Autumn 2019

After one of the hottest summers on record, many Australians will welcome Autumn and the opportunity to be more active outdoors and perhaps get busy in the garden. There will be no let-up in the heat on the political and economic front though, with the Budget and a Federal election looming.

The Australian economy began to show signs of slowing in February, on global concerns about the US-China trade war, Brexit and higher oil prices; and falling property prices locally. The Reserve Bank cut its forecasts for economic growth and inflation in 2019 to 3 per cent and 2 per cent respectively. RBA Governor Philip Lowe said there was no 'strong case' for a near term change in the cash rate from its low of 1.5 per cent.

The economic slowdown is reflected in company earnings. As the profit reporting season draws to a close, 94 per cent of companies reported a profit in the December half, but only 50 per cent increased profits on a year ago. Retail spending is also sluggish, up 0.1 per cent in the December quarter and up 3 per cent over the year. The price of unleaded petrol rose in February, from a national average of around 130.8c a litre to 136.9c last week on rising global oil prices. Brent Crude rose 8 per cent in February to more than US$66 a barrel. Consumer sentiment fluctuates; the weekly ANZ-Roy Morgan survey fell four points over the month to 114.1, still above the long-term average.

On a positive note, unemployment was steady at a 7-year low of 5 per cent in January, while the NAB business conditions survey rose from a 4-year low to +6.6 points in January. The Aussie dollar is roughly unchanged at around US71.5c.

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How to keep ahead of the yield curve

US Interest rates have been making headlines in recent months, but do they really matter to Australian investors? The short answer is they do, a lot.

Changes in US interest rate settings have made a big impact on investment returns from bonds and shares over the past year, while uncertainty about the future direction of interest rates is also weighing heavily on markets.

Where are rates headed?

The US Federal Reserve has increased its federal funds rate (which controls short-term interest rates) nine times from zero in 2015 to 2.5 per cent, as the US economic recovery gathered steam.

As late as last December the Fed was forecasting two more hikes in 2019. Then in early January it announced a 'patient' approach. Respected market observer and former Pimco chief, Mohamed El-Erian now expects the next move will be a cut, but not until 2020.[i]

Over the same period, the Reserve Bank of Australia cut the official cash rate from 2 per cent to a record low of 1.5 per cent. Until recently, the consensus was that the next move would be up, but many economists now expect a rate cut.[ii]

This turnaround in sentiment in the US and Australia is due to weaker economic figures, the escalating trade war between China and the US and fears of a China slowdown. Australia also faces slow wages growth and falling property prices.

Late last year nerves got the better of investors and global shares fell sharply. Shares bounced back in January after the US Fed's about-turn on interest rate policy. But bond markets had been predicting an economic slowdown for some time, due to something called the yield curve.

What is the yield curve?

The yield curve is a graph that plots the yields currently offered on bonds of different maturities, ranging from a few months to 30 years. The yield on a bond is the annual interest paid as a percentage of the bond price.

The 'typical', or positive, yield curve is a gently rising line as maturities increase because investors expect a higher return for the added risk of holding an investment for lengthy periods. A flat yield curve occurs when yields on short and long securities are similar.

The relatively rare inverted yield curve, where short-term yields are higher than long-term yields, looks like a downhill slide.

Market watchers use yield curves, especially of US Treasury bonds, to test which way the economic wind is blowing. A positive yield curve is a sign of continuing economic growth, whereas an inverse yield curve implies that investors expect sluggish economic growth, low inflation and hence lower interest rates.

What is it telling us?

At present yield curves are flattening, especially in the US. While the Federal Funds rate has increased to 2.5 per cent over the past year, the yield on 10-year Treasury Bonds has fallen to 2.68 per cent as bond markets priced in an economic slowdown.[iii]

By suspending further rate hikes, the Fed may have avoided further falls in long term bond yields which would have set off alarm bells in financial markets.

What does this mean for investors?

