

# POWELL TO HIT PAUSE BUTTON?

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28 November 2018

The US Federal Reserve has been increasing rates since 2016 as it implements its normalisation programme. The official US rate, known as the federal funds rate, was slashed to zero in 2008/2009 as the US economy went into a deep recession. The US central bank then kept it there for the next seven years.

However, during the latter part of those seven years, market participants had been led by the Fed to expect rates to rise to more normal levels. The US banking system was no longer at risk, the US economy had recovered and the zero interest rate policy sometimes referred to as “ZIRP”, was no longer appropriate. Thus, the ongoing discussion of monetary policy became not so much about whether rates would rise but by how much.

On 3 October during an interview, Fed Chief Jerome Powell said “Interest rates are still accommodative, but we’re gradually moving to a place where they will be neutral... We may go past neutral, but we’re a long way from neutral at this point, probably.” Powell’s statement suggested not only was there some way before the federal funds rate got to neutral but the federal funds rate could be expected to go higher.

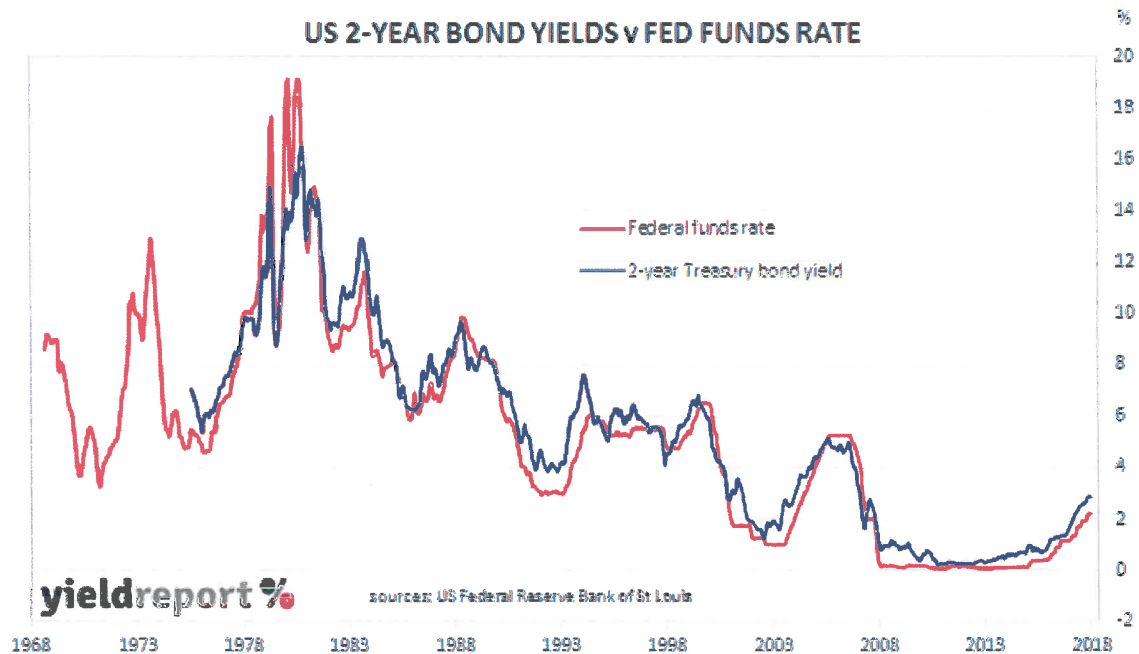
The neutral rate is the rate at which the federal funds rate is neither stimulatory nor contractionary. As such it is a theoretical value; when a country’s economy is struggling, the neutral rate is likely to be lower than when a country’s economy is powering ahead. Different economists will provide different values as to the neutral level at any given time.

When Powell made this statement, the federal funds target rate was (and still is) at the mid-point of the 2.00% to 2.25% target range. A 25bps increase was expected in December, with two or three more 25bps increases expected through 2019.

That appears to have changed. In a speech to The Economic Club of New York on Wednesday night (AEDT), he made some observations which included the following statement. “Interest rates are still low by historical standards, and they remain just below the broad range of estimates of the level that would be neutral for the economy; that is, neither speeding up nor slowing down growth.”

Well, “just below” is a bit different from a “long way”. Observers immediately picked up on the apparent change and effects were seen in the markets for bonds, cash futures and currencies.

2-year bond yields, which are more sensitive to the federal funds rate, fell by 3bps while 30-year bonds, which are more sensitive to inflation expectations, increased by the same amount.



Expectations regarding US Fed monetary policy also moved. A 25bps rise in December is still on the cards; the implied probability of a December rate increase firmed from 73% to 77%. However, the probability of an additional increase in March fell back from 47% to 42% and, if it falls further, will signal a likely slow-down in future rate rises.

In currency markets, the US dollar was noticeably weaker against the euro, sterling and especially the Aussie dollar, where it fell by over 1%.

Westpac's Finance AM team called it "a notable shift" while ANZ economist Jack Chambers went further, saying the Fed was probably going to hit the pause button. "Overall, his speech was taken to confirm that the Fed is likely to temper the path of rate hikes in December, and that it is closer to pausing the tightening cycle than previously thought."

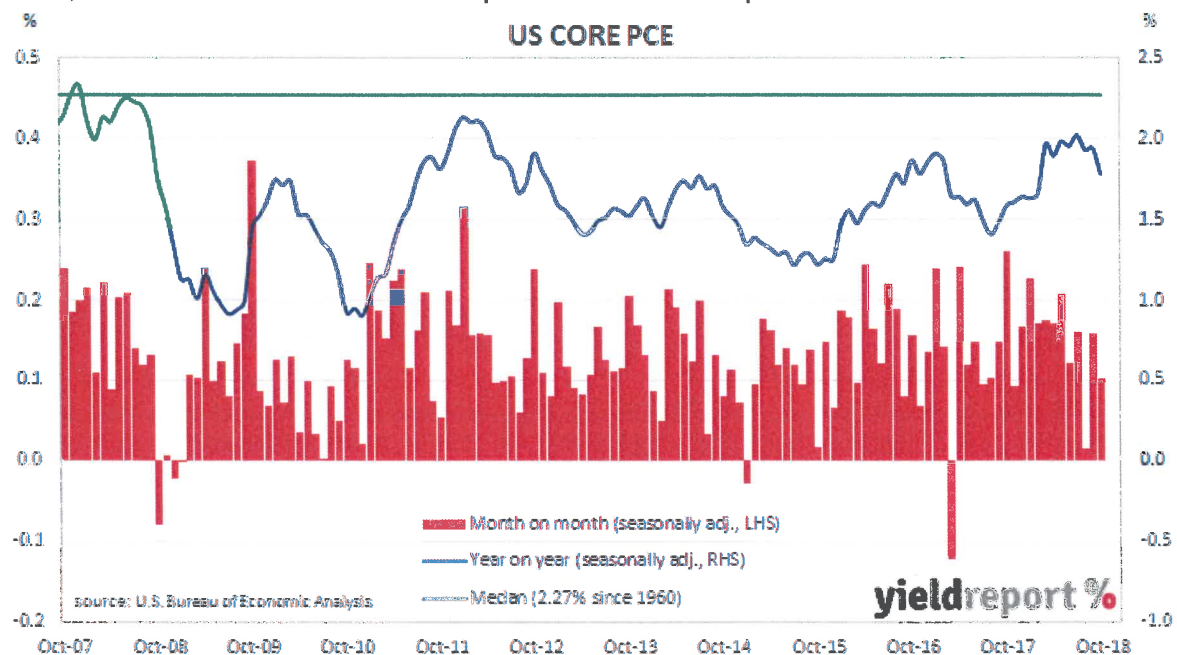
# US PCE FIGURES SHOW “LITTLE EVIDENCE THAT INFLATION IS ACCELERATING”

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30 November 2018

One of the US Fed's favoured measures of inflation is the change in the core personal consumption expenditures (PCE) price index. After hitting the Fed's target at 2.0% in July, the annual rate then slipped a little in August and September.

The latest figures have now been published by the Bureau of Economic Analysis as part of the October personal income and expenditures report. At +0.1% for the month, core PCE inflation was lower than September's +0.2% and lower than the +0.2% consensus expectation. On a 12 month basis, the core PCE inflation rate registered 1.8%, a fall from September's comparable rate of 1.9%.



