Investing in Volatile Times

Introduction

As Australia emerges from lockdowns in New South Wales, the Australian Capital Territory and Victoria, and the economy recovers from a September quarter contraction, where should investors put their money?

Currently cash and bond returns are very low. The local bourse had another weak September; during eight out of the last 11 Septembers the S&P/ASX200 has gone backwards. Residential property has boomed, but will it keep going? And what about crypto currencies, should they be part of a portfolio?

The best place to start when thinking about investing is the big picture, the macroeconomic outlook.

The big picture

There are four main reasons why global growth is likely to be solid into 2022. Firstly, there is massive and continuing fiscal stimulus. Then there is the ultra-easy monetary policy. There is also pent-up demand evident in excess savings, and high savings rates. And finally, vaccines are working to head off serious coronavirus illnesses.

Global business conditions might have peaked, but they still point to strong global growth and business investment plans have improved.

China, and particularly its property market, is a concern for investors. The troubles of real estate giant Evergrande being unable to repay its debt, and other property developers struggling, have highlighted risks to the world's second largest economy.

Chinese authorities are likely to eventually step in and help with a debt restructuring, but not before they've sent out a sobering message to property developers to not take on too much debt and stick to their basic businesses.

Ultimately there will be more stimulus out of China.

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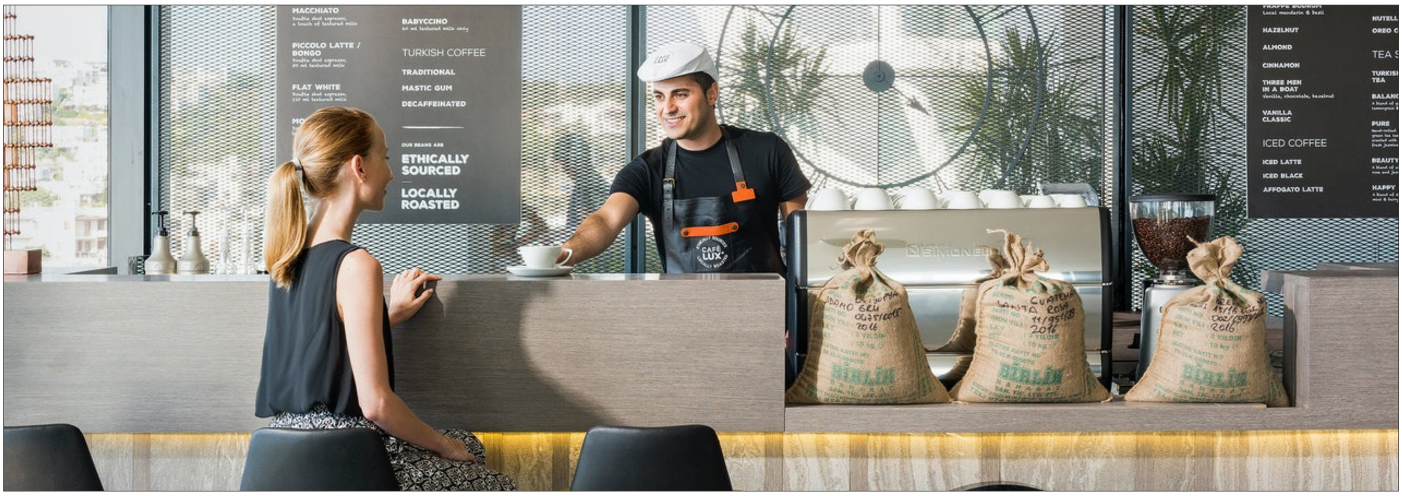


The tables have turned in Europe. It was a laggard, but Europe has outperformed as economies reopen and it is now a star performer. The US is also recovering, though not as fast as Europe.

For Australia, the worst should be over after contracting during the September quarter due to the lockdowns in New South Wales, the Australian Capital Territory and Victoria. As restrictions ease, GDP is expected to grow again through the December quarter and be back to its pre-COVID trend late-last year.

The continued strong global growth will benefit a cyclical economy like Australia. And there is plenty of pent-up demand. After last year's lockdowns there was about $200 billion sitting in bank accounts above normal levels. It looks like it's roughly double that this time around.

Business investment plans have improved, and policy stimulus remains, so it is reasonably likely that beyond the short term, the Australian economy will get back on track.

The lasting impacts of the coronavirus crisis

As the global economy emerges from the COVID crisis, there will be long lasting implications beyond health.

The pandemic has triggered increased geopolitical tensions, notably with China. Government liabilities are bigger with more public debt. There's a risk of higher inflation in the long term caused by the printing of money in 2020 and 2021.

