INFORMED INVESTOR

November 2021

threePILLARS wealth management

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ECONOMIC UPDATE

INTRODUCTION

Investors remained focused on rising inflation and the possibility of policy settings being tightened worldwide.

Bond yields continued to rise – particularly in Australia – as investors brought forward their expectations for interest rate hikes.

This hampered returns from fixed income markets.

Equity markets performed much more strongly, aided by the release of pleasing corporate results for the September quarter.

Continued over...

FURTHER INFORMATION

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Capstone FINANCIAL PLANNING

ECONOMIC UPDATE
CONTINUED

AUSTRALIA

The latest surveys indicate conditions have improved modestly for both manufacturers and services companies, although backward-looking economic data were largely ignored given recent restrictions in NSW and Victoria. Instead, like elsewhere, the main focus was on potential changes to central bank policy.

In early October the Reserve Bank of Australia reiterated its yield target of 0.1% on 3-year government bonds.

Later in the month, market movements had pushed the yield on these securities above 1.0%, seemingly with limited effort from the Reserve Bank to defend the target. This prompted investors to question whether officials were changing their stance on policy settings.

At an annual rate of 3.0%, headline inflation for the September quarter printed in line with consensus forecasts.

The Reserve Bank's preferred measure of inflation – the trimmed mean – rose at a more modest 2.1% over the year.

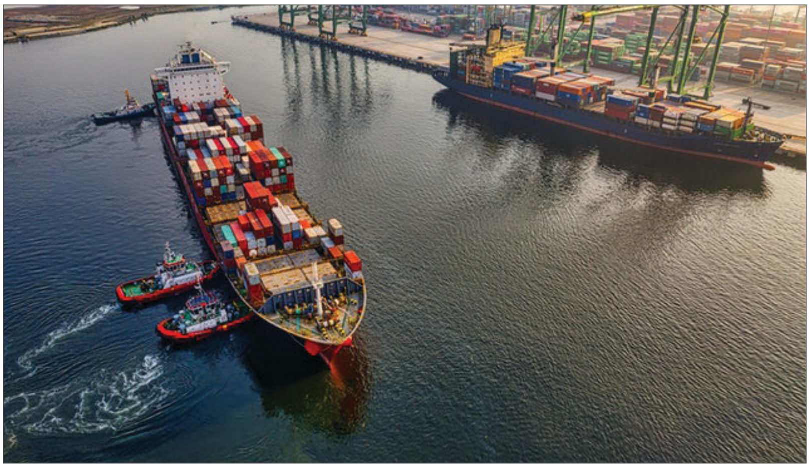
Official interest rates are unlikely to be changed for the foreseeable future.

NEW ZEALAND

As had been widely anticipated, official interest rates were raised by 0.25%, to 0.50% in October.

Reserve Bank of New Zealand officials appear to be concerned about quickening inflation – consumer prices rose by more than 2% in the September quarter alone, and are nearly 5% higher on a rolling 12-month measure.

As a result, some commentators are suggesting interest rates could be raised by a further 0.75% at the Bank's next meeting in late November.



US

At an annual pace of 2.0%, growth in the world's largest economy fell short of expectations for the September quarter.

Pandemic-related supply shortages and bottlenecks continued to hamper manufacturers. Car production fell around 7% in September, for example, due to a shortage of semiconductors. Services sectors are enjoying better operating conditions, as consumers continue to increase spending following months of lockdowns and disruptions.

There were mixed signals of the jobs front – new payrolls were lower than expected, but the unemployment rate dropped 0.4%, to 4.8%.

All of these data releases were overwhelmed by comments from Federal Reserve officials on the outlook for inflation and, in turn, potential changes to interest rate policy. The Federal Reserve is still expected to start tapering its quantitative easing program during November, likely reducing its monthly purchases of Treasuries and mortgage-backed securities.

Afterwards, attention is expected to increasingly shift to the likely timing of interest rate hikes.

