Pitcher Partners

Wealth Update

Summer 2020/21

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Welcome to our latest Wealth Management Update.

This edition covers the following topics:

- The economics behind low interest rates
- Prospective portfolio returns in a low interest rate world
- Child superannuation contributions

The economics behind low interest rates

We are often asked why interest rates are so low, what is a negative interest rate and when will rates rise again. In this article we explain the economics behind low interest rates, consider what the Reserve Bank of Australia is aiming to achieve and explore whether interest rates are likely to rise again in the near-term. We have attempted to explain the core factors at play while keeping it easy to understand, however if you have any questions please don't hesitate to contact us. It's also worth noting that there's different views on the way the economy works so some may disagree with our view on the world.

Nirvana

To begin with, it's worth considering what an ideal economy is likely to look like. This "nirvana" is an economy where inflation is relatively stable, most people can find gainful employment and economic growth improves our collective living standard. People can obtain the goods and services they require at prices they can afford, while still generating a profit for the companies they purchase from. Stable inflation and sustainable profit incentivise businesses to continue investing in new projects, which provides jobs to the workforce. Additionally, the local currency (Australian dollar) is relatively stable, balancing our purchasing power for imports while remaining an attractive producer for other countries to purchase from (our exports).

Economic shocks

Economic shocks are typically unforeseen events that have a wide-spread impact and move the economy away from the above described "nirvana". These shocks can come from any number of sources with recent examples being:

- **Global Financial Crisis:** a string of worldwide financial vulnerabilities that were exposed by a housing price correction in the US.
- **COVID-19:** a global pandemic resulting in closures to large parts of the real economy, job losses and large falls in investment markets.

Result

The impact of an economic shock can be wide-reaching and varies depending on the cause, however the overall uncertainty has detrimental outcomes. Each of which feeds into the other and can be self-perpetuating (a downward spiral):

- Investors simultaneously move from assets such as shares and property, into more stable investments, such as bank deposits and government bonds, causing a sharp fall in investment markets.
- Businesses are cautious about the future and seek to reduce wage costs (job losses) and cut spending on new projects.
- Consumers, now feeling less wealthy and uncertain about job security, begin spending less and saving more ... and the cycle continues.

What action does a Government take?

The Government (hopefully) steps in using two key measures:

- **Fiscal policy:** To stimulate the economy, the Government takes steps such as:
  - Spending on new projects including infrastructure, healthcare or education. This creates jobs and wages, giving consumers confidence to begin spending again.
  - Reduces taxes to allow workers and business to retain more of the money they earn, increasing take-home income and encouraging spending.
  - Increasing Government payments as seen recently with job-keeper and job-seeker payments.
- **Monetary policy:** Broadly this takes two forms:
  - The Reserve Bank (known as Central Bank) reduces the "cash rate". This is the more common approach and the focus of this article.
  - More recently, the less traditional approach of quantitative easing.

The economics behind low interest rates (cont.)

The Reserve Bank of Australia (RBA)

To explain why interest rates are low, I'm going to focus on the "cash rate" in this article. The cash rate is known as the official interest rate and is controlled by the central bank, which in Australia is the RBA. Broadly speaking, the RBA's primary objectives are to keep Australia in that nirvana situation described initially:

- Stable inflation and Australian dollar (relative to trade partners)
- Low unemployment
- Growth to improve the prosperity and welfare of Australians

Setting the cash rate is one of the RBA's key tools to achieve its objectives. The cash rate influences the economy in several ways:

- Interest rates on saving (bank deposits) and borrowing (loans)
- Asset prices i.e. houses, shares or your super fund value
- Exchange rate
- Expectations and confidence

For each point, I've provided a simplified explanation of the impact of lower interest rates below.

1. Saving and borrowing

Savers: The return you receive from saving money in a bank account is much lower. This disincentivises saving and it is hoped that consumers instead spend their money, which stimulates the economy.

Borrowers: The cost of a personal loan or credit card spending is reduced, further increasing the likelihood that people will buy that new car, handbag or television. Businesses may choose to borrow to fund a new project, which creates new jobs in the process. Again, this increases economic activity.

