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Financial Markets Update

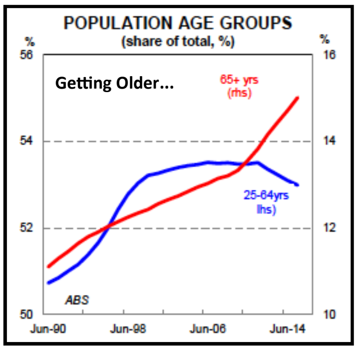
March 2016

The investment world was introduced to 2016 with a thud. Markets had their worst January performance on record and by mid February, most were down by over 10%. Share prices mirrored the direction of oil prices, a proxy for future growth. Selling was broadly based and on large volumes. Not good technical signs. Between February and mid March, shares and commodities rallied giving investors respite from their despair. Meanwhile, Australian politicians are toying with the minds and purses of voters touting tax changes. The old political chestnuts of negative gearing and super have made their way into the public forum again, whilst mooted GST changes have been given a decided thumbs down (for now). With a Federal election due, 2016 looks to be very interesting year.

The Winds of Change Beckon

A Glimpse Into The Future - Baby Boomers Part 1

In this edition of our newsletter, we will introduce the first of many snapshots we expect to discuss about the aptly named baby boomers and how they have shaped the world we live in today and the world we will live in tomorrow. We hope our discussion will be of interest to our readers since it will certainly impact on their financial well-being.



We suspect that in time, most people will be very familiar with demographic charts such as the ones shown on this page. These simple graphs are road maps of our financial future, that cryptically convey subtle messages to astute investors. By definition, any investment made today requires assumptions to be made about future conditions in order to correctly forecast income and growth prospects.

Recognising changing social, technological and lifestyle trends is as critical to successful investing as any other factor.

As advisers, we must consider the impact of changing preferences, just as we do changing economic environments. The two go hand in glove.

Looking at the above graph, one should grasp the profound impact that post WWII baby boomers will progressively impart. Notice the increasing gradient of the red line, the over 65 year olds, and the declining blue line, the working age under 65's. Over time, these lines will continue to diverge, especially since people are living longer now than ever before.

In Australia, the rate at which boomers are attaining 65 years is accelerating. **Presently, almost 5,000 Australians turn 65 each and every week.** That is over 1% of our entire population per annum. Known as the **"dependency ratio"**, the proportion of retired citizens to working age citizens impacts greatly on our country's future pension costs as well as both the extent and nature of spending on various goods and services.

Public and private spending on health, aged care, home services, travel and recreation "experiences" will increase. Similarly, government faces the thorny dilemma of funding an ever increasing welfare bill with an ever decreasing proportion of working age taxpayers. Although this situation has been known for decades, it is only now becoming a reality. It highlights the need for future governments to **broaden the taxation base (revenue) and reduce welfare/tax concessions (costs)** whilst maintaining public services. We need to learn how to get more out of less.

The transition to a leaner future will be slow, but inexorable. Concurrently, but of no less importance will be how Australia manages to unwind its 21st century self induced debt burden. The greatest per capita debt load in history, borne mostly by people between the ages of 30 and 55 for whom job security is the most tenuous in modern history. Mmm.

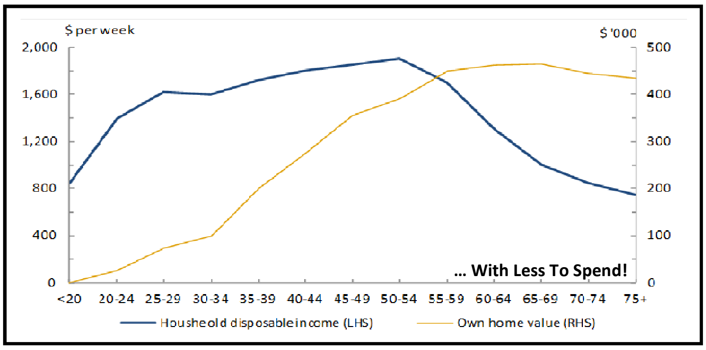
For obvious reasons, **retirees rarely carry debt**. Most **people over 55**, often "empty nesters", tend to have one eye out for their own retirement and thus **accelerate their savings** in the years leading up to 65, **coinciding with their peak earning capacity**. The large number and behaviour of this cohort, clouds the statistical comfort often drawn from our nation's savings rate. Yes, many are saving plenty, but many others are borrowing far more than they should.

