connect

Summer 2019

Economic update

Global economy

The trade war between the United States (US) and China continued during the September 2019 quarter as the US imposed new tariffs on goods imported from China. In other trade news, the World Trade Organisation found that subsidies provided by the European Union (EU) to Airbus, a leading European global aerospace organisation, disadvantaged the aerospace industry in the US. This led to new US tariffs on European goods, contributing to weaker global business confidence and concern for global economic growth.

Across a number of countries, monetary policy was eased further with cuts to interest rates. Fiscal policy (taxation and spending) also featured in public debate (Germany) and was implemented in certain cases (India). The US and the EU reduced interest rates in an attempt to boost economic growth. The rate of economic growth slowed slightly in China, the US and Europe.

The Markit Global Manufacturing Purchasing Managers Index (PMI), which provides a forward-looking measure of global manufacturing activity, remained in contractionary territory. Similar surveys in the US and China remained positive and improved slightly compared to last quarter. The European economic outlook continued to weaken, which was led by the poor performance of Germany.

Weakness in the EU's services sector prompted a restart of the European Central Bank's asset purchasing program, also known as 'quantitative easing', which aims to increase the money supply and encourage lending and investment.

Australia

In Australia, economic data was disappointing. Economic growth in the June 2019 quarter was 0.5%, which, while in line with expectations, resulted in economic growth of only 1.4% for the 12-month period. This is a decline from the 3.1% growth rate reported in the 2017/18 financial year.

The annual inflation rate was 1.6% for the year-ended 30 June 2019. This is below the Reserve Bank of Australia's (RBA) target of between 2% and 3%.

Both the NAB Monthly Business Survey and the Westpac Melbourne Institute Index of Consumer Sentiment pointed to subdued confidence among businesses and consumers. This has occurred despite the anticipated stimulus driven by the RBA's sequence of interest rate cuts and the Government's tax offsets for lower income earners. The Government may need to do more to reinvigorate economic growth.

The relatively weak economic data may see the RBA make further reductions to interest rates before the end of the year.

Fixed income and currencies

Interest rate cuts contributed to the positive performance of bonds during the quarter. As interest rates fall, bond prices typically appreciate because they offer a higher yield than the cash rate. This enhances short-term returns and increases potential capital gains.

However, this comes at the cost of lower future returns. The Australian 10-year Government Bond is now offering a yield of only approximately 1%. This suggests the possibility of investors receiving lower long-term returns from bond portfolios.

The Australian dollar fell as a result of weaker global growth, RBA interest rate cuts and weaker iron ore prices following increased production in Brazil by Vale, a major iron ore producer.

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The impact of the Reserve Bank of Australia's rate cuts

This year the RBA cut rates by 0.25% in June, July and October. This was for several reasons. The RBA was responding to a weaker global economy and was concerned about how this would impact the Australian economy. It also hoped that by cutting interest rates it would lower unemployment without increasing inflation substantially. And a third reason was to stop the Australian dollar rising too much, which would impact our exporting businesses against countries such as New Zealand which had already cut interest rates substantially.

RBA rate cuts have different impacts across the economy. Some groups and areas benefit while others are disadvantaged. These include:

- **Borrowers:** The majority of bank lending is for housing. Lower interest rates, provided they are passed on by banks to borrowers, reduce mortgage repayments and improve borrower spending capacity. The hope is for increased consumer spending to support economic growth.
- **Savers:** Savers are penalised by lower interest rates because they receive less interest income. This disadvantages retirees and people with large amounts of cash held in bank accounts or conservative investment portfolios.
- **Property market:** Lower interest rates increase potential borrowing power and help to increase property prices. They also make property, with its potential for higher returns, more attractive than other safer investments such as cash. As a result, following the rate cuts, we have seen price rises in the Sydney and Melbourne property markets.
- **Consumer spending and sentiment:** If consumers feel confident about their future prospects, rate cuts can help encourage further spending. Or, interest rate cuts can have the opposite impact where too many cuts make consumers feel concerned about economic growth. Recently this has occurred with consumer sentiment falling to below-average levels after the three rate cuts.
- **Business investment:** Rate cuts make it easier for businesses to borrow at lower rates of interest or to issue bonds with lower yields. While this can encourage business spending this is typically only true if businesses are already struggling from a high cost of capital. If that is not the case then any impact on business investment is likely to be minimal.
- **Economic growth:** To grow the economy, rate cuts can be seen as a supply-side solution by making borrowing easier. If access to credit is not a major issue for consumers or businesses then the impact is limited. This may mean the Government needs to implement demand-side solutions, such as investing in transport and other infrastructure, that directly encourage more spending within the economy.

Source: IOOF

Two common errors investors make…and how to overcome them

Understanding compounding and portfolio rebalancing could have helped investors overcome emotion-driven decisions during a turbulent six months for stock markets. Duncan Lamont shares why.

The past six months have highlighted two common errors that investors frequently make - misunderstanding the way investments compound over time and letting emotions cloud our judgement. With the right knowledge, both can be remedied relatively easily.

The impact of compounding

The US stock market fell by 13.7% in the fourth quarter of 2018 but has since rallied by 13.9% this year so far (as of 12 April 2019). 13.9 is more than 13.7 so that means investors are up overall, right? Wrong. Investors are actually down by 1.7% over this period.

A 13.9% return on $100 would indeed lead to a gain of $13.90, if the investment was made at the start of 2019. But, in this situation, a $100 investment made at start of October 2018 has fallen by 13.7% by the year end, to $86.30. As a result, you have less capital to earn that 13.9% return on. Instead you only make back $12.00 (13.9% x 86.30). This takes your final amount to $98.30.