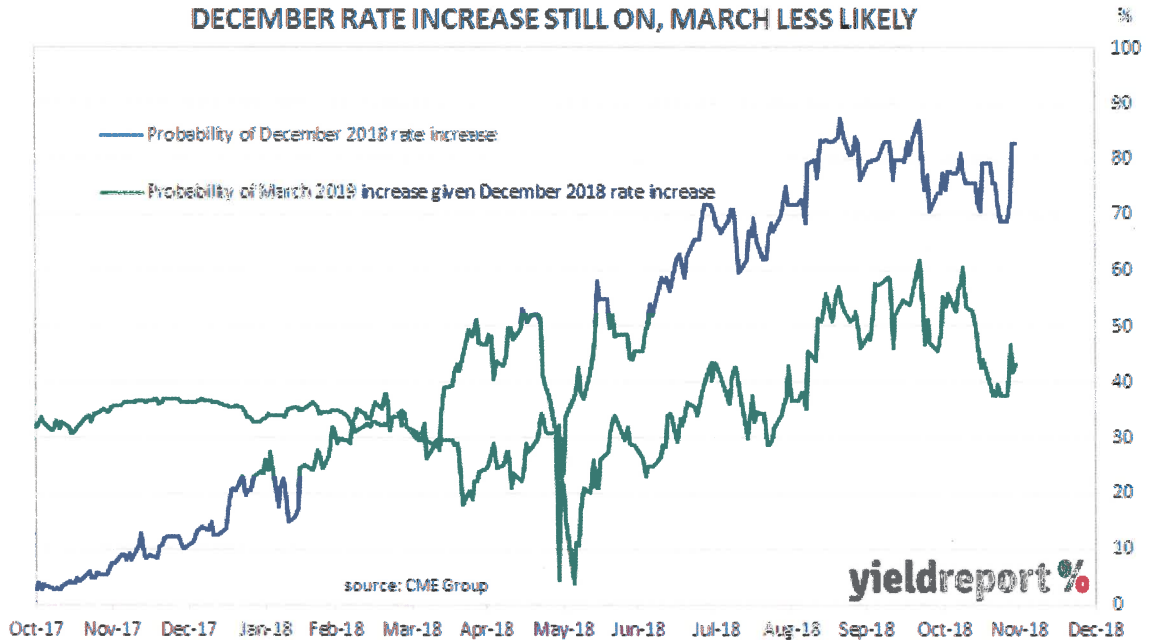
ANZ Head of FX Strategy Daniel Been said the figures confirmed a lack of inflationary pressure in the US. “Despite the tight labour market and recent lift in wages, there is little evidence that inflation is accelerating.”

The core version strips out energy and food components, which are volatile from month to month, in an attempt to identify the prevailing trend. It's not the only measure of inflation used by the Fed; it also tracks the Consumer Price Index (CPI) and Producer Price Index (PPI) from the Department of Labor.

US financial markets were pre-occupied with the upcoming G20 summit in Buenos Aires and the figures had little effect. By the end of the day, 2-year Treasury bond yields were unchanged at 2.81%, 10-year yields had lost 3bps to 3.03% and 30-year yields were 2bps lower at 3.33%. The US dollar was weaker against the euro and yen but weaker against sterling.

In terms of US monetary policy, according to CME Group the probability of an additional rate rise before the end of 2018 was unchanged after the report's release, while the once-expected March increase became a little more doubtful. Cash futures implied a 79% chance of a rate increase in December but the chance of an additional 25bps increase at the FOMC's March meeting moved from 44% to 39%. Historically, whenever cash futures contracts implied a 70% or greater probability of a rate rise, the likelihood of an actual move by the Fed has been high.

### DECEMBER RATE INCREASE STILL ON, MARCH LESS LIKELY



**Economics**

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# Chief economist update: Finding neutral

BY **BENJAMIN ONG** | TUESDAY, 20 NOV 2018 @ 11:07AM

**I commented about the tug-o-war between the bulls and the bears on Wall Street yesterday, and Monday's action on 'The Street' shows they're still tugging and pulling.**

It's so easy to commentate on the day-to-day action on Wall Street these days. Wall Street down ... it's because of the US-China trade war, Brexit, Italy, overvaluation, peak earnings, Fed policy mistake. Wash, rinse, repeat at the next down day.

Wall Street up ... easing trade tensions, good news on Brexit and Italy, China policy stimulus, a gentler Fed.

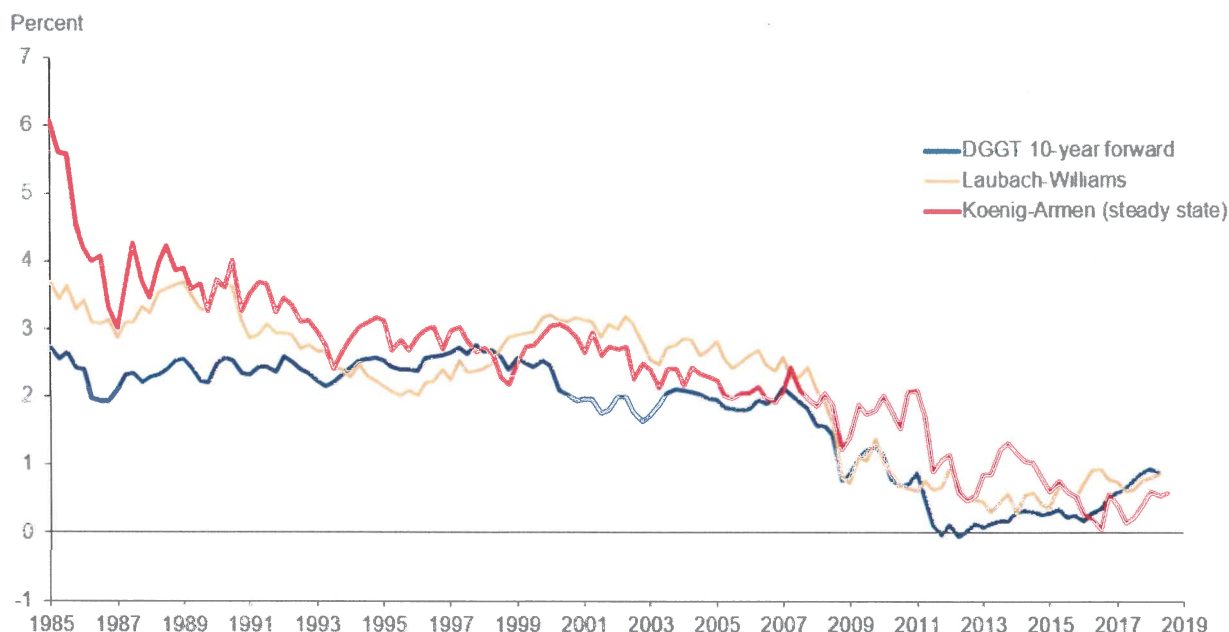
This brings me back to the up on Wall Street on the last day of trading activity in New York last week which, according to reports was underpinned by Fed vice-chairman Clarida's statement that Fed policy is close to neutral as opposed to chairman Powell's earlier declaration that they are "far from neutral".

But where exactly is the neutral level of interest rate?

If I remember correctly, the Fed's last published estimate of the "neutral interest rate" is 2.5% to 3%. All good and yippee-kay-yay for at the current fed funds rate of 2.25% (2%-2.25% to be exact), the Fed needs to raise interest rates by only one to three times (at 25 bps each) before it hit neutral and it's job is done - the Goldilocks state of monetary, neither accommodative nor restrictive.

An essay on "The Neutral Rate of Interest" by Dallas Fed president Robert Kaplan (published late last month) appears to justify the 3% rate. I've cut pasted his chart showing the real level of interest rate below:

**Chart A-1**  
**Estimates of the Longer-Run Real Neutral Rate**



SOURCES: Laubach and Williams (2003), Armen and Koenig (2015), Del Negro et al (DGGT) (2017).

Note that, three measures converge around the real rate at about 1% - add 2% target inflation and voila, we get the 3% neutral rate.

But what if it's lower or higher than 3%? Then, Houston, we have a problem. Clarida and Powell's statements wouldn't mean nothing (yeah, I know double negative, but I've always wanted to be a gangsta).

This reminds me of some "economists" jokes:

Q: How many economists does it take to change a light bulb?

A: Seven, plus or minus ten.

Neutral interest rate of 3% plus or minus 10.

Q: How many economists does it take to change a light bulb?

A: Eight. One to screw it in and seven to hold everything else constant.

Neutral interest rate of 3%, assuming potential GDP, NAIRU and productivity growth are constant.

I can go on and on but my point is that no one really knows where the neutral level of interest rate lies.

As former Fed Chairman Alan Greenspan quipped during his heydays,

"It's very difficult to know where that so-called neutral rate is. But we probably will know it when we are there because we will observe a certain degree of balance, which we had not perceived before, which would suggest that we are somewhere very close to where that is."

# Call that disruption? Investors are forgetting

[cuffelinks.com.au/disruption-investors-forgetting/](http://cuffelinks.com.au/disruption-investors-forgetting/)

Roger Montgomery

September 18, 2018

I have been stunned for many years by Tesla’s market capitalisation. At US\$291.00 per share, Tesla is valued by the market at US\$50 billion (\$69 billion).

