Winter Newsletter 2016

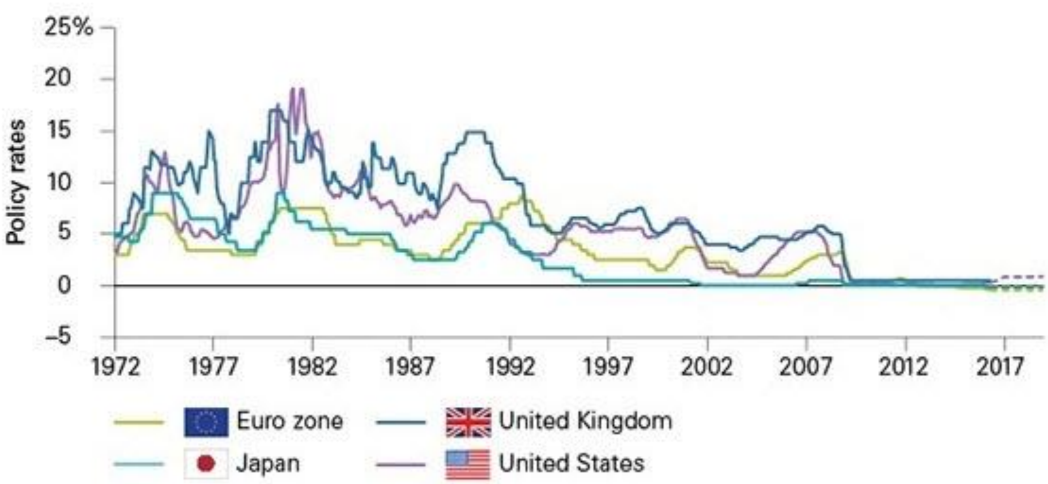
2016-17- More of the Same?

As we enter the 2016/17 financial year the doubts that have plagued us since the GFC remain. It can be argued that many of the geo-political issues we see may be linked to the GFC. Would Europe be facing their current issues if the harsh Austerity measures had not have been implemented? Would the US be contemplating Trump as President without the socio-economic washouts since 2008?

Where are we?

Interest rates are the oil of financial markets. Central banks adjust interest rates to control flows of capital as a tool to control inflation and/or employment within a pre-determined band. The graph below indicates the drastic action taken by central banks in regards to rates. The theory is that low rates will encourage borrowing and therefore spending. Houses will be built, businesses will expand and employment will rise. Eventually inflation will lift and rates will start to head back to normal. The depth of 2008 crisis meant that rate adjustment was not enough.

Slashing of rates…



Note: Dashed lines indicate future projected policy rates. Sources: Vanguard calculations, using data from the US Federal Reserve, Bank of England, European Central Bank, Bank of Japan and Thomson Reuters Datastream.

But even cutting the rate as far as it could go, economies still failed to reignite. Central banks looked to engage other tools to encourage banks to pump money into the economy. One of them was Qualitative Easing (QE)

How QE works

To carry out QE central banks create money by buying securities, such as government bonds, from banks, with electronic cash that did not exist before. The new money swells the size of bank reserves in the economy by the quantity of assets purchased- "quantitative" easing. Like lowering interest rates, QE is supposed to stimulate the economy by encouraging banks to make more loans. The idea is that banks take the new money and buy assets to replace the ones they have sold to the central bank. That raises stock prices and lowers interest rates, which in turn boosts investment. Today, interest rates on everything from government bonds to mortgages to corporate debt are probably lower than they would have been without QE. If QE convinces markets that the central bank is serious about fighting deflation or high unemployment, then it can also boost economic activity by raising confidence. Several rounds of QE in America have increased the size of the Federal Reserve's balance sheet—the value of the assets it holds—from less than $1 trillion in 2007 to more than $4 trillion now.

The jury is still out on QE, however. Imbalances have been recreated and studies suggest that it did raise economic activity slightly. But some worry that the flood of cash has encouraged reckless financial behaviour and directed a concentration of money to emerging economies that cannot manage the cash. Others fear that when central banks sell the assets they have accumulated, interest rates will soar, choking off the recovery. In late 2015, when the Fed first considered the idea of tapering, interest rates around the world jumped and markets wobbled. Still others doubt that central banks have the capacity to keep inflation in check if the money they have created begins circulating more rapidly.

QE and Equity Markets-

According to economist Brian Barnier, principal at ValueBridge Advisors the US Equity Bull market has been caused by one thing:-QE. What's more, he says previous bull runs in the market lasting several years can also be explained by single factors each time. Barnier sees the Fed as responsible for over 93% of the market from the start of QE until today and that during the first half of 2013, the Fed caused the entire market's growth.

