INFORMED INVESTOR

February 2023

threePILLARS
wealth management

CONTENTS

Welcome to the February edition of our quarterly newsletter, Informed Investor.

ECONOMIC UPDATE

Risk assets performed strongly in January, following further indications that inflation may have peaked in key regions.

Global economic growth forecasts were lowered by both the World Bank and the IMF but investors appeared to brush off these concerns. Instead attention was focused on the central bank meetings, to see whether interest rates would continue to be raised.

Most global share markets added between 5% and 10% over the month, although strength in the AUD eroded returns from overseas exposures for Australian investors.

Locally, the S&P/ASX 200 Index returned 6.2% and closed the month close to its all time highs.

Fixed income performed well too, with downward movements in government bond yields aiding returns from Australian and global bond markets.

The generally strong risk appetite among investors also enabled credit to generate pleasing returns over the month.

Continued over...

FURTHER INFORMATION

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FINANCIAL PLANNING

ECONOMIC UPDATE CONTINUED

AUSTRALIA

Unlike in other regions, inflation still appears to be accelerating in Australia. Headline inflation rose at an annual rate of 7.8% in the December quarter, while the 'trimmed mean', the favoured measure among Reserve Bank of Australia (RBA) officials, quickened to 6.9% year on year. This was the highest level since the series was introduced in 2003.

Prices for 'discretionary' items surged over the period, with particularly strong demand and prices seen for cars, clothing and travel.

Despite sluggish retail sales in December, the latest inflation data will almost certainly concern policy makers and suggest the RBA will continue to raise interest rates in the months ahead.

NEW ZEALAND

The quarterly Survey of Business Opinions suggested firms are expecting profitability to collapse this year. This does not augur well for investment and growth.

Consumer confidence is also subdued, owing to higher mortgage interest costs and general weakness in the residential property market. The volume of home sales was 39% lower in December from 2021 and prices were down 7.2%.

US

The annual rate of inflation in the US has now slowed for six straight months.

In turn, there were suggestions that the Federal Reserve was preparing to slow the pace of its policy tightening cycle. Interest rates were raised by a quarter of a percentage point on 1 February. This compared to the past six rate hikes, all of which saw borrowing costs increased by either 0.5 or 0.75 percentage points.

Consensus forecasts suggest US officials might raise borrowing costs once or twice more in the next six months or so but any further moves are expected to be modest. That said, policy makers have emphasised the need for interest rates to be held at elevated levels for an extended period.

In other news, US GDP growth slowed less than expected in the December quarter, to an annual rate of 2.9%. So far, the economy has been more resilient than anticipated following significant increases in interest rate hikes in 2022.

Some other indicators were less encouraging. A closely watched gauge of activity levels in services sectors deteriorated, for example.

EUROPE

The weather in Europe in the Northern hemisphere winter has been milder than anticipated. This has resulted in lower than expected demand for energy for heating and seen wholesale energy prices trend lower. The outlook for inflation in the months ahead is therefore not as bleak as previously feared.

Gas storage in Europe has risen quite sharply; from the lower end of the historical range a year ago when Russian gas was flowing freely, to the higher end of the historical range during a period when Russian supplies have almost entirely ceased.

Lower energy prices are also feeding through to official inflation data. Consumer prices rose at an annual rate of 9.2% in the Eurozone in December, below the double digit annual inflation rates seen in each of the previous three months.

Nonetheless, European Central Bank officials remain steadfast in their fight against inflation and raised official interest rates by half a percentage point on 2 February.

The Bank of England raised borrowing costs by a further half percentage point the same day, taking the base rate to 4.0%. UK interest rates are now expected to peak around 4.5%.

In other news, the UK will be the only economy in the G7 group of nations to shrink in 2023, according to the IMF.

ASIA

The 'China reopening' story dominated attention in Asia. Officials finally appear to be softening their stance on COVID, removing a range of virus related restrictions.

