# Everything’s looking rosy, but it pays to watch for an X-factor


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**ONE of my three golden rules for investing is to allow for major unexpected influences. The X-factors, as I like to call them, can have a big effect — for better or worse — on investment returns. And the other two golden rules? Recognise the inevitability of cycles and enjoy the magic of compounding.**

The X-factors in investment markets have recently been generally positive. They include some things that had been expected to go wrong but didn’t, such as another round of sovereign debt problems in Europe and a serious slowdown in the Chinese economy.

The dominant X-factor in investment markets in the past 12 months is low volatility. That’s thanks to the ultra-accommodating monetary policy and expectations the US economy will achieve modest growth in the next couple of years. And it’s despite the heightened geopolitical risks from Russia’s threats to Ukraine and from recent events in the Middle East — and despite the unexpectedly sharp fall in US GDP in the March quarter because of an extreme winter.

The most watched measure of sharemarket volatility — the VIX index for US shares, which is calculated from option prices — has been unusually stable and low. So has measured volatility in the 20 other national sharemarkets for which similar “fear gauges” are calculated. In bond markets, too, volatility has been well below average levels — especially for the pricing of long-dated bonds. There has also been reduced volatility in foreign exchange markets.

Low volatility doesn’t cause markets to turn down; but it leaves them vulnerable to unexpected bad news. Nicholas Bloom, professor of finance at Stanford University puts it well:

“The fact that volatility is well below its long-run average right now suggests that there is not much downside risk and a lot of upside risk for volatility.

“Many political or other events could send volatility higher — another US political crisis, war in Ukraine or the Middle East, instability in South America of East Asia, or a natural disaster to name a few.”

Many investors would have also been surprised that all major asset classes have delivered positive returns over the financial year. Sharemarket valuations seem now to be neutrally priced or a little expensive — suggesting the next leg-up in average share prices could well await a lift in confidence towards corporate earnings. As a sector, real estate investment trusts again hold appeal to investors hunting for yield.

Prices of government bonds, which move inversely with yields, are currently trading at levels well above those generally expected — including by this commentator — 12 months ago.

The global rally in bond prices has been supported by market expectations that the US will maintain low cash rates for a very long time and by hints of deflation in Europe. In my thinking, the mood in bond markets will become cautious, even negative, as and when strong employment growth or higher inflation are reported in the US.

Alas for Australian investors, interest rates paid on cash trusts and newly acquired term deposits have fallen further over the past year. Prospects for an early increase in our short-term rates are dim.

Despite the sharp slump in iron ore prices (which mainly reflects increased supply) and Senate obstruction of the budget, the Australian dollar is higher than was generally expected. That's because China's economy has slowed only a little (to date at least) and capital inflow remains buoyant. My guess is our dollar will weaken in the next 12 months but not by as much as many people are hoping.

The new financial year will have its X-factors, positive and negative. Appropriate diversification is always sensible — including maintaining a core holding of safe assets — especially when risk assets such as shares are doing so well.

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