2. Asset prices

Consider a stock that pays a 4.5% dividend yield, an investment property that pays a 3.5% rental yield and a bank deposit that pays a 2% interest rate. If bank deposit rates are then reduced to 1%, more people will choose to buy stocks and property for the higher yield. The increased demand pushes share prices and property prices higher, including your super fund value which owns these. Existing asset owners begin to feel wealthier, which increases the likelihood that they will spend money in the economy.

3. Exchange rate

Hypothetically, if the interest rate in the US is 3% and the interest rate in Australia is 2%, large international investors would prefer to move their money to the US to achieve a higher return. To do this they need to buy US dollars and sell Australian dollars, reducing the demand for Australian dollars and leading to a lower exchange rate.

The lower exchange rate reduces the cost to Americans of buying Australian goods, so they may choose to buy more Australian produced goods and services. With a lower exchange rate, Australian exports should increase and imports decrease, creating a positive flow of money into the Australian economy through local businesses that provide jobs to Australian people.

4. Confidence

Low rates imply that the interest cost of loans and debt is reduced. This is hoped to boost business confidence that they will profit by borrowing to invest in new projects and encourage consumers to spend rather than save or repay debt. The RBA can broadcast its expectations on future interest rates to provide additional certainty on the future path of interest rates, making the future less of an unknown.

Should we be worried about "negative interest rates"?

Our commercial banks (CBA, Westpac, ANZ, etc.) can deposit their excess money with the RBA and receive interest in return, similar to your own bank deposits. If the RBA's interest rate was to be below zero, every deposit with the RBA would cost the commercial bank money. Thus, a negative interest is intended to encourage commercial banks to lend money to businesses and consumers, where they receive a higher return than putting the money with the RBA. To date, banks have been reluctant to move to negative interest rates on consumers bank accounts. The effectiveness of negative interest rates remains debated among economists. The RBA has at times ruled out negative rates in Australia, but it has occurred in parts of the world.

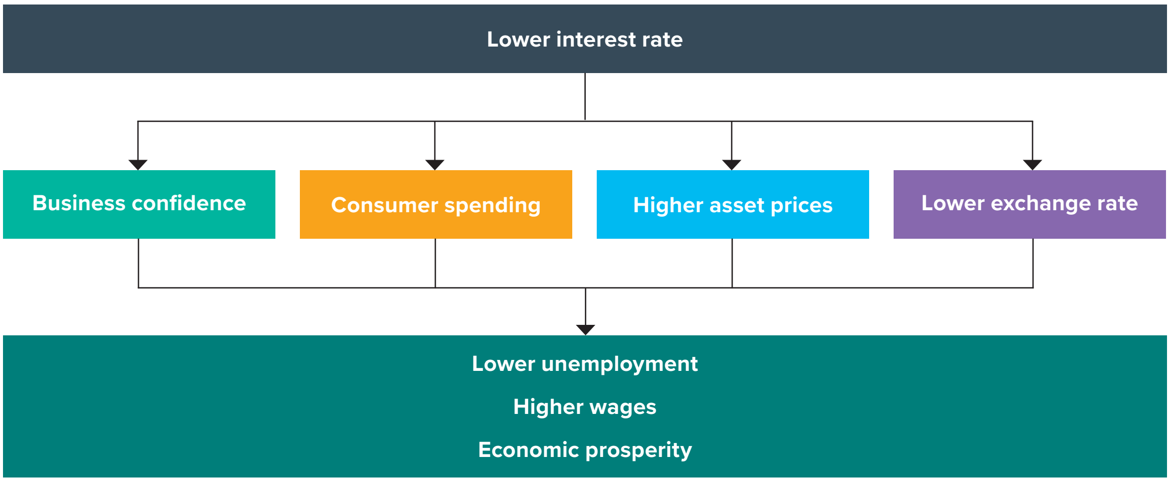
The *real interest rate* should be of more concern to savers, that is the nominal interest rate (interest rate on your bank deposit) minus the rate of inflation. As the RBA forecasts inflation to be 1% over the next 12-months, money invested in a bank deposit with interest rate of less than 1% has negative real interest rate. This means the bank deposit is losing its purchasing power, or put another way, the return is not keeping pace with the increasing cost of living.

