes (Democrats) Vs spending cuts (Republicans)*. The level of Government debt is not at the extreme levels that apply to some Southern European countries and the US have a number of options available to it to get the situation under control which is no doubt what will happen in the end.

7. US company earnings are at a forecast level of 7.52% of share prices *(as at January 2013)* and have been and are expected to continue growing. This provides a very healthy margin over and above what US investors can get by investing in bank deposits or Government bonds.

China

The change of leadership in China has occurred very smoothly and their economic growth appears to have bottomed out at 7.8% p.a. above inflation and started edging up again. China is a big positive for global economic growth which should ultimately feed into higher share prices.

Other Emerging Market Countries

Emerging market share prices have not increased as much as those in the so called developed economies in recent times, but over the longer term you would expect them to increase by more. So at current levels I believe emerging market share prices represent good value.

Europe

Whilst Northern European countries (*Germany, Holland, Sweden, Norway etc.,*) are going OK, some of the Southern European countries are what could best be described as "basket cases". That is not to say that no one in those countries is making any money, it is just that overall (*in total*) they are going backwards. While that may be the case, some companies are as suggested, making profits. Particularly some of those that are probably more correctly classified as Global companies. Some of these companies because they are associated with Southern Europe, have very cheap share prices and could be considered excellent buying.

Australian Listed Property (*AREIT's*)

Australian Real Estate Investment Trusts (*AREIT's*) have transformed over the past 4 years. The sector has de-risked and de-leveraged and is in much better shape than it was in the lead up to the GFC. With solid balance sheets, sensible debt levels and a renewed focus on basic rent collection and management, we welcome the sector's return to its defensive roots.

With lower interest rates impacting term deposit and cash returns, we expect investors will increasingly return to the share market in search of higher yields. A portion of these income seeking investors will be attracted by the security and quality of the returns offered by the AREIT market.

Earnings should rise over 2013 (*following rent growth*). We anticipate that overall, distributions will increase in line with inflation.

Underlying asset values will increase as more buyers enter the physical property markets and we expect to see the flow-through impact on Net Tangible Asset (*NTA*) values to emerge by the end of this calendar year 2013.

We expect total returns of around 7-10% from the AREIT market over the course of 2013. Importantly, this return will be typified by a high and steady income component of 5-7% coupled with modest, yet sustainable capital growth of 2-3%.

Australian Direct Commercial Property

Gradually improving valuations and mostly good income levels (*7% to 9%p.a.*) should be achievable from quality direct commercial property (*Office, Retail & Industrial*).

Global Listed Property

Similar comments as those applied to Australian Listed property also seem appropriate for global listed property, with some markets looking a little more expensive (*e.g. USA*) and some looking a little cheaper (*e.g. some Asian and believe or not some European countries*). Overall though we have a bias towards Australian property at this point in time.

Fixed Interest – Australian

The Reserve Bank of Australian cut their reference rate on 4/12/12 from 3.25% to 3.0%. This meant that rates on offer for on call and term deposits with banks fell.

Bank *(Building Society)*	Current 12 month Term Deposit Rates
ANZ	4.05%
CBA	3.95%
NAB	4.20%
Newcastle Permanent B/S	4.20%
Westpac	4.05%

The expectations are that these rates will move even lower over the next 12 months due to possible further rate cuts by the Reserve Bank and the fact that cheaper bank funding sources from overseas are starting to re-emerge.

Even lower interest is payable on Australian Government Bonds – as I write 10 year Australian Government Bonds are paying a paltry 3.34% p.a.

In my opinion much better value than Term Deposits & Government Bonds can be found in the listed fixed interest markets which are paying anything from 1% to 7% p.a. more than TD's, but on average about 2% to 3% more. For example Notes issued by the above banks (*which can be bought and sold on the ASX*) are paying 1.5% to 3.0% more than term deposits with the same banks. The best way to access these returns in my opinion is through an actively managed portfolio of diversified fixed interest options, run by managers with genuine skills in those areas.

Fixed Interest – Global

Similar sentiments as apply to Australian Fixed Interest are applicable in this category. 10 year US Government Bonds are paying 1.89% p.a., German 1.45% p.a. and cash rates are at 0.28% p.a. in the US and 0.20% p.a. in Euroland. These sorts of investments in my view should be avoided because there is very little potential upside, but quite considerable downside. Having said that there are Government Bonds in a few countries that do look attractive and quite a few Corporate fixed interest offerings in most countries that also look attractive. Currency exposures also need intelligent management when dealing with any overseas investments. Once again the best way to access these returns is through an actively managed portfolio of diversified fixed interest options run by managers who have the resources, philosophy and skills to generate consistently above average returns.