Since the Fed stopped buying bonds in late 2014, the S&P 500 has been batted around in a 16% range and is more or less where it was when the QE came to a close. Investors need to anticipate the next driver, said Barnier.

"Quantitative easing has stopped, but now we're into the interest rate world," he said. "That means for any investor trying to figure out what to do, step one is starting with a **macro strategy."**

Macro Strategy

With so much upheaval and uncertainty, macro strategies are difficult and liquidity is a definite theme.

On a valuation basis certainly US shares look expensive. The 12-month forward PE Ratio for the US S&P 500 index shown in the graph below shows just how expensive large caps are in the US compared to earnings. Australian shares are cheaper but still expensive.

12-month forward PE Ratio for the US S&P 500 index

12-month forward PE Ratio for the ASX 200 index

The high valuations illustrates the problems facing investors. Japanese, European and Asian equities are operating at much lower valuations. Cash as an asset class is liquid and safe, but adds no value above inflation. Bonds are low yielding and have the risk of interest rate rises, but do offer protection on the downside. Direct residential property is a bubble that could burst, so where can investors chase yield in a low growth world?

Australian Interest rates- To comment on the direction of Interest rates moving in Australia we really need to take a view on the Australian economy. China managed to buffer our economy during the GFC and the residential building boom substituted neatly, at least in NSW and Victoria. WA & Qld- the main benefactors of the mining boom, are suffering with record amounts of insolvencies in the March quarter. Unfortunately the building boom is coming to an end. House prices in Sydney and Melbourne have reached 10 times income levels, precisely the levels they reached in California before the bubble burst and the market was decimated. Banks are not so keen to lend to property developers so the likelihood of the building boom continuing is close to zero. What are the scenarios for Australia?

Scenario 1. The Good Story

China's banks do not implode under the mass of bad debts which are outpacing GDP growth. A successful transition is made where Chinese middle class continues to support Australian growth through our agriculture, services and tourism industry. Commodity prices have found their range and continue at current levels. European growth picks up on the back of QE and the effects of Brexit are minimal. US growth continues under a moderate democratic government. The Australian government instigates an ambitious infrastructure spend which increases economic production while borrowing at record low levels. Housing prices decline but in an orderly fashion. Bank bad debts lift but only to their 10 year average. Interest rates cut and then increase by 1.50% over 2 years in line with higher growth and moderate inflation.

Result cash-positive

Result Australian Bonds- Negative

Result Equities- Positive

Result Property- Slightly Negative

Result Infrastructure-Neutral to negative.

Result AUD-initial decrease and then increase.

Scenario 2. The “middling” story

Chinese government steps in to bail out several Chinese banks. Chinese property market suffers a serious decline, Renminbi declines 10%. Commodity price drop accordingly. Chinese middle class continues to support Australian growth through our agriculture, services and tourism industry. European growth picks up slightly due to QE but instability from rising nationalism and Brexit continue to hinder growth. The UK falls into a mild recession. The US growth is flat lining with a strong US dollar shouldering most of the blame. The Australian government has launched some infrastructure projects but not enough to pick up from housing boom. Sydney and Melbourne house prices have fallen 10%. Bad debts and Basel 4 erode bank profits. Banks lift rates independently by 1% to offset Basel 4 and rising funding costs. RBA lowers rates 0.75%

Result cash-negative

Result Australian Bonds- Positive

Result Equities- broadly negative but with winners.

Result Property- Negative

Result Infrastructure-Neutral to positive

Scenario 3. The horror story

Chinese government deals with a major bank crisis and Chinese property prices are decimated. China's middle class reduce spending which flows on to Australian services. Commodity prices fall sharply. A messy Brexit has sent the UK into a major depression and rising nationalism signals a possible failure of the EU. Trump is president and the world is in a spin. Australian housing bubble is pricked and prices tumble 30-40% in line with other western economies during the GFC. Banks suffer considerable losses and dividends are cut. Australian economy heads into recession. RBA cuts rates to near zero and launches a QE program.

Result cash-negative

Result Australian Bonds- Positive

Result Equities- initial substantial market fall but a slow rebound with QE.

Result Property- Very Negative

Result Infrastructure-Positive.

What will happen?

I believe we will see much the same as we have seen over the last couple of years. We are in a low growth environment so lower returns are to be expected especially from conservative assets such as cash & bonds. Events shape markets in the short term but cast your eyes back to what has happened over the last 100 years and your will note that markets have dealt and moved on from far larger crisis's then what we are dealing with now. The middling scenario is probably more likely but no doubt with a different set of circumstances and therefore different outcomes. The world is a dynamic place and events will continue to keep us on our toes; - adapting to new scenarios.