Some sectors will be hit harder than others. Airlines are likely to see a fall in business travel, more retailing will shift online and demand for office space may initially be soft as people continue to work from home.

Significantly there will be less immigration into Australia than pre-COVID, with the population expected to be about one million less by 2025 than pre-COVID forecasts.

However, not all the lasting implications will be negative.

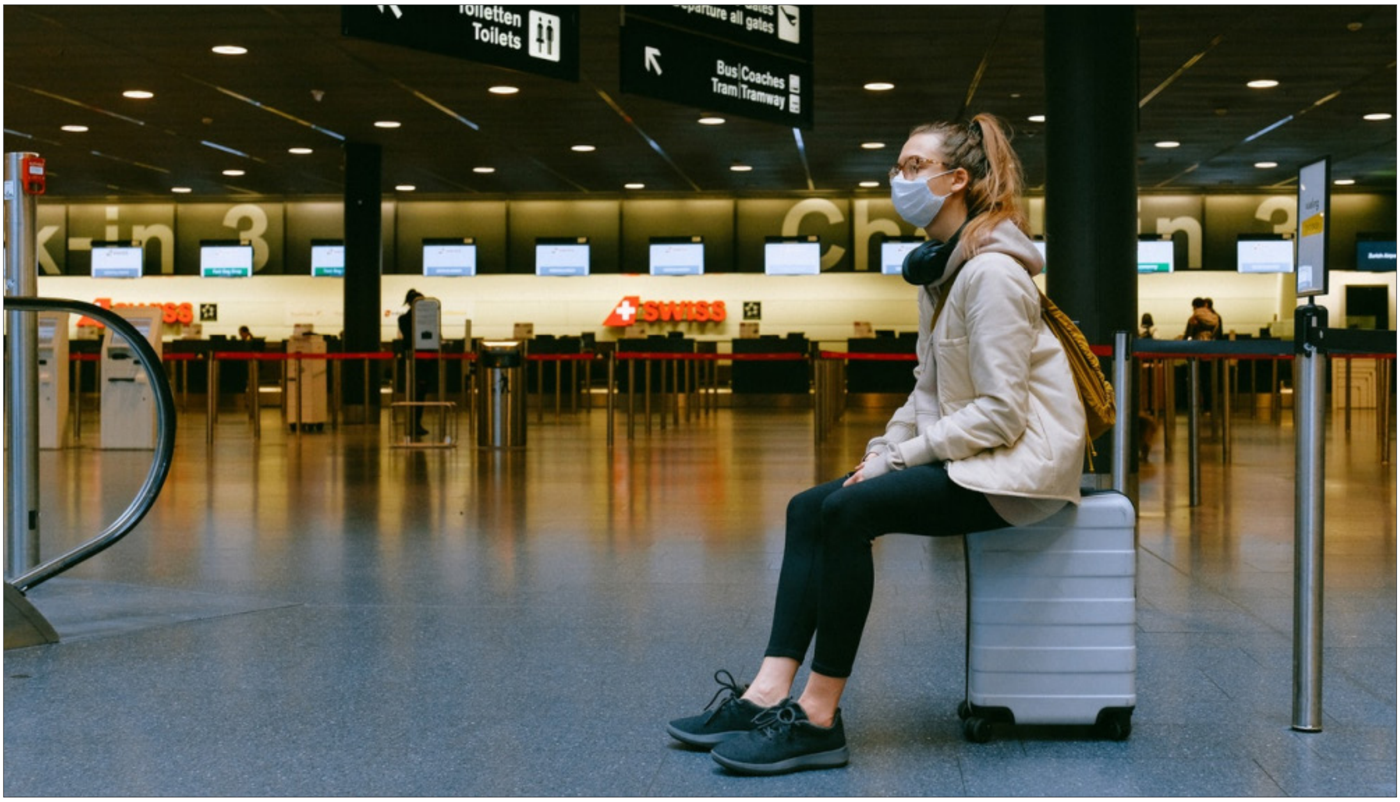
COVID has triggered a much faster adoption of technology, and this should lead to greater productivity.

And keep in mind that after the 1918-1919 Spanish flu, the world experienced the 'Roaring Twenties'. When you come out of something like we've just experienced, you can unleash a lot of spending and feelgood factors.

Of course, inflation is potentially a big issue, and the unknown is whether recent rises in prices will prove to be distortions due to the pandemic or something more permanent. In the US it looks like price rises are mostly transitory and we are already seeing some of them falling out of the data. The same thing is happening in Australia. It's likely that the current bout of inflation is mostly transitory.

