April 2019

Growing concerns about a slowdown in global economic growth preoccupied financial markets in March. The US Federal Reserve now forecasts no rate rises in 2019 instead of the two it previously planned. US 10-year government bond yields fell below 3-month yields on the news. This ‘inverted’ yield curve is viewed by markets as an historical predictor of recession.

In Australia, economic growth slowed to 0.2 per cent in the December quarter, for an annual rate of 2.3 per cent. This was reflected in the more cautious mood of business and consumers. Both the weekly ANZ-Roy Morgan consumer confidence rating and the monthly Westpac-Melbourne Institute survey of consumer sentiment fell below their long-term average in March. While the NAB business confidence index fell to a 3-year low of 2.0 point in February.

On a positive note, unemployment fell to a 10-year low of 4.9 per cent in February. Australia’s trade surplus rose to a 2-year high of $4,549 million in January, with exports up 5 per cent and imports up 3.3 per cent. Our trade surplus with China reached a record high, due largely to a 33 per cent increase in iron ore prices over the past year to around US$86.50 a tonne. Corporate Australia is also doing well, with record profits up 10.5 per cent in the year to December. The Aussie dollar rose slightly to US71c.

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WHAT WILL THE BUDGET MEAN TO YOU?

Working Australians have been promised bigger than expected tax cuts along with billions in increased spending on health and welfare for young and old. This was all made possible as Treasurer Josh Frydenberg delivered the good news that the Budget will soon be back in surplus for the first time since the GFC.

The only hitch is that Australians will have to wait until after the federal election, expected in May, to find out if these promises will stand.

The Government is promising to maintain or increase spending in most areas without resorting to tax increases. What's more, it's bringing forward planned income tax cuts and reducing the tax burden on small businesses.

Tax relief for middle Australia

Overall, 10 million Australians will receive a tax cut, with those in the middle benefiting the most. Factoring in the tax cuts announced in last year's budget, an individual earning up to $48,000 will receive a maximum return of $480, while one earning $48,001-$90,000 will be $1,080 ahead.

Those earning $90,001 - $126,000 receive a relatively small tax cut of a few hundred dollars at best, and there's no tax relief at all for those earning more than $126,000.

The Government has reiterated its intention to further flatten tax rates, which would benefit those on higher incomes. However, this isn't scheduled to happen until 2024-25.

A helping hand for small business

There's also good news for the nation's small business owners. The company tax rate is shifting from 27.5 per cent in 2019-20 to 26 per cent in 2020-21 and 25 per cent in 2021-22.

The popular instant asset write-off is increasing from $25,000 to $30,000. Plus, it can now be used for multiple assets instead of just one every financial year. What's more, small to medium businesses with turnover up to $50 million are now eligible, up from $10 million previously as of April 2nd 2019.

A selection of super tweaks

With the peak baby-boomer retirement years looming, the Government has introduced some modest changes to make it easier for older Australians to put a bit extra into their – or their partner's – super.

From July 2020, those aged 65 and 66 will be able to make concessional and non-concessional top-ups to their super without meeting the work test. This test had required individuals to have worked at least 40 hours over a 30-day period to be eligible to make top-ups.

The 'bring forward' arrangements, which currently allow those under the age of 65 to make three years' worth of non-concessional contributions (capped at $100,000 a year), will be extended to those aged 65 and 66. Also, the age limit for making contributions to a spouse's super has been raised from 69 to 74.

Health, welfare and job training

A combination of higher tax receipts, rising commodity prices and restrained spending has given the Government money to spend on health and welfare for young and old.

Money is being directed to increasing the number of home care packages for the elderly by 10,000 and listing more medicines on the Pharmaceutical Benefit Scheme.

Four-year-olds will receive universal preschool access, while funding will be provided to teach their older sibling to "sensibly and safely use the web".

Younger Australians will be able to apply for one of the 80,000 apprenticeships that will be created over the next five years. And almost half a billion is being spent to improve young Australians' mental health.

The Treasurer announced the 2019 Budget was designed to encourage Australians to "have a go" and allow them to "get a fair go". The coming weeks will reveal whether he has done enough to secure the support of voters for another term in Government.

It is important to note that the policies outlined in this publication are yet to be passed as legislation and therefore may be subject to change.

Franking credits on the chopping board

What started as an issue few people understood and even fewer cared about has suddenly become a flashpoint for self-funded retirees as we head into a federal election. Yes, we're talking about cash refunds of franking credits.

Even if you're not directly affected it's worth paying attention, because it's an $8 billion issue that affects us all.

What is being proposed?

The policy the opposition Labor Party is taking to the election proposes abolishing cash refunds of franking credits on share dividends 'to make the tax system fairer'. It argues that closing this 'tax loophole' will soon save the budget $8 billion a year, which is more than we spend on public schools, childcare or the Australian Federal Police.

Pensioners and allowance recipients will be exempt, as will charities and not-for-profits including universities. Self managed superannuation funds (SMSFs) with at least one pensioner or allowance recipient before 28 March 2018 are also exempt.

If Labor wins the election the policy will take effect from 1 July 2019.

How did we get here?

Dividend imputation was introduced by the Hawke/Keating Government in July 1987 to end the double taxation of company profits. Before then, companies paid tax on their earnings and shareholders were taxed on the dividends paid out of profits at their marginal rate.

Under dividend imputation, companies pass on a tax credit to shareholders for tax already paid at the company level. Shareholders can then use these imputation credits or franking credits to offset tax liabilities on other income, including salary.