What should Investors do?

Investors should invest to their risk parameters and consider their time frames. If you are a Growth Investor and are happy to ride the volatility as you have a long time frame then you should ensure that you are well diversified in different style managers. An allocation to absolute return funds may be warranted to lower exposure to equities and property to add a further layer of diversification. Balanced investors should consider the same but allocations to bonds and credit should be diversified with a larger than normal allocation to cash. Conservative investors should not chase yields in equities as they do not have the risk parameters to suffer volatility.

It should be remembered that all returns must be brought back to the real return on your money or the after inflation return over a 7 year period. Currently inflation is below 2% so a good return in current environment for a growth portfolio is 6.5%. In 2007 a good return was 11%. If inflation were to pick up then so should your return expectation.

For example

Conservative CPI (2%) + 1% i.e. 3%

Balanced CPI plus 3% i.e. 5%

Growth CPI Plus 4.5% i.e. 6.5%

As always we are here at your service so do not hesitate to call us if you would like to discuss your investments or circumstances.

Paul Hudson

Insurance Premiums – Stepped? Level? What?!?

Despite what you might read on many websites; how you initially 'set up' your insurances will have a significant bearing for a long while to come both on what you are covered for and possibly most importantly; if you can afford to keep the policy when you might need it most.

Stating the obvious I know; but to keep any insurance policy in place you need to pay for it. But what choices do you have here?

There are two main options available when it comes to paying for insurance premiums; stepped and level premiums. Put briefly stepped premiums will increase each year dependent on age and sometimes these changes can be quite significant. The good thing about stepped premiums is that they are normally cheaper to start with. Level premiums will initially be more expensive, however will usually only increase by CPI or slightly more each year. Over the medium to long term, the total cost may be less expensive than a stepped premium.

So what do you choose? Isn't paying less for the same item better?? Why not simply use stepped premiums every time?? The answer to this lies in your financial goals and the reasons why you are seeking insurance. For example, say if you are taking on debt for the short term and need cover 'in case' something happens to you. Stepped premiums might be better here as they will initially be lower. However with a policy that you wish to keep for the long term and you start the policy when you are relatively 'young' (?) it may be less expensive over the medium to long term.

Perhaps it is best that you don't do this yourself. Examining your life holistically and establishing and documenting your life goals is so very important. Developing a financial plan will mean that a good advisor can provide you with sound guidance and advice. At Hudson Gore we can run multiple scenarios on insurance costs and determine what is best for you, what is the best 'fit' with your life? We can review initial and cumulative costs and see how that will work with your goals and budget, as well as other goals such as increasing your wealth and building retirement income.

Remember as well that despite our best plans, life will throw 'curve balls' at us;- sometimes when we least expect it. Hope for the best and plan for the worst? Possibly! Seek sound advice from people that have 'been there and done that' quite a few times before. At Hudson Gore we can share our experiences with you and bring wisdom to an important decision that may affect your future livelihood.

Ian Cameron

Aged Care Costs and Keeping the Family Home

As I've been doing a lot of work with clients recently (on paying for Aged Care for their parents), I thought I'd give an update on recent trends that are emerging. On our website & YouTube page you can look at more detail on general Age Care issues i.e. current accommodation costs & care expenses, assessment of income & assets etc. but today I'll discuss what happens to the family home (if it is now vacant) in light of recent and proposed government changes.

For most families the family home is their most important asset. It is not only the family's single biggest financial asset but there is also personal attachment. Deciding to sell to pay Age Care costs can create problems. Sons & daughters feel the family home in Sydney is a good long term investment and should be kept, in some cases, "Mum" thinks maybe one day she might go back home and, in big families, there can many opinions from borrowing against the home to funding the costs themselves. It is never easy! These are difficult issues to deal with magnified by the median price of homes in Sydney currently around $1 million.

Expenses

I won't go into detail about the accommodation and care costs (you can see these on our website), suffice to say if you have personal income & assets the fees can be substantial. In many Sydney aged care facilities a lump sum Refundable Accommodation Deposit (RAD) are regularly over $600,000. The equivalent Daily Accommodation Payment (DAP) is over $100 a day. The care fees are in addition to these costs AND in some circumstances an "extra" fee can be charged! What is the best way to pay?

Keeping the Family Home

In most cases the first question the family ask me is, "can we keep the home?"
As in most things financial the answer is … "let's do the numbers".
In the past where the Sydney home was rented out ($900 p/week net) and the asset value and the rent did not affect Age Pension or substantially effect the means tested care fee expenses could be met by the rental income and the pension. The house was kept and everyone was happy!
However, changes to relevant legislation that took effect from January 1, 2016 have added further complexities. For aged care residents who entered care after Jan 1 ,2016, rental income from the former family home is now being included in their resident's income for the purpose of calculating their means tested care fee.