We believe this situation is hazardous to the financial well-being of the entire community since much of the wealth held by older Australians is tied up in the value of their homes. This in turn is tied to the financial (credit) system which makes up over 35% of Australia's stock market capitalisation, which in turn is reliant on the ongoing ability of younger borrowers to manage their debt, amidst life's ebbs and flows.

Most readers have heard of the commodity super cycle (now ended). Many may not have considered the longevity of **Australia's banking and credit super cycle** that has, over the last 20 years, delivered a rich vein of profitable debt and taxes and propelled our small nation's 4 major banks into the world's Top 20. **It won't last forever, bank on it!**

Whilst we hold no fear of Australian banks failing, their continued growth in profits (and thus their share price and dividends) relies on continued growth in lending and few bad debts. To us, this seems an increasingly difficult ask, in a nation that appears nearly tapped out.

Again we remind readers that we are merely observing longer term trends, and certainly not predicting any calamity in the near term. That said, **the days of simply buying and holding any asset, be it shares or property are long gone.** Investors would do well to always be aware of what is happening around them and act accordingly. Older clients over exposed or over reliant on bank assets or retailers for their income should take note and have a Plan B. Almost every investment strategy has a use by date. Those built on debt are no different.



To conclude this introduction to Australia's changing demographic landscape we draw your attention to the above graphic. In essence, it illustrates the point that not only does retirement reduce the number of taxpayers, it is also a drag on economic growth since **retirees will progressively have less disposable income as they age.**

Up to age 60, household disposable income steadily increases to around $1,600 per week. After age 60, it gradually diminishes to $800-$1,000 per week by 69. As our population ages, more people having less money reduces the economy's gross spend. In the last 15 years that trend has been offset by rising immigration and increased borrowing, but those offsets now appear to have peaked. In time, this pattern will gradually manifest itself into sustained lower GDP growth.

Ultimately, a declining income base and diminishing investment funds needing to fund longer lifespans inevitably leads retirees to unlock the equity in their only remaining store of wealth, their home. Traditional owner occupied homes are released via downsizing as people seek capital to meet their living costs and/or aged care needs and/or their preference for smaller, lower maintenance accommodation.

The **transfer of property ownership from generation to generation** is already visibly evident in many of our more affluent suburbs. Older homes make way for mansions or unit developments designed to meet today's lifestyles. This cycle, and where it leads us, is somewhat predictable as more advanced overseas experience shows us.

Although an imperfect model, Europe's generally stagnating economy is in part based on its now aging population resulting from a significantly shorter and shallower baby boom period. It has reached an economic point of no return, in a forward moving global economy that has made its "old world" economic strengths redundant.

The relatively recent comatose fate of Europe, was earlier seen to have fallen on Japan in a similar manner, even though their pathway was very different. In each case a combination of **debt driven growth, capital and labour inefficiency, ageing and a plateauing or declining population**, hobbled GDP growth and led to asset price stagnation. Curiously, Europe's post GFC monetary response of reducing interest rates to zero was as spectacularly unsuccessful in reviving growth as Japan's attempt 15 years earlier. We are next in line.

Australia, the US , Canada and New Zealand, where the baby boomer phenomenon was the most sustained, is probably about 10 years behind the European experience. Those 10 years will pass quickly.

Negative Gearing - Not Black or White

It is liberating to hear broad based discussion around our tax system. Its features, its failings and its future. This is a process Australia needs to have because our current model is out-dated. That said, it is up to political parties to have the courage of conviction to map out change and implement it. Policy cannot be determined by the populist vote of the media, for if it were so, **no serious reform will ever be mandated**. Front and centre of current debate is the matter of negative gearing. "To be or not to be", as Shakespeare so eloquently put it.

