

OUTLOOK FOR FINANCIAL MARKETS as at 6/6/2019

There has been a lot of talk lately regarding the possibility of a recession, both in Australia and globally. Therefore, in this Outlook I will firstly discuss the likelihood of this occurring, including factors which might provide some indications supporting this outcome or not. Secondly, I outline my thoughts on how best to handle investing in the current environment if we do lapse into recession.

Chances of a Recession

The generally accepted definition of a recession is 2 successive quarters of negative real (*inflation adjusted*) GDP growth – GDP “gross domestic product” is a dollar measure of the market value of all the final goods and services produced in a period of time.

Australia

According to some, we are already in a per capita recession and the only reason it is not an official recession is due to population increases from immigration and some natural increase from births exceeding deaths causing the productive workforce to increase – so the total value of goods and services increase. Australia's real GDP growth in total for the 12 months ended 31/3/19 is only 1.8% and if you take the first quarter of that period (3 months ended 30/6/18) then growth for the most recent 3 quarters is only 0.92%. If you then adjust for population increases, the growth per capita is break even at best, if not slightly negative. To put things in context, Australia's long-term average real GDP growth rate is more like 3.5% per annum. Another small negative for Australia is that unemployment has increased from around 4.9% a few months ago to 5.2% now (*something in the low 4's would be considered full employment*). Also, residential home prices have fallen on average over 10% during the last 18 months (*particularly in Sydney and Melbourne*). The Reserve Bank is concerned enough to reduce its official interest rate from 1.5% to a record low of 1.25% just last Tuesday (4/6/19) and consensus from most economists seems to be that they expect at least one more cut to interest rates later this year. Furthermore, Australian 10 year Government Bonds are now trading on a yield (*effective interest rate*) of just 1.48% per annum which is indicative of financial markets expecting low growth, low inflation and low interest rates to persist for many years. So it would appear that low interest rates will be with us for some time yet, which I guess is a positive for most people, except for those who have substantial amounts invested in fixed interest investments such as bank deposits. Inflation is also low – the last official CPI figure released for the 12 months ended 30/4/19 was only 1.33% (*note the Reserve Bank's target inflation rate is 2% to 3%*).

This all sounds fairly negative but some positives could be:

- Low interest rates are good for anyone borrowing;
- Low inflation is good for consumers;
- Unemployment at 5.2% is not too bad (*it has been above 10% in the early 1990's but over the last 40 years it hasn't been below 4%*) although one could argue that the amount of under employment is higher than in the past (*more part-time and casual workers*);
- High commodity prices at the moment (*such as iron ore*) means the Australia trade balance is positive (*dollar value of exports is higher than imports by about \$5 billion a month*). Add to this the fact that the \$A has fallen over the last year or so against most other major currencies providing a boost to our exporters and import replacement industries;
- Household savings rates have increased mainly due to more net loan repayments which is a positive as far as those who say we have too much household debt – note however that this means there is less consumption which is not good for some business, e.g. new car sales are down quite a bit;
- The Coalition Government was re-elected last month (*I'm not taking sides*) meaning they will try to have their tax reductions passed through the senate and with the mix of the new senate it would seem they have a good chance. Some of these reductions for tax on higher incomes won't happen for 3 and 5 years but the increase to the “Low and Middle Income Tax Offset” should happen immediately putting more dollars in consumer's hands.

USA

The USA has been growing quite strongly, inflation is lower than the Fed's target, unemployment is very low and the Fed for the moment have stopped increasing interest rates (*currently 2.25% to 2.5%*). Furthermore, there is an increase in commentary that the next interest rate change might be a reduction. That all sounds quite good but more recent indicators suggest growth might be slowing a bit, with many blaming this on Trump's trade wars with China, Europe and others (*including Mexico more recently*). Is this just bluff, a negotiating tactic or does he intend to go through with more tariffs? Let's hope not.

Another factor generating a lot of attention at the moment is the US's inverted yield curve where long term interest rates are lower than short term rates – US 10 year Treasuries are now paying only 2.1% while as recently as November 2018 they were yielding 3.2%. It is said that an inverted yield curve is often indicative of a coming recession within the next couple of years. These current developments might result in a softening \$US which indirectly may provide a boost to other countries financial markets.

Other Countries

There are very low interest rates in all developed countries. Some emerging market countries have higher rates. Growth in Europe is low, as is inflation. Italy may have some debt problems and who knows how Brexit will pan out and affect things – it might eventually turn out to be good for the UK. Japan looks to me to be one of the few developed countries that you could say was stable, without too many problems that weren't under control.

The Late Cycle Proponents

Supposed experts are saying we must be getting closer to a recession because the growth cycle following the global financial crisis (GFC) has run for a record 10 years, which is longer than usual. Historically there is usually a shorter gap between downturns. But growth has been much slower than in normal recoveries, so total growth in this cycle is lower than most other cycles. 10 years at 2% growth is almost identical to 5 years at 4%. Plus we were coming off a very low base (*perhaps record lows*) after the GFC, so the first part of the supposed 10 year cycle was merely a catch up to a bit more normality (*recoupment of an over reaction on the down side*) plus there have been blips along the way (2011, 2015/16, late 2018). So it hasn't really been a 10 year cycle.

So How Should the Economic Outlook Affect Our Investment Decisions?

So there might be a recession in Australia and/or in some other countries. But there might not be. My best guess is for a period of lower than normal growth and/or mild recession to be followed by a pick-up in economic growth a year or so later. The problem is not only predicting if there will be a recession, but if there is, when exactly will it be and how will it affect financial markets. So you could choose to reduce your exposure to shares, property investments and higher yielding fixed interest investments and replace these with cash and bank deposits earning 1% to 2% per annum. But what if you move too early and you give up a year or so of 6% to 10% returns from these other investments? What happens if you try and time this move to coincide with the start of a downturn – it could be a false down followed quickly by an upturn or the downturn could happen so quickly that by the time you are ready to move, most of the fall in prices would have already occurred? In my opinion I can't justify having too much money tied up earning only 1% to 2% even if investment markets do take a fall. Falling markets eventually recover. My advice would be to have just slightly more cash than normal so it is available to buy things cheaply if there is a significant fall, but to basically maintain a genuinely well diversified portfolio of investments. While the price of some shares, fixed interest securities and property investments currently seem expensive, there are still plenty that are fair value and others that are cheap. So within each different category of investments, be selective and pick those investments that are intrinsically sound and that are priced fairly or cheaply. History would reveal that these types of investments don't fall as much in a downturn and they recover faster. It is more often the high flyers that suffer the most and also quite often these same investments are the ones that have the most debt. Almost without exception, those investments that "blew up" during the Global Financial Crisis had too much debt.