OUTLOOK FOR FINANCIAL MARKETS as at 3/3/22

What are the main things impacting financial markets globally at present?

1. Inflation and the likelihood of higher interest rates.
2. Russia's invasion of Ukraine. No doubt Xi Jinping is watching to see how that goes as he considers if China should annex Taiwan.
3. As a consequence, the sanctions being applied to Vladimir Putin, his billionaire friends and the Russian economy. Will he turn off gas and oil supplies to Europe?
4. While it is no longer the main news story, we are still suffering a global pandemic, although its affects on activity seem to be waning for the time being.

And with regard to the East Coast of Australia

5. Floods, although these are only likely to have a relatively short-term impact on the Australian economy overall. It's bad for those directly impacted (*and my best wishes go to those people*), and also bad for insurance companies and will temporarily add to supply shortages and inflation.

A lot of the above is interlinked. Inflation has risen because of:

1. Supply shortages caused by Covid related shutdowns.

2. Increased costs of running businesses due to various Covid related changes to work practices.

3. Increasing wages in some cases due to difficulties in securing the right people for various jobs. Unemployment rates are now very low in many parts of the world, including Australia (*which has found some difficulties in sourcing the right skills whilst immigration has been virtually stopped due to Covid*).

4. Shipping and transport costs and delivery times have increased significantly, not the least because oil / gas prices are much higher.

5. The deglobalisation / protectionism trend which over the last few years has seen many countries try to re-establish various manufacturing capabilities within their own countries rather than import goods from overseas at lower cost. This trend can be seen as a by-product of Geo-Political tensions. e.g. Trump's "make America great again" whilst he was in power, China's more aggressive posturing over the South China Sea, Hong Kong, Taiwan and its sudden change to conditions for Australian exports such as wine, barley and coal temporarily. Also, Brexit, the Middle East / Afghanistan, and Russia's invasion of Ukraine and its Cyber warfare interference with many other countries.

Inflation above Central Bank targets (*it seems consensus has 2.5% per annum as ideal*) usually means rising interest rates, unless the excess is judged to only be temporary. Australia's annual inflation for the year ended 31/12/2021 was 3.5% per annum, but if you annualise the last quarter's figure it is running at 5.3% per annum. In the USA their inflation rate has risen to 7.5% per annum. To date the Reserve Bank of Australia or the US Federal Reserve have viewed any increases in inflation to be temporary due to the effects of Covid. However, whilst Central Banks had been trying to encourage an inflationary pick-up by setting record low interest rates and running Quantitative Easing (*QE*) programs (*buying Government Bonds with money created out of thin air*) to try and also keep longer term interest rates low, it may soon be time to recognise they may have over stimulated inflation and acknowledge that some of the increases may not be temporary. So, they will need to start reining it in by raising interest rates and start Quantitative Tightening (*the opposite of QE*). Consensus seems to be that the US Fed will start raising interest rates this month (*March*), but in Australia it won't start until the 2nd half of 2022 (*or even not until 2023*). Note they can't afford to raise interest rates too much because of the large amount of Government debt accrued by the spending programs invoked in order to mitigate the economic effects of the Covid shutdowns, and also the vast amounts of money borrowed by households in order to purchase residential real estate properties.

Generally speaking (*apart from bouts of occasional short term volatility*), economies and financial markets cope quite well with moderate inflation and small increases in interest rates. Increases of 1.5% to 2.5% per annum, especially coming off record lows, shouldn't have too much impact on prospects for financial markets and in fact may ultimately be beneficial.

OUTLOOK FOR FINANCIAL MARKETS (*Cont'd*) as at 3/3/22

What about Russia and Ukraine? If the invasion is contained to those two countries, whilst the humanitarian aspects are terrible, I don't see it having any lasting impacts on the world's financial markets. Russia's share market is currently worth only 0.19% of the worlds share-markets and Ukraine is much less again. Obviously, Ukraine is suffering, but thanks to massive sanctions, so to will Russia. Russian interest rates went from 8% to 20% overnight, the Russian ruble has lost 30% of its value against the $US, the Russian stock exchange has been closed since the 28th February, Putin and his billionaire mates have had their assets outside of Russia frozen (*very large $'s*) by the USA, UK, Europe etc. Russia's access to the SWIFT international banking payments systems has been blocked, Russian banks have suffered large cash withdrawals, Russian planes have no right to fly through European airspace and Russian sporting teams have been thrown out of European and World sporting competitions, such as footballs world cup qualifiers. Even things like Apple Pay, Google Pay and Samsung Pay have been stopped for many Russian banks facing sanctions. The list goes on. Note these sanctions have also been applied to Belarus.

Many of Putin's supporters would not be happy.

However, what if Putin cuts off the oil / gas supply to Europe even though that would make things worse for Russia? This would no doubt cause some short-term problems but in the northern hemisphere spring has now arrived. It will force European countries to move much faster towards green energy alternatives (*to Russia's disadvantage*) and in the interim it could possibly be a boom to other oil/gas suppliers – maybe even Australia's Woodside Petroleum. It would make no sense for Putin to do this but when has that ever stopped him.

What if Putin decides to start attacking other countries? Once again this makes no sense because then he would have to fight NATO (*including the USA*).

What if Putin goes full troppo and presses the nuclear button? If that happens then all bets are off, and it doesn't matter what investments you hold because they are probably all "going to s--t".

All that said, there are some positives. As the world and Australia get used to living with the pandemic, economic growth seems to be doing well, unemployment is down, wages are slowly increasing, and company profits are rising on average at a healthier rate than analysts have been expecting.

From an investment perspective, I believe there are still plenty of good investment options out there even though some options are still clearly expensive.

The Australian share market may have fallen over the past few months but is still only 6% behind its all-time high. It is similar for other countries. The simplistic conclusion would be that market prices must be quite high, but the "market" is an aggregate number adding the total movements (*both positive and negative*) of a large basket of companies against specific market capitalisation related weightings. The aggregate computation necessarily obscures the specific pricing of many companies, particularly smaller companies, which due to their relatively small market capitalisation have very little influence on the overall "market" index. The reality of the asset class of Microcaps and Small Caps is therefore much more nuanced and warrants a deep dive analysis.

There seems to be a quite extreme market bifurcation with some companies at highly elevated and perilously optimistic pricing that are not justified by their fundamentals or the risks of achieving long-term earnings growth. Equally, there are many totally mispriced and undervalued businesses with highly attractive pricing.

The key as always is to be selective, be diversified, ignore the noise and embrace the likely volatility of markets (*be patient when prices fall temporarily*). And as insurance and acknowledgement to where the world is at the moment, it might be worth considering a small amount of gold exposure via high quality profitable gold mining companies that pay decent dividends (*not physical gold because it doesn't generate any income)*.

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