



March Quarter 2022

The most recent quarter saw global equity markets enter correction territory for the first time since the outbreak of COVID 2 years ago. Markets, forward looking as they are, finally see interest rate rises crimping the cost of capital, as the economic stimulus around the world is finally pushing demand in an enduring manner.

While the war in Ukraine has been in the headlines, the real economic news is the return of inflation to developed economies globally. Inflation began to feature around October 2021 and was passed off as transitory by many participants. Central banks have largely held fire on rate rises until this year on the basis that they do not want to kill the demand they've been stimulating since the start of 2019. The view now is that inflation is running well ahead of the target 2-3%p.a. level with latent stimulus, supply chain issues and the Ukraine war acting to accelerate price rises. The expectation in the U.S. is for more than 7 rate rises in the next year. Locally the tone is for a slightly slower pace of rate rises. We are carefully watching how the withdrawal of US\$95billion per month by the US Federal Reserve from the U.S economy affects equity prices. Similar, albeit smaller stimulus removal programs are occurring in other developed economies. There is a high likelihood that volatility will return to asset prices. Essentially, when free money is no longer available assets have to be priced on more traditional metrics. For investors, volatility is both threat and opportunity. Property is a perfect example, interest rates act to push down prices while inflation is usually good for property prices.

Locally, our economy has emerged from the Omicron news that dominated markets with more momentum than we've seen in many decades. Demand for Australian agricultural and natural resources is currently at an all time high. Current demand for our exports are akin to levels seen in the 1970's. Historically, such times lead to large increases in economic prosperity for the Australian population. Real wage growth flows, unemployment remains low and governments can both spend and save at the same time! The lucky country again perhaps? Returns for the 9 months are below:

All Ordinaries: 7789, up 204 points or +2.68%;

Listed Property Accumulation 200 Index 64525, up 3717points or +6.1%;

90 Day Bank Bills 0.23%, up 0.03% or 760%

AUD vs U.S. Dollar \$0.7480, up 2.22cents or 3.10%;

Dow Jones Industrial Avg, 34707 points, down 1631 points or -4.48%

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WHAT'S UP WITH INFLATION?



Fears of a resurgence in inflation has been the big topic of conversation among bond and sharemarket commentators lately, which may come as a surprise to many given that our rate of inflation is just 1.1 per cent. Yet despite market rumblings, the Reserve Bank appears quite comfortable about the outlook.

Inflation is a symptom of rising consumer prices, measured in Australia by the Consumer Price Index (CPI). The RBA has an inflation target of 2-3 per cent a year, which it regards as a level to achieve its goals of price stability, full employment and prosperity for Australia.

Currently the RBA expects inflation to be 1.5 per cent this year in Australia, rising to 2 per cent by mid-2023.ⁱ Until the inflation rate returns to the 2-3 per cent mark, the RBA has said it will not lift the cash rate.

US inflation rising

The situation is a little different overseas where inflation has spiked higher. For instance, US inflation shot up to an annual rate of 5 per cent in May, the fastest pace since 2008, up from 4.2 per cent in April.ⁱⁱ As experienced investors would be aware, markets hate surprises. So with inflation rising faster than anticipated, share and bond markets are on edge.

But just like the RBA, the Federal Reserve views this spike as temporary, pointing to its being a natural reaction after the fall in prices last year during the worst days of the COVID crisis. In addition, companies underestimated demand for their goods during the pandemic and as a result there are now bottlenecks in supply that are putting upward pressure on prices.

The central banks believe that once economies get over the kickstart from all the government stimulation, inflation will fall back into line. After all, most world economies went backwards last year, so any growth should be viewed as a good thing and more than likely a temporary event.

But markets are not convinced.

Inflation and wages

Market pundits argue that if businesses must pay more for materials and running costs such as electricity then these increases will most likely be passed on to the consumer.

That's all very well if your wages also rise, but if your income remains static then your standard of living will go backwards as you will have to spend more money to buy the same goods.

This then becomes a vicious circle. If the cost of living rises, then you will seek higher wages; this will put further pressure on the costs for businesses. They will then have to increase their prices further to cover the higher wages bill. Some companies may react by reducing staff levels which will lead to higher unemployment.

Impact on investment

Inflation can also have a negative impact on investors because it reduces their real rate of return. That is, the gross return on an investment minus the rate of inflation.

Rising prices and interest rates also impact company profits. With companies facing higher costs, the outlook for corporate earnings growth comes under pressure.

