HORIZON
INVESTMENT SOLUTIONS

# February 2019 — Over the Horizon Market Commentary by David Offer

February was a particularly strong month for the Australian share market, with the All Ordinaries index rising 315 points or 5.3% to close at 6,252 points. This followed a strong January where our market was up 4%. As a consequence, the sell-off we experienced in the December quarter has now largely unwound. The result is even more impressive when one considers that many companies have recently gone ex dividend. This includes our major resource shares, whom have lead this market recovery primarily due to a spike in iron ore prices stemming from the Vale dam wall collapse.

Changes in central bank outlook and policy appear to be the key factor driving the current rebound in share markets. In particular, the US Federal Reserve has tempered its US growth outlook for the year ahead, from 2.5% down to 2.3% GDP growth. As a result, Fed Chair Jerome Powell (a Trump appointment) has suggested that there is a 'fairly high degree of uncertainty' about what the Fed will do. This suggests that ongoing US rate hikes are no longer a sure thing. Current market expectations are now for two interest rate hikes this year, down from three rate hikes previously.

The theme is similar in Australia. GDP growth has been weak in both the September and December quarters, rising 0.3% and 0.2% respectively. Given Australia's population growth runs at approximately 0.4% per quarter, we have technically entered a 'per capital recession'. It is highly unlikely that our Central Bank will be raising interest rates in this environment, with future interest rate cuts now more likely.

With future Centre Bank interest rate rises now on hold, share markets globally have been beneficiaries as investors seek yield. Long term debt instruments such as government bonds have benefited even more. For example, 10 year US Government bonds, recognised as being the global benchmark, have fallen in yield from 3.2% last November to now yield just 2.62%.

This suggests that cash and term deposit rates will not go up anytime soon. We are also mindful that slowing economic conditions will create increasing headwinds for businesses and in turn impact on corporate profitability. While we are grateful for the recent rally, we doubt its sustainability and to us feels more like a short term 'sugar hit'.

With limited investment options, one area we feel that is showing value are hybrid securities. In particular, Ramsay CARES ($104.98), which are paying a margin of 4.85% above the 180-day BBSW of 1.95%. This equates to a 6.8% yield. These perpetual notes (they do not have pre-agreed redemption date) are about to go ex-dividend $3.48 (grossed up) so the effective buy price is $101.50. This results in a grossed up yield of 6.7%. Over the last 5 years, Ramsey Notes have traded between $101 and $110, so there is also scope for some capital growth.

The Macquarie Capital Notes 3 ($100.70) are another example. These have an expected remaining life of 5.77 years and will pay a yield to maturity of 5.78%. A point of difference is that these notes are only partially franked so, excluding the franking credits, the cash payment is still a respectable 5.14%. These notes are presently trading at the bottom of their trading range since listing last June and have traded as high as $104.90.

Looking ahead, I suspect the upcoming Federal Election will start to dominate news flow. Sportsbet is presently paying $1.14 for a Labor win and $5.00 for a Coalition victory. Given the infighting within the Liberal and National Parties, Federal Labor doesn't even appear to need to kick any goals, our current Coalition Government specialises in kicking own goals for them. As close too certain that we can be that Labor will form the next government, just imagine if they had a popular leader ... at this point there would be zero doubt.

Also thought provoking is that, given Australia has had 6 Prime Ministers in the last 10 years, what are the odds that Bill Shorten, who is widely regarded as unpopular before even assuming the role of Prime Minister, will himself last a full term once his government comes under inevitable pressure?

Under Bill Shorten, Federal Labor appears set to maintain its traditional big taxing, big spending tendencies. To give some credit, they have provided plenty of notice about where they expect additional revenue will come from. Key Labor taxation policies include;

- Abolishing cash refunds for excess imputation credits to individuals and superannuation funds from 1 July.
- Limiting negative gearing to new housing with grandfathering to apply for existing loan arrangements for housing.
- Reducing the capital gains tax exemption to 25% from 50% across all assets.
- Introducing a minimum 30% tax rate on discretionary trust distributions from 1 July 2019.
- Making the following changes to superannuation;

    - Non-concessional cap to be reduced to $75,000 (currently $100,000);
    - Income threshold for the extra 15% contributions tax for high income earners to be lowered to $200,000 p.a. (currently $250,000 p.a.);
    - Catch-up concessional contributions to be abolished;
    - Deductibility of personal contributions for employed persons to be removed;
    - Borrowing by SMSFs to be prohibited;
    - Superannuation Guarantee coverage to be expanded to include both parental leave and salary and wages of less than $450 per month; &
    - Increase in the Superannuation Guarantee rate to 12% ahead of the current timetable.

Labor policies will still need to pass the Senate before becoming law and as such we are likely to see at least some modifications.

Of particular contention concerns the abolishing of franking credits. Even more so is that while Age Pensioners as at 28 March 2018 will be exempted and allowed to continue to receive franking credits (including superannuation funds with a least one pensioner recipient), those who become eligible for Age Pension after this date will not. This is incredibly unfair. For Labor to have any chance of getting its broader abolishment of franking credit refunds through the Senate, I suspect this will be a point Labor will need to concede on by allowing all current and future Age Pensioners to be exempted.

If this outcome eventuated, it will further increase the significance of receiving at least some Age Pension in retirement, in addition to the actual Age Pension cash payment and pension concession card.

Likewise, we consider that the introduction of the deductibility of personal contributions for employed persons (to the contributions cap of $25,000) from 1 July 2018 was sensible and helped those with variable incomes, multiple employers or range of work scenarios over any given year (which is increasingly becoming the new normal in the 'Gig' economy). Also sensible was the allowing of catch up concessional superannuation contributions for those with superannuation balances under $500,000, a policy aimed primarily at women who are likely to spend a number of years out of the workforce while raising young children and therefore have lower superannuation balances than their male counterparts. If Labor abolished these recently introduced initiatives this would be mean spirited and seemingly against their ethos of supporting the battler and less privileged. As such, these could be areas Labor gives ground on as part of negotiating their broader taxation polices through the Senate.

One thing we can be sure on is that the current background noise we hear on these policies will rise to a crescendo in the lead up to the election, most likely to be held on 18th May. Unfortunately, the noise will not end then as the passing of legislation through the Senate is likely to be a drawn out and public process.

Recently, Graham Oates and myself attended a SMSF conference in Melbourne. This provided considerable food for thought and was the stimulus for assessing the impacts of likely rule changes and how they will impact you. There is no doubt the proposed changes are detrimental to many. However, when factoring in other recent legislative changes, there are a number of strategies that can be employed to minimise the impact of Labor's proposed changes. In some instances, depending on one's priorities, there is scope to even benefit.

Our intention is to hold a client seminar post the election detailing these strategies to provide food for thought for you going forward on how to best accommodate these upcoming changes.


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