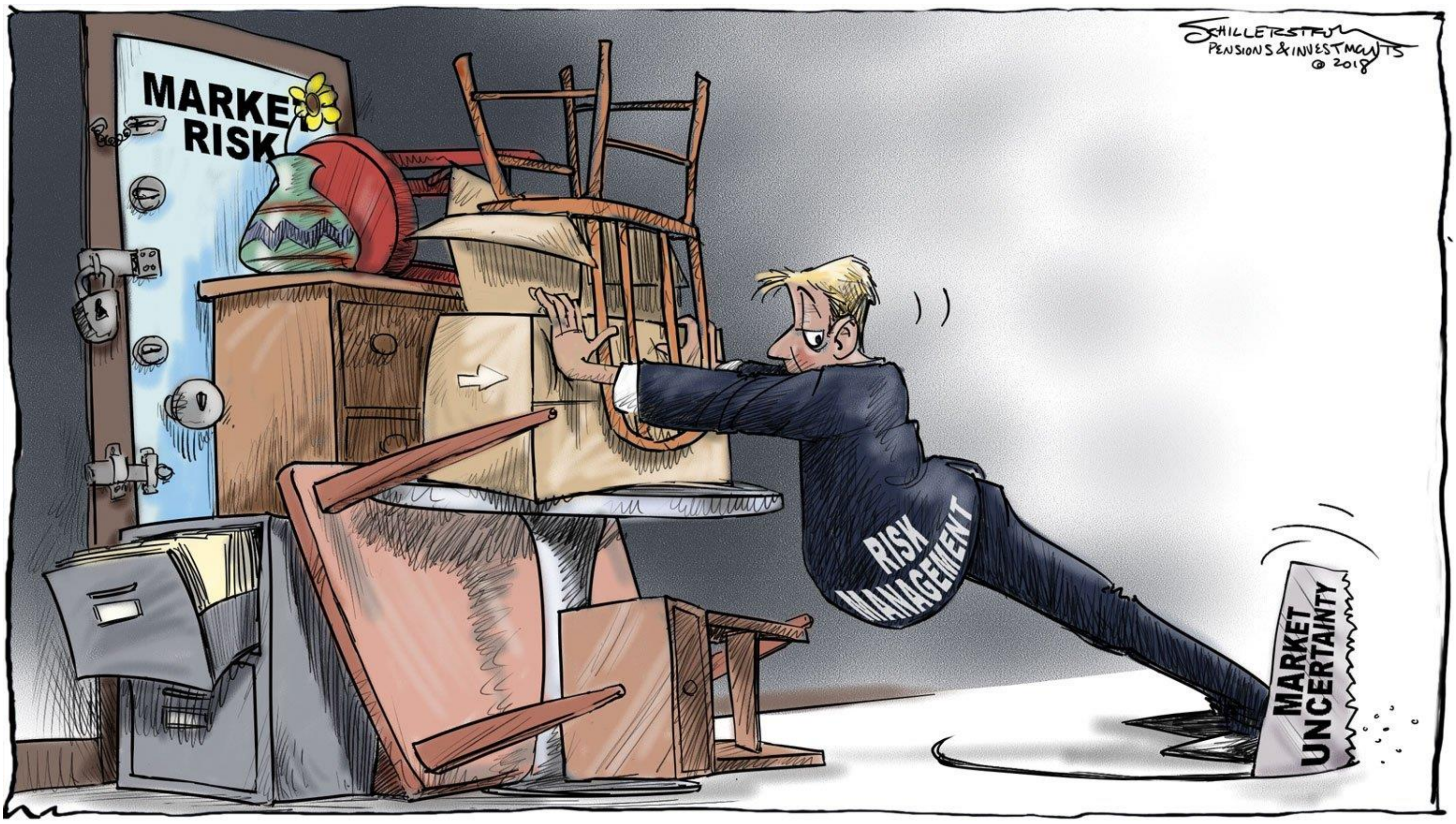
INVESTING DURING EXTREME UNCERTAINTY



INVESTING DURING EXTREME UNCERTAINTY

BY PAUL MIRON

As we return to work after a Federal Election and the appointment of a new government, there still seems to be no end in sight regarding the war in Ukraine…not to mention an energy crisis, world food shortages, supply chain issues…COVID-19…and rising costs of living, with persistent high inflation, and to top it all off – the prospect of further interest rate hikes. It seems that our economic future has never been more uncertain. Or are things really all that bad for investors?

