<u>OUTLOOK FOR FINANCIAL MARKETS : Investing 101 as at 6/12/2019</u>

How do you make money out of investing?

There are 3 main types of investments, together with various alternatives which utilise them:

1. Shares — Big or Small, Australian or Overseas, Listed or Unlisted (Private Equity), Options, Futures Contracts, Short Selling etc.
2. Fixed Interest — Bank Deposits, Government Bonds, Various Loans (*fixed rate or variable*), Secured or Unsecured, Australian or Overseas, Short Term or Long Term, Swaps, Options, Futures Contracts, Short Selling etc.
3. Property — Listed or Unlisted, Residential or Commercial *(Retail, Office, Industrial, Hotels etc*.), Infrastructure, Australian or Overseas.

When assessing which investments to buy or sell, there are two key factors to consider:

1. Price — This is fairly straight forward – it is what you pay or receive when an investment is bought or sold.
2. Value — Value in some senses is subjective and difficult to determine. Many factors have a bearing on value which include (*but are not limited to*) the expected returns from the investment you are considering <u>relative</u> to other alternatives. For example, because of risk factors you should expect to get a higher return from investing in shares than in Government Bonds. So, when interest payable on Government Bonds is incredibly low as is the case now, the return you need to justify investing in shares is less than it would be when interest rates are higher.

   Note the relativities between investments will change over time and consideration of likely (*or possible*) changes should form part of a decision to buy or sell an investment.

   At various points in time the prices of different investments become distorted for all sorts of reasons (*many not very logical*). By distorted, I mean significantly out of kilter with some reasonable estimate of fair value. This presents opportunities to either buy investments when they are cheap (*relative to fair value*) or sell them when they are expensive, as prices inevitably return to close to "fair value" over time. That said, the process of return to fair value can in some cases take much longer than you think, so in the case of a purchase you may need to have the capacity, patience and willingness to remain invested, and in the case of selling an expensive investment which subsequently became even more expensive (*further price rises*), you just need to be happy that you have made a good gain and move on.

So how do various investments make money?

<u>Shares</u>

Shares are just a means of sharing in the ownership of a business. The aim of most businesses is to make profits, hopefully increasing over time. You get paid a share of these profits by way of dividends, and if successful, the <u>value</u> of the business (*and your shares*) increases each year in line with the portion of profits they retain and the year by year increases in profits.

<u>Commercial Property</u>

Tenants pay rents and many of the costs associated with the property. The landlord (*investors*) incur some other costs and the excess in rents over these costs is profit. Most commercial leases are written with automatic annual increases to rents payable (*e.g. 3% per annum*), so the profits from renting a property should hopefully increase each year and consequently the <u>value</u> of the property should also increase over time. Hopefully the <u>price</u> the property could hypothetically be sold for, will also increase over time in line with <u>value</u>. Of course, the above depends on being able to keep the property leased to tenants who don't go broke. From time to time the annual costs may be higher due to the need to refurbish commercial properties in order to keep the property tenanted.

Fixed Interest

In its simplest form, you deposit or lend money to Governments, Banks or Companies who pay you interest and eventually return your capital. In an ideal world you won't have any of these investments with an organisation that becomes insolvent and can't repay your capital. In reality many of these investments can be bought or sold in the world's fixed interest markets (*which are much larger than the world's stock markets*) and as a consequence their price can fluctuate materially. Somewhat counter intuitively, if interest rates are rising then the price you could sell "fixed rate" (*as opposed to variable rate*) securities will fall and vice versa if interest rates fall.

The Economic Influences on Investment Returns

How various economies are performing have a big influence on how investments perform on average, but there are always exceptions.

Shares

A booming economy means sales and profits are higher on average and therefore dividends and share prices should be increasing. An economy moving into a recession is the opposite.

Property

A booming economy probably means vacancy rates are low, properties are fully leased, and rents are higher due to lack of suitable supply. In a recession, businesses are contracting, vacancy rates are rising, and rents are falling, or landlords have to provide incentives to find or retain tenants.

Fixed Interest

If an economy is booming, interest rates should be higher. Given that we now have record low interest rates, if economies were to start improving (*growing faster*), then interest rates should rise and the price of "fixed rate" securities will fall as new offerings become available at higher rates. If an economy moves to recession, then I don't know that the reverse necessarily applies now, as it normally would, because how much lower can interest rates fall from where they are now. Countries will have to find other means to stimulate their economies instead of lowering interest rates – maybe more Government spending on say infrastructure or more Government incentives and less red tape.

So where are we now, economically speaking?

As mentioned above, current interest rates are at or close to record lows:

- In Australia, the Reserve Bank's Official Cash Rate is at an all time low of 0.75% per annum and 10 year Government Bonds are yielding 1.09% per annum (*as at 5/12/19*).
- Overseas rates are also very low and in some cases negative (*where you have to pay the Government to keep your money*):

	USA	UK	Germany	Japan
Central Bank Cash Rate	1.50%	0.75%	0.0%	0.1%
10 Year Government Bonds	1.78%	0.76%	-(0.3)%	-(0.05)%

Normally, low interest rates should stimulate growth in economies (*cheaper to borrow*), less incentive to keep money in a bank account earning next to nothing and more inclination to spend. Lower interest when combined with some tax cuts means more money in people's pockets but they don't appear to be spending it for the time being, preferring instead to pay it off loans or save it.

