Personal Wealth

Autumn 2017 — A Quarterly Newsletter for **Lifespan Clients**

What's inside...

- **Superannuation changes for 2017 and beyond**
- **Investment Markets**

Superannuation changes for 2017 and beyond

Introducing the transfer balance cap

What is it?

From 1 July 2017, there will be a $1.6 million transfer balance cap on the total amount of accumulated superannuation an individual can transfer into the tax–free retirement phase. Subsequent earnings on balances in the retirement phase will not be capped or restricted.

Savings beyond this can remain in an accumulation account (where earnings are taxed at 15 per cent) or outside the superannuation system.

Transitional arrangements will apply. People already retired with balances below $1.7 million on 30 June 2017 will have 6 months from 1 July 2017 to bring their retirement phase balances under $1.6 million.

The transfer balance cap will be indexed and will grow in line with CPI, meaning the cap will be around $1.7 million in 2020–21.

How does it work?

Agnes, 62, retires on 1 November 2017. Her accumulated superannuation balance is $2 million. Agnes can transfer $1.6 million into a retirement phase account. The remaining $400,000 can remain in an accumulation account where earnings will be taxed at 15 per cent.

Alternatively, Agnes may choose to remove all or part of the extra $400,000 from superannuation.

Subsequent earnings on balances in the retirement phase will not be capped or restricted. The minimum drawdown will apply.

Who is affected?

Less than one per cent of Australia's superannuation account holders will be affected by the transfer balance cap.

A balance of $1.6 million is approximately twice the level of assets at which a single homeowner currently loses entitlement to the Age Pension.

The average balance for a 60–year old is expected to be $240,000 in 2017–18.

Reforming the taxation of concessional superannuation contributions

What is it?

From 1 July 2017, the threshold at which high income earners pay additional contributions tax (Division 293) will be lowered from $300,000 to $250,000.

The Government will also reduce the annual cap on concessional (before–tax) superannuation contributions to $25,000 (currently $30,000 for those aged under 49 at the end of the previous financial year and $35,000 otherwise).

How does it work?

In 2017–18, Madeline earns $260,000 in salary and wages. In the same year she has concessional superannuation contributions of $30,000. Madeline's fund will pay 15 per cent tax on these contributions. Madeline will pay an additional 15 per cent tax on $25,000 of the concessional contributions, resulting in these amounts effectively being taxed at 30 per cent.

The $5,000 of contributions in excess of the cap will be treated as income taxed at her marginal rate. Madeline pays $1,600 income tax on her excess contribution. Madeline can choose to leave this excess in her superannuation (as a non–concessional contribution) or remove it from super.

Who is affected?

Around 1 per cent of Australia's superannuation account holders will be affected by the reduced Division 293 threshold.

Around 3.5 per cent of Australia's superannuation account holders will be affected by the lower annual concessional contributions cap.

Lowering the annual non–concessional contributions cap

What is it?

From 1 July 2017, the Government will lower the annual non–concessional contributions cap to $100,000 and will introduce a new constraint such that individuals with a balance of $1.6 million or more will no longer be eligible to make non–concessional contributions. As is currently the case, individuals under age 65 will be eligible to bring forward up to 3 years of non–concessional contributions.

This is in place of the $500,000 lifetime non–concessional contributions cap announced in the 2016–17 Budget.

How does it work?

The $1.6 million eligibility threshold will be based on an individual's balance as at 30 June the previous year. This means if the individual's balance at the start of the financial year (the contribution year) is $1.6 million or more they will not be able to make any further non–concessional contributions. Individuals with balances close to $1.6 million will only be able to access the number of years of bring forward to take their balance up to $1.6 million.

Transitional arrangements will apply. If an individual has not fully used their non–concessional bring forward before 1 July 2017, the remaining bring forward amount will be reassessed on 1 July 2017 to reflect the new annual caps.

Individuals aged between 65 and 74 will be eligible to make annual non–concessional contributions of $100,000 if they meet the work test (that is they work 40 hours within a 30 day period each income year). As per current arrangements, they will not be able to access the three year bring forward of contributions.

Who is affected?

This measure is expected to affect less than 1 per cent of fund members.

Improving access to concessional contributions

What is it?

From 1 July 2017, the Government will allow all individuals under the age of 65, and those aged 65 to 74 who meet the work test, to claim a tax deduction for personal contributions to eligible superannuation funds up to the concessional contributions cap.

How does it work?

Currently, an income tax deduction for personal superannuation contributions is only available to people who earn less than 10 per cent of their income from salary or wages. This limits the ability for people in certain work arrangements to benefit from concessional contributions to their superannuation. Under the new arrangements, more individuals will be able to make concessional personal contributions up to the annual cap.