Manufacturing and quality control issues, longer delivery times, and the antics of the CEO aside (please stay away from Twitter, Elon), Tesla delivered only 126,740 vehicles in the year to 30 June 2018. That’s a market capitalisation of US\$394,500 per vehicle. To put that in perspective, Ford Motor Company sits on a market capitalisation of US\$37 billion (\$51 billion) and delivered 217,700 vehicles worldwide in the month of August alone. In 2017 Ford sold approximately 6.6 million vehicles worldwide. That equates to a market capitalisation per vehicle of US\$5,600.

Over in Europe, Volkswagen AG trades on a market capitalisation of €68 billion (US\$79 billion), which puts it on a market capitalisation per vehicle of \$7,383 given it sold 10.7 million vehicles in 2017. Only the luxury brands such as Daimler and BMW trade on market caps of more than US\$20,000 per vehicle sold and even then, they are more than 10 times cheaper than Tesla.

## Market madness, or a transformative approach to market valuation

The following table summarises the price investors are willing to pay, per vehicle sold, for each manufacturer. Market caps are converted to US dollars.

	Manufacturer	Market cap (US\$)	Vehicles sold annually	Market cap per vehicle sold
1.	Tesla	\$50 billion	127,000	\$394,000
2.	Daimler (Mercedes-Benz)	\$67.7 billion	2.3 million	\$29,434
3.	BMW	\$61.2 billion	2.5 million	\$24,480
4.	Toyota	\$197.6 billion	10.4 million	\$19,000
5.	Volkswagen	\$79 billion	10.7 million	\$7,383
6.	Ford	\$37 billion	6.6 million	\$5,600
7.	GM	\$48 billion	9.6 million	\$5,000

Investors can buy GM for \$5,000 per vehicle sold, or they can buy Tesla for nearly \$400,000 per vehicle sold. The economics between Tesla and every other car manufacturer in the world, in the long run, might be slightly different but they cannot be sufficiently dissimilar to justify such a disparity.

Clearly, enthusiasm for the world-changing potential of EV technology has translated to an equally-transformative approach to stock market valuation. What investors are forgetting however is that Tesla will ultimately be a car company.

Since the horseless carriage was invented by Karl Benz, there have been more than 1,500 car manufacturers in the United States of which only one exists today – Ford – that makes a profit and was not bailed out by the US Government during the GFC. Changing a drive train from petrol to electric will not miraculously alter the economics of the business of making and

delivering cars. Ultimately, if it survives, Tesla will be making cars, which is a highly labour- and capital-intensive fashion item where tastes for colours and styles change just as frequently as on the catwalk. Oh, and Ford plans to invest US\$11 billion in electrification by 2022.

### **The same nutty logic is applied in Australia**

While Tesla has not distracted me from the harsh realities of competitive business dynamics, it has distracted me from the fact the same insanely optimistic, if not just plain nutty, logic is being applied to high potential growth companies here in Australia. Let's not forget this is purely a function of cheap interest rates and inflation-free growth that simply won't last.

But more importantly, investors here in Australia are forgetting that the new businesses – even those that promise an exciting theme and a 'global' opportunity – aren't really new at all. Yes, in some cases they are signing up customers at a rapid rate, but ultimately, it is growth in profits not 'users' that counts. If they survive competition, they are more than likely to be a business with vastly similar economics to those they disrupt. There are no free lunches.

Take a look at the market capitalisations of some of Australia's listed businesses whose share prices have rallied on the back of hopes of global domination; A2 Milk, Afterpay Touch, Xero, Wisetech Global, Altium and Appen have an aggregate market capitalisation of \$31 billion, combined revenue of less than \$2 billion and combined net profits of just \$240 million. Of that profit, A2M is responsible for \$185 million and Xero and Afterpay Touch are losing money.

An equally-weighted portfolio of the above companies is trading on 129 times earnings. Yes, value investors tend to get a bit grumpy when the optimists are winning but it is not unexpected to see party revellers having a great time during the party. It's the morning after when heads hurt.

### **Afterpay builds in massive growth hopes**

Afterpay Touch is a classic example of a company that has benefited from a hopeful approach to valuing growth. I cannot count how many times I have heard "if they can grab just X per cent of US retail sales, they'll be worth ... X to the power of ...". It's a good rule of thumb to zip up your wallet when a promoter includes in their slide deck the size of a market, and then asks you to consider what would happen if they 'only' take one per cent.

Afterpay is effectively providing a small and short-term (roughly 56 days) line of credit on an average transaction value of \$150. When interest rates are zero and credit is cheap, consumers love borrowing money and consequently consumption surges. It's a combination that, in the absence of disruption, represents Goldilocks conditions for retailers and consumer finance companies.

The only problem of course is that when interest rates rise consumer finance companies are hit, not only by rising bad and doubtful debts but slowing consumer conditions too. Margins are squeezed between slumping revenues and rising costs. It wasn't so long ago that Afterpay was trading at less than \$3.00, and today its shares are more than five times higher at \$17.00.



Afterpay earns its money by charging consumers \$10 if they miss a payment plus another \$7 if they are more than a week late (the maximum cumulative penalty is \$68), and by charging the retailer a few percent from each sale. Afterpay generates 75% of its revenue from retail merchant fees and about 25% from the customer via late fees, which jumped 364% in 2018.

As I mentioned earlier, many of these new age businesses and 'digital disrupters' aren't that new at all. Afterpay looks very similar to a factoring business, just as Tesla looks scarily like a car manufacturer.

When a business wants to receive cash flow, one of things it can do is sell its receivables at a discount. In a factoring arrangement, a business makes a sale and generates an account receivable. The 'factor' buys the right to collect on that invoice (the receivable) by agreeing to pay the seller the invoice's face value, less a fee. Sound familiar? It's exactly what these retail finance offerings are. A merchant is selling the goods today to a customer who hasn't yet paid, and is instead receiving a discounted payment from the finance provider – the 'factor', in this case Afterpay.

And because the factoring businesses extends its credit to the clients' customers, rather than the client, it's concerned about the credit risk of the customers, not the client. The client is laying off the risk of non-performance to the finance provider. Factoring is one of the oldest forms of finance available and the economics of factoring businesses aren't particularly attractive because factoring is not a particularly high-return business.

There is a basic relationship in investing that has always held true. High returns usually come from assuming higher risk. So how can investors in Afterpay generate high returns from what is effectively a low-return factoring business?

Some professional investors might argue that the returns from Afterpay's factoring business are in fact high and the risks very low because small individual amounts are being assumed and the terms are short at 56 days. But if that were true, how is Afterpay able to extract such high returns when extending credit to low risk customers?

If such great returns are available from extending credit to very low risk customers, others will join the party. And that is something both Afterpay and Tesla investors seem to have missed.

*Roger Montgomery is Chairman and Chief Investment Officer at Montgomery Investment Management. This article is general information and does not consider the circumstances of any individual.*

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## Value stocks - time to shine

PERSPECTIVE FROM THE TEMPLETON GLOBAL EQUITY GROUP

### SUMMARY

- Since 2008, US growth stocks (particularly in faster-growing sectors such as technology) have tended to perform better than US value stocks.
- As the performance gap between growth and value widens, more investors may be wondering when this dynamic between growth and value might change.
- Rising inflation and interest rates will likely see value stocks outperform growth and investors should look closely at the many opportunities that exist in Europe and Asia for value-style investing.

### CHARACTERISTICS OF GROWTH AND VALUE INVESTING

**Growth** investing focuses on companies that are growing at a faster-than-average rate. These companies often have accelerating revenues, earnings and cash flows, but also typically have relatively high price-to-earnings (P/E) metrics. Often these companies have dividend payouts that are low or non-existent, since profits are used to expand the business.

**Value** investing focuses on companies whose stock prices don't reflect their intrinsic or fundamental value. These companies are often mature, and their stocks may have suffered due to a temporary earnings setback or an economic or political event hampering their industry. They are often characterised by low P/E or price-to-book ratios and sometimes by higher-than-average dividend yields.

### Just as bubbles burst, rates rise...

In the US, at the peak of the tech bubble at the turn of the century, growth stocks had significantly outperformed value stocks for a number of years. By February 2000, the 10-year average annual return differential had reached 6.49% in favour of growth.<sup>1</sup>

Only months later in December 2000, that 10-year differential had been wiped out.

Investors might recall some of the prominent tech names that were leaders during the boom and bust – companies like Yahoo, CompuServe, Alta Vista, Compaq and Netscape. All multi-billion dollar companies that had a big impact on the market indices and many of which are now gone or have been bought out.

Since 2008, growth has again outperformed value due to monetary policy that has kept global interest rates low.

All things being equal, when you have artificially low interest rates, growth companies are worth more than value companies because earnings in 10 years become more valuable than earnings in one year. The lower an interest rate is, the greater the value of future earnings.

