

OUTLOOK FOR FINANCIAL MARKETS as at 26/2/2018

Almost every day I am reading articles from financial market commentators about the level of debt in Australia and Globally. They are concerned that this level of debt might cause a financial collapse. The Institute of International Finance estimates that global debt stands at \$US233 trillion (\$A293 trillion). This is around 320% of global GDP. Australian Government debt now exceeds \$600 billion and is still growing at more than \$100 million every day, yet before the Global Financial Crisis, it was almost non-existent. Household debt in Australia is currently around 200% of annual household income which is one of the highest debt to income ratios in the world – the majority of which is borrowing for residential property purchases.

But here's the thing. For every person, business, organisation or government who owes money, on the other side of the ledger is someone who it is owed to. That is an inescapable fact. So liabilities (*debt*) equal assets (amounts owed to lenders) and if the borrowers can't repay the full amount of the debt (*or if it can't all be recovered by other means, e.g. foreclosing on a mortgage*), then there are equal number of winners and losers – the borrower wins by not repaying the full amount, businesses who sold goods or services to the borrower win and the lender loses by the shortfall on the repayments they were due. This is how things are supposed to work and the emphasis should be on the lender to do proper due diligence on who they lend to and not just lend to anybody because they earn more fees and interest, the more they lend. Lending should be done responsibly. You might say, well there are other costs involved in trying to recover amounts owed, e.g. legal costs, so in this case both the borrower and lenders positions are worse, but the lawyer's position is better by the equivalent amount. I have heard the argument that consumer spending will ultimately fall and business sales and profits will drop because consumers will ultimately 'tighten their belts' and spend less and save more (*repay debts*). This I don't get? On one hand the so-called experts are saying there is too much debt and on the other hand, they are saying it is bad if people pay down their debt. You can't have it both ways, so which do they want? If some people are spending less and repaying more, what do the recipients of the extra loan repayments do with the money? If I am not mistaken, they either spend it, relend it or invest it somewhere else and it eventually gets spent or relent.

So debt handled responsibly is not a bad thing and the only way that too much debt negatively impacts overall economic and investment activity is if it affects the psychology of the masses. If people en masse get worried then they reduce spending, stop investing, stop making positive decisions, and economic activity stagnates and productivity declines.

This unfortunately is what happened in the Global Financial Crisis. To be honest, I am not sure what the initial catalyst to start things off was but basically the credit markets froze and banks (and other financiers) stopped lending and the whole thing snowballed from there. I think the media had a lot to do with making things much worse by producing copious quantities of negative press (you "sell more newspapers" if you sensationalise things). Financial institutions stopped trusting and doing business with each other, the authorities took extraordinary actions to protect many of the large banks (*except for Bear Stearns and Lehman Brothers*) and economic activity took a deep dive. Some people blame the whole thing on USA sub-prime loans where by money was lent by greedy banks to people for home purchases who had no chance of repaying the loans. The banks then packaged these loans into bundles (CDO's etc) and sold them to investors after the credit rating agencies (*Moody's, Standard & Poors etc*) had given them AAA ratings. Sub-prime loans were actually only a small percentage of all loans, but they were the ones that got all the publicity.

What should happen in a properly run free market economy is the banks who made the bad loans should suffer the losses associated with them and the directors and staff who promoted the rorts should have had the pants sued off them and, in some cases, thrown in jail. If the guilty parties knew they had this hanging over their heads maybe they may have been a little more cautious as to who they lent money to.

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The key to prosperity is to ensure an efficient allocation of resources and to have your working population productively employed in the right quantities in activities that are needed by and beneficial to society. This is much easier to achieve if most people have a positive mind set and confidence in their outcomes.

So how does this relate to our current outlook for financial markets? If the naysayers can be kept at bay then the outlook should be quite okay. Global economic growth is solid and positive almost everywhere, inflation and unemployment are low, and while interest rates may rise a small amount, please remember they are coming off an extraordinary low base. Sure, some assets (*some shares, property and fixed interest securities*) look expensive but there are plenty of things that are cheap to decent value. The key is to be selective in what you invest in.

If the financial market bogeyman (i.e. the media) go on a negative crusade and cause prices to fall across the board, just remember that if you are never a forced seller and have your money invested in those assets that are decent to very good value, then you will eventually be rewarded. I am not saying that will happen but if it does, you certainly don't need to panic. We have tried to populate our client's portfolios with a genuinely diversified spread of investments that will outperform over time, but more importantly due to their approach and philosophy we choose investments that outperform their peers in down markets (*fall less*).

So where does that leave us now? Global economic growth is reasonably steady almost everywhere now, but not booming. Inflation is still low in many countries and still below most countries Central Bank target of 2% to 3% per annum. Interest rates are not much above record lows in most countries (*the Australian Reserve Bank's official interest rate is unchanged since 2016 at 1.5% per annum*) although the US Fed is expected to raise their official rates in small increments over the next few years to what they regard as more normal neutral rates. The unemployment rate is around 4.1% in the USA and this is quite low and possibly putting some upward pressure on wages, which in my book is not necessarily a bad thing. Unemployment in Australia is sitting at 5.5% and when you take underemployment (*employed, but less hours than wanted*) into account, this takes the number above 10%, so Australia needs to work on creating more jobs. Globally, company profits appear to be growing again after a few years of fairly stagnant numbers.

As far as investment markets are concerned, I think USA share prices are on average expensive but because of the size of their market there are still plenty of opportunities to acquire shares at reasonable to good prices.

Australian share prices (*and most of the rest of the world*) are a bit of a mixed bag – reasonable value on average with some stocks being expensive, some fair value and some cheap. This should provide good opportunities for skilful stock pickers.

Interest rates in Australia and Japan don't look to be going anywhere at present. Globally USA rates are expected to rise a bit, European rates might rise a bit (*but this is off a very low base – negative in some cases*) and emerging markets offer a mixed bag – some rates rising and some falling.

Taking interest rates and other factors into account my best guess is that the \$A will fall in value over the next couple of years, meaning unhedged global investments will provide currency gains to supplement whatever other returns they can generate.

I think commercial property in Australia on average is reasonably priced for the current environment (*not cheap and mostly not expensive*). Australian residential property still seems expensive to me and I think we might be in for quite a few years of minimal, if any capital growth from this sector.