Inflation remains very high and whilst officials continue to suggest this will prove temporary, pricing pressures owing to supply disruptions seem likely to persist into 2022 and longer-term inflation expectations are rising due to elevated energy prices.

Consequently, some investors are now anticipating two interest rate hikes in the US before the end of next year.

EUROPE

The latest GDP data in the Eurozone beat expectations. The region's economy grew by 2.2% in the September quarter, meaning overall activity levels have rebounded to 99.5% of pre-Covid levels. The upturn has been attributed to an encouraging recovery in services sectors.

The increase in discretionary spending is being reflected in higher inflation; consumer prices rose 0.8% in October alone. Like elsewhere, this prompted suggestions that the European Central Bank might have to raise official interest rates.

Less encouragingly, the latest data highlighted a slowdown in industrial production in Germany; Europe's largest economy.

Moreover, ongoing reports of supply shortages suggest weakness in the manufacturing sector could persist through the December quarter and, potentially, into next year.

ASIA

In China, large property developer Evergrande Group avoided a bond default following a last-minute coupon payment. This failed to calm investors' nerves, however; high yield credit spreads in Asia widened sharply over the month, resulting in disappointing returns from the region's credit markets.

In Japan, there was an unexpected upward revision to economic growth forecasts for 2022. Officials expect growth to rebound back towards pre-pandemic levels in the next 12 months or so.

AUSTRALIAN DOLLAR

The dollar reversed its recent weakness and strengthened by 4.0% against the US dollar. The 'Aussie' appreciated similarly against a trade-weighted basket of international currencies.

Performance relative to the Japanese yen was particularly impressive. At the end of October the Australian dollar bought nearly ¥86, an increase of 6.6% over the month.

The dollar was buoyed by rising commodity prices – coal and oil increased, which offset slightly lower iron ore prices.

AUSTRALIAN EQUITIES

The local share market started October on the back foot, as concerns about rising inflation drove the S&P/ASX 200 Index more than 2% lower on the first day of the month.

Equities quickly recovered and had moved nearly 2% higher towards the end of the month thanks to positive trading updates from the start of the AGM season. A sudden jump in bond yields on the last day of the month saw these gains reverse, however, and caused the Index to finish the month close to where it started, with a total return of -0.1%.

The Energy sector fell 2.7%, despite higher oil prices (Brent oil rose 7.5%). Energy companies struggled late in the month as news releases indicated oil supplies could soon increase, given a surprising jump in US inventories and the possibility of a resumption in Iranian oil exports.

Weakness among iron ore miners drove Materials stocks -0.5% lower. Iron ore prices fell around 5% due to Chinese steel production restrictions and weakening demand expectations.

In contrast, Materials stocks helped drive the S&P/ASX Small Ordinaries Index 0.9% higher thanks to strong performances from several gold and rare earth mining companies.

LISTED PROPERTY

Global property stocks fared well, with the FTSE EPRA/NAREIT Developed Index increasing by 1.9% in Australian dollar terms. The best performing regions included Sweden (+14.0%), USA (+7.8%) and Hong Kong (+6.1%), while laggards included Germany (-0.3%), Japan (-0.3%) and Australia (+0.4%).

GLOBAL EQUITIES

Several major share markets enjoyed their strongest month of performance of the year. The S&P 500 Index in the US closed October 7.0% higher, for example. Technology stocks continued their good form, enabling the NASDAQ to perform even better; up 7.3%. In Europe the Stoxx 50 added 5.0%, while in Asia Hong Kong's Hang Seng and Singapore's Straits Times rose 3.3% and 3.6%, respectively. Japan was the only major market not to participate in the rally, with the Nikkei closing the month 1.9% lower.

Returns from all major markets were diluted for Australian investors due to the strength of the dollar. Nonetheless, global shares made a positive contribution to diversified portfolios over the month.

