OUTLOOK FOR FINANCIAL MARKETS as at 1/12/2021

My predictions (*but I could be wrong because I can't predict the future*) based on current data and observations:

- Share markets (*both Australian & International*) will be volatile (*more ups and downs than normal*) but share prices will rise over the next 3 to 5 years. Without stating the obvious, some shares will do much better than others, so good stock picking is very important.
- Interest rates will rise from their record lows over the next few years but not by much (*1% to 2%*).
- Inflation will rise but not excessively due in part to structural issues and Central Bank actions designed to target inflation in the range of 2% to 3%. Some of the issues will be transitory such as supply chain shortages caused by Covid shutdowns. The latest inflation reading in Australia was 3.01% per annum at 30/9/21 (*It was 1.11% for the year to 31/3/21*).
- Economic growth in Australia will improve after some negative periods (*due to shutdowns caused by Covid*) but will take a while to get back to where it would have been if not for Covid.
- Unemployment in Australia at last count was 5.22% (*31/10/21*) which isn't too bad, but this doesn't take account of the underemployment – people working less hours than they would like and those having given up looking for work (*the "participation" rate is lower than it was*).
- One of the reasons I can't see interest rates rising much is because of record debt levels, particularly household debt (home loans) and Government debt which is way higher than it was before Covid (*but still not very high compared to other countries*). The Reserve Bank can't afford to let interest rates rise too much because it would mean our government has to pay more interest and household mortgage defaults would rise to a level that would be problematic because of the knock-on effects to our economy.
- Immigration to Australia is likely to increase from close to nothing but not back to where it was before Covid - at least not in the near future.
- On a positive note, Australia has been running a trade surplus (*more exports than imports*) for a number of years now which has improved our "current account" to the stage where it is almost in surplus.
- Some risks to Australian economic growth causing a RECESSION may include:
    - New and more severe strains of Covid (*not necessarily the Omicron version which appears as though it may be fairly contagious but with milder symptoms and less deaths – but still too early to call*).
    - Collapsing residential property prices (*not a prediction but it could happen*) when interest rates rise, APRA's new prudential lending controls take effect, new supply becomes available, maybe other recessionary factors start to bite and because of the ridiculously high prices caused in part by FOMO (*Fear of Missing Out*) reversing and becoming Fear of Missing Out on the opportunity to sell you property at one of these inflated prices causing downward momentum.
    - A War with China.
    - Or because of Australia's failure to commit to sufficient specific climate change action, other countries may potentially impose increased tariffs and / or trade blockages on Australia and overseas businesses choosing not to deal with Australian companies because of ESG (*Environment, Social & Governance*) considerations. Many share investors now won't invest in companies with a poor ESG score.

AUSTRALIAN SHARES

In my opinion share prices in Australia are slightly above fair value on AVERAGE. To arrive at this conclusion, it would seem to me that quite a lot of shares are fairly priced and even cheap, but the average is slanted a bit towards expensive by those shares that are expensive. Therefore, I believe decent returns can be generated by investing in Australian shares (*ignoring short term fluctuations*) by avoiding exposure to the expensive ones. One crude measure of a share's relative value is its Price Earnings Ratio – it's PE. A PE is the Price per Share divided by the Earnings per Share. The lower the number the cheaper the price is, and the higher the number, the more expensive it is. The long-term average PE ratio for the Australian share market is a touch below 15, but we have never had interest rates so low as they are now, which means an equivalent fair value PE would now be 18 to 20. It is also fair to say that companies that are growing their profits at an above average rate can justify a higher PE ratio and for those whose profits are stagnant (*or even falling*) the fair PE ratio should be lower. To illustrate the point:

AUSTRALIAN LISTED COMPANIES

Fair Value Stocks			Price Earnings Ratio
Commonwealth Bank (*CBA*)	-	8/11/21 @ $110.13 per share	22.20
		Now @ $93.04 per share	18.75
National Australia Bank (*NAB*)			14.39
Westpac (*WBC*)			12.40

Note While CBA may have historically performed better than the other major banks the price it got to by 8/11/21 was not justified.

Macquarie Group (*MQG*)	21.80
Telstra (*TLS*)	20.02
Woodside Petroleum (*WPL*)	16.90

Cheap Stock

BHP	8.27

Expensive Stocks

Wesfarmers (*WES*)	27.42
Woolworths (*WOW*)	33.81
CSL (*CSL*)	44.06

Note Woolworths has in my opinion limited capacity to grow its profits by more than 2% to 4% per annum. CSL has grown its profits at an impressive rate for many years now, but given the size the business has grown to, it is hard to see how it will continue growing at the rate (*percentage wise*) it has in the past.

GLOBAL SHARES

Similar comments (*made above*) with regard to Australian shares also apply to shares in other countries. Having said that, shares in the USA would appear to be the most expensive globally (*on average*) with some being at extreme prices, e.g. Tesla whose market capitalisation (*shares on issue multiplied by its share price*) of $1.149 Trillion is higher than Toyota, Volkswagen, Daimler / Benz, General Motors, Ford, Ferrari, BMW, Honda, Hyundai, Kia, Volvo, Suzuki, Nissan, Subaru, Isuzu, Renault and Mazda combined *($0.974 Trillion*). To be fair, Tesla also manufactures and sells batteries.

There is also a new electric vehicle manufacturer called Rivian who only recently listed on the Nasdaq (*USA Tech Stock Exchange*) who to date have only delivered about 150 vehicles and lost around $1 Billion dollars. Rivian's market capitalisation is around $105 Billion which makes it bigger than all of those car companies mentioned above except for Tesla, Toyota *($246 Billion*) and Volkswagen *($123 Billion*). How CRAZY is that?

However, globally there are still many opportunities to buy shares in companies with good future prospects and profits at reasonable and cheap prices.

PROPERTY

Residential property prices look to be at extreme levels and I'm not saying they won't go higher still in the short term, but I firmly believe that in a year or two, these prices will be meaningfully lower than they are now.

Some Commercial property investments (*both listed and direct*) look to be decent value at present – high quality properties, with AAA tenants, on long leases, with annual rental increases, generating 5.5% to 7% per annum in net income returns.

Similar comments apply to overseas property investments although overseas there seems to be a more diverse set of opportunities available to invest in, compared to Australia, e.g. Multifamily apartments, Manufacture Housing, Student Accommodation, Healthcare, Storage, Data Centres, Life Sciences etc. Most of these types of properties exist in Australia, but there are limited opportunities to access suitable investments in them.