But not all stocks are affected the same. Companies that produce food and other essentials are not as sensitive to inflation because we all need to eat. Mining companies also benefit from rising prices for the commodities they produce. Whereas high growth stocks like technology companies traditionally suffer from rising interest rates.

Markets current fear is that central banks will tighten monetary policy faster than expected. Interest rates will rise, money will tighten, and this will fuel higher inflation.

Bond market fallout

Expectations of higher inflation has already seen the bond market react, with the 10-year bond yield in both Australia and the US on the rise since October last year.

If yields rise, then the value of bonds actually fall. This is particularly concerning for fixed income investors. Not only are you faced with the prospect of capital losses because the price of your existing bond holdings generally falls when rates rise, but the purchasing power of your income will also be reduced as inflation takes its toll. Investments in inflation-linked bonds should fare better in an inflationary environment.

Inflation is part of the economic cycle. Keeping it under control is the key to a well-run economy and that is where central banks play their role.

Call us if you would like to discuss how an uptick in inflation may be impacting your overall investment strategy.

ⁱ <https://www.rba.gov.au/media-releases/2021/mr-21-09.html>

ⁱⁱ <https://tradingeconomics.com/united-states/inflation-cpi>

Bonds, inflation and your investments

The recent sharp rise in bond rates may not be a big topic of conversation around the Sunday barbecue, but it has set pulses racing on financial markets amid talk of inflation and what that might mean for investors.

US 10-year government bond yields touched 1.61 per cent in early March after starting the year at 0.9 per cent.ⁱ Australian 10-year bonds followed suit, jumping from 0.97 per cent at the start of the year to a recent high of 1.81 per cent.ⁱⁱ

That may not seem like much, but to bond watchers it's significant. Rates have since settled a little lower, but the market is still jittery.

Why are bond yields rising?

Bond yields have been rising due to concerns that global economic growth, and inflation, may bounce back faster and higher than previously expected.

While a return to more 'normal' business activity after the pandemic is a good thing, there are fears that massive government stimulus and central bank bond buying programs may reinflate national economies too quickly.

The risk of inflation

Despite short-term interest rates languishing close to zero, a sharp rise in long-term interest rates indicates investors are readjusting their expectations of future inflation. Australia's inflation rate currently sits at 0.9 per cent, half the long bond yield.

To quash inflation fears, Reserve Bank of Australia (RBA) Governor Philip Lowe recently repeated his intention to keep interest rates low until 2024. The RBA

cut official rates to a record low of 0.1 per cent last year and launched a \$200 billion program to buy government bonds with the aim of keeping yields on these bonds at record lows.ⁱⁱⁱ

Governor Lowe said inflation (currently 0.9 per cent) would not be anywhere near the RBA's target of between 2 and 3 per cent until annual wages growth rises above 3 per cent from 1.4 per cent now. This would require unemployment falling closer to 4 per cent from the current 6.4 per cent.

In other words, there's some arm wrestling going on between central banks and the market over whose view of inflation and interest rates will prevail, with no clear winner.

What does this mean for investors?

Bond prices have been falling because investors are concerned that rising inflation will erode the value of the yields on their existing bond holdings, so they sell.

For income investors, falling bond prices could mean capital losses as the value of their existing bond holdings is eroded by rising rates, but healthier income in future.

The prospect of higher interest rates also has implications for other investments.

Shares shaken but not stirred

In recent years, low interest rates have sent investors flocking to shares for their dividend yields and capital growth. In 2020, US shares led the charge with the tech-heavy Nasdaq index up 43.6%.^{iv}

It's these high growth stocks that are most sensitive to rate change. As the debate over inflation raged, the so-called FAANG stocks – Facebook, Amazon, Apple, Netflix and Google – fell nearly 17 per cent from mid to late February and remain volatile.^v

That doesn't mean all shares are vulnerable. Instead, market analysts expect a shift to 'value' stocks. These include traditional industrial companies and banks which were sold off during the pandemic but stand to gain from economic recovery.

Property market resilient

Against expectations, the Australian residential property market has also performed strongly despite the pandemic, fuelled by low interest rates.

National housing values rose 4 per cent in the year to February, while total returns including rental yields rose 7.6 per cent. But averages hide a patchy performance, with Darwin leading the pack (up 13.8 per cent) and Melbourne dragging up the rear (down 1.3 per cent).^{vi}

There are concerns that ultra-low interest rates risk fuelling a house price bubble and worsening housing affordability. In answer to these fears, Governor Lowe said he was prepared to tighten lending standards quickly if the market gets out of hand.