For those people who entered residential aged care <u>before</u> to January 1, 2016 and whose former home has been retained and rented out to help pay a daily accommodation payment (DAP), the rent will continue to be exempt.

Let's look at what this means for our clients ….
Patricia is a widowed lady aged 85, has $100,000 in her bank account and her home is valued at $1.3 million, and she is in receipt of a full age pension. The aged care assessment team (ACAT) has completed her assessment (May 2016) and she enters an aged care home that requires a RAD of $400,000.The first reaction is to sell the home and pay the RAD of $400,000. Patricia's position after the payment of the RAD is as follows:
Bank Account : $1,000,000

Total Assets	:	$ 1,000,000

For the purposes of her age pension, Patricia's assets are too high for any payment. For the purposes of aged care her assets total $1,400,000 because the RAD of $400,000 is included.

Her aged care fees are:

Basic daily fee	$48.25
Means tested care fee	$88.12
Total	$136.37 per day ($49,775 pa)

Patricia's annual income, based on interest of 3% on the cash, would be $30,000.This represents a cash flow shortfall of nearly $20,000 per annum which would have to be made up for by capital withdrawals.

Let's look at what happens to Patricia if the family do not follow their first reaction and instead of selling the family home, they rent it out and partially pay the RAD. The RAD is $400,000 and they decide to pay $100,000, the balance being paid as a DAP. If we assume the home is rented, after expenses the annual net rent is $45,000 per annum.

As far as her aged care fees are concerned, the net rent of $900 per week <u>will be</u> taken into account but the value of the home remains capped at $159,423. The rental income <u>is not</u> counted towards Age Pension. Based on her changed circumstances the means tested care fee is $56.55 per day. The aged care fees now look like this:

Basic daily fee	$47.86
Daily accommodation payment	$49.31 ($300,000 x 6.01% ÷ 365)
Means tested care fee	$ 56.55
Total	$153.72 per day ($56,107 pa)

While her aged care fees have increased, Patricia's income also has increased significantly now that she is receiving rent from the family home). The total fees payable in this scenario, including the basic daily fee, the means tested care fees and the daily accommodation payment, equal $56,107 per annum. However, her total income from the age pension and the net rent has increased to $67,721p.a. providing her with surplus income of $11,604 per annum.

Given the level of income Patricia is now receiving, tax maybe an issue however with offsets (current medical expense tax offset which takes into account aged care fees and the low income tax offset) this would substantially reduce any tax liability. She may also have to pay capital gains tax on the eventual sale of her home. However, if the home was purchased prior to September 1985, which is often the case in these situations, capital gains tax will not be an issue.

Therefore under the <u>current rules</u> you could still consider keeping the family home particularly where there is good rental yield. However to find the optimal financial outcome, you have to "do the numbers". However IF the proposed changes (detailed below *) are introduced we will again have to 'do the numbers" and the likelihood is it will be a lot harder as Age Pension won't be payable. I will "do the numbers" closer to 2017.

In summary advantages and disadvantages of keeping the family home.

Advantages	Disadvantages
Age pension not affected, provided part of accommodation fees are paid periodically	Costs to make home ready to rent
Family reasons	Ongoing repairs and maintenance
Mum knows that the home is still there if she decides to return	Rent may give rise to income tax liability
Future capital growth	Potential capital gains tax liability on sale, unless pre-September 1985
Value of home capped for means-tested care purposes	Potential Loss of Aged Pension (rule change 2017)

*Proposed changes (2015/16 Mid-year Economic and Fiscal Outlook) indicate that from January 1, 2017 the Age Pension assessment will also count rental income (from the former family home). This means that the asset test exemption and rental income exemption currently available for the former home under the Age Pension means test would be removed for aged care residents paying their accommodation costs by periodic payment. *This change is proposed to apply for new aged care residents from 1 January 2017.*
These changes are going to make it very difficult for families to keep the family home and pay Mum's aged care expenses. Therefore when I am asked, "can we keep Mum's home, rent it out and afford all the costs ?" … the answer in the past has been ;

- Yes
- Currently the answer is maybe let's look at the numbers.
- In the future …. Increasingly difficult (for most families).

Link to Hudson Gore's YouTube Page https://www.youtube.com/channel/UCHkkeZ-tNR3ejDlVL7kQVaw

Michael Gore

Disclaimer: This information is general in nature and does not consider your individual circumstances or needs.

Do not act until you seek professional advice and consider a Product Disclosure Statement. The views and opinions expressed within this letter are those of the author and do not necessarily reflect those of Hudson Gore Pty Ltd.