ECONOMICS & MARKETS

The outlook for the 2021-22 financial year

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The past financial year saw a spectacular rebound in returns for investors as the focus shifted from the recession to recovery against a backdrop of policy stimulus and vaccines. But what about the year ahead?

Before jumping into that discussion, it's worth remembering a few of the lessons from 2021. The first is that share markets look ahead. Second is that timing markets is hard. Staying fully invested as markets rebounded despite the recession and ongoing coronavirus scares would have been very difficult at times.

Lesson number three is don't fight the US Federal Reserve or the Reserve Bank of Australia. Despite very low interest rates they still impact investment markets in a big way. Another lesson was that investment valuations need to be assessed relative to interest rates.

And finally, and this one is important, and I say it a lot. Turn down the noise. The noise around investing is now at fever pitch making it very hard to stay focused on long term investing.

With those lessons in mind, what about the year ahead?

Share markets have had strong gains from last year's lows. US shares are up by around 95%, global shares are up by around 85% and Australian shares are up by around 60%. As a result, they are no longer unambiguously cheap, so the easy gains are likely behind us.

There is always a worry list when investing.

Coronavirus is continuing to cause havoc with the global trend in new daily cases starting to head up again, particularly driven by the newer more transmissible Delta and Beta variants. This is particularly evident in lowly vaccinated countries, including parts of Asia, Africa and South America. But it's also evident in advanced more vaccinated countries like the UK, parts of Europe and the US.

Inflationary pressures have increased globally with the re-opening of economies and this is most evident in the US. At the same time central banks are starting to back away from ultra-easy monetary policy.

Peak fiscal stimulus has likely already been seen. And geopolitical tensions between Western democracies and China are arguably continuing.

Fortunately, there are positives as well, and this time around they are likely to dominate.

First, while coronavirus cases may be on the rise again the vaccines are keeping a light shining at the end of the tunnel. They don't appear to be completely effective against getting infected by the new variants, but the evidence suggests they are at least 90% effective in preventing serious illness requiring hospitalisation and causing death.

In the countries that are further advanced in vaccination, such as Israel, the United Kingdom, most of the United States and Europe, this should allow reopening to continue without rising new cases overwhelming the hospital system. Thanks to the vaccines these economies are able to start the process of learning to live with coronavirus.

For those countries further behind in reaching herd immunity – like Australia – it likely means a continuing reliance on snap lockdowns to keep case numbers down and head off bigger outbreaks that overwhelm the hospital system and send economies backwards.

The evidence so far is that snap lockdowns don’t derail the recovery providing they start early enough and are tough enough. And global production schedules point to plenty of vaccines being available later this year enabling Australia and other vaccine laggards to proceed down the same path as other advanced countries late 2021 or early 2022, in terms of avoiding lockdowns.

Second, while inflation pressures have picked up this is mainly evident in the US and largely reflects pandemic related distortions. Other countries including Europe, Japan and Australia are seeing far less of an inflation spike.

Third, this in turn will likely see central banks adopt a gradual pace in removing ultra-easy monetary policy with rates likely to remain low for a long while yet. We don't expect the first rate hikes in the US and Australia till 2023 (and Europe and Japan are a long way behind that) and even then it will take several years to reach tight monetary policy that threatens economic activity and company profits.

Fourth, against this backdrop while we have probably seen the peak in terms of growth momentum globally, the recovery is likely to continue as the rollout of vaccines progressively allows more countries to safely reopen.

Finally, while traditional valuation measures for shares show them to be expensive, they continue to look okay relative to still lower bond yields. This is particularly evident in Australia with a grossed-up dividend yield of 5 per cent or so for the year ahead well above bank term deposit rates of around 0.5%.

The big question is what will returns look like in the 2022 financial year?

- While there is a risk of a short-term correction in shares and returns are likely to slow from the pace of the last year, overall returns from well diversified portfolios are still likely to be reasonable over the next 12 months.

  Shares are expected to see reasonable returns helped by strong economic and earnings growth and still low interest rates.

- Cash and bank deposit returns are likely to remain poor as the RBA is expected to keep the cash rate at 0.1%.
- Low starting point yields and a capital loss from gradually rising yields are likely to result in low returns from bonds.
- Unlisted commercial property may still see some weakness in retail and office returns but industrial is likely to be strong. Unlisted infrastructure is expected to be solid.
- Home prices are expected to rise 20% this year but slow to 5% growth next year as poor affordability, rising fixed rates, tighter lending standards and reduced population growth impact.
- And the Australian dollar is likely to trend up in line with global recovery and strong commodity prices.

A final note. Investors will need to keep a close eye on COVID-related hospitalisations and deaths in more vaccinated countries. They will be the key metrics going forward. Other things to keep watch on include inflation, central banks, growth momentum and tensions with China.