The economics behind low interest rates (cont.)

Conclusion

Reducing interest rates is a measure undertaken by the RBA to boost the economy. The aim is to move back toward a lower unemployment level and a sustainable environment where Australians enjoy economic prosperity and a high quality of life. The RBA has flagged its intent to keep interest rates low for the foreseeable future and for as long as it deems necessary. Before the RBA lifts the cash rate, we would expect to see increasing confidence levels, lower unemployment, wage growth and confidence that inflation is sustainably within the RBA's target band of 2-3% p.a.

Retirees can be negatively impacted by low interest rates if their life savings are held in bank deposits generating a substantially lower return then past years. Retirees can look toward investment markets to generate a higher level of income and overall return. However, there is no free lunch in investing: higher return comes with higher risk and I'd be sceptical of anyone suggesting otherwise. Understand the risks you take and diversify your asset base to protect your financial position from unforeseen events. Importantly, understand your cash flow requirements and ensure you have sufficient liquidity to meet this. Seeking professional advice is always recommended.



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Prospective portfolio returns in a low interest rate world

Background

Interest rates plumbed new lows in November with a further cut to the official rate of 15 basis points to a level of 0.1%. The accompanying statement from the Reserve Bank of Australia (RBA) noted that, as employment and inflation expectations (and by extension, wage growth) over the next few years are muted, monetary and fiscal support is expected to be required for some time, leading to interest rates being kept on hold for at least three years. This view was re-affirmed in December's RBA statement, which accompanied the monetary policy decision to leave interest rates unchanged at the effective lower bound of 0.1%.

The shift to a lower for longer interest rate environment

This very low interest rate outlook has significant implications for prospective asset class returns over the next few years. Whilst supportive of equity prices, low interest rates are a headwind for investors with defensive risk profiles. The returns of defensive asset classes have been historically attractive as can be seen in Table 1, where returns across various asset classes are shown over a period of three decades ($10,000 is assumed to have been invested on 1 July 1990 and the accumulated asset value is the value as at 30 June 2020).

Asset class	Compounded Annual Return	Accumulated Asset Value
Australian shares	8.9%	$130,457
International shares	7.3%	$82,969
US shares	10.3%	$186,799
Australian bonds	7.7%	$93,545
Listed property	7.8%	$95,395
Cash	5.1%	$44,172

Table 1: Accumulated value of $10,000 invested across asset classes in 1990 for 30 years with no acquisition costs and all income reinvested. Source: Vanguard.

An investor with a "balanced" risk profile would typically have an asset allocation, which is likely to not be very different from that shown in Table 2.

Balanced profile	Compounded Annual Return
Australian shares	30%
Listed property	10%
International shares	20%
Australian bonds	15%
Cash and TD's	25%

Table 2: Example of a Balanced Asset Allocation.

Prospective portfolio returns in a low interest rate world (cont.)

The investor with such a balanced asset allocation would have seen an annualised return of 7.34% over the past three decades (this assumes that the asset allocation is performed only in 1990 and not changed or rebalanced over the subsequent 30 years). Not only have interest rates been brought to the lower bound by central banks across the globe, guidance around interest rate expectations has been clear that these low rates will remain in place for many years. This sustainability of low rates will be dictated by subdued inflation readings and continued labour market weakness. Should the labour market strengthen over the medium term so as to induce wage growth, which in turn leads to improved consumer sentiment and a sustained boost to household spending, inflation expectations would eventually need to be reset higher, which is likely to ultimately lead to an increase in interest rates.