The Australian dollar has fallen over the last couple of years against most major currencies – on average around 8% (*between 5% Euro and 15% USA*). This is good for our businesses competing against imports and good for our businesses exporting to overseas. It is not so good for those who have borrowed from overseas (*without hedging*) and have to repay loans in foreign currencies. Probably more good than bad though for our economy – we have had a balance of trade surplus for some time now and it is suggested we are just about to see our first current account surplus.

Inflation is below average in pretty much all developed economies – actually a little below the level various central banks are targeting. Conventionally, wisdom seems to suggest that somewhere around 2.5% per annum is ideal. Higher inflation or very low inflation (*or deflation*) is considered not good for a whole raft of reasons. So I believe current inflation rates globally are not bad – USA 1.8%, UK 1.7%, Germany 1.1%, Japan 0.2% and Australia 1.67%. Although the Australian figure has me a bit puzzled – the Bureau of Statistics obviously doesn't give much weight to electricity, council rates, medical costs, health and other forms of insurance.

Unemployment is very low in some countries. Full employment is generally considered to be around low 4 point something and below this results in some degree of labour shortages (*particularly skilled labour*). At present USA is 3.6%, UK 3.8%, Japan 2.4%, Germany 3.1%, France 8.6%, Italy 9.7%. Australia's unemployment rate is a little higher than we would prefer at 5.3% (*especially with an underutilisation rate as high as 13.8% - people employed but not for as many hours as they would like*).

Economic Growth as measured by real GDP (*Gross Domestic Product adjusted for inflation*) is below average almost everywhere, but not negative – sustained periods of negative growth are referred to as recessions (*or if they get really bad like in the 1930's they become depressions*). Current growth figures are USA 2.1%, China 6.0%, Japan 1.4%, UK 1.0%, Germany 0.5%, France 1.4%. Australia's most recent GDP growth figure was 1.4% and our long-term average is around 3.3%.

So as far as interest rates, inflation, unemployment and economic growth are concerned, the outlook seems reasonable – obviously we would prefer economic growth to pick up to a bit higher levels, but at least it isn't negative for now.

However there are some potential negatives which may affect things:

1. Increasing income inequality causing the rise of populist political parties with more radical agendas which are not necessarily good for a nations economic health. So far none of these parties have come to power, but the fractured voting has caused hung parliaments and minority governments needing to do deals with some of the radicals in order to be able to govern to some extent.
2. Global warming and less arable land to grow food.
3. Aging populations potentially meaning the percentage of the population working is shrinking, although this may be offset to some degree by Artificial Intelligence replacing some of the more basic jobs.
4. Increasing trade protectionism is a negative for global trade and economic growth – also causes some things to be more expensive than they need to be. The classic example of this in Donald Trump's trade war with everyone – China, The European Union, France, Brazil, Argentina, Mexico, Iran etc. The world's stock markets seem to react every time he tweets about the on again, off again, on again deal on newly imposed tariffs with China.
5. At the moment my biggest worry is if the collective mind set (*sentiment*) of a big enough proportion of the population, spurred on by the media, turns negative to the extent that they stop making decisions as this could push us into a recession/downturn. Businesses keep putting off decisions to invest and households put off spending. Lower sales may mean more people unemployed with less money to spend and businesses with lower profits, resulting in a downward spiral – a negative feedback loop. Negative feedback within financial markets takes on significantly greater importance during periods of distress. Given humans' propensity to overreact to greed and fear, markets have a tendency to get erratic during moments of uncertainty. The panic during sharp market corrections illustrates this point clearly. Negative feedback, even for benign issues, becomes a negative self-fulfilling cycle (*or loop*) that feeds on itself. Investors seeing others panic, in turn, panic themselves, creating an environment that is difficult to reverse. If this happens, given time it will reverse and do the opposite. People will start to spend, business will start expanding, sales and profits will increase, and asset prices will rise. But you need to be able to stay the journey and not panic when things appear bad. You need to have a diversified mix of investments, so if you need access to cash for whatever reason then you have a choice to take it from somewhere that is not presently priced well below fair value. It is not good if you are forced to sell too much at well below fair value thereby locking in a loss resulting in perhaps permanent loss of capital that can't be recovered.

So, at present there are some things which are good for the Australian and Global economies, some which are neither here nor there, and some which are potentially negative to some degree. But hasn't this always been the case?

So, in my opinion, the price of investments assets globally on average may be marginally expensive but to achieve this average there are those assets that are very expensive and should be avoided, some that are around fair value and they are ok, and some that are relatively cheap and worth buying or holding. This applies across all sectors, both Australian and Global, but more so with shares and property – I must confess at present it is hard to find much in the way of good value investments in the Fixed Interest category without looking to areas where the risk of default by borrowers is noticeably higher (*meaning the selling price is likely much more volatile*).

As always, I believe the best way to invest is to remain well diversified, but currently having a bit higher weighting to appropriately selected shares and property based investments.