GLOBAL AND AUSTRALIAN FIXED INCOME

Bond yields rose in most major regions, as investors continued to focus on high inflation and the possibility that interest rates could be raised earlier than previously thought.

The yield on 10-year Treasuries rose 6 bps over the month of October, to 1.55%. Similar moves were seen on 10-year yields in other countries (Germany +9 bps, Japan +3 bps and the UK +1 bp).

The most significant yield movements were seen in Australia, where 10-year yields skyrocketed by 60 bps and closed the month above 2% for the first time in more than two years; well before the Covid pandemic began.

GLOBAL CREDIT

Spreads on investment grade and high yield credit were little changed in October, at least in the US and Europe. Asian markets were a little weaker, partly reflecting ongoing concern about high leverage in the Chinese property sector. Consequently, returns from global credit markets were broadly neutral over the month.

Source: Colonial First State

MARKET VOLATILITY DURING COVID-19

Market volatility refers to extreme price movements over a given period.

These movements may occur in a particular area, such as real estate or shares, and may be upward or downward.

Ever since COVID-19 started spreading across the world in late 2019, affecting every aspect of our lives, the term 'market volatility' has been hitting headlines.

But, what does market volatility mean? And what might it mean for your finances?

Market volatility can feel like a one-off crisis. However, it's important to remember that volatility is in the very nature of markets. Fluctuations are bound to occur and, sometimes, they're rather extreme.

For instance, in February and March 2020, markets dropped 37%, but fast-forward to the June quarter, and they picked up 16%. That's quite a wild swing. Anyone who panicked and withdrew from the market at the end of March would have missed out on the subsequent gains.

In the scheme of things, three months isn't long at all. In the 141 years since the ASX was established, there have been 28 negative years, and the rest have been positive. In other words, each year, the average investor has a 1 in 5 chance of a setback, but a 1 in 4 chance of making gains.

Further, in the 20 years leading up to 2018, the ten best days in the market were responsible for 50% of returns.

During downturns, it's easy to be swayed by the news. Headlines often focus on the negatives. When the COVID-19 pandemic began, the emotional impact of worrying financial news was intensified by the fact that the virus itself was new and unknown.

Plus, so many people were unable to go to their workplaces, or catch up with friends and relatives.

If you were reading the headlines and not speaking to anyone about them, you may have been susceptible to making big financial decisions based on your emotional reactions.

That's why it's important to speak to your financial adviser, who will remind you of your long term plan—and that a downturn is just a short term blip, when you think of the next 20 years.

Source: TAL

AN OVERVIEW OF THE MAIN RESIDENCE CGT EXEMPTION

Generally, a property, including a taxpayer's main residence, ie their family home, is considered to be a Capital Gains Tax (CGT) asset.

When CGT assets are sold, taxpayers may be liable to pay tax on all, or part, of the capital gain. However, tax law provides an exemption for a dwelling that is the taxpayer's main residence, where certain criteria are satisfied.

This exemption means there will generally be no tax liability for the taxpayer upon the sale of the main residence.

To be eligible for the main residence exemption, the following conditions must be satisfied:

- the taxpayer is an individual
- the taxpayer is an Australian tax resident
- the dwelling was the taxpayer's main residence throughout the 'ownership period', and
- the dwelling was not transferred to the taxpayer as a beneficiary in, or as the trustee of, a deceased estate.

IS A DWELLING A MAIN RESIDENCE?

A number of factors are taken into consideration when determining whether or not a dwelling is the taxpayer's main residence, including:

- the length of time the taxpayer has lived in the dwelling
- the place of residence of the taxpayer's family
- whether the taxpayer's personal belongings are located at the residence
- the taxpayer's address on the electoral roll
- the address to which the taxpayer's mail is delivered
- the connection of gas, telephone or electricity services
- the taxpayer's intention in occupying the dwelling

It is important to note that a mere intention to live in a dwelling as your main residence, without actually doing so, is insufficient to be eligible for the exemption – the taxpayer must actually occupy the dwelling.