Chris has started his own online merchandise business but continue to work part-time at an accounting firm earning $10,000 as his business is growing. His business earns $80,000 in his first year and he would like to contribute $15,000 of his $90,000 income to his superannuation. He currently could not claim a tax deduction for any personal contributions. Under the changes, Chris could claim a tax deduction for his $15,000 of superannuation contributions.

Who is affected?

This reform will benefit individuals who are partially self–employed and partially wage and salary earners – such as self–employed contractors, individuals employed by small businesses or freelancers – and individuals whose employers do not offer salary sacrifice arrangements.

Around 800,000 working Australians are expected to benefit from this measure.

Allowing catch–up concessional contributions

What is it?

From 1 July 2018, the Government will help people 'catch–up' their superannuation contributions by allowing individuals with a total superannuation balance of less than $500,000 just before the beginning of a financial year to carry forward unused concessional cap space (for up to 5 years) to use if they have the capacity and choose to do so.

How does it work?

Cassandra has a superannuation balance of $200,000 but did not make any concessional superannuation contributions in 2018 –19 as she took time off work to care for her child. In 2019–20 she has the ability to contribute $50,000 in concessional (before-tax) contributions into superannuation ($25,000 under the annual concessional cap and $25,000 from her unused 2018–19 concessional cap which she can carry forward).

Who is affected?

In 2019–20, this will help around 230,000 Australians who take time out of work, whose income varies considerably from one year to the next, or who find their circumstances have changed (e.g. mortgage payments or school fees have ceased) and are in a position to increase their contributions to superannuation.

Individuals aged 65 to 74 who meet the work test will be eligible to access these new arrangements.

For further information, please contact your adviser.

Source: The Treasury

Investment Markets

Recent Events

Equity markets continued to move higher in 2017 while bond yields stabilised after the sharp sell-off in the last quarter of 2016. Meanwhile everything has taken a back seat to watching the dealings of the Trump presidency and what that means for economic growth and investment markets. US equities hit new all-time highs on hopes of tax cuts with the Dow Jones Industrial Average passing 20,000 for the first time.

The price of iron ore went above US $90/ tonne and this has contributed to the strength of the Australian dollar. The Aussie dollar rose dramatically from 72 US cents at the end of 2016 to be currently trading close to 77 cents. However, despite this move it is almost flat over the 3 months to the end of January 2017.

The Australian share market returned 6.6% for the 3 months to the end of January 2017. Australian Small Cap Equities significantly underperformed large caps returning -0.1% for the same period. Developed Market Global shares slightly underperformed Australian shares returning 6.0% for the period.

Emerging market equities were laggards on concerns of higher US interest rates and returned just 1.2% for the 3 months to the end of January. Fixed interest had a bad 3 months as bond yields continued to rise from their post Brexit lows. The Australian fixed interest benchmark returned -1.0% for the 3 months while Cash returned 0.45%. Australian listed property (AREITS) returned 2.5% over 3 months but the benchmark is down -12.2% over 6 months .

Economy

The US economy grew at annualized 1.9% in the 3 months to December 2016. This was lower than the 3.5% rate in the previous quarter and below market expectations of 2.2% growth. In calendar 2016, US GDP expanded 1.6%, the lowest since 2011.

European economic data was fairly positive over the period. One of the leading indicators, the composite purchasing managers' index (PMI) came in at 54.3 in January. A reading of over 50 indicates that the economy is expanding. In fact GDP for the Eurozone grew by 1.7% during 2016.

The European headline inflation rate rose to 1.8% in January although the Core rate is about half that. The European unemployment rate fell to 9.6%. Chinese GDP growth slightly exceeded expectations in the last quarter of 2016 coming in at 6.8%. For calendar 2016 the economy grew at 6.7%.

Australia recorded a Trade Surplus of $3.5bn in December 2016, a record on higher iron ore and coal prices. The current account deficit, which reflects financial flows as well as trade flows is projected to be just 1.3% of GDP this financial year, the smallest since the early 1970s .