However, with the advent of rising inflation and higher interest rates, potential headwinds for growth stocks are developing.

## Growth Has Outperformed Since 2008

### Growth of \$10,000 Investment (USD)

31 December 2007 - 31 December 2017



Source: Russell Indices

According to Templeton Global Equity Group's analysis of companies in the MSCI All Country World Index universe, at the end of the second quarter 2018, global valuation spreads (the gap between the market's cheapest and most expensive stocks) were the widest they have been in at least 30 years.<sup>2</sup>

Put another way; value stocks globally have only been this cheap 1% of the time in the past three decades.

As value investors, we believe we are at a unique point in the market cycle where many global equities, particularly outside the US, look exceedingly attractive.

## Europe and Asia - the value hubs

The improving global economy should help bolster corporate fundamentals outside the US. Tightening US policy conditions may represent a headwind for a maturing US bull market, while helping recovery gain pace in other regions.

In the US, corporate margins and earnings per share are well above the levels reached in the 2007 cyclical peak. Company valuations may inadequately reflect rising political uncertainty, tightening monetary policy and a more mature profit cycle.

On the other hand, European equities are experiencing their most extreme and sustained underperformance against the US in at least half a century, and the region is trading near its cheapest levels on record relative to the US.

We have been identifying value opportunities in Europe since post the Global Financial Crisis (GFC), particularly in financial and energy stocks, and both the equity market rally and the economic recovery in Europe remain less mature than in the US, and we believe it has much more room to run.

Beyond Europe, there is also opportunity. For example, South Korea has been one of the world's cheapest markets for some years and continues to offer compelling investment opportunities. Other Asian markets such as China and Japan should also be considered, with the telecommunications and utilities sectors in these countries two standouts.

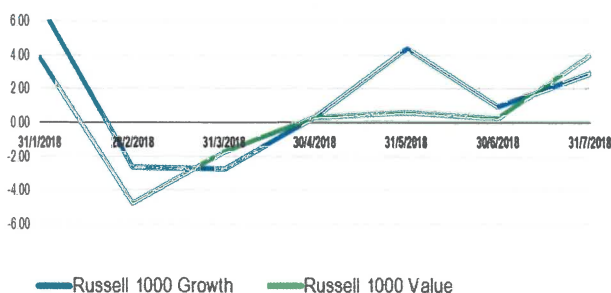
While there are obviously very different levels of economic development across these markets, they should have a place in a well-diversified portfolio.

Conditions are increasingly pointing to an imminent value revival. Investors can find some of the cheapest and most attractive opportunities outside the US, with European financials and energy stocks, as well as Asian telecommunications and utilities, offering some of the best value buys.

## Value Stocks Outperform in July

### Monthly Index Returns (%)

January 2018 – July 2018



Source: Russell Indices

## Growth Versus Value over 30 Years

### Rolling 10 Year Annualised Excess Return

31 December 1988 - 31 December 2017



Source: Russell Indices

1. Source: Russell Indices. Growth stocks represented by the Russell 1000 Growth Index. Value stocks represented by the Russell 1000 Value Index.
2. Source: MSCI Indices, as at June 2018.

#### WHAT ARE THE RISKS?

All investments involve risks, including possible loss of principal. Value securities may not increase in price as anticipated or may decline further in value. Special risks are associated with foreign investing, including currency fluctuations, economic instability and political developments; investments in emerging markets involve heightened risks related to the same factors.

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# 10 years after GFC, 7 lessons for investors

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[cuffelinks.com.au/lessons-global-financial-crisis/](http://cuffelinks.com.au/lessons-global-financial-crisis/)

Shane Oliver

September 12, 2018

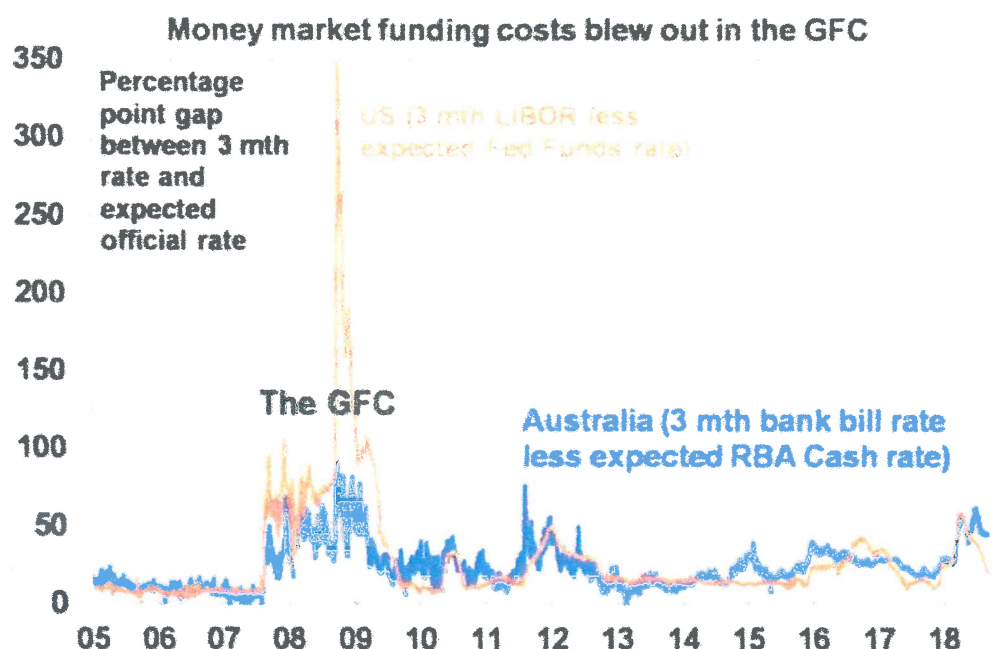
The period August to October is a time for anniversaries of financial market crises – the 1929 share crash, the 1974 bear market low, the 1987 share crash, the emerging market/LTCM crisis in 1998, and of course the worst of the Global Financial Crisis in 2008. The GFC started in 2007 but it was the collapse of Lehman Brothers on 15 September 2008 and the events around it which saw it turn into a major existential crisis for the global financial system. Naturally each anniversary begs the question whether it can happen again and what the key lessons are. And so it is with the 10th anniversary of the worst of the GFC.

## A brief history of the GFC

The GFC was the worst financial crisis since the Great Depression. It saw the freezing of lending between banks, multiple financial institutions needing to be rescued, 50% plus share market falls and the worst post-war global economic contraction. Low interest rates prior to the GFC saw too many loans made to US homebuyers that set off a housing boom that went bust when rates rose and supply surged. Specifically:

- About 40% of loans went to people with a poor ability to service them – sub-prime and low doc borrowers. And many were non-recourse loans so borrowers could just hand over the keys to the house if its value fell.
- This was encouraged by public policy aimed at boosting home ownership and ending discrimination in lending. Some extolled the 'democratisation of finance'.
- It was made possible by a huge easing in lending standards and financial innovation that packaged the sub-prime loans into securities, which were then given AAA ratings on the basis that while some loans may default the risk was offset by the diversified exposure. These securities were then leveraged, sold globally and given names like Collateralised Debt Obligations (CDOs). But after securitisation there was no 'bank manager' looking after the loans.
- Banks were sourcing an increasing amount of the money from global money markets.

This stopped in 2006 when poor affordability, an oversupply of homes and 17 Fed interest rate hikes saw US house prices slide. Sub-prime borrowers struggled to refinance loans after their initial 'teaser' rates so they started defaulting, causing losses for investors. In August 2007, BNP froze redemptions from three funds because it couldn't value the CDOs within them, triggering a credit crunch with sharp rises in the cost of funding for banks. See the surge in short-term borrowing rates relative to official rates in the chart. A reduction in credit availability initially caused sharp falls in share markets.



Source: Bloomberg, AMP Capital

Shares rebounded but peaked around late October 2007 before falling about 55% as the credit crunch worsened, the global economy fell into recession and many banks failed with a big one being Lehman.

The crisis went global as losses magnified by gearing mounted, forcing investment banks and hedge funds to sell sound investments to meet redemptions which spread the crisis to other assets. The wide global distribution created a loss of trust resulting in a freezing of lending between banks and sky-high borrowing costs which affected confidence and economic activity.

The GFC ended in 2009 after massive monetary and fiscal stimulus along with government rescues of banks, but aftershocks continued for years with sub-par growth and low inflation into this decade. From an economic perspective the GFC highlighted that:

- **Fiscal and monetary policy work.** There is a role for government, central banks and global cooperation in putting free market economies back on track when they go into a downward spiral. While some have argued that easy money just benefitted the rich, doing nothing would have likely ended with 20% plus unemployment and worse inequality.
- **The return to normal from major financial crises can take time.** The blow to confidence depresses lending and borrowing and hence consumer spending and investment for years afterwards. The key is to allow for this and not turn off the policy stimulus prematurely, but also to avoid thinking it is permanent as the muscle memory does eventually fade.
- **'Stuff happens'.** After each economic crisis there is a desire to make sure it never happens again, but history tells us that manias, panics and crashes are part and parcel of the process of creative destruction that has led to an exponential increase in material prosperity in capitalist countries. The trick is to ensure that the regulation of financial markets minimises the economic fallout that can occur when free markets go astray but doesn't stop the dynamism necessary for economic prosperity.