WHAT HAPPENS IF THERE IS A DELAY IN THE TAXPAYER MOVING INTO THE MAIN RESIDENCE?

In some cases, there may be a gap between when a taxpayer purchases a dwelling that is intended to be their main residence and when they actually occupy the property. In this instance, the main residence exemption will apply from the date of ownership provided that the dwelling was occupied by the time it was first practicable to do so. Generally, this would be the settlement date of the purchase contract.

A taxpayer may not be able to move into the dwelling upon settlement due to illness or some other unforeseen reason. So long as the taxpayer occupies the dwelling as soon as the cause of the delay no longer exists (eg recovery from illness) then the exemption will most likely still be available from the date the taxpayer acquired ownership.

Note that delaying occupancy due to an existing tenant is not sufficient grounds, and as such, the exemption would not apply from the date of ownership.

CAN A TAXPAYER HAVE MORE THAN ONE MAIN RESIDENCE?

Where a taxpayer acquires a dwelling that is to become the main residence whilst at the same time still owning an existing main residence, the taxpayer is allowed to treat both dwellings as their main residence for the shorter of:

- six months, or
- the period between the acquisition of the new residence and disposal of the existing residence.

This exemption on both dwellings will only apply if:

- the old dwelling was the taxpayer's main residence for a continuous period of at least three months in the 12 months before it was disposed of
- the taxpayer did not use the old dwelling for income-producing purposes in any part of that 12 months when it was not the main residence, and
- the new dwelling becomes the taxpayer's main residence.

If it takes longer than six months to dispose of the old dwelling, the taxpayer may choose to treat it as the main residence in order to obtain a full exemption on this dwelling. This however may impact on the taxpayer's ability to receive the full exemption on the new main residence when that dwelling is disposed of at some point in the future.

WHAT HAPPENS WHEN A TAXPAYER IS ABSENT FROM THEIR MAIN RESIDENCE?

Where a main residence is vacated and not rented out (and no other main residence election is made in respect of another property), the property will maintain its exemption status indefinitely.

Where the dwelling is used to produce assessable income when the taxpayer is absent (for example, is rented out), the exemption will apply for a period of up to six years. If the dwelling is re-established as the taxpayer's main residence, another maximum period of six years applies if the dwelling is again vacated.

The taxpayer can only continue to apply the main residence exemption to the vacated property where no other dwelling is treated as a main residence during the period of absence.

EXAMPLE

Emily has lived in her own house for two years. She is posted overseas for four years, during which period she rents the house. On her return, she lives in the house for two years and is then posted overseas for a further five years. Again, she rents out her house. On her return she sells the house.

Emily can choose to treat her house as her main residence during both periods of absence because each absence is less than six years. She can do this by not including any capital gain or loss in her income tax return for the year in which the house is sold.

If any part of the dwelling was used to produce assessable income (such as a home office) before the taxpayer vacated it, the taxpayer cannot apply the six year rule to that part of the dwelling.

WHAT IF A TAXPAYER AND THEIR SPOUSE HAVE DIFFERENT RESIDENCES?

Only one full main residence is permitted per family. In instances where a couple has more than one dwelling they must choose one of the properties as their main residence.

Where separate dwellings are maintained and both are elected as main residences (one by the taxpayer and the other by the taxpayer's spouse), special rules will apply and the exemption will be split. This is typically based on the ownership percentages, to determine the extent of the exemption for each dwelling.

Source: Macquarie Group Limited

HOW TO BEAT INFLATION BEFORE IT BEATS YOU

Investors with long memories – or a good education – will recall the bad old days when inflation was the economic bogeyman.

It broke Germany's Weimar Republic in the 1930s and nearly cratered America's economy in the 1970s.

Fortunately, inflation has been a non-issue in Western economies for decades. But is that about to change? In the first quarter of FY2021, Australian inflation ran at a comfortable 1.1%. By the second quarter it had leaped to 3.8%.