The Chinese economy grew 'only' 3.0% in 2022; the second slowest annual growth rate since the 1970s and well below Beijing's 5.5% annual target.

Activity levels could accelerate immediately following the Lunar New Year celebrations as restrictions are relaxed. This could be good news for neighbouring countries in the Asia Pacific region, including Australia, which tend to be reasonably reliant on growth in China to drive their economies.

AUSTRALIAN DOLLAR

The general 'risk on' tone benefited the AUD. The currency strengthened by 3.6% against the US dollar, closing January above 70 US cents for the first time in nearly six months.

The AUD has now appreciated by more than 10% against the US dollar in the past three months.

The 'Aussie' also appreciated against other currencies, including the euro, the UK pound and the Japanese yen. Collectively, the AUD gained 1.6% against a trade weighted basket of currencies, adding to strength from late 2022.

AUSTRALIAN EQUITIES

Australian shares started 2023 positively, with all but one sector posting gains. As a whole, the S&P/ASX 200 Accumulation Index added 6.2%.

A combination of moderating inflation expectations, lower bond yields both locally and offshore and an increasing number of large international firms announcing cost cutting initiatives helped spur a renewed sense of optimism.

The Consumer Discretionary sector (+9.9%) was the strongest performer over the month.

Market sentiment towards mining stocks improved on expectations that an acceleration in growth in China will benefit demand for bulk commodities. This supported index heavyweights with increases of more than 8.0%. Strong performances from lithium companies also supported an 8.9% return from the Materials sector.

Utilities (-3.0%) was the only sector to register a negative return in January.

Small caps outperformed their larger peers for the first time since October, with the S&P/ASX Small Ordinaries Index closing the month 6.6% higher.

All sectors in the small cap index posted gains. The Consumer Discretionary sector (+11.2%) was a standout.

LISTED PROPERTY

Global property securities appreciated in January, consistent with the upward move in share markets globally. The FTSE EPRA/NAREIT Developed Index returned 8.0% in Australian dollar terms, comfortably outperforming wider equity markets.

In general, sentiment was supported by moderating inflation expectations in key regions. In turn, there were hopes we might be nearing the end of monetary tightening cycles in the US, Europe and Australia.

The best returns from international property markets were found in Germany (+16.8%), France (+10.7%) and Sweden (+10.7%). Laggards included Hong Kong (+5.2%) and Spain (+6.0%).

Japan was the only country to register a negative return (-1.6%), following a surprise change to the Bank of Japan's yield curve control policy in December.

GLOBAL EQUITIES

Overseas share markets fared well too. The MSCI World Index added 6.5% in local currency terms, although strength in the AUD reduced the return to 3.1% for Australian based investors.

The NASDAQ performed extremely well in the US, adding 10.7%. This was the best January return for more than 20 years.

The broader S&P 500 Index added 6.3%, essentially reversing December's weakness and closing around its end November level.

All of the major indices in Asia also posted positive returns.

There was a fair degree of dispersion among European markets, although all made positive progress.

GLOBAL AND AUSTRALIAN FIXED INCOME

Suggestions inflation may have peaked or being close to peaking in major regions saw investors reassess their interest rate forecasts. In general, the peak in borrowing costs is now expected to be a little lower than anticipated before Christmas.

These evolving expectations saw bond yields trend lower in most major regions, which supported gains from global fixed income.

Comments from Federal Reserve policy makers attracted the most scrutiny, especially since developments in the US tend to set the tone for other bond markets worldwide. Ten year Treasury yields closed the month down 37 bps, to 3.51%.

There were similar moves over the Atlantic. Ten year yields on UK gilts and German bunds closed the month 34 bps and 28 bps lower, respectively.

Japan was an outlier. Yields on 10 year JGBs rose 8 bps over the month, to 0.49%.

Australian bond yields fell sharply; by 50 bps in the 10 year part of the curve. This aided returns from the local bond market. The Bloomberg AusBond Composite 0+ Year Index added 2.8%, clawing back some lost ground from 2022.