The system was made more generous in July 2000 when the Howard/Costello Government allowed excess franking credits to be paid as a cash refund. This meant that people who pay no tax can claim a full refund from the ATO.

The Labor Party proposal effectively restores the original tax treatment of dividends prior to July 2000.

How does it work?

Say an Australian company makes pre-tax earnings of $1 a share. It pays tax at the company rate of 30 per cent, or 30c a share, and returns the remaining 70c to shareholders as a fully franked dividend.

When shareholders complete their tax return, they add the 70c dividend to the 30c franking credit and declare $1 of taxable income. They then pay tax on the $1 of taxable income at their marginal rate.

If you are on the top marginal rate of 47 per cent (including Medicare levy), then tax is 45c but after the 30c tax credit you pay tax of just 17c.

If your marginal tax rate is zero, as is the case for all but the wealthiest retirees, you receive a 30c cash refund from the Australian Taxation Office even though you pay no tax.

Under Labor's proposal, there will be no refund for shareholders who can't use the full 30c credit unless you are a pensioner or allowance recipient.

Who is most affected?

Labor argues that 80 per cent of the benefits of the current system of franking credit cash refunds go to the wealthiest 20 per cent of retirees, and that 92 per cent of taxpayers won't be affected by the change.

However, critics say the proposed changes unfairly target retirees with their own self-managed super funds. Labor does single out SMSFs on its campaign website arguing that the top one per cent of SMSFs received an average cash refund of more than $80,000 in 2014/15.

Self-funded retirees argue that the policy is unfair for people who saved and planned their retirement income around one set of rules, only to have the rules changed when it's too late to rearrange their affairs.

But whoever wins the election, share dividends will remain an important source of income for retirees. The dividend yield on Australian shares is currently around 4.4 per cent (5.7 per cent with franking credits), compared with interest of around 2 per cent on term deposits. Shares also have the potential for capital growth over the long run, while term deposits do not.

If you would like to discuss your retirement income strategy, give us a call.

How to keep ahead of the yield curve

US Interest rates have been making headlines in recent months, but do they really matter to Australian investors? The short answer is they do, a lot.

Changes in US interest rate settings have made a big impact on investment returns from bonds and shares over the past year, while uncertainty about the future direction of interest rates is also weighing heavily on markets.

Where are rates headed?

The US Federal Reserve has increased its federal funds rate (which controls short-term interest rates) nine times from zero in 2015 to 2.5 per cent, as the US economic recovery gathered steam.

As late as last December the Fed was forecasting two more hikes in 2019. Then in early January it announced a 'patient' approach. Respected market observer and former Pimco chief, Mohamed El-Erian now expects the next move will be a cut, but not until 2020.[i]

Over the same period, the Reserve Bank of Australia cut the official cash rate from 2 per cent to a record low of 1.5 per cent. Until recently, the consensus was that the next move would be up, but many economists now expect a rate cut.[ii]

This turnaround in sentiment in the US and Australia is due to weaker economic figures, the escalating trade war between China and the US and fears of a China slowdown. Australia also faces slow wages growth and falling property prices.

Late last year nerves got the better of investors and global shares fell sharply. Shares bounced back in January after the US Fed's about-turn on interest rate policy. But bond markets had been predicting an economic slowdown for some time, due to something called the yield curve.

What is the yield curve?

The yield curve is a graph that plots the yields currently offered on bonds of different maturities, ranging from a few months to 30 years. The yield on a bond is the annual interest paid as a percentage of the bond price.

The 'typical', or positive, yield curve is a gently rising line as maturities increase because investors expect a higher return for the added risk of holding an investment for lengthy periods. A flat yield curve occurs when yields on short and long securities are similar.

The relatively rare inverted yield curve, where short-term yields are higher than long-term yields, looks like a downhill slide.

Market watchers use yield curves, especially of US Treasury bonds, to test which way the economic wind is blowing. A positive yield curve is a sign of continuing economic growth, whereas an inverse yield curve implies that investors expect sluggish economic growth, low inflation and hence lower interest rates.

What is it telling us?

At present yield curves are flattening, especially in the US. While the Federal Funds rate has increased to 2.5 per cent over the past year, the yield on 10-year Treasury Bonds has fallen to 2.68 per cent as bond markets priced in an economic slowdown.[iii]

By suspending further rate hikes, the Fed may have avoided further falls in long term bond yields which would have set off alarm bells in financial markets.

What does this mean for investors?

Interest rates don't directly affect share prices, but they do affect the cost of borrowing and decisions by businesses and consumers which can flow through to corporate profits and share prices.

As for bonds, as interest rates fall on new bond issues, prices rise for existing bond issues paying higher interest.

This helps explain why Australian fixed interest topped the asset class performance chart in 2018, up 4.5 per cent, while Australian shares fell 2.8 per cent.[iv]

Past returns are no guide to future performance; what the past does teach us is the importance of diversification. Returns from bonds and cash may not shoot the lights out but they help cushion the impact of falling share prices.

While the yield curve has proved to be a useful indicator of future economic slowdowns, it is simply a prediction based on current market sentiment and can change direction with the economic breeze.

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

i https://www.cnbc.com/2019/02/05/mohamed-el-erian-fed-next-rate-move-more-likely-a-cut-than-a-hike.html

ii Finder, RBA cash rate survey, 4 February 2019, https://www.finder.com.au/press-release-feb-2019-rba-survey-experts-predict-cash-rate-cut-to-come-not-hike

iii Trading economic as at 28 February 2019, https://tradingeconomics.com/bonds

iv Cuffelinks, edition 291, https://mailchi.mp/cuffelinks/edition-291