Amidst the macroeconomic upheaval in the global economy, the question of the day is, “How does one remain calm, continue to be invested strongly, and actually take advantage of these changes in the global economic cycle?”

It all comes down to understanding risk and aligning your investment decision-making with a rational and disciplined risk-reward philosophy.

How Heightened Risk can Increase Market Awareness

An analogy can be drawn from a social experiment conducted some years ago in Drachten, Holland, by a traffic engineer named Hans Monderman.[1] He removed all traffic signs, speed control, and traffic lights in this city. Naturally, you would expect complete chaos to have ensued. Almost completely counter-intuitively, both fatality rates and car accidents reduced, while traffic flows improved. Why?

It all comes down to personal risk assessment; when drivers have a constant level of heightened risk awareness, they become better judges of risk…more careful and prudent. Consequently, they become MORE cautious in an environment with fewer road signs and other traffic measures to falsely give you comfort and bombard you with colourful (but perhaps distracting) information.

[1] https://www.wired.com/2004/12/traffic/.

Precisely the same concept applies to investing. When investors are constantly thinking about risk, being self-reliant and filtering through market noise cautiously, investor behaviour changes for the better, resulting in better investment decisions.

It also demonstrates an essential truth about life and investing – **risk is a constant** – whether you are driving on a crowded highway or investing your hard-earned money.

What changes is both our attitude and reaction to risk. Suppose the market does not place a high value of risk on an investment. This investment will then become too risky as investors become more careless and speculative, thereby mispricing the asset. This results in a dislocation in the market, creating either an opportunity or a bad investment.

Macroeconomic Forecasts

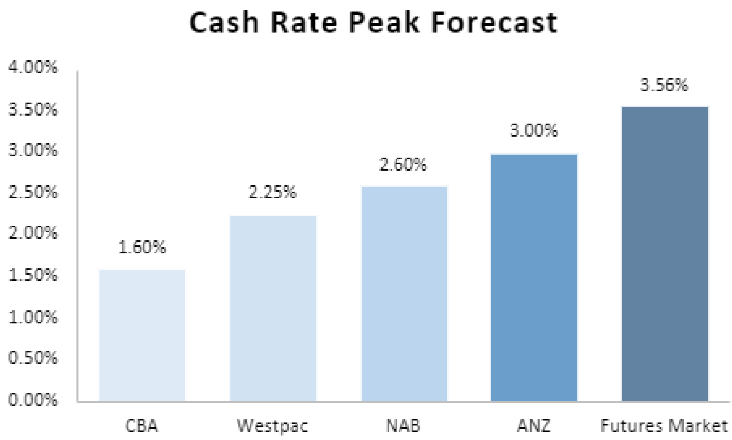
Investors are often lulled into a false sense of security based on what other people are forecasting and thinking, meaning that they are often caught up in speculative investment trends, often with undesirable outcomes.

I am astonished by the current significant economic events. We have not seen a sharper contraction in both stocks and property values for a long time.

The most pressing economic issue impacting all investors is the nexus between inflation and interest rates. How far will the RBA go in raising interest rates to curb inflation? This is now the centrepiece of all forecasts and market predictions. If rates are raised too quickly and aggressively, it increases the risk of an exceptionally prolonged recession. If our central bank is too lax, the inflation we are experiencing may morph into something more disturbing, such as stagflation, deflation, or even hyperinflation.[2]

Thus, the question becomes: how reliant are we on forecasts when making investment decisions?

Below are the Big Four bank economists giving their best attempt at a forecast. Interestingly the CBA and financial market forecasts would differ significantly regarding overall asset prices, from notions of a modest correction to a full-fledged market collapse.[3]



Taking the conservative estimate, if the CBA predictions are accurate, mortgage holders' monthly repayments will increase by 14.6%,[4] which is aligned with the last time we experienced a rise in the interest rate between 2002 and 2008. However, if they take the forecasts priced in by the financial market, mortgage payers would be making 39.7% higher monthly repayments.