However, there is a 'but.'

We have seen a significant decline in inflation over the last 30 to 40 years that's led to a massive fall in bond yields. And to some degree we are now seeing a reversal of globalisation, given the trade tensions with China.



We are experiencing more money printing and a decline in the number of workers relative to consumers, or people in retirement. Put all these factors together and it could lead to higher inflation over the longer term, i.e. beyond any transitory near-term inflation.

Overall, the global and Australian economies still have a way to go before reaching the top of the cycle. The last 18 months have been messy and rough. However, we are still a long way from being at the point of saying things are really booming and central banks really need to slam on the brakes.

With that macro-economic background, where should investors put their money?

Share markets?

As always there are pros and cons for equities markets and the near-term outlook is a bit uncertain but there are more positives than negatives for shares on a six-to-12-month view.

The negatives have helped create volatility in share markets in recent weeks. The coronavirus keeps coming back, especially in regions with lower vaccination rates.

There are ongoing tensions with China. The economic recovery could be slower going forward and there is a spike in inflation, which is pushing bond yields up sharply.

The positives are led by the simple fact that vaccines are helping prevent serious illnesses and allowing economies to reopen.

Also, monetary and fiscal policy is still ultra-easy, and low interest rates make shares relatively cheap. If you put your money into a term deposit right now you can get 0.25 per cent. If you put it into the share market, the dividend yield once you add in franking credits is probably closer to five per cent over the next 12 months.

The US is calmer under President Joe Biden, compared to his predecessor, Donald Trump, and that's helping equity markets. Also, the world's largest economy is undertaking massive fiscal stimulus. A new Cold War with China could be a boost to productivity in the short term.

And finally, company earnings expectations are being revised upwards.

Putting all the positives and negatives together suggests while there might be some short-term volatility, the 12-month outlook for shares is still optimistic.

What about the property market?

There are a number of reasons why the property market has surged again but the big one is low interest rates.

We've had lockdowns in Victoria and New South Wales, but property prices have continued to rise, albeit at a slower rate.

You can debate that the Reserve Bank should be lifting interest rates to settle the property market, but it has to set interest rates for the whole economy, not just residential real estate. So, it seems that it's up to macro prudential measures to slow lending.

Australia has high prices because the population is concentrated in a handful of cities, and there's limited supply of housing in those cities. For many years, the Australian population has risen year after year, but the supply of properties has not risen at the same pace. That's the core reason for the ongoing strong house price rises.

Property prices are still rising in Australia. That's horrible for those not in the property market and it creates big issues for affordability and intergenerational equity.

We expect property prices to rise around 20 per cent this year and seven per cent next year.

For investors, price rises will by mixed across geographies.

What about cryptocurrencies?

While we are optimistic about blockchain technology, we are a bit sceptical on cryptocurrencies and whether they should be considered an asset class. It's hard to see Bitcoin becoming digital cash because it's very expensive per transaction – about $30 per transaction, and it's extremely volatile.

Bitcoin bounces all around the place in the short term so you don't know quite what it's going to be worth at any point in time.

Also, Bitcoin uses a lot of energy, so if you're worried about the environment, it might not be the investment for you. Ultimately governments and central banks could do digital currencies themselves.

Additionally, people already have digital cash on their phones via their credit cards and digital wallets. It costs nothing to run if managed properly with loyalty points, so why would they switch to a digital currency?

The question then becomes whether it's an asset like property or shares that generates income. It's not a capital asset. It might generate yield if you lend it out to traders, but that's not the same thing as putting it in a bank or lending it out to families to get homes or businesses.

So, it's hard to justify crypto currencies in investment portfolios.

Nine rules for investors

There are nine key rules that investors should keep in mind, particularly when there's volatility and uncertainty. Make the most of compound interest. If you want to grow your wealth you have to have growth assets over the long term, unless you don't like the short-term volatility that comes with that, then you have to be more conservative in your investments.

Don't get blown off trying to time the cycle. Corrections are incredibly difficult to pick and most of the time you will get it wrong.

Invest for the long term, diversify and make sure you don't have all your eggs in the one basket. And finally, turn down the noise around investing.

1. Make the most of the power of compound interest.
2. Don't get thrown off by the cycle.
3. Invest for the long term.
4. Diversify.
5. Turn down the noise.
6. Buy low and sell high – selling after a big fall just locks in a loss.
7. Beware the crowd at extremes – shares bottom at the point of maximum bearishness.
8. Focus on investments you understand and that provide decent, sustainable cash flows.
9. Seek advice.

Further information

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