OUTLOOK FOR FINANCIAL MARKETS as at 8/3/2016

Last month David and I attended the Portfolio Construction Forum's annual Market Summit (*at Australian Technology Park in Sydney*). The conference included 15 presentations on the World's various financial markets and economies (*including Australia's*) from some high profile speakers from Australia and abroad, offering their opinions on where various markets were positioned now and where they thought they might be headed. For the most part it would be fair to say the majority of speakers were a bit negative with their outlooks, but having been to these types of events over many years, I guess this is what I would have expected. The psychology of the situation (*speaking to hundreds of delegates*) almost universally ensures these so called experts err on the very conservative side with their predictions. History would show that sometimes they are right but more often than not things turn out better than they predicted. Have you ever heard the saying with regards to economists that they "predicted 9 of the last 2 recessions". That said they did make some interesting points which are certainly worth considering in our assessment of where things are headed. Some of these were:

- Debt cycles do not repeat themselves - but this one rhymes. A 50-year era of inflation is ending and we are left with an environment of no inflation, little growth and too much debt. Unlike inventory and debt cycles of the past, this one is moving slowly toward its demise. Central banks have postponed the day of reckoning with extraordinary programs of negative rates and asset purchases. Those policies should be viewed as palliatives that buy time for debtors to mend their ways - not as remedies. China's slowdown and the current oil glut are early signs that this debt bubble may end badly. Like other debt cycles, however, this one will end in much the same way as they have in the past, namely when banks tighten lending standards and refuse to roll over maturing debt. We are not there yet. In the interim, investors will need investment strategies that are more nimble, more opportunistic and off-index.

- The Fed recently began its interest rate tightening, and there continues to be a great disagreement about the quantum of the rises. Rates will go higher than most expect and quantitative tightening (QT) will impact on financial asset volatility. This scenario heightens the likelihood of an equity market correction. As this rate cycle unfolds further, the impact of these higher rates on financial markets and client portfolios will be greater volatility, requiring closer attention and more dynamic asset allocation.

- 2015 was a year to forget, 2016 will not be the year to forgive. For all its ups and down, 2015 ended up being a year to forget for Australian investors, with little variation in the performance of major asset classes. The coming year will be a rerun of this theme – little variation in the performance of asset classes that generate an excess positive return for the additional risk. Investors should be compelled to hold riskier assets because of the low returns on cash and Australian investors, in particular, will no longer be able to hide behind higher income from equities to guarantee positive returns. Dynamic allocation within portfolios and additional levels of diversification will be critical for 2016.

- Recent Chinese equity market volatility has been a wakeup call for global investors. As the Chinese economy slows and policymakers struggle to deal with a range of challenges - stabilising growth, liberalising financial markets, reducing overcapacity, and eliminating corruption - economic frictions are mounting. The current policy mix will not be enough to stabilise growth and without more drastic reforms China will find it difficult to avoid the middle income trap. Volatility and uncertainty will increase as a result, so investors must remain highly selective in their allocation to emerging markets.

- Anaemic global growth rates coupled with low inflation highlight the ongoing lower return environment that we are all in. The New Neutral is here to stay. In this environment, you should stop blindly following a barbelled approach in deriving income - term deposits mixed with retail hybrids and high dividend-paying stocks. It's possible to have your cake and eat it too by, being smart and exploring today's global fixed income universe. Global investment grade credit has not been this attractive in spread terms for the past six years, yet the sector has returned over 7.0% p.a. to Australian investors over the same time period.

- Demographic shifts are polarising investment opportunities. Explosive population growth in some areas against declines in others contributes to everything from shifts in economic power, to resource scarcity, to the changes in societal norms. We are at an inflection point where the global dependency ratio - the ratio of young and old to the workforce - is becoming adverse. This will lead to profound changes to the composition of the population around the world, polarising investment opportunities. In developed markets, growth is scarce. However, investors can access growth in sectors such as healthcare, with growing health care budgets necessary to support the growth of the over-65s. In emerging markets, growth is more abundant but more risky - an attractive exposure to growth is via emerging market consumption, as GDP/capita moves closer to the magic U$10,000/capita mark. Risk appropriate sizing of investments on both sides of the coin is critical.