GLOBAL CREDIT

Credit spreads narrowed quite sharply over the month, consistent with gains in major share markets and with a general increase in risk appetite among investors.

Spreads on investment grade securities closed the month 14 bps tighter, at 1.33%.

Spreads on high yield credit also narrowed sharply.

We saw a good level of new corporate bond issuance over the month. Encouragingly, all of this new issuance was comfortably digested by the market.

Early indications from the latest corporate earnings announcement season suggest most firms remain in healthy shape financially.

Source: Bloomberg. Issued by First Sentier Investors.

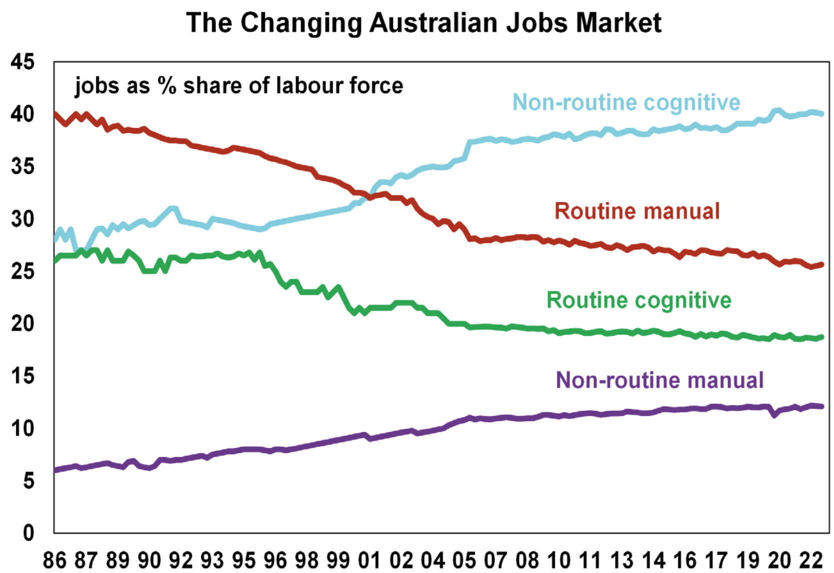
FIVE LONG TERM GLOBAL TRENDS AND IMPLICATIONS FOR MARKETS

This article looks at some structural trends in the economy and their impact on economic growth and investments.

1. A DECLINE IN ROUTINE BASED JOBS

Fear of technology replacing jobs has been around for years, although concern around this risk appears to have waned in recent times, as impacts of the pandemic on labour markets has taken focus. New technology is constantly displacing some jobs but it is also creating new ones in its place. The jobs most at risk are routine based jobs, because this type of work can be replicated, learned and taught by machinery and automatic intelligence. In Australia, there has been a long term decline in manual and cognitive routine based jobs. In the late 1980s, routine manual jobs were 40% of the workforce and are now around 26% of the workforce while routine cognitive jobs were 26% of the workforce in the late 1980s and are now worth 19% (see chart). Similar medium term trends are evident across other developed countries. Non routine jobs (either manual or cognitive) are less at risk of being displaced by technology because they are harder to replicate and often need a human element (for example in jobs related to health, childcare or teaching). Problems in recent years with self driving cars also shows the difficulties associated with technology.

Middle income households tend to be most susceptible to routine based jobs so this trend will increase inequality and could put downward pressure on wages growth in the long run. The OECD (Organisation for Economic Co-operation and Development) in a report done in 2018, estimated that around 14% of jobs (in the OECD) are at high risk from automation, with large variations across countries (countries at higher risk include Slovakia, Slovenia, Greece and Spain while the countries at the lowest risk include Norway, Australia, Finland and Sweden). The workforces that are more at risk tend to have a lower educated workforce, a weak tradeable services sector and have a low urbanisation rate. In Australia, around 7% of jobs are estimated to be at high risk of automation and in the US its slightly higher at 10%. The government has a role to play in ensuring that the transition to new types of employment for impacted employees is managed through training programs, appropriate university curriculum and ensuring that funding is targeting those areas at the highest risk of job losses due to automation.