While this may seem a bit abstract, understanding the difference between arithmetic returns (i.e. adding them together) and geometric returns (i.e. compounding them together over multiple periods) is key in preparing yourself to make informed decisions.

Keeping your investments balanced

The end of 2018 was a difficult time to be investing in the stock market. Stocks fell sharply, sentiment was rock bottom and the immediate emotional response would have been to sell. However, during this time earnings-based measures of valuations had fallen to their cheapest levels for several years and markets rallied sharply from that low.

With hindsight, it would have been a great time to invest. But, we are hard-wired as emotional beings so overcoming the urge to sell is not easy. One way to take emotion out of the equation entirely is to follow a rebalancing policy.

Rebalancing starts with deciding what percentage of your investments you want in the stock market, bonds, cash, etc. If one asset class outperforms the others, its weight in the portfolio will rise. A rebalanced portfolio would then sell some of the specific winner, to bring its weight back to where it was initially intended it to be and reinvesting the gains in assets that have under-performed. Remember to speak to your financial adviser before deciding if this is right for you. This is essentially "buy low-sell high" in practice.

Source: Schroders

Be conscious of how you invest in equities during the 'retirement risk zone'

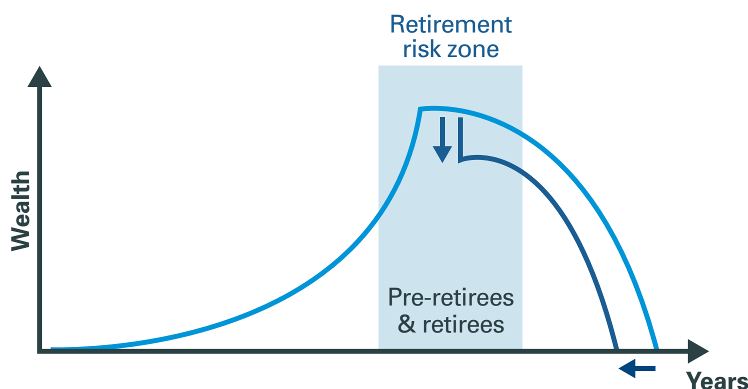
In the years just before and after your retirement is a period known as the retirement risk zone. It's a decade when your nest egg is likely to be its highest.

There is probably no other time when your financial wellbeing is at risk to a sudden decline in value of your nest egg – simply because it's at its peak balance. This is known as sequencing risk. A 5% decline in equity markets during this zone is not uncommon, and it can have a huge impact and shave years off a retirement portfolio, simply due to bad timing. Put it this way, it's worse having a bad performing year when you have more money, than when you have less.

This period is shown in the chart to the right.

It is during the years in this retirement risk zone that financial advice offers its greatest value.

And this period demonstrates why portfolio strategy for retirees is more about protecting capital as much as possible (and that still means investing in equities), and less about shooting the lights out with total return performance.



How do you get your equities?

There seems to be three broad camps when it comes equity investing:

- Direct equities
- Accumulation strategies
- Equity income

Direct equities

A direct holding means an investor holds shares in their own name, most likely via a broker or even a Separately Managed Account.

Accumulation strategies (active or index funds)

The accumulation strategy describes traditional Australian equity approaches designed for pre-retirees that seek to maximise total return and capital growth. In pursuit of wealth, accumulation investors are generally happy to accept a reasonable level of risk volatility in their capital, because they have time to recover and wages can help top up any shortfall.

Even a strong performing accumulation equity fund can still be highly volatile.

And it may not provide adequate refuge from sequencing risk during a decline when it hurts most – the retirement risk zone years when a super balance is highest.

Equity Income

Equity income funds are designed to provide a lower level of risk than accumulation strategies and provide a higher amount of their return as dividend income. Generally, you would expect an equity income to have lower capital volatility than an accumulation fund, and higher income at the same time.

The trade-off is that equity income funds tend to have lower long-term capital growth potential.

Source: Challenger

Gross Domestic Product (GDP) – What does it mean?

What does Gross Domestic Product (GDP) mean? Well, it depends who you ask. If you ask the renowned artist Banksy, it is a means by which trademarks can be registered.

His store of the same name in London exists so that he has a physical address with which to trademark his artworks, without needing to also register (and hence reveal) his true identity. The store stocks an eclectic mix of the most 'gross' homewares the country has to offer.

If you ask an economist, however, the answer to the question is more prosaic! GDP is the main summary measure of the national accounts as compiled, in Australia, by the Australian Bureau of Statistics (ABS). It seeks to quantify local production – this is the 'D' in GDP. Taking the June quarter numbers as an example, they highlight three key points:

1. The value of production: this is the 'P' in GDP. The value of the goods and services used in the production process are deducted so as to avoid double counting, and in the 2nd quarter of 2019 the value of this production was $496bn.

2. The income generated by this production. Australia's gross disposable income in the year to September 2019 was $482bn, and the shortfall with the figure above is mainly due to income paid to foreigners.

3. Of the $482bn of income generated by the Australian economy over the quarter, $368bn was spent on final consumption. After allowing for depreciation of fixed assets of $85bn, this left net saving of $29bn.

Why is Gross Domestic Product measured, rather than simply 'Domestic Product'? The 'G' of course does not correspond with Banksy's definition! Rather, it signifies that the gradual using up of fixed assets like buildings (i.e. depreciation) is excluded. In fact, one criticism of GDP as a concept is that is excludes much more than this. As a result, GDP measures attract criticism from many in society. The national accounts were, however, never designed to be a fully comprehensive measure of well-being. They cannot measure things like the cost of excess pollution, for example. Nonetheless, GDP is the most comprehensive measure we have for now and despite its shortcomings, it does present a wealth of interesting information about Australia's current economic performance.

Source: Perennial

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