OUTLOOK FOR FINANCIAL MARKETS as at 5/9/2018

LETS LOOKS AT AUSTRALIA

Positives (*plus the OK's*)

- Inflation is around 2% (*Reserve Bank's target is 2% to 3%)*
- Real (*above inflation*) economic growth is OK at 2% to 3%, but longer term we would prefer about 1% higher than this.
- Interest rates are low with the Reserve Bank's official reference rate still at the all time low of 1.5% (*unchanged since mid 2016*) and they don't look like changing any time soon. This is good for those that borrow but perhaps not so good for investors who insist on putting their money in bank deposits.
- Unemployment rate is not too bad at 5.4%. Ideally it would be a bit lower than this at around the low 4% mark.
- The $A has recently fallen a bit, relative to other currencies e.g. One Australian Dollar buys $US0.718 or 0.558 British Pounds or 80 Yen or 0.62 Euros. A year ago, the $A was over 8% higher relative to a basket of other currencies (*represented by the trade weighted index*). This is helpful for our companies that are exporters or who have to compete with imports.
- The Minerals and Energy sectors have improved and are going quite well on the back of increased commodity prices
- Technological Advancements in many different areas.
- Australian share prices are slightly expensive on average relative to historical levels, but probably fair value on average relative to where interest rates are. The key word here is "on average"; so in my opinion there are some prices that are very expensive pushing up the average, but there are plenty of companies whose prices are fair to good value. The key is to actively manage share portfolios to try to avoid expensive shares and fill the portfolio with genuinely good value ones – some shares are cheap for a reason (*often referred to as a "value trap")*. Dividend yields across the ASX200 average around 4%, which equates to around 5.7% when grossed up for franking credits. If, hypothetically, share prices were to say rise in line with inflation (*on average*) then a grossed-up return from Australian shares should be able to return say 8%, but we should be able to achieve well above that over the medium and long term by "getting most of our share picks right".
- Australian Commercial Property looks to be reasonable value at present. Vacancy rates are relatively low, and rents have been increasing at a minimum in line with inflation. The earnings yield on listed Australian property funds is currently around 6.3% and current valuations of actual commercial properties would suggest a similar yield for those on average. Therefore, one could expect a medium to long term return from this type of investment of at least 8% to 9%.

Negatives

- The high level of household debt means purchases that might otherwise have been made over future years have been brought forward to the recent past. This might put a bit of a brake on company sales of goods and services, because people have less money to spend as they have already spent it.
- Residential property prices have started falling from elevated levels, particularly in Sydney (*down nearly 6%*) and Melbourne (*down around 4%)*. If this trend gains momentum and prices fall further, and in other locations, then it could be problematical for our economy if loan default levels start to rise.

Conclusion Regarding Australian Investments

So, I think selected Australian share and commercial property (*listed and direct*) investments look OK. Australian fixed interest and residential property investments look unattractive to me at present.

OUTLOOK FOR FINANCIAL MARKETS as at 5/9/2018 *(Cont'd)*

GLOBAL INVESTMENTS

- Similar comments to those for Australia at the moment. However, the Fed have been increasing interest rates in the US to 2% but I can't see them adding any more than 0.5% to 0.75% to this. There does seem to be a little more scope for better returns from actively managed and diversified global fixed interest funds over the medium term than Australian fixed interest, as there is a much larger opportunity set to choose from. Obviously, news outlets are regularly talking about the USA share market reaching record highs, but if you take out Facebook, Apple, Amazon, Alphabet (*Google*), Netflix, Microsoft and a handful of others then the gains are only very modest. Residential property prices in most overseas jurisdictions do not seem to be as stretched as they are in Australia.
- Every day I read numerous articles from the financial sector and I have noticed of late that there seems to be a higher than normal number of articles suggesting we are headed for a "correction" (*falling asset prices*) across most markets. Therefore, I think at present it might be prudent to hold a bit more than normal in cash to be deployed at a later date when the outlook is a little more settled or if we do in fact get a material "correction" and some asset prices fall to cheaper levels where they represent better buying.

OTHER INVESTMENTS

Our preferred investment for exposure to Private Equity, Partners Group Global Value Fund, continues to do well, has low volatility, and has limited direct exposure to global share markets. Direct infrastructure investments look solid with in most cases predictable earnings and low volatility. Managed futures funds have struggled for a little in recent times (*due to a lack of sustained trends in financial markets*), but the case for their inclusion is as valid as ever since they invariably do very well when times are tough, such as during the GFC. Long short funds have mostly underperformed more recently mainly because their short positions on very expensive shares are in loss positions – due to short term momentum these very expensive shares have become even more expensive.