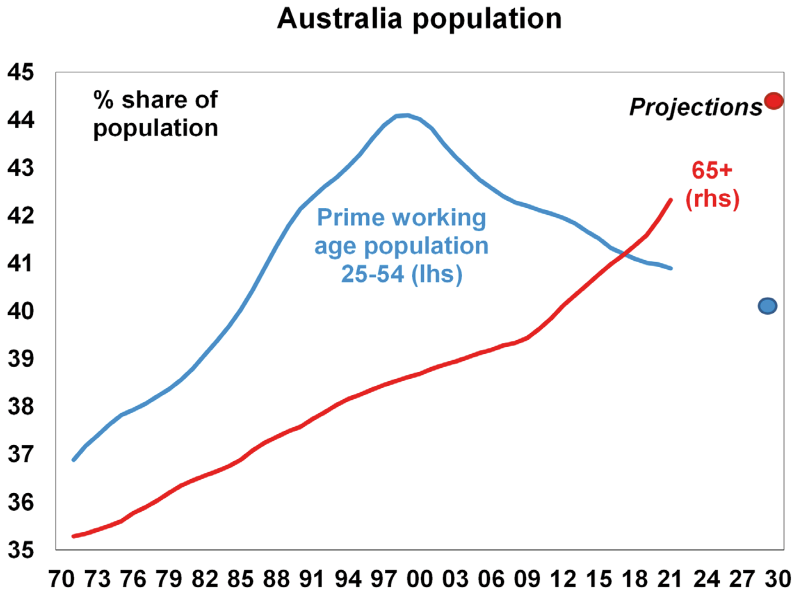


Source: ABS, AMP

2. AN AGEING POPULATION AND AN INCREASE IN THE 'DEPENDENCY RATIO'

The global population, especially in major developed countries, is ageing which has been a long term trend as the birth rate has declined.

In Australia, the share of the prime working age population (those aged between 25-54) peaked at 44% of the population in 1999 and has been falling slowly since then, currently at around 41% and projected to be around 40% by the end of the decade. In contrast, the share of the population that is aged 65+ is expected to keep climbing to just under 20% by 2030, up from 17% now (see chart). An ageing population will put upwards pressure on the 'dependency ratio' (the sum of those aged under 15 and over 65 as a share of the whole population) which will detract from national savings (people who work increase savings while the very young and old drain savings) which is inflationary in the long term.