Risk Tolerance

As per my last opinion piece, Msquared's view is aligned with the CBA forecast; that is, we would anticipate property prices falling 15%. However, our risk tolerance towards new opportunities is more conservative as we continue to prioritise asset preservation. In other words, we have adjusted our risk profile to a more extreme decline in property prices, which is reflected in the opportunities we are providing our investors.

Our new opportunities reflect current forecasts as economists make their best market predictions based on the latest information. This takes into account the inability to predict people's behaviour or erratic future events.

As Voltaire said, "uncertainty is an uncomfortable position. But certainty is absurd".

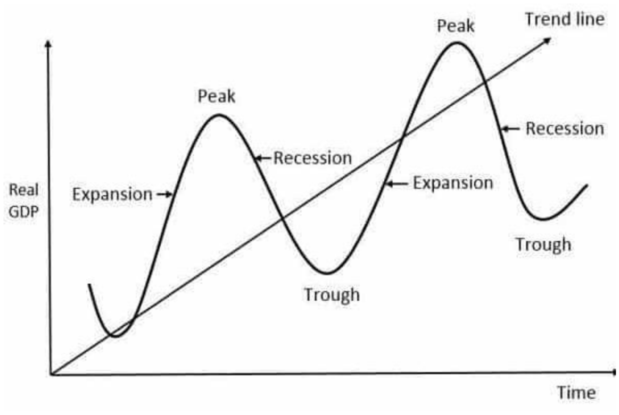
This highlights the impossibility of being able to predict the timing of peaks and troughs consistently, or even the extent, depth and length of recessions and booms.

[2] **Stagflation** – an economic phenomenon characterised by low economic growth and relatively high unemployment.
Deflation – a general decline in prices for goods and services; associated with contraction in money supply.
Hyperinflation – an economic phenomenon where the prices of all goods and services rise uncontrollably over a defined period of time.

[3] https://www.macrobusiness.com.au/2022/05/australias-housing-market-braces-for-record-interest-rate-rise/.

[4] Based on a $600,000 loan size, 25-year term, 2.5% variable rate, cash rate of 0.35%, and that banks pass on the full rate hike. $600,000 average loan size is based on the following source: https://mozo.com.au/home-loans/articles/borrowing-big-australia-s-average-mortgage-size-is-now-just-shy-of-600-000.

The Inevitability of Market Cycles



Embracing the volatile world we live in enables an investor to prepare and navigate uncertainty effectively.

The one thing that is certain is Mark Twain's dire warning that "History does not repeat itself, but it often rhymes". Market cycles have been around since the advent of money, largely a result of people's emotions/sentiments. In other words, the market is not driven solely by economic fundamentals, meaning that it is often directed to random outcomes.

What *is* certain and predictable is that market busts will inevitably be followed by market booms, and vice versa. These cycles will continue as long as people make decisions regarding money – that is – *forever*.

What are the True Fundamentals of Investing?

- Do not be afraid to have your own risk preferences
- Remember to ask yourself whether the risk-reward ratio of a particular investment is suitable for your portfolio
- Do your research and understand the extent of a downside risk for a particular investment – i.e. how probable is the loss of capital and the extent of potential losses?
- Does your portfolio generate solid, stable and reliable income? Remember Albert Einstein's wise words: "Compound interest is the eighth wonder of the world."
- Reposition your portfolio when you see a change in the market cycle
- Ensure you have the liquidity to take advantage of buying opportunities
- Always be invested in the market

Msquared Capital is a private credit provider with investment opportunities backed by quality property along the Eastern Seaboard, we ensure that all investment opportunities are based on risk-to-reward as our core offering. Investors are in the driving seat when it comes to choosing the type of investments, as well as risk and return, via our unique structure and offering.

This gives investors the peace of mind that the Msquared strategy can withstand economic shocks and deliver stable, consistent monthly returns.

If you would like more information, please feel free to contact myself or our dedicated team of professionals at our office with the following details:

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