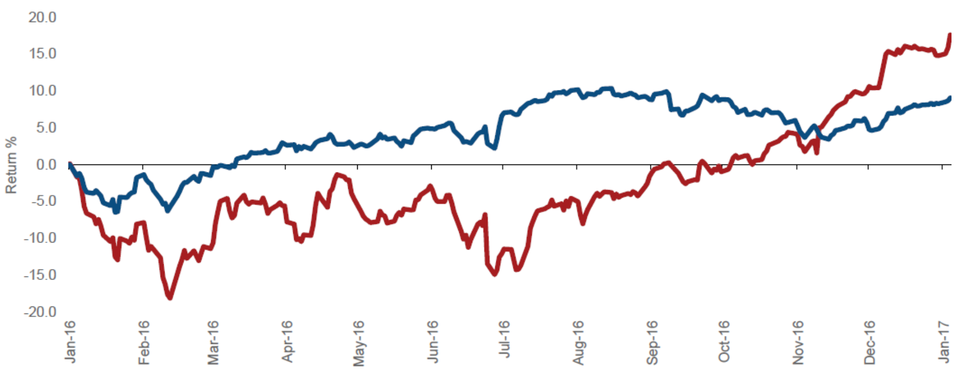
Markets and Outlook

Markets are expecting that Donald Trump's policy goals of tax cuts, deregulation and fiscal stimulus will boost economic growth which should lead to a lift company profits and raise the level of inflation. Markets in the US have certainly anticipated some of these benefits and US markets have had a succession of record highs. Currently the one year forward PE for the S&P 500 stands at 17.7x earnings estimates (S&P 500 at 2,365). This is well above the 25 year average PE of 15.9x and has risen from 16.9x at the start of 2017 (JP Morgan: 31 Dec 2016).

Until very recently markets were expecting a deflationary environment with low inflation and interest rates staying very low for the foreseeable future. Even before the election of Trump, global inflation expectations had been rising but received an extra kick on his unexpected victory. US headline inflation is currently 2.5% and Core Inflation is 2.3% (ex food and energy). The European inflation rate is within reach of the 2% target. However before December 2016 it had not exceeded 1% for 38 months. While Core Inflation is low for Europe as a whole, it is 1.7% in the stronger German economy.

With unemployment well below 5% and Core Inflation over 2%, we expect the US Federal Reserve (Fed) to raise short term interest rates a number of times this year. Markets are currently anticipating roughly 3 moves of 0.25% in 2017. The situation is less clear in Europe. Any tightening there would be likely

Chart 1: Performance of Global Quality Stocks versus Value Stocks in 2016



Source: Societe Generale Cross Asset Research, Fidelity International, January 2017 be a tapering of the existing QE program. It should be noted that higher inflation in Europe is largely due to a bounce back in the oil price in 2016 and that effect will dissipate if current prices are maintained.

While rising bond yields are negative for fixed interest we are less worried about this asset class now than we were last year. With yields now about 1% higher in both the US and Australia, you are at least receiving a positive real rate of return (after inflation). If yields move up gradually then fixed interest returns can still be positive although much lower than recent returns.

The rise in bond yields and steeper yield curves has had dramatic effects on markets apart from the sharp rally post the Trump victory. We have seen a rotation to ‘cheaper’ Cyclical and Value stocks away from more expensive Quality and Growth stocks (chart 1). Also bond proxies such as utilities and REITS have underperformed.

Stocks with more predictable earnings and steady growth prospects had been bid up relative to Value stocks. While we would normally expect a valuation premium for Growth stocks over Value stocks, that premium had become stretched. If we now expect stronger economic growth then Cyclical and Value stocks are expected to be the big beneficiaries of this.

We are not sure if the world has changed that dramatically in the last 3 months. In the end it is going to come down to earnings growth of individual companies. While we believe that bond proxies will likely underperform (if bond yields rise) it is less clear on Growth versus Value after the recent adjustment.

The Australian equity market has been in an upgrade cycle due to higher commodities prices leading to serial upgrades for mining shares. Also fiscal year 2017 is expected to be the first year since 2014 that we will see earnings growth in our market, this is almost all due to Resources companies. For example iron ore is currently trading above USD $90/tonne and was up 81% in 2016.

Australian Banks have also done well recently as steeper yield curves are good for US bank profits. The rise in US banks has helped to lift Australian bank shares as well. Also this has largely been a large cap rally for the 3 months to January 31, Small Cap shares are actually slightly down over this period.

The rally in commodities has contributed to the Australian dollar rising 5 cents to almost 77 cents to the US dollar in 2017. The lift in the Aussie has pretty much wiped out any gains investors have received from unhedged global assets. We do not know where the Australian dollar will go from here but would point out that earnings growth in 2017 is coming from a wider spread of sectors in Global equities than it is in Australia, where it is quite narrowly based. Therefore we would maintain our allocation to Global equities if only for diversification purposes.

Equity markets are certainly not cheap right now and have factored in a lot of good news. Returns will be harder from here as markets will now focus on issues like the timing of US tax cuts and the horse trading to get them through the US congress. Given that, we would not be aggressive in allocating to growth assets after the recent gains in markets .

Chart 2: Investment Returns to 31 January 2017 (% p.a.)

Asset Class	1 month	3 months	1 Year	3 Years	5 Years
Australian Shares	-0.79	6.65	17.34	7.40	10.57
Global Shares	-2.01	6.00	9.88	10.50	16.28
Listed Property	-4.84	2.49	6.55	15.89	16.14
Fixed Interest	0.61	-1.01	2.3	4.89	5.05

Source: Mercer

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