**Will it happen again?**

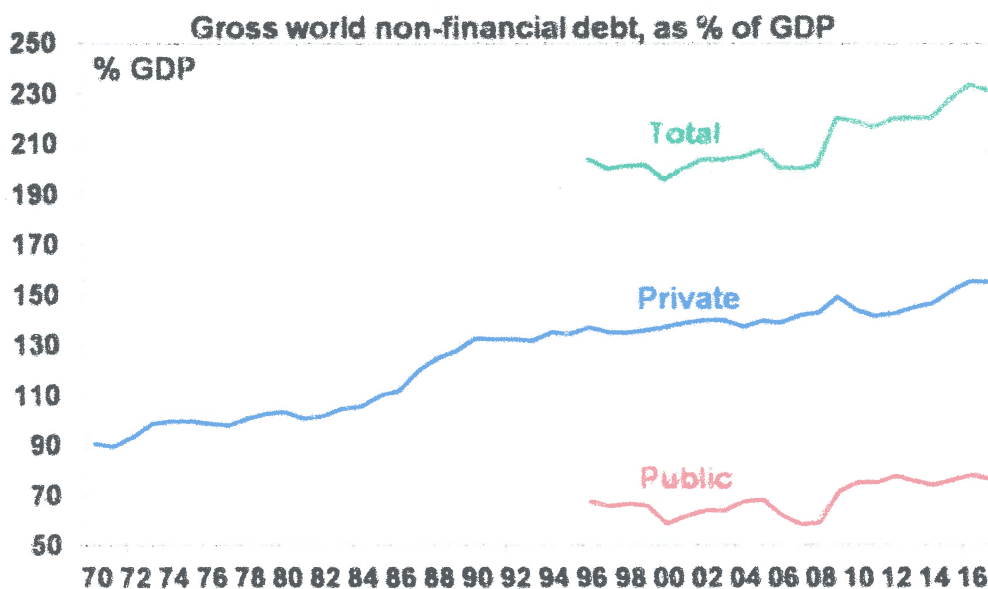


History is replete with bubbles and crashes and tells us it's inevitable that they will happen again as each generation forgets and must relearn the lessons of the past. Often the seeds for each bubble are sown in the ashes of the former. Fortunately, the post-GFC environment has seen an absence of broad-based bubbles on the scale of the tech boom or US housing/credit boom. There was a brief surge in gold and some commodity prices early this decade but it did not become too big. Bitcoin and other cryptos blew up before sucking in enough investors to have a meaningful global impact. E-commerce stocks like Facebook and Amazon are candidates for the next bust but they have seen nowhere near the gains or infinite P/E ratios seen in the late 1990s tech boom.



Source: Thomson Reuters, Bloomberg, AMP Capital

Post GFC, global debt has grown to an all-time high relative to global GDP, but this alone does not mean another GFC is upon us. The ratio of global debt to GDP has been trending up forever, much of the growth in debt in developed countries has been in public debt and debt interest burdens are low thanks to still low interest rates. Other signs of excess like those in the GFC are not present on a widespread basis. Inflation is low, monetary policy globally remains easy, there has been no widespread overinvestment in technology or housing.



Source: IMF, Haver Analytics, BIS, Ned Davis Research, AMP Capital

Banks are required to have higher capital ratios and raise more funds from their depositors. Much of the surge in debt post the GFC has been in private emerging market debt rather than in developed countries suggesting emerging markets are at greater risk. Another economic crisis is inevitable at some point, but it will likely be different from the GFC.

## Seven lessons for investors from the GFC

The key lessons for investors from the GFC are:

- 1. There is always a cycle.** Talk of a 'great moderation' was all the rage prior to the GFC but the GFC reminded us that long periods of good growth, low inflation and great returns are invariably followed by something going wrong. If returns are too good to be sustainable they probably are.
- 2. While each boom-bust cycle is different, markets are pushed to extremes.** The asset at the centre of the upswing becomes overvalued and over-loved at the top and undervalued and under-loved at the bottom, which for credit investments and shares was in first half of 2009. This provides profit opportunities for patient contrarian investors.
- 3. High returns come with higher risk.** While risk may not be apparent for years, at some point when everyone is relaxed it turns up with a vengeance. Backward-looking measures of volatility are no better than attempting to drive while looking at the rear-view mirror.
- 4. Be sceptical of financial engineering or hard-to-understand products.** The biggest losses for investors in the GFC were generally in products that relied heavily on financial alchemy purporting to turn junk into AAA investments that no one understood.
- 5. Avoid too much gearing of the wrong sort.** Gearing is fine when all is well, but it magnifies losses when things reverse and can force the closure of positions at a loss. When lenders lose their confidence and refuse to roll over maturing debt or when a margin call occurs, investors are forced to sell when they should be buying.
- 6. The importance of true diversification.** While listed property trusts and hedge funds were popular alternatives to low-yielding government bonds prior to the GFC, through the crisis they ran into big trouble (in fact Australian Real Estate Investment Trusts (REITs) fell 79%), whereas government bonds were the star performers. In a crisis, correlations go to one except for true safe havens.
- 7. The importance of asset allocation.** What matters most for your investments is your asset mix – shares, bonds, cash, property, etc. Exposure to particular shares or fund managers is a second order risk.

*Dr Shane Oliver is Head of Investment Strategy and Chief Economist at AMP Capital, a sponsor of Cuffelinks. This article is general information and does not consider the circumstances of any investor.*

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# Most estate planning for tax is inadequate

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 [cuffelinks.com.au/estate-planning-tax-inadequate/](http://cuffelinks.com.au/estate-planning-tax-inadequate/)

Matthew Collins

August 28, 2018

Over the next 20 years, there will be an intergenerational transfer of wealth the likes of which has never been seen before. Wealthy baby boomer parents will die leaving their estates, in most cases, to their children. Most will also leave income tax liabilities.

When they receive their inheritance, the children will have two main tax issues to deal with:

- Minimising tax payable on the benefit (eg. tax payable by the estate) and
- Finding an investment structure to hold assets that allows for future tax minimisation.

Through proper management and planning, the 'after-tax' value of the inheritance can be greatly improved. Despite this, many wealthy individuals have a will that does not deal with the tax consequences of their death adequately.

## What can be done within a will?

A will provides excellent opportunities for tax planning. Generally, under a will, assets can be transferred to a new investment structure without the usual impost of stamp duty or capital gains tax. The ownership of assets can be rearranged to provide a better tax result.

A will also allows for the establishment of a 'testamentary trust'. In broad terms, assets can be inherited by a beneficiary but held via a trust which they control. The beneficiary can generally then direct income from the trust to pay various family members in a tax-effective way. Family members receiving distributions may include children under the age of 18. Family trusts, set up while a person is alive, cannot distribute to children under 18 without the beneficiary being taxed at the top marginal tax rate.

## Management of tax payable by the estate

In most cases, the assets of the deceased are liquidated and the funds distributed to the various beneficiaries. This can result in two major tax consequences:

- Capital gains tax on the disposal of the deceased's assets
- Death benefit tax on superannuation withdrawals.

Proper planning may reduce or eliminate these taxes.

### 1. Capital gains tax

In basic terms, a testamentary trust can provide flexibility to those who receive taxable income resulting from the sale of estate assets.

I recently had a client die while holding two properties. One was his home, which is exempt from capital gains tax. The other was a 'weekender' which had grown in value by \$400,000 since it was purchased. He had four children, who each had personal taxable income over \$100,000, and 12 grandchildren, all under 18-years-old.

Before the property was sold, it was transferred, under the will, to four testamentary trusts, one for each beneficiary. This allowed for the capital gain to be split between the grandchildren. As a result, no tax was paid.

## **2. Superannuation death benefit tax**

A common scenario is where the last parent dies and leaves superannuation to their adult, non-dependant, children.

Adult non-dependant children will be required to withdraw money from superannuation. They have no choice. This will usually result in tax of 17% being payable on the withdrawal of the 'taxed' portion of superannuation. If the member's balance is large, this can amount to many hundreds of thousands of dollars in tax.

So, what can be done?

The simplest way to avoid death benefits tax is for the superannuation to be withdrawn before death. The assets are then held in the member's personal name instead of being held in the superannuation fund. A withdrawal by a member, over 65, and in some cases earlier, is not subject to tax.

The obvious problem with this strategy is we don't know when we are going to die. However, often we have some idea, and if reducing income tax payable is important to the member, then steps can be taken.

