OUR OUTLOOK FOR FINANCIAL MARKETS as at 2/6/2021

Australia and the World are gradually recovering (*some countries more so than others*) from the effects of COVID-19, as more and more people are being vaccinated and Governments and Central Banks continue to provide elevated levels of Fiscal and monetary stimulus. As a consequence, many economies are now growing at above average rates, unemployment levels are falling, albeit coming off negative growth that occurred in early to mid-2020, and as a consequence many businesses are seeing their profits recover and property prices are rising. Interest rates are still very low and not likely to shift too far from these levels for a couple of years, particularly short-term interest rates. Longer term interest rates could shift up a little bit if inflation picks up too much, which leads me to consider the outlook for inflation.

Central Banks around the World would like inflation to be a bit higher than currently. Conventional wisdom seems to suggest 2% to 3% per annum is ideal, with a tolerance for even a bit higher than this in the short term (*as a catch up*). They want to avoid deflation at all costs. So Central Banks for the foreseeable future will continue to run monetary policy (*low interest rates and quantitative easing*) with an aim of achieving higher inflation and stimulating economic growth – company profits increasing, lower unemployment, rising wages. Low interest rates combined with some inflation is also helpful in repaying debts – particularly the massive increase in Government debt due to large increases in spending designed to support the economy. Lower interest rates are also helpful in preventing a country's currency from rising in value too much (*relative to other currencies*) making its exporters and industries who compete with imports more competitive.

Some factors contributing to the likely rate of inflation are:

- Adding to inflation are supply chain disruptions caused by COVID-19 and low inventories; some elevated commodity prices; Government and Central Bank stimulus; deglobalisation (*restrictive trade policies have been increasing to some degree, e.g. China vs Australia*).
- Decreasing inflation caused by still higher than normal unemployment/underemployment; accelerating automation and digitisation; excessive debt levels (*expenditure brought forward from future years*) and lower consumer spending (*except on houses*); demographics such as the aging population in many parts of the world (*particularly developed countries and China*) – as people get older they tend to spend less and more people need Government handouts.

So what does this mean for financial markets?

Low interest rates, accelerating economic growth, moderate inflation are all positives for company profits and therefore share prices. They are also positive for most property markets, but are probably a negative for many fixed interest options. The negative for the outlook for shares and property is that currently the pricing of some shares and property investments is excessively high. Thankfully that does not apply to all shares and properties and many are fair value to cheap in some cases.

Some people might get the impression that share prices have taken off, but it all depends on where you measure from – just before the COVID-19 sell-off in February 2020 or just after the sell-off and start of the recovery in late March 2020. For example, picking some of Australia's largest companies from different sectors:

	SHARE PRICE		
	Feb-20	Mar-20	02/06/2021
Commonwealth Bank	$ 90.73	$ 54.59	$ 100.33
BHP	$ 38.80	$ 25.33	$ 49.39
CSL (Blood Products)	$ 341.03	$ 271.52	$ 286.96
Macquarie Group	$ 151.81	$ 72.74	$ 151.99
Woolworths	$ 43.54	$ 34.86	$ 42.30
Telstra	$ 3.79	$ 2.98	$ 3.49
Transurban (Toll Roads)	$ 16.33	$ 10.00	$ 14.00
Newcrest (Gold)	$ 30.26	$ 21.89	$ 28.29
Woodside Petroleum	$ 33.82	$ 15.30	$ 23.13

As you can see, every one has recovered (*to some degree*) since March 2020, some quite a lot; CBA and BHP are ahead of where they were in February 2020, some are back to approximately where they were and some still below where they were then.

That said, if there is a sell-off in share markets at some stage, for whatever reason, then most share prices will fall to some degree, but the cheap or fairly valued shares (*including listed property funds*) are more likely to fall less and recover more quickly. Because direct property holdings aren't traded daily on a market their valuations are unlikely to be affected (*particularly in the short term*). Valuations for direct property holdings would however be affected over the medium and long term depending on a variety of factors, not the least of which would be the health of the economy and various subsectors of the economy.

At present, given where interest rates are, I can't see much point in having too much invested in fixed interest, except in actively managed, diversified fixed interest portfolios where the managers are able to take advantage of various idiosyncratic anomalies that occur regularly across all manner of fixed interest securities.

I currently like the outlook for some private equity options, emerging markets and selected small/microcap shares.