Interest rates don't directly affect share prices, but they do affect the cost of borrowing and decisions by businesses and consumers which can flow through to corporate profits and share prices.

As for bonds, as interest rates fall on new bond issues, prices rise for existing bond issues paying higher interest.

This helps explain why Australian fixed interest topped the asset class performance chart in 2018, up 4.5 per cent, while Australian shares fell 2.8 per cent.[iv]

Past returns are no guide to future performance; what the past does teach us is the importance of diversification. Returns from bonds and cash may not shoot the lights out but they help cushion the impact of falling share prices.

While the yield curve has proved to be a useful indicator of future economic slowdowns, it is simply a prediction based on current market sentiment and can change direction with the economic breeze.

If you would like to discuss your overall investment strategy, give us a call.

i https://www.cnbc.com/2019/02/05/mohamed-el-erian-fed-next-rate-move-more-likely-a-cut-than-a-hike.html

ii Finder, RBA cash rate survey, 4 February 2019, https://www.finder.com.au/press-release-feb-2019-rba-survey-experts-predict-cash-rate-cut-to-come-not-hike

iii Trading economic as at 28 February 2019, https://tradingeconomics.com/bonds

iv Cuffelinks, edition 291, https://mailchi.mp/cuffelinks/edition-291

Making the most of a windfall

Who among us hasn't daydreamed about receiving a windfall? In reality, people receive large sums of money in the form of inheritances, redundancy payouts and lottery wins all the time. Yet many soon find themselves back in their pre-windfall financial position.

To take a recent example, 28-year-old Victorian Brodie Bond burned through a $220,000 inheritance in 12 months by splurging on drugs, alcohol, clothes and a car (which she crashed).[i]

The wisest use of a windfall will depend on its size and its recipient's circumstances. But here are some broad guidelines for avoiding Brodie's fate.

Splurge (a little bit)

You're going to want to live it up a little. That's fine, but make a deal with yourself to spend, say, at most 10 per cent of the windfall on a new car or family holiday. Then devote the other 90 per cent to investments that will facilitate long-term financial security.

Pay down debts

Before you start looking at investments, it makes sense to clear non-productive debts beginning with the one with the highest interest rate, such as a credit card. Then look at non-tax-deductible debt such as your home loan.

Paying off the mortgage has emotional as well as financial benefits – the sense of security that comes with owning a home is priceless. Yes, while mortgage interest rates are low you might get a better return investing elsewhere, but you'll have money to plough into other investments after slashing your housing costs. Plus, those who receive a windfall while they still have a substantial mortgage can save hundreds of thousands in interest by paying back the bank early.

Top up your super

If you are close to retirement or already have substantial equity in your home, you might top up your super.

If you received a large windfall, you could make an after-tax (non-concessional) super contribution of up to $300,000 in any three-year period, for those aged under 65 depending on your superannuation balance.

You can also make tax-deductible (concessional) contributions of up to $25,000 a year, including contributions made by your employer. You may also have the option of combining five years concessional contributions and depositing up to $125,000 in any one year.

The pro of super is that it is a tax-effective home for your retirement savings. The con is that you can't access your money until you reach retirement age.

Start (or grow) an investment portfolio

Over the long term, it's hard to get a better return on your money than buying growth assets such as shares and property.

While past performance is no guarantee of future returns, during the 20 years to December 2017, Australian shares returned (before tax) 8.8 per cent a year and residential investment property returned 10.2 per cent.[ii]

In recent years, technology has made it much simpler and cheaper to trade shares. The advantage of investing directly in the sharemarket (rather than indirectly through your super fund) is that you can sell your shares and access your money whenever you want. The disadvantage (which also applies to investment property) is that you'll have to pay capital gains tax on your profits at your marginal rate, less a 50 per cent discount if you hold the investment for more than 12 months.

Historically, Australians with spare capital have been inclined to purchase an investment property. Around two million Australians own one or more.[iii] Australia's major property markets are currently deflating, but this may offer good buying opportunities down the track.