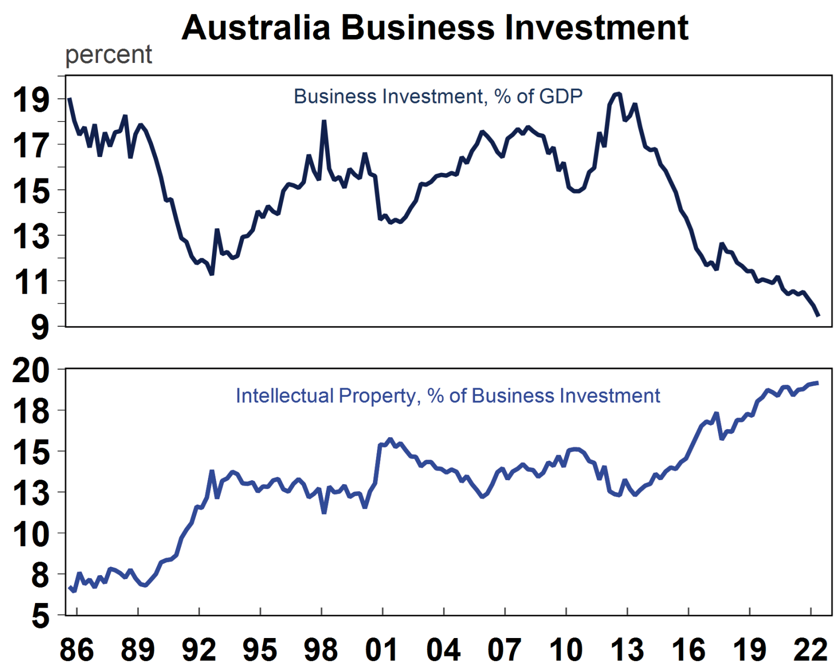


Source: ABS, AMP

3. A DECLINE IN BUSINESS INVESTMENT AS A SHARE OF GDP BUT A LIFT IN INTELLECTUAL PROPERTY AS A SHARE OF INVESTMENT

In many developed countries, private business investment is declining as a share of the economy, in place of a rising services sector which is less investment intensive.

In Australia, business investment often goes through cycles because of the dominance of the mining sector (at its peak mining investment reached 11% of GDP). After the last mining investment boom (which ended in 2012 after business investment was 19% of GDP), investment has been on a gradual decline and is now 9.4% of GDP (see chart). While there may be ups and downs in the cycle from the mining investment contribution and the usual wear and tear associated with depreciation, private business investment is likely to decline further as a share of GDP because of the changing nature of business investment. The typically large scale buildings and structures, machinery and equipment type of investment is being replaced with less 'heavy' types of investment, like intellectual property with the rising importance of the tech sector in all industries. A less capital intensive economy could weigh on long run productivity growth, although the impact is probably marginal as intellectual property investment should still boost productivity growth.



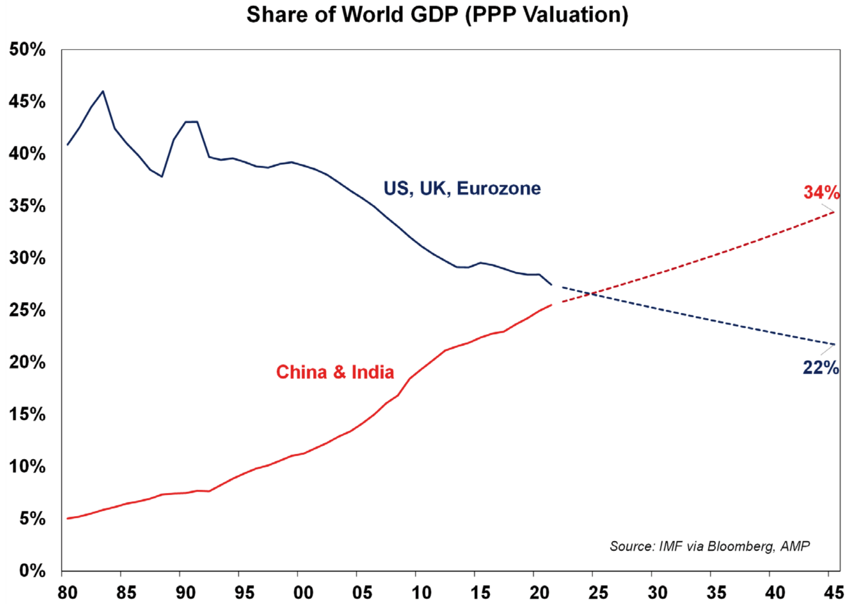
Source: Macrobond, AMP

4. A MULTI POLAR WORLD MEANS MORE GEOPOLITICAL RISKS

The US economy has been increasing in importance to the global economy since the end of the Second World War. The rising significance of the US economy to global trade, cultural influences, military presence and economic power has been increasingly consistent with a unipolar world, especially as the United Kingdom and the Eurozone have had challenging economic conditions in the past decade.