Perpetual's recent Quarterly Update summed up the problem: "With very easy monetary policy likely to continue for the next couple of years, and government spending at record-breaking levels, there remains the risk that inflation could become out-of-control. Historically, high levels of inflation have been very difficult to contain once in place."

INFLATION HURTS RETIREES

Inflation is bad news for retirees. "A continual rise in the price of goods and services can really affect someone who's retired or approaching retirement", says Malissa Tobias, a Perpetual Private adviser in Melbourne. "Inflation eats your purchasing power - you get fewer goods and services for the same amount of money."

If you're still working, your salary can rise to keep pace with inflation. Retirees - especially those with money in low-rate assets like term deposits or cash - suffer because their spending power is cut and the real (after-inflation) value of their capital is falling.

ANTI-INFLATION STRATEGIES FOR RETIREES AND NEAR-RETIREES

Manage your retirement

By managing the timing and shape of your retirement you can offset some of the inflation threat.

If you work a little longer (either full or part-time) you can earn an income that might go up with inflation.

Those extra earning years also give you more time and money to build up the largest possible nest egg to generate your retirement income.

Finally, but just as importantly, retiring later delays the day you start drawing on your capital.

Invest in inflation-beating assets

Investing in higher-returning assets - like shares or property - can deliver the same benefits as earning work-income because their value can rise in line with, or above, the rate of inflation. However, the inevitable complication is that higher returning assets are usually higher risk assets.

Plan your spending

Knowing how much money you're going to need in retirement is a crucial part of retirement planning.

Draw on capital

The recent Retirement Income Review suggested many retirees die with their capital intact. But that's not the case for everyone. In a world where the threat of inflation is rising, some retirees will need to dip into their capital to fund the retirement lifestyle they want. The key is to do that prudently.

Source: Perpetual

INVESTING IN INVESTMENT BONDS

Investment bonds can be used to build wealth without increasing an investor's personal tax liability.

Investment bonds are long-term investments that may offer tax efficiency to investors on a high marginal tax rate and those investing for children or grandchildren.

Unlike traditional investment products, such as managed funds, bonds are a 'tax paid' investment. This means that tax on investment earnings is paid at the applicable company rate of 30 per cent by the bond issuer – not by you, the investor.

Investors receive 'tax paid' returns provided they meet certain conditions – most notably that the investment is held for at least ten years and contributions do not exceed the 125% rule.

125% rule

Bonds have a valuable taxation status; as long as any additional investments you make do not exceed 125 per cent of the investments made in the previous year, then the taxation status will not be jeopardised. This is called the 125% rule.

By using the 125% rule, a bond investment becomes even more tax effective because it gives you the opportunity to make additional investments (or contributions to a savings plan) each year. The level of additional contributions you can make continues to increase until the end of the tenth anniversary, after which all withdrawals from the bond are tax-free.

Investment bond		Managed fund	
Investment earnings	$10,000	Investment earnings	$10,000
Tax paid by bond manager	$3,000	Tax paid by fund manager	$0
Net return (at maturity)	$7,000	Assessable income	$10,000
Assessable income	$0	Tax paid by investor	$4,500
After tax return	$7,000	After tax return	$5,500

For example, if you invest $10,000 in year one, then, using the 125% rule, $12,500 (125%* 10,000) may be invested in year 2, and so on.

A tax-effective alternative

The table above shows the tax benefits of an investment bond.

What investment choices are available?

While different investment bonds have different investment menus, generally they include a wide range of diversified funds, multi-manager funds, Australian share funds, international shares, fixed income and capital guaranteed investments.

Who should consider an investment bond?

Investment bonds may be suitable for:

- investors with a long-term investment horizon (at least 10 years).
- investors who have contributed as much concessional contributions to super as possible.
- parents or grandparents who wish to invest on behalf of the next generation.
- investors who do not require access to their funds, as investment bonds re-invest distributions.

Source: IOOF