As an interested observer, your writer has considered the views of many, just as governments would do, but with an added filter. Before listening to any argument, either for or against, he considers the author/source of the argument to determine the self interest of the speaker. Property people, financiers and brokers generally sit on one side arguing that our economic blue sky will fall in if any changes were considered. Social welfare groups, home buyers and egalitarians trumpet the view change must come for equality to prevail for the many.

We do not ascribe to one view or another because **negative gearing, of itself, is not bad policy**. However, when combined with other tax concessions, it does and can present itself as a simple, irresistible and victimless wealth strategy. That is a discussion for another day.

We seek to contain our brief writing to some simple home truths that have been lost in the highly emotive arguments of both sides.

When debating personal tax rates or corporate tax rates or indirect tax rates, reference is usually made as to where Australia sits, relative to our Western peers. Strangely, when debating negative gearing, rarely are such references made. We aim to correct that deficiency.

The table below shows where Australia's policy is consistent with other countries and where it differs. This table is not exhaustive as it does not compare land taxes, CGT, depreciation or personal tax scales between the countries, each factor of which is important.

Bottom line

Interest deductibility and negative gearing in selected OECD countries

	Interest deductibility		Tax on imputed rents	Negative gearing
	Own home	Investment home		
Australia	✗ No	✓ Yes	✗ No	✓ Yes
Canada	✗ No	✓ Yes	✗ No	– Limited
NZ	✗ No	✓ Yes	✗ No	✓ Yes
Switzerland	✓ Yes	✓ Yes	✓ Yes	– Limited
UK	✗ No	✓ Yes	✗ No	✗ No
US	✓ Yes	✓ Yes	✗ No	✗ Generally not

SOURCE: AUSTRALIAN TREASURY

Please study the table to best understand the following observations:

1. No two systems are identical, each is unique
2. Interest deductibility is accepted in all countries
3. Barring NZ (not identical to us), no country adopts our model
4. **Generally speaking, countries permit gearing losses to be offset against investment gains and income, but not salary and wages**
5. Investment booms/busts occur with or without negative gearing

Any conversation on negative gearing must involve the taxation of capital gains. **If the first rule of investing is to make a profit, it makes no senses to make a loss (negative gear)**. Unless of course, the intention is to make a tax deductible income loss but a tax concessional capital gain. It is on this point that our policy differs most from others.

Australia has not had a friendly approach to the taxation of passive income (interest, rents, dividends, etc). In fact, it has downright discouraged savings via income. On the other hand, until 1985, Australians paid no tax at all on any capital gains derived from assets held for investment. **Paul Keating introduced CGT on 20th September 1985**.

Thus for generations, Australians naturally pursued wealth from tax free gains rather than taxable income. Keating's CGT capped the benefit of that strategy until, in 1999, Howard introduced a pre GST carrot of a 50% CGT exemption for any asset held for 366 days or more.

Coinciding with a period of declining interest rates, liquid capital markets, strong immigration and a willingness by borrowers to take on debt, the 1999 tax change heralded a new wave of negative gearing. The strategy was popular with both high income earners and ordinary income earners. Indeed, in many cases, "average" Aussie workers could become leveraged slumlords and if they bought well, be considered a successful role model among their peers. Which brings us to where we are today, inflated prices and systemic indebtedness.

Generations of **current policy settings** have not provided more affordable accommodation or lead to great gains in employment or growth. It **shuffled existing titles and rents between owners and banks,** like a game of Monopoly. It has led us to the world's most distorted housing prices (outside of Hong Kong) and to a multi generational lock out of home buyers in Australia with **median prices now 10 times income**.

Australia's investment tax policy needs to be fundamentally reformed with a long term vision of its objective. To his credit, Keating's bold (and painful) 1980's reforms including **CGT, FBT, compulsory super and dividend imputation, have stood the test of time**.

We do not believe "tinkering" with negative gearing, CGT or superannuation is in Australia's best interests. What is demanded is a comprehensive system of reforms across all aspects of tax, welfare and housing policy. Such policy needs to be cohesive, equitable and consider the interests of both current and future generations. If Hawke/Keating in the 1980's and Howard/Costello in the 2000's could do it, surely we will find a reformer for our day capable to forge policy for the future.