Final tip – don't get carried away

Humans seem prone to blowing windfalls. Academic studies suggest people take bigger risks with money that arrives out of the blue than with money they've had to work for.[iv]

Post windfall, after you've celebrated your good fortune, discuss your changed circumstances with your spouse and, where appropriate, other family members. Avoid the temptation to do anything rash, such as quit your job. Your investment strategy will vary depending on your circumstances but, whatever it is, keep in mind Warren Buffett's two investment rules.

Rule One: Never lose money.

Rule Two: Never forget Rule One.

If you'd like some advice on how to make the most of a windfall, please call us.

i https://www.news.com.au/lifestyle/health/health-problems/brodie-bond-wasted-her-220k-inheritance-on-ice-booze-and-clothes/news-story/27f8f858d13c4f4b90599a0f15c74191?from=rss-basic

ii https://www.asx.com.au/documents/research/russell-asx-long-term-investing-report-2018.pdf

iii https://www.corelogic.com.au/resources/pdf/reports/CoreLogic%20Investor%20Report_June%202016.pdf

iv https://marketbusinessnews.com/financial-glossary/windfall-gains-definition-meaning/

NAVIGATING love & money

Money makes the world go around. But when it comes to relationships, it can sometimes stop them in their tracks.

Navigating love and money can be tricky, but it's simpler when you learn to communicate about finances in an open and transparent manner. Sometimes easier said than done, we know, but with a few simple tools you could end up reaching your mutual goals sooner and finding more fulfilment in your relationship.

Honesty – the best policy

We're conditioned as children not to talk about money. It's rude to ask someone's salary, and unbecoming to whinge about finances. There's often good reason for keeping mum around friends and acquaintances, but in intimate relationships, things are a little different. Being transparent about finances with your partner in general leads to better outcomes. Shaking habits we've learned as kids can be difficult, but getting used to communicating about money is well worth it in the long term.

So, with that said, let's look at some ground rules:

1. **Don't keep financial secrets.**
2. **Consult on big purchases.**
3. **Talk about how you were raised and what informs your attitudes towards money.** Chances are your relationship to money either mirrors your parents or is a rebellion against either their perceived thrift or carelessness.

Shared dreams/ mutual enemies

Budgets, like new exercise regimes, work best when you have someone to hold you accountable. That said, when it all just becomes about numbers on a spreadsheet and saving every last penny, things can start to look a bit bleak.

Try instead to reframe the conversation. Chances are you and your partner are together because you share the same tastes and values. Logically then you might have similar dreams. Talk about your goals together and use them as your focus in money talks. It's much more attractive than scrimping for scrimping's sake.

Similarly, if you both have debt, you can make it a team effort to pay it down. There's nothing so unifying as a mutual nemesis.

It's never too early or too late

Money is an ever-present force in our lives and the sooner you have 'the chat' the better. Okay… so maybe not your first date. But in any relationship, there are a series of milestones which present an opportunity for the talk.

If it's early days, first joint holiday, moving in together, or opening a shared account are all good times to start the dialogue. Or, if you're already well into your partnership, buying a house, saving for your children's education and preparing for retirement might prompt a chat.

And it's not a conversation you only have once and then forget. Endeavour to make time to touch base on a regular basis—once a month is a good starting point. This will allow you to check in regularly rather than only dealing with differences in approach at times of financial emergency.

Remember too that just because a particular savings method works for you doesn't mean it will necessarily work for your partner. Keep in mind what informs their approach towards money and use this knowledge to shape budget plans.

And don't fret if you're in a long-term relationship and you still haven't quite got the money talk down pat. It's a conversation that changes over a lifetime as your goals, expectations and circumstances change. However, if money is becoming a source of resentment in your relationship, remember it's never too late to open up the dialogue.

At the end of the day, we will all experience conflict over money at some point in our life, but by making financial communication a regular and comfortable thing, you'll likely de-escalate these situations before they blow out of control.

If you and your partner would like to talk about your joint financial goals, give us a call.