In a simple scenario, a member with a terminal illness can withdraw their superannuation themselves. However, individuals are often not able to make such decisions once their health has deteriorated. An alternative is for a power of attorney to be provided with the authority to make the withdrawal. In my experience using an attorney can work, but only if the following takes place:

- The member gives clear instructions to the power of attorney before their health deteriorates, and
- The process is explained to the other family members.

It always needs to be remembered that the attorney owes a fiduciary duty to act in the best interest of the member.

There are a number of strategies that can be used to make a speedy withdrawal, but these are outside the scope of this article. Suffice to say that, where the tax liability is reasonably high, it may be worth considering as part of a tax effective estate plan.

## **Strategies to minimise future income tax payable by beneficiaries**

In recent years, it has become increasingly difficult to invest in a tax-effective way. Changes to superannuation place limits on the ability to reduce income tax. Labor policy includes additional measures such as the removal of negative gearing and the taxing of trusts at a rate of 30%.

There is every likelihood that future beneficiaries may receive an inheritance in an environment where:

- After-tax superannuation contributions are limited to \$100,000 per year or less
- A person can no longer make after-tax superannuation contributions once their balance reaches \$1,600,000.

Two strategies could be considered:

### **1. Holding investments long term via a testamentary trust**

For many years, families have used discretionary trusts (also known as family trusts) to hold investments and distribute income to family members with little or no taxable income. Labor intends to stop this. Their proposed policy can be found in a fact sheet titled "A Fairer Tax System – Discretionary Trust Reform". On page 10, it states that the policy will not apply to testamentary trusts. If legislation is eventually introduced, and this exemption remains, testamentary trusts may become a useful structure for holding investments for the long term.

### **2. Lending to adult children so they can make contributions**

I expect the following scenario becoming common in the future:

- Children not having available funds to make superannuation contributions during their working life
- When they are older, perhaps in their 60's, receiving a sizable inheritance
- Only being able to transfer a small portion to superannuation due to contribution restrictions.

In selected circumstances, the following strategy may be useful:

- Parents lend money to their adult children
- The children make a contribution to superannuation
- The loan is 'paid back' out of the estate on the death of the parents.

If implemented correctly, this strategy may result in additional funds ending up in the beneficiaries superannuation accounts. However, there is a lot to consider before implementing a strategy like this and professional advice should be sought.

## **Conclusion**

The purpose of this article is not to provide an exhaustive list of potential strategies or to analyse any particular strategy in depth. Instead it is to alert readers that there are opportunities available and to encourage you to seek advice sooner rather than later. I have found that many people are uncomfortable speaking about estate and death issues. I understand this. However, a well thought out and considered estate plan can not only result in significant tax savings but also provide for greater family harmony.

*Matthew Collins is a Director of Keystone Advice Pty Ltd and specialises in providing superannuation tax, estate tax and structural advice to high net wealth individuals and their families. This article is general information and does not consider the circumstances of any individual investor. It is based on a current understanding of related legislation which may change in future.*



# Six key Labor financial policy proposals

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[cuffelinks.com.au/six-key-labor-financial-policy-proposals/](http://cuffelinks.com.au/six-key-labor-financial-policy-proposals/)

Vinay Kolhatkar

September 5, 2018

In the week of 20-24 August 2018, another round of musical chairs played in Canberra. When the music stopped, the cabinet had changed, and Australia had a new Prime Minister and a new Treasurer. Political pundits picked May 2019 as the most likely date for the next federal election. The Newspoll conducted in late August had Labor as the clear favourite, leading the Coalition in the two-party-preferred measure by 56% to 44%.

With a Labor victory a strong possibility, investors should understand the potential impact on their portfolios.

## Labor's plan to make housing more affordable

Labor's document "Positive plan to help housing affordability" asserts that:

- The middle class is being priced out of the housing market.
- Ownership rates for young people aged 25-34 have spiralled downwards in recent years from 60% to 48%.
- In all home purchases, first-home buyers make up only 1 out of 7 buyers.

Labor's response is to reform negative gearing and the capital gains tax discount effective from a yet-to-be-determined date after the next election, a policy which they claim "*... will help put the Australian dream of home ownership back within the reach of middle and working class families.*"

### 1. Capital gains tax

Capital gains can be offset against previously incurred but unused (carried over) capital losses and against losses incurred that fiscal year.

Currently, individuals and trusts are also entitled to a 50% discount on the capital gain amount providing they have held the asset for more than one year.

Labor proposes to halve that capital gains discount (CGT) for all assets purchased after a yet-to-be-determined date following the next election, if held over a year, to 25%.

The exceptions (for which the current rules will remain as is) are:

- Investments made before this date
- Investments made by superannuation funds
- Assets of small business owners.

### 2. Negative gearing

Negative gearing is where investment-related expenses (especially borrowing costs on a property) exceed revenue and the loss is claimed as a tax deduction against other income.

Labor proposes to limit negative gearing to 'new' housing from a yet-to-be-determined date after the next election. Investments made before this date will be grandfathered from the impact. Losses from new investments in shares and 'existing' properties ~~will still~~<sup>won't</sup> be able to offset other taxable income. These losses can also continue to be carried forward to offset the final capital gain on the investment.

One industry reaction came from RiskWise Property Research, who co-authored a report assessing the impact on property markets of the proposals to amend the CGT discount and negative gearing. They asserted that the unintended consequences would result in "some geographical areas especially those with weak or fragile property markets, [being] adversely impacted more than others." The report also warns of the consequences in the Sydney unit market being the equivalent of a 1.15% increase in interest rates.

### 3. Private health insurance

In a radio interview in Adelaide on 18 May, Shadow Health Minister Catherine King outlined that, to cap the rising costs of health insurance,

*"Labor will cap [rises in] private health insurance premiums at 2% for the next two years. But we also think the Productivity Commission needs to have a good root and branch look at what's actually happening in this industry across the board."*

The industry reaction was swift. Dr Rachel David, CEO of Private Healthcare Australia, spoke to the likely unanticipated consequences:

*"An arbitrary cap could put some of our regional and employee-based funds at risk of becoming insolvent. And what it will do in terms of flow-on effects is some even of the larger funds, to retain their prudential reserves, will need to freeze the payments they're making for hospitals and for doctors, which could lead to a cap on nursing wages and a cap on the income of the people who work in hospitals. I know it's only for two years but expenditure in the health sector is very large, we're paying out record amounts in claims, and the effects will be felt very quickly."*

### 4. Superannuation: non-concessional limits, catch-ups and tax deductibility

Speaking on behalf of Labor at the Financial Services Council Political Series Breakfast in Sydney, Labor Senator Kristina Keneally outlined that:

*"In 2016 we made it clear that we will oppose the government's measure to allow catch-up concessional contributions and tax deductibility for personal superannuation contributions. We will also lower the annual non-concessional contributions cap to \$75,000 and further lower the high-income super contribution threshold to \$200,000."*

Asserting that the proposals lacked logic and equity, Noel Whittaker countered that by taking us back to first principles.

*"One would think a major goal of all political parties would be to minimise changes to superannuation in the foreseeable future. Hopefully that would restore trust in the system, and encourage people to use superannuation for its original purpose: funding their retirement so as not to be a burden on the welfare system."*



In the "A Fairer Tax System for All Australians" speech in July 2017, Bill Shorten announced the minimum 30% tax on distributions from discretionary trusts:

*"Under Labor's policy, individuals and businesses will still be able to use discretionary trusts. However, the new minimum 30% tax rate on distributions will make sure discretionary trusts cannot be used as a vehicle for aggressive tax minimisation.*

*"Labor's policy builds on the reforms of former Treasurer John Howard in the early 1980s. Mr Howard cracked down on artificial income splitting to minors by taxing distributions at the top marginal tax rate. Labor's policy extends this principle to adult beneficiaries, but at a less punitive rate of 30%."*

Writing in Cuffelinks, Matthew Collins considers that since testamentary trusts are to be exempted from the new proposal, "testamentary trusts may become a useful structure for holding investments for the long term," and that, "in selected circumstances, the following strategy may be useful:

- Parents lend money to their adult children
- The children make a contribution to superannuation
- The loan is 'paid back' out of the estate on the death of the parents."

## 6. Removal of excess imputation as cash refunds

Labor's policy is that it will deny cash refunds for excess imputation credits, with some exceptions.

Cuffelinks has run numerous articles on this issue, commenting on its operation and equity as summarised in "Cuffelinks articles on Labor's franking policy". Subsequent articles include Olivia Long's "SMSFs hit by loss of tax-free status and franking refunds" and Geoff Warren's paper in this week's edition.

### Taking stock

Depending on individual circumstances, one or more of Labor's proposed policies may cut sharply into financial plans. While it is worthwhile taking stock now, anyone contemplating changes should note that a lot can happen in eight months of politics, and even if Labor wins, the final policy might be modified.