However, the balance of power has been shifting in recent years as the Chinese economy grows and becomes a larger share of the global economy (see chart). In purchasing power parity (PPP) terms (which adjusts individual country prices into a global comparison after accounting for exchange rates and purchasing power in each country which allows a better sense of living standard comparison) the Chinese economy is already the largest in the world (at 19% versus the US at 16%). If we also account for India then China and India make up 26% of the global economy compared to the US, UK and the Eurozone at 27% (in PPP terms). But we are currently at a crossroads, with China and India about to take over as a larger share of the global economy. On our estimates China and India will be 34% of the global economy by 2045, versus 22% for the US, UK and Eurozone (if growth rates continue at its current pace). As a result, the global economy is increasingly moving towards a multi-polar world as the balance of power shifts away from the US. This shift in the balance of power will keep geopolitical tensions and risks high over coming years as the US and China compete for global control, particularly in the technological space. Investors should be prepared for periodic inflammations in geopolitical tensions and heightened risks of conflict or war, keeping volatility in share markets high. Concerns over the growing Chinese economy are expected to again be a feature of both the Democratic and Republican party campaigns in the 2024 US Presidential election.

However, in Australia, the relationship with China looks to be improving with a recent meeting between Australian PM Albanese and China's President Xi Jinping seemingly the most positive in years.

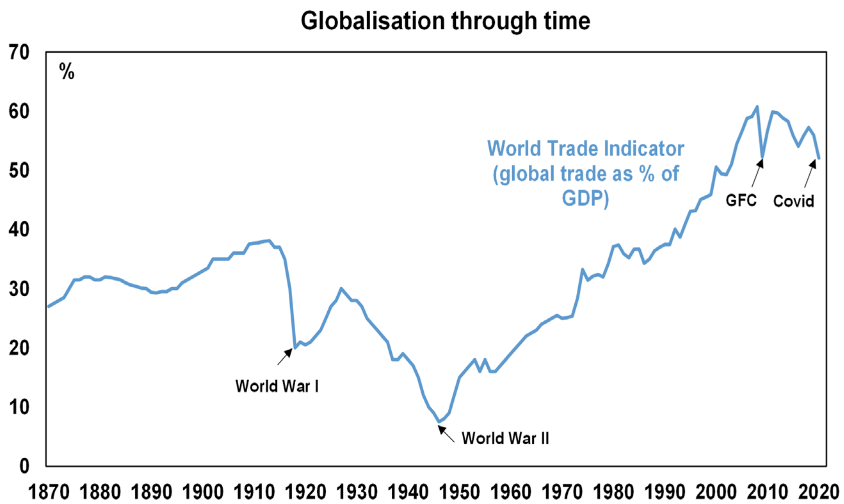


Source: World Bank, AMP

5. PEAK GLOBALISATION IS INFLATIONARY

Globalisation looked to be reaching a peak before COVID-19 broke out, with global trade (the sum of exports and imports) declining as a share of GDP since the Global Financial Crisis in 2008 (the chart shows that global trade was 56% of GDP in 2019, below its peak of ~61% before the GFC), as countries decided to become more self-sufficient after seeing the contagion impacts of the GFC. COVID-19 dealt another blow to global trade as closed borders and transport delays led to a push towards bringing as much production onshore as possible, or at least to closer countries ('nearshoring' or 'friendshoring'). Given that globalisation was disinflationary because production was transferred to countries to the most efficient producer (which most often ended up being the lowest cost producer) some reversal in the globalisation trend will be more inflationary for the global economy.

Source: AMP



Source: World Bank, BCA, AMP

BUYING AN INVESTMENT PROPERTY

Is an investment property the right choice for you in retirement?

WHAT YOU NEED TO KNOW ABOUT BUYING AN INVESTMENT PROPERTY

Buying a rental property is a very popular investment in Australia. For many investors, the appeal of owning an investment property is linked to their familiarity with this asset class – most of us either own or rent a house, apartment or villa. Over time, a quality, well located property could generate long term growth and decent income returns.

Houses and units may be easier to understand as an investment than many other assets such as shares and bonds, yet owning an investment property is not a licence to print money. There are risks and costs budding landlords need to consider.