Only time will tell who wins the tussle between those who think inflation is a threat and those who think it's under control. As always, patient investors with a well-diversified portfolio are best placed to weather any short-term market fluctuations.

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

i Trading economics, viewed 11 March 2021, <https://tradingeconomics.com/united-states/government-bond-yield>

ii Trading economics, viewed 11 March 2021, <https://tradingeconomics.com/australia/government-bond-yield>

iii <https://rba.gov.au/speeches/2021/sp-gov-2021-03-10.html>

iv <https://www.washingtonpost.com/business/2020/12/31/stock-market-record-2020/>

v <https://finance.yahoo.com/quote/%5ENYFANG/>

vi https://www.corelogic.com.au/sites/default/files/2021-03/210301_CoreLogic_HVI.pdf



AVOID THE RUSH

Get ready for June 30

It seems like June 30 rolls around quicker every year, so why wait until the last minute to get your finances in order?

With all the disruption and special support measures of the past two years, it's possible your finances have changed. So it's a good idea to ensure you're on track for the upcoming end-of-financial-year (EOFY).

Starting early is essential to make the most of opportunities on offer when it comes to your super and tax affairs.

New limits for super contributions

Annual contribution limits for super rose this financial year, so maximising your super contributions to boost your retirement savings is even more attractive.

From 1 July 2021, most people's annual concessional contributions cap increased to \$27,500 (up from \$25,000). This allows you to contribute a bit extra into your super on a before-tax basis, potentially reducing your taxable income.

If you have any unused concessional contribution amounts from previous financial years and your super balance is less than \$500,000, you may be able to "carry forward" these amounts to further top up.

Another strategy is to make a personal contribution for which you claim a tax deduction. These contributions count towards your \$27,500 cap and were previously available only to the self-employed. To qualify, you must notify your super fund in writing of your intention to claim and receive acknowledgement.

Non-concessional super strategies

If you have some spare cash, it may also be worth taking advantage of the higher non-concessional (after-tax) contributions cap. From 1 July 2021, the general non

concessional cap increased to \$110,000 annually (up from \$100,000).

These contributions can help if you've reached your concessional contributions cap, received an inheritance, or have additional personal savings you would like to put into super. If you are aged 67 or older, however, you need to meet the requirements of the work test or work test exemption.

For those under age 67 (previously age 65) at any time during 2021-22, you may be able to use a bring-forward arrangement to make a contribution of up to \$330,000 (three years x \$110,000).

To take advantage of the bring-forward rule, your total super balance (TSB) must be under the relevant limit on 30 June of the previous year. Depending on your TSB, your personal contribution limit may be less than \$330,000, so it's a good idea to talk to us first.

More super things to think about

If you plan to make tax-effective super contributions through a salary sacrifice arrangement, now is a good time to discuss this with your employer, as the ATO requires documentation prior to commencement.

Another option if you're aged 65 and over and plan to sell your home is a downsizer contribution. You can contribute up to \$300,000 (\$600,000 for a couple) from the proceeds without meeting the work test.

And don't forget contributing into your low-income spouse's super account could score you a tax offset of up to \$540.

Get your SMSF shipshape

If you have your own self-managed super fund (SMSF), it's important to check it's in good shape for EOFY and your annual audit.

Administrative tasks such as updating minutes, lodging any transfer balance account reports (TBARs), checking the COVID relief measures (residency, rental, loan repayment and in-house assets), and undertaking the annual market valuation of fund assets should all be started now.

It's also sensible to review your fund's investment strategy and whether the fund's assets remain appropriate.

Know your tax deductions

It's also worth thinking beyond super for tax savings.

If you've been working from home due to COVID-19, you can use the shortcut method to claim 80 cents per hour worked for your running expenses. But make sure you can substantiate your claim.

You also need supporting documents to claim work-related expenses such as car, travel, clothing and self-education. Check whether you qualify for other common expense deductions such as tools, equipment, union fees, the cost of managing your tax affairs, charity donations and income protection premiums.

Review your investment portfolio

After a year of strong investment market performance, now is also a good time to review your investments outside super. Benchmark your portfolio's performance and check whether any assets need to be sold or purchased to rebalance in line with your strategy.

You might also consider realising any investment losses, as these can be offset against capital gains you made during the year.

If you would like to discuss EOFY strategies and super contributions, call our office.