- ASX performance from 2001 to 2010 was outstanding. But, over the past five years, the index has significantly underperformed global equity markets - as it did for much of the 1980s and 1990s. Diving commodity prices, combined with a high concentration in a few stocks, means the Australian equity market will continue to underwhelm going forward. As the Australian economy begins to 'rebalance', so too Australian investors will need to invest in an equally-weighted approach to capturing market returns that places far less emphasis on commodities and banking. Failure to do so will risk repeating the poor returns of the past.

- The eurozone is an economic calamity. After 17 years, the eurozone has managed annualised real GDP growth of just 1.4%. Greece, Italy and Portugal have barely grown at all. Labour productivity growth across the "zone" is and has been woeful. Unemployment is more than 10%, while youth unemployment stands at more than 20%. All of the eurozone faces a serious "ageing" problem, and pension and social security systems are inadequate. One currency and one short-term interest rate continues to make no economic sense for 19 disparate economies - and while full political union might work, it is neither on the table nor agreeable to the bulk of the eurozone's residents. The protest vote is growing and austerity is wearing thin. The refugee crisis adds further uncertainty and is chipping away at Mrs Merkel's power-base. Breakup will eventually occur. First to go will be the countries suffering from the largest public debt burdens (*relative to GDP*). In the meantime, investment in "peripheral" Europe is a high-risk proposition.

- Australia is the land of complacent oligopolies. Australian equity investors may find their portfolios have become reliant on a few companies for a significant portion of their returns. While that might not have been a great concern when returns have been positive, a portfolio that is concentrated in specific companies and industry sectors may find it is vulnerable to changing economic conditions and structural shifts. Australian equity investors should look beyond the largest blue chip stocks in the financial, resources and telecommunications sectors – to industrial companies that are better positioned for growth. Market dynamics are changing, and in ways that we have not experienced before.

- The resources cycle is getting closer to the bottom. Extended periods of high prices provide both incentive and funding for new projects and expansions. Today, after five years of declining prices, more than half the industry is struggling to generate free cash flow. Companies are forced to respond aggressively - cutting capex, costs, jobs and high cost production. Assets sales and M&A usually come next. Later cycle, consumer-oriented commodities such as base metals, precious metals, diamonds and oil have the best potential for price recovery in the medium term. Bulk commodities like iron ore, coal and steel are likely to remain in over supply longer. Seek out robust businesses that can weather the storm and prosper when economic conditions improve. Company valuations look attractive but a premium is justified for quality. As the outlook improves, equities usually rally before commodity prices, responding to improved demand forecasts.

- Old fears in emerging markets are masking new opportunities. If you think you've heard all there is to hear about emerging markets, think again. It's true that the past few years have been challenging for this part of the world as a whole. But not all emerging economies are equal, and uneven prospects are driving compelling return differences. Several countries including India are not wasting a good crisis and have pushed through game-changing reforms. Both equities and bonds offer tremendous opportunities to benefit from these diverging conditions. For investors concerned about volatility, a flexible multi-asset approach is a solution. As emerging markets begin to shake off the indiscriminate gloom surrounding them, investors should have them back on their radars.

- Get ready for a record-length US recovery. The Global Financial Crisis was unparalleled in post-war history and so will be the recovery. Some believe it will die of old age. They are wrong. This recovery is still middle aged and has years to go before it fades into memory. Despite China's stumbles and only the beginnings of forward momentum in Europe, the US recovery transition in the next one to two years will be a broader-based, more normal growth cycle driven by job market strength, lower fuel prices, a belated housing recovery and strengthened consumer demand. While the easy money of the multi-year equity market rally may be behind us, there will be increased dispersion in securities markets and improved opportunities for non-beta reliant returns. Equity markets continue to be attractive on their own merits and especially relative to fixed income.

So what does all this mean?

Whilst there are things to avoid and things to be cautious about, there are still opportunities for decent investment returns. They key is to remain genuinely diversified, very selective in the investments we choose and be willing to actively manage your investment portfolio by making changes whenever changes seem sensible.