*Vinay Kolhatkar is Assistant Editor at Cuffelinks. This article is general information only and does not constitute financial or tax advice.*

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# Get real: how we delude ourselves about investments

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 cuffelinks.com.au/real-delude-ourselves-investments/

Graham Hand

August 28, 2018

In 1988, I bought \$750 worth of special \$5 coins, minted to commemorate the opening of Australia's Parliament House. I figured it was a one-way bet to investment success. They were legal tender costing \$5 and would always be worth at least \$5, and if they became sought-after by collectors, the sky was the limit.

I found the box of coins recently while cleaning the attic. They are made of aluminium bronze, so not only do they have no valuable metal content, but they look slightly tarnished after 30 years. Eager to learn about my booty, I called a coin dealer to check their value.

"They are legal tender, so they're worth \$5 each," he said with little enthusiasm.

"But they're 30-years-old, packed in a commemorative sleeve, marking a proud moment in Australian history," I replied, realising my expectations of untold wealth were draining away.

He sounded rather tired. "They made millions of them, and please don't bring them in here. We'd charge you a handling fee to take them to the bank and collect \$5."

After I spent an hour in a major bank branch where they eventually accepted them, at least I received my money back, right? Wrong.

## The importance of real returns

Most of us delude ourselves about our investments. For example, we talk about our winners while the losers sit quietly in the bottom drawer.

The biggest delusion is not adjusting rates of return for inflation, using what is known as the **real** rate. Every investment return should be expressed in real terms, because it reflects the true purchasing power of money. Even with inflation as low as 2.5%, \$100 today will need to grow to \$102.50 to buy the same basket of goods in a year. If your money is in a term deposit earning 2% a year, it's a negative yield in real terms.

The Reserve Bank of Australia provides an excellent inflation calculator, [linked here](#). Every time you think about money or investments over a long time period, put the numbers into this calculator for a reality check. It's simple to use. All you need is the year you bought something and how much you paid, and the amount is adjusted for inflation to a current day equivalent.

Take my \$5 coins (yes, please take them). My \$5 paid in 1988 adjusted for inflation would now be worth \$11.46, up 129%, with an annual inflation rate of 2.8%. If my coins had doubled in value, I could have deluded myself that turning \$750 into \$1,500 showed my investing prowess, but in truth, my money would not have retained its purchasing power.

Looked at another way, on average, what cost \$1 in 1988 now costs \$2.29. Therefore, what costs \$5 now would have cost  $5/2.29$  or \$2.18 in 1988. So my \$5 has been eroded by inflation and now has the equivalent of \$2.18 buying power. I didn't really get my money back.

Many people proudly boast of the increase in the value of their house or investment property. Let's say you bought an apartment for \$500,000 in 1998. Average inflation of 2.6% compounded over 20 years reaches \$838,000. Okay, property prices have done well in the last five years, but not only must you adjust for legal fees, stamp duty, maintenance and renovations, but the real price is 68% higher or \$338,000 more than you paid.

While it might sound good to say you doubled your money if you sold the apartment for a million dollars, it's likely you earned little in real terms (of course, there are many other factors such as rent and loan payments to consider in calculating the total real return).

### **Are we close to an Australian sharemarket all-time high?**

The All Ordinaries Index is currently (28 August 2018) about 6,400. The all-time high for the index is 6,873 in October 2007, before the GFC. It then fell precipitously to a low of 3,112 in March 2009, a period that destroyed the wealth of many Australians. Over the past decade, the market has clawed its way back, and a strong second half of 2018 may see the all-time high threatened. There will be headlines and celebrations of the good times across the media.

But the All Ordinaries is a price index, similar to the price of apples or bananas. To measure the all-time high in real terms, the 2007 level should be adjusted for inflation. Using the inflation calculator, 6,873 in October 2007 is 8,795 now in real terms.

So when the news breaks one day that the Australian market is at an all-time high, you can wisely tell everyone that it's a couple of thousand points or 28% away in real (inflation-adjusted) terms – or whatever the number is at the time – and everybody should stop deluding themselves.

*Graham Hand is Managing Editor of Cuffelinks. This article was first published by leading retirement website, [YourLifeChoices](#), and some of the comments below are taken from there.*

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# Aussie shares: 50 years and we're finally ahead

[cuffelinks.com.au/50-years-finally-ahead/](http://cuffelinks.com.au/50-years-finally-ahead/)

Ashley Owen

August 28, 2018

Over the past few weeks the media have been getting excited about the local stock market hitting '10-year highs'. It is true, but only because 10 years ago the market was falling like a stone in the sub-prime crisis. The All Ordinaries index is still 7% below its pre-GFC peak. It will get there soon enough but Australia will be one of the last countries to do so.

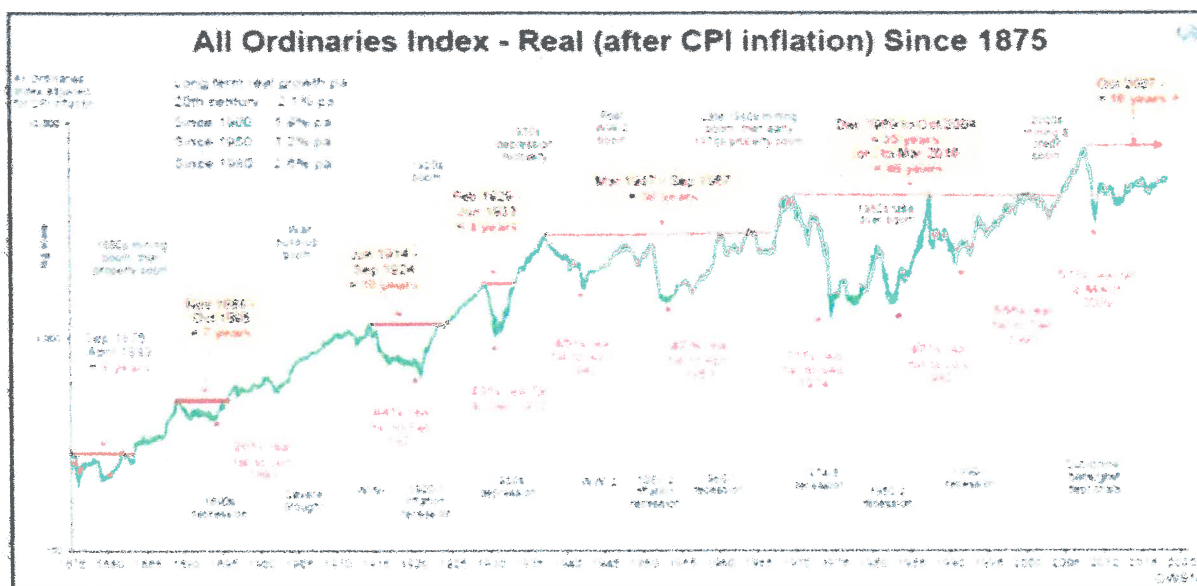
Denmark won the gold medal for the first country to surpass its pre-GFC peak way back in January 2013. The US was second in March 2013. The UK took bronze in May 2013. Dozens of other countries have done it since then, but we are still waiting. Why? Australia has been slow to recover because our 2003-2007 boom was bigger than most. Not only did we have a credit boom like the rest of the world, we had a mining boom as well. The bigger the boom, the bigger the bust that follows it.

## Need to think in real terms

More importantly, in *real* terms (after inflation) the All Ordinaries index is still 27% below its 2007 peak. People who bought in at the top of the boom – which unfortunately was many first-time investors lured in by frenzied media and by the '\$1 million super contribution window' – will have to wait a few more years to get back to square one after adjusting for inflation. Dividends add to returns, of course, but we want to see the real *capital* value of shares, or real *wealth*, rising not falling.

Am I being too negative by adjusting for inflation? No, because we need to adjust for inflation to measure the real value or spending power of our money. Inflation is everything. If I were to tell you that the Venezuelan stock market index is up by a whopping 6,976% so far this year (it is), would you race in to get some of the action, or would you run the other way? Now if I were to add that the inflation rate in Venezuela is running at 46,000% (it is), you would see that the real value after inflation is a train wreck.

Inflation can cripple real returns for decades. For people who follow the traditional 'buy and hold', 'set and forget' approach to investing, it is sobering to see that the broad market index in Australia (the All Ordinaries and its predecessors) is just 24% higher than where it was 50 years ago in August 1968. The market hit a mini-high on 16 August 1968, and then went on to peak at the end of 1969 at the top of the nickel boom, which also lured in many thousands of first-time investors. It promptly crashed and took 46 years to finally get ahead, in March 2016.