The costs of having an investment property include property management fees, legal charges, mortgage interest payments and landlord insurance. You may also need to consider whether you could service the costs of owning the investment property if a tenant decides to move on and you're left with a vacant property.

If you're not sure you could cope financially, you might need to rethink your investment strategy. Likewise, you need to be aware real estate prices can take a tumble.

DOWNSIZING TO BUY AN INVESTMENT PROPERTY

Downsizing into a smaller property or moving to a more affordable location could be a worthwhile way to help finance your retirement lifestyle.

It can be a valuable strategy for empty nesters, some of whom may find maintaining a big and empty family home no longer makes sense financially or from a lifestyle perspective.

By downsizing to a more affordable property such as an apartment or townhouse, you could unlock any significant capital tied up in the family home.

With this extra capital, you may have the financial freedom to invest in either an investment property or another asset class. Before you make a move, be sure to speak to a financial adviser to determine whether a downsizing strategy is right for you.

TAKE ADVANTAGE OF DOWNSIZER RULES

Downsizer rules may help older Australians who sell their family home to invest some of the proceeds into superannuation.

From 1 July 2022 the eligibility age for downsizer contributions was reduced to 60 and from 1 January 2023 it reduced further to 55. Under these rules, if you're in the suitable age range you may make after-tax or non-concessional contributions into superannuation of up to $300,000 for an individual or up to $600,000 for a couple from the proceeds of selling your principal residence. The usual contribution caps of $110,000 per year ($330,000 under the bring forward rule) don't apply and it doesn't matter what your super account balance is (you would usually only be able to make after-tax contributions if your total super balance is less than $1.7 million on the previous 30 June)[1].

UNDERSTANDING THE COSTS OF BUYING/SELLING A PROPERTY

The costs of buying a property include stamp duty for the property transfer and for the registration of your mortgage. Stamp duty is charged by state and territory governments so the amount you will pay depends on the location of the property and its price. To find a stamp duty calculator appropriate to your state, or territory, visit the ASIC Money Smart website.

When buying property, you should also factor in the cost of pest and building inspections, which vary depending on the size and location of the property.

Also don't forget if you can save a deposit worth more than 20 percent of the value of your property you may not be required to paying lenders mortgage insurance (LMI). LMI is generally charged by a lender if your deposit is less than 20 percent of the value of the property.

LMI enables lenders such as a bank or a credit union to lend you a larger percentage of the purchase price. The cost of LMI may be included either upfront or in your loan repayments so it's spread out over the term of the loan.

If you're selling your current home and buying an investment, you'll probably sell through a real estate agent and this means paying the agent a commission on the sale. Agents in your area will have different fees, so be sure to shop around.

There are also legal costs for the transfer of a property from a vendor to a buyer. You're likely to need the professional services such as a conveyancer to legally transfer ownership of the property you are buying or selling. Your conveyancer will also conduct property and title searches to ensure the seller is legally entitled to sell the property. There may be some minor charges for completing these searches, in addition to the conveyancer's professional fee.

There may be a range of fees levied by your lender such as application, valuation and settlement fees. Make sure you ask your lender or mortgage broker about these fees.

Once you secure the property, you may also need to take out landlord insurance. This is insurance that may protect the building and its contents and cover if the tenant defaults on his or her lease obligations.

1 https://www.ato.gov.au/individuals/super/growing-your-super/adding-to-your-super/downsizing-contributions-into-superannuation/

HOW MUCH CAN I BORROW?

To estimate what you can borrow to buy an investment property, you could use a mortgage or home loan calculator to help translate the loan amount into a corresponding monthly payment. Calculators give you the luxury of playing with interest rates, deposit amounts and loan term to help you figure out what may be affordable. They can be useful tools to crunch some numbers and get a ballpark estimate. Though it's worth noting that many calculators won't give a complete picture of all costs and it may be worth considering advice from a financial adviser before making any financial decisions.

Once you know your borrowing power, you'll have a better idea of what your next step will be. You'll know whether you can afford an apartment or house near the CBD or out in the suburbs.