Prospective returns over next decade

In the absence of higher interest rates globally, returns from traditionally defensive assets such as bonds, cash and fixed interest are likely to remain low over the next 3-5 years, with the possibility that rates remain well below longer term averages for the best part of the next decade. The balanced investor in our example will likely see negligible returns for the defensive component (40% of the portfolio) of their portfolio. The portfolio return of 5.34% under this scenario is effectively 2% lower than that obtained on an annual basis over the past 30 years (assuming Australian bonds return 2% and cash and term deposits return 0.5% over the next decade). This negative impact would be mitigated to a certain extent by the probable higher return obtained in the equities market as equities are likely to be aided by (i) the ever-increasing search for yield and (ii) the uplift obtained to their Net Present Value (NPV). However, the expected returns on a balanced portfolio are likely to remain lower than those seen in the past.

The investment outcomes for more conservative investors is even more significant. With over half of the portfolio for these investors being allocated to defensive assets, the contribution from the growth assets will drive overall returns. Investment selection for such investors will be even more important than it has for many years.

Conclusion

Low interest rates globally are likely to pressure returns from defensive components of investors' portfolios over the short to medium term. Whilst positive for prices of growth assets, more conservative investors have a relatively small allocation to such assets. Under these circumstances investors will need to carefully consider whether they are prepared to accept potentially lower returns or take on more risk.

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Child superannuation contributions

Child superannuation contributions strategies are often dismissed due to the very long time it takes before the funds can be accessed. In this article, we explore if contributions can be made and whether they are worthwhile.

Can my children make contributions to super?

Superannuation regulations permit a super fund to accept contributions for children under age 18 without restriction, regardless of their employment status. In practice many funds impose restrictions on minors opening superannuation accounts on the basis that minors lack contractual capacity, unless there is an employment arrangement.

Self managed super funds (SMSF's) can also face logistical difficulties. This is because all members of a SMSF must also be trustees. In the case of a corporate trustee, each director of the company is a member of the fund and each member of the fund is a director of the company. Minors are considered to be under a legal disability and cannot be a trustee of a SMSF or a director. However, this issue can be easily overcome if a parent or guardian acts in that capacity on their behalf.

Can my children make tax deductible contributions to super?

Children under age 18 can only make personal concessional (tax deductible) contributions if they have earned income from employment or from carrying on a business. This means that minors that receive trust distributions from wealthy families can't reduce their assessable income (from penal tax rates) by making a tax-deductible contribution.

If you're aged under 18, you are subject to the same caps or limits on your super contributions as an adult. The concessional contributions cap is $25,000 and the non-concessional contributions cap is $100,000 (or $300,000 over a three-year period if you use the 'bring-forward' rule).

Can parents/grandparents make contributions for their children/grandchildren?

A fund may accept contributions made in respect of a member who is under age 18. These can include contributions by parents or grandparents. Contributions made by anyone other than the child or their employer are treated by the fund as a non-concessional contribution. The contributor cannot claim a tax deduction or tax offset for the contribution.

Contributions made on behalf of a child count towards the child's contribution limits and not those of the contributor.

Are employers required to pay employees under the age of 18 super?

Australian employers are required to pay employees under the age of 18 the compulsory 9.5% Super Guarantee on top of that person's wages, if the employee earns more than $450 (before taxes) in a calendar month and works more than 30 hours per week.

Should I consider gifting money to my children/ grandchildren so they can put money into super?

Now that we have established that contributions by minors can be made, the question then turns to should contributions be made.

Preservation rules means that super cannot be accessed by a child until they meet a condition of release. As legislation is currently structured, this is likely to be retirement after reaching age 60. This long-time horizon often precludes super as being a viable strategy given that the child will have more pressing needs earlier in their adult life, such as housing and living expenses.

Nevertheless, the power of compounding is significant over long time horizons and so starting super contributions early in life can provide your children/ grandchildren with compelling retirement outcomes.

Contribution at age 15	Post tax return % p.a	Future Value (at age 60)	Present Value (in today's dollars)
$100,000	8.0%	$3,192,045	$1,309,377
$100,000	7.0%	$2,100,245	$861,513
$100,000	6.0%	$1,376,461	$564,620

Note: Present value assumes an average long term inflation rate of 2%pa.

Please contact your adviser to discuss suitability for your child/grandchild's circumstances.

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Making business ***personal***

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