Click to enlarge

**Share prices of our biggest companies have done little for 50 years**

The companies that dominated the index in 1968 are mostly the same old companies that still dominate today. Let's take the largest bank. Bank of NSW, now called Westpac, was \$7.56 which is \$2.18 adjusted for capital structure changes and \$26.82 after inflation. It was \$29.46 at the end of July 2018, a real gain of just 0.1% per year for 50 years! ANZ and NAB are still below their share prices 50 years ago, adjusted for capital structure changes and inflation. BHP is ahead by just 1.7% pa, Woodside is ahead by 1.5% pa. AGL is the best of the bunch, up by +3.6% pa over the 50 years, but CRA (now RIO), Santos, QBE and Lend Lease are all still below.

This is just the big 'blue chip' stocks. Unfortunately, in the booms people chase the speculative 'hot' stocks, which mostly end up worthless.

This is a sobering reminder of the destructive effect of inflation, and also a reminder not to get caught up in boom-time media frenzies that lure people in at the worst time. 'Buy and hold', 'set and forget' only works if you have 50 years to wait to get your money back.

It is also a reminder that GFC-type crashes are not unusual at all, contrary to the media nonsense that the GFC was a 'once in a century' event. The good news is that there are tremendous gains to be made by going against the herd and buying when everybody else is panic-selling in the busts.

*Ashley Owen is Chief Investment Officer at advisory firm Stanford Brown and The Lunar Group. He is also a Director of Third Link Investment Managers, a fund that supports Australian charities. This article is general information that does not consider the circumstances of any individual.*

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# Five structural headwinds hitting the global economy

[cuffelinks.com.au/structural-headwinds-global-economy/](http://cuffelinks.com.au/structural-headwinds-global-economy/)

Jason Orthman and Mark Arnold

August 28, 2018

The bad news is that low interest rates, low inflation and low economic growth are likely to be our global economic reality for at least for the next decade. This means challenging business conditions for businesses and investors.

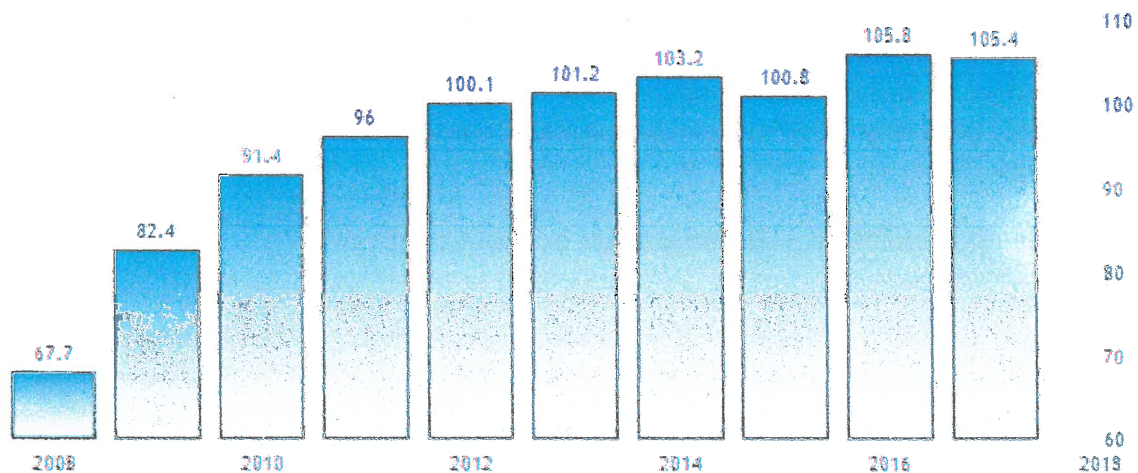
However, the good news is that quality businesses will come into their own. The cyclical improvement in economic growth that has occurred over the past two years is likely to run its course over the next 18 months or so, and average businesses and speculative stocks that have enjoyed temporary macro tailwinds will face a more difficult environment as the cycle turns. Only quality companies with fundamentally solid business propositions will produce long-term growth.

Let's look at some of the key structural headwinds facing the global economy.

## 1. The future fall-out from high levels of debt

Consumer and government debt have both increased substantially in most major economies over the past decade. Gross Federal Government debt to GDP in the US has risen from around 40% in the 1980s to approximately 105% in 2017.

US GROSS FEDERAL DEBT TO GDP



Over the same period, household debt to GDP in the US has risen from just under 50% to around 80%. And the same story has played out in China, where gross government debt to GDP has risen from under 25% in the 1990s to approximately 48% in 2017, and household debt to GDP in China has increased from under 20% to 48%.

Higher levels of debt have provided a one-off boost to historical economic growth rates by bringing forward consumption and investment, but at the same time, higher financial gearing has increased financial risk levels generally. The global economy's ability to respond to economic shocks is lowered, while society's sensitivity to future increases in interest rates has risen.

## 2. Globalisation drives wealth inequality in developed countries

As the world has become more interconnected, materials and workforces can be more effectively sourced from countries with the lowest cost. Access to foreign capital has improved the lot of workers in less developed countries, but placed downward pressure on the income of workers in developed countries.

Furthermore, migration rates and the declining influence of unions in developed countries have also had the effect of reducing labour costs. The benefits of globalisation have become particularly evident in the increasing numbers of high net worth individuals in countries such as China and India. From 2012 to 2017, the growth in individuals with US\$50 million or more in the Asia-Pacific region grew by 37%, and it's predicted that the number of ultra-wealthy individuals in China will double in the next five years.

The wealth of high net worth individuals is growing relative to individuals in the middle and lower economic brackets. A hollowing out of the middle class is occurring due to downward pressure on wages and increases in automation at the middle-income level. Also, a general trend towards lower corporate tax rates and lower effective marginal tax rates for high-income earners over the past few decades has also accelerated the trend towards inequality. Lower corporate tax rates primarily benefit the wealthy because they are the biggest owners of businesses. According to the World Inequality Database, in 2014, the wealthiest 1% in the US owned 39% of total wealth, up from 22% in 1978.

### **3. No higher productivity despite technological innovation**

Humans have always innovated to improve production output and reduce human labour hours for economic gain. At certain stages, technological advancement has caused huge leaps in both productivity and the average standard of living. However, since the late twentieth century, technological changes in the form of computing, communication, robotics and artificial intelligence have not resulted in higher levels of productivity, and average wage levels have remained depressed in most developed countries.

We have reached a point where some predict that most of the jobs currently undertaken by humans will be replaced by machines and artificial intelligence, and the nature of jobs will change fundamentally. The emergence of some fundamental changes are already impacting the workforce: increasing use of robotics and 3D printing in warehouses, manufacturing and medicine, to name a few. Businesses generally benefit from automation through lower costs, whereas workers only benefit if they can be redeployed into better quality, higher paying jobs.

### **4. An ageing population will suppress real economic growth**

An ageing population has implications for labour force growth, both the number of work hours per person and consumer spending. As a population ages, fewer people will be engaged in full-time employment or be able to generate an income from human labour activities. The retirement of the baby boomers is predicted to negatively impact the growth in labour hours per person from 2008 to 2034, with negative implications for real economic growth.

Also, living longer means that individuals will have extended economic requirements that will need to be funded. This may be through government pensions, pension funds or working longer. However, lower incomes mean lower income taxes, at the same time that increasing numbers of retirees are placing strains on pension systems.

### **5. Climate change and other environment-related constraints**

According to the Worldwide Fund for Nature Living Planet Report from 2016, the bio capacity equivalent of 1.6 Earths was needed in 2012 to provide the resources and services humans consumed in that year, and the situation has since worsened. Demand for natural resources is fast outpacing the rate at which resources can be renewed, and the burning of fossil fuels is most to blame.

The link between climate change and investment markets may not be immediately obvious, but every business and household in the world will be negatively affected.

Extreme weather events, including prolonged drought and super storms adversely affect agricultural production, and acidification of the ocean as it absorbs excess CO<sub>2</sub> does the same to the marine ecosystem and fishing. It is difficult to predict with certainty what the specific outcomes will be, but the geographic distribution of the supply and demand of goods and services will change, redefining global trade.



## Concluding

Global economic activity has experienced a cyclical uptick in the past couple of years, but in our view, the longer-term outlook for economic growth remains subdued due to these structural headwinds.

In a low-growth world, most asset classes will produce relatively low total returns. Our base case is for global equities to produce total (real returns) that average around 3.5% to 4.5% p.a., and many sectors of the market will find it difficult to maintain current levels of earnings in real terms over the next decade.  
*in excess of inflation*

For investment managers, tackling low growth is challenging. When the economic tide turns, average businesses frequently fail, and only those businesses with strong fundamentals, in the form of high-quality business models, including low gearing, and large addressable markets will have the ability to offer earnings growth and long-term returns for investors.

*Mark Arnold and Jason Orthman are the Chief and Deputy Chief Investment Officers respectively at high-conviction equities manager, Hyperion Asset Management. This article does not consider the individual circumstances of any investor.*

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