HOW CAN FINANCIAL ADVICE HELP WITH YOUR INVESTMENT PROPERTY?

Financial advice could help you achieve your investment property goals and get the right strategies in place to help you achieve them. It can help you:

- Establish and achieve your financial goals such as buying an investment property or putting more money into superannuation.
- Make the most of your money with sound advice around budgeting and establishing savings plans.
- Protect yourself and your assets by assessing your insurance needs.

Source: BT

WHY INVESTING FOR RETIREMENT IS DIFFERENT

When you're still employed and earning a salary, there's money coming in you can rely on. In retirement, in the absence of a regular salary you'll need to find a new way to secure enough income to cover your living costs.

Investing your money is one way to make the most of your savings and provide an income in retirement but if you're expecting savings and investment earnings to help cover your expenses, it's important to get your strategy right.

WHY TIMING MATTERS

When accumulating super for retirement, you can afford to be patient. With years ahead to top up your super, you can stay invested during falls in the share market and wait for markets and your assets to bounce back. For the few years just before and after retirement, it's a different story. This period, known as the 'retirement risk zone', is the time when you have most to lose from a fall in the value of investments. Your super has likely reached its peak in value and you want to make the most of these savings for your future retirement income.

In order to protect your savings and provide you with income throughout your retirement, it's important to be aware of three key risks:

1. Living longer

Australians are living longer than ever before. Life expectancy has grown by more than 30 years in the last century[1]. Living off retirement savings for 20-30 years or more introduces the very real risk of running out of money. So it's no wonder more than half of Australians aged 50+ are worried about outliving their savings according to a 2019 National Seniors Australia survey.

We're lucky that we live in a country that if your retirement savings run out; the Age Pension is there as a safety net but these regular payments may not be enough to maintain the lifestyle you've been enjoying in retirement. You could also be left with limited funds and options for aged care, if you should need it. That's why it's so important to make a financial plan early in your retirement so that you can help to protect your income now and in the future.

2. Inflation

Inflation measures the change in the cost of living over time and represents an important and often underestimated risk to your financial security in retirement. Given your retirement could last 20 plus years, there's a good chance your savings and income will be affected by inflation. At an average annual inflation rate of 2.5%[2], a dollar today is worth roughly half what it was 25 years ago. Even this modest year on year rise in the price of goods and services can put you at risk of having an income that no longer covers your living expenses from year to year.

3. Share market performance

Share market performance is a risk for investors with exposure to investments such as shares, bonds and commodities. If you're worried about market collapses similar to the Global Financial Crisis (GFC) in 2008, you're not alone. A 2018 National Seniors Australia survey found that 7 out of 10 older Australians share your concerns.

Falls in the value of investments are impossible to predict and can make a big difference to income and financial security throughout your retirement. When investments earn negative returns, your retirement savings are falling in value. Crucially, if you also need to make regular withdrawals to pay for living expenses, it's a twofold blow for your overall financial position in retirement. Less savings now means more potential for outliving those savings later in life.

PROTECTING YOUR INCOME AND FUTURE IN RETIREMENT

Diversifying your investments – balancing growth and defensive assets for example can limit the impact of market risks and inflation on your retirement savings. However, even with a well diversified portfolio, your super and Age Pension may not provide you enough income for your entire retirement. If you'd like the peace of mind that comes with a regular income for life, a lifetime annuity might be right for you.

Using a portion of your savings or super, you can invest in a lifetime annuity and receive regular income payments for life. It can act as a safety net ensuring that you will receive income for life, regardless of how long you live.

Talk to an adviser about the benefits of a lifetime annuity and whether it might be right for you.

Source: Challenger

[1] Australian Bureau of Statistics, Life Expectancy improvements in Australia over the last 125 years, 18 October 2017.
[2] Australian Bureau of Statistics, 70 years of inflation in Australia, Andrew Glasscock, 2017. Fig 2.