<u>OUTLOOK FOR FINANCIAL MARKETS as at 31/12/2018</u>

In recent months share markets have declined. Australian Shares are down on average around 10% (*dividends included*) since the 29/8/18 and Global Shares are also down on average around 10.5% (*dividends included*) since the 3/10/18.

The primary reasons for this would appear to have been concerns about a trade war between the USA and China (*by default involving other countries*) and concerns about the US Fed increasing interest rates. These factors have also caused a sell off in credit markets. But more recently these concerns may have eased slightly. Firstly, at the G20 summit in Argentina at the beginning of December, USA President Donald Trump and Chinese President Xi Jinping met (*together with their key advisers*) and agreed to work together to resolve the issues concerning trade between both countries. Secondly, in a speech to The Economic Club of New York (*on 28/11/2018)*, Federal Reserve Chairman Jerome Powell made the following statement "Interest rates are still low by historical standards, and they remain just below the broad range of estimates of the level that would be neutral for the economy; that is, neither speeding up nor slowing down growth."

The "just below" comment has been interpreted as suggesting further interest rate increases by the Fed over the next year or so are likely to be lower than everyone seemed to be expecting (*based on previous comments from the Fed)*. The Fed's official rate was increased to 2.25% to 2.5% on the 19/12/2018 and maybe now they will only look to increase rates by say 0.25% if at all before 2020 which is below what markets have been expecting. Rising interest rates can sometimes be a negative for share prices.

Some might argue that share prices have fallen because they had risen too much. Whilst that may be the case for some companies, I do not believe that to be the case across the board. In fact, given that prices have fallen, logically at current prices shares represent better value on average than they did a few months back and I am less concerned (*given recent developments as mentioned above*) about share price declines (*other than in the short term which is impossible to predict*). I also don't think interest rates overall are going to rise very much in the foreseeable future, particularly in Australia.

As far as fixed interest markets are concerned, there are 2 outcomes that are likely to react in opposite directions. My best guess is that the actual outcome will fall somewhere between the 2 opposite scenarios:

1. If we are headed towards recession/slowdown or whatever you wish to call it, then Central Banks are likely to try and counteract this by reducing interest rates and/or recommence quantitative easing. Also, in recessionary environments high quality Government or Corporate Bonds become more attractive and the buying pressure pushes their prices up, thereby adding to the downward direction of interest rates. In this environment you would want your fixed interest exposure to be in the high credit quality sector (*AAA to BBB+*) because defaults are likely to rise.
2. If economic growth is booming, inflation may start to re-emerge causing Central Banks to raise interest rates and investors to sell bonds in favour of shares, thereby putting downward pressure on their prices and adding to the upward movement of interest rates. In this scenario, defaults are likely to be low and fixed interest exposure might be best served by investing in short dated high interest options.

Factors affecting interest rates are:

- The US Fed has been raising interest rates (*official rate now 2.25% to 2.50%*). Consensus seems to be that this raising cycle might end sometime in 2019 at 2.5% (*no change*) to 3.0%, which is still quite low by historical standards.

- The US Fed is also looking to commence shrinking their balance sheet (*Quantitative Tightening*) by selling Government Bonds (*or collecting Bond maturity proceeds*) and cancelling the sale proceeds. This could have two opposite effects; the Bond selling may put downward pressure on prices and thereby <u>increase interest rates</u>, but at the same time this will have the effect of removing some liquidity from circulation, acting as a brake on inflation and thereby <u>reducing the need to raise interest rates</u>.

- The US Government budget deficit is increasing (*lower taxes etc*) meaning they will need to issue more Bonds. This may result in higher interest rates to attract buyers meaning the price of existing Bonds may fall a bit.

  But on the flip side, on many measures the US economy is doing quite well; very low unemployment, low inflation, strong economic growth. So, when an economy is going well there are presumably less defaulting loans making Fixed Interest more attractive, increasing the number of buyers thereby pushing up prices and resulting in lower interest rates, particularly if inflation remains under control.

- The "Canary in the Coal Mine" is trade wars. Is Donnie Trump serious about going ahead with all the threatened tariffs or is it just a negotiating tactic? Let's hope it is the latter and they can all sort things out. If they don't then maybe, we will be looking at a global slowdown and an increase in loan defaults.

- Ignoring the US, interest rates in most other developed countries are not much above record lows (*if at all*) and they don't seem to be moving much either – maybe the UK's are up a bit, but the outcome of Brexit may have some impact (*although it could be up or down*).

- The Reserve Bank of Australia's official cash rate is still 1.5% (*since mid 2016*) and doesn't look like changing any time soon.

- Yes, it is true that Global debt is at record levels, but interest rates are still very low (*even in the USA*) and I can't see why there should suddenly be a significant increase in defaults. Defaults have been low in recent times, so what has changed to make them increase? Nothing yet, but I suppose if something caused a recession then that would obviously have an impact. What might cause a recession? Possibly an escalation in Trade Wars, a split in the European Union, an actual War, a Pandemic or in Australia's case, collapsing residential real estate prices – although (*with the exception of more recent purchases*) the majority of people with mortgage loans have comfortable equity in their homes (*even with lower prices*). But if economic growth slows, Government Bonds become more attractive as safe havens pushing prices up and interest rates down, and Central Banks usually reduce interest rates to try and stimulate their economies.

I just don't see interest rates rising much in the foreseeable future. Even in the USA. If their rates go much higher (*out of step with the rest of the world*) it would cause problems for their Government who has large deficits and it would almost certainly force the $US higher, acting as a brake on whatever inflation there is by making imports cheaper and damaging US export or import replacement industries.

So it is difficult to make accurate predictions but if I had to, I would say interest rates won't move much, because the main source of rising rates (*the US Fed*) will want to be careful they aren't the cause of a US recession, so I suspect that they may not increase rates much and they may back off their planned Quantitative Tightening (*depending on the data*) till some time further down the track.