

YOUR PERSONAL WEALTH

SPRING 2022

WELCOME TO SPRING

Recent talk has been about inflation, interest, and recession. In an effort to curb inflation, both the RBA and the US Federal Reserve have lifted interest rates four times in the first 8 months of 2022. Meanwhile, the US has effectively experienced two consecutive negative growth quarters, technically defined as recession, however, their employment figures stand defiant. Despite these bumps, staying focused on the long game is important.

We look at the potential impact of inflation on your savings and how to ensure you don't sacrifice your retirement dreams for your adult children.

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Market Update

Virtually all global equity markets were sold down in the first half of 2022 as markets worried about Central banks lifting interest rates to fight runaway inflation. The first six months saw the US Nasdaq drop over 30%, while the S&P 500 was down over 20%, its biggest first-half percentage drop since 1970. There was no safe haven in bonds, with both the US and Australian fixed interest benchmarks at one stage down around 13% since January. This was almost double the 'famous' bond bear market of 1994.

In an effort to curb inflation, both the RBA and the US Federal Reserve have lifted rates four times so far this year. The concern for markets earlier in the year was that higher rates would tip many economies into recession, and we would end up with very low or negative growth with persistently high inflation, or stagflation like that in the 1970s and 80s. However, the current feeling in markets is that a slowing US economy will result in the Fed either not raising as much as first thought or needing to quickly reverse policy sooner than previously expected.

So at least for the moment, markets, and more particularly bond markets are more concerned with slowing growth rather than high inflation. The US 10-year government bond yield peaked at around 3.5% in mid-June while the Australian 10 year peaked at just under 4.2% at the same time. This was also when equity markets bottomed, with the S&P 500 subsequently increasing around 17%.

Australian Outlook

The worries about growth have resulted in Australian equities also finally joining the global pullback after holding up early in the year. The Australian market benefited early on with our high weighting to resources seen as an inflation hedge. However, resources exposure is now seen as a negative as markets are worried about slowing growth or a recession in the US and Europe. The war in Ukraine caused a big spike in commodities prices but many of these (e.g., oil and copper) have pulled back on these growth concerns. In fact, industrial metals have suffered their worst quarter since the 2008 financial crisis.

The Australian economy grew by 4.8% in the calendar year 2021 which was the fastest growth in 23 years. However, this is forecast to be closer to 2% in 2023.

Australian GDP 2021



4.8%

Australian GDP 2023 forecast

2.0%

6.1%
Australian CPI current
7.55%
end 2022 CPI forecast
3%
end 2024 CPI forecast



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The Australian dollar, at 75 US cents on 31 March is now trading below 69 cents, again reflecting global growth concerns as well as a US Fed that is seen as more aggressive in hiking rates. Australian equities have also bounced around 9% on the global rally but are still in negative territory for 2022.

Global outlook

Global growth forecasts have been steadily revised down in 2022. The IMF for example downgraded its forecast for global growth in July to 3.2% in 2022 (from 6.1% in 2021). This is 0.4% below its April forecast. Growth in 2023 is projected to be even lower at 2.9%. Growth in China is likely to be closer to 3% this year than the official target of 5.5%, as it persists with a zero Covid policy.



When is a recession not a recession?

The US economy shrank at an annualised rate of 0.9% in Q2 of 2022, following a 1.6% drop in Q1, and technically entered a recession. However, there were 528,000 jobs created in July and the unemployment rate came in at 3.5%. As these figures are not consistent with a recession, the NBER (National Bureau of Economic Research) has not called a recession which requires a broader economic downturn than the current data suggest.

The good news is that US CPI inflation for July came in at 8.5%, unchanged from June and down from the recent peak of 9.1%. This was mainly due to a fall in energy prices. The producer price index (PPI) fell 0.5% in July to be up 9.8% from a year ago. This was the first fall in the PPI since April 2020 and again was due to lower energy costs.

‘Peak’ inflation in the US and lower bond yields have resulted in a strong rebound in equity markets. However, the jury is out on whether this is just a bear market rally with more falls to come down the track. In the early 1980s (the era of stagflation), it took 3 years and 2 recessions before the Fed was able to control inflation. In previous periods, the Fed has had to raise the cash rate to the level of inflation, to get inflation under control. Currently, expectations are for the US cash rate to peak around 3.6% in April of 2023, before gradually coming down. We would suggest that a peak cash rate at this level would be a good result, given how high rates have been hiked in previous cycles.

The thing that may hold the Fed back is the bond yield inversion that currently exists. The 2-year bond yield is trading above that of the 10 year by 0.3% to 0.4%. This normally signals an economic slowdown and is around 80% accurate in predicting a recession. This inversion first occurred in March 2022. Historically, the timing between yield inversion to recession has averaged around 13 months for the last 8 recessions.

In terms of the probability of a recession, the situation is probably worse in Europe than in the US, while the probability seems lower in Australia. Germany, the largest European economy, is a special case in that they are dependent on Russian gas which has been weaponised by Putin. Germany's producer prices (PPI) rose by 37% in the 12 months to July, driven by higher energy prices, posting the biggest increase ever recorded. The producer prices index rose 5.3% in July alone, the biggest month-on-month increase ever recorded.

Stock market & price-to-earnings (PE) ratios

As expected, we have had a lot of PE compression this year as cash rates and bond yields have been rising.

PE Multiple	Jan 2022	Jun 2022	Aug 2022
Australia		12.9x	14x
US S&P 500	21.5x	15.5x	18x

PE multiples compared to the 25 year average of 16.8x. The major reason for the low multiple in Australia is that resource stocks are trading on very low PEs as there is an expectation that commodity prices will fall further. In addition, earnings expectations for this year and 2023 have been coming down slowly. We would expect this downgrade cycle to continue for a while but it is hard to estimate the extent of it. The other complicating factor is that markets tend to rise part way through one of these downgrade cycles, i.e., they anticipate improvements in earnings before analysts start raising forecasts.

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DON'T SACRIFICE YOUR RETIREMENT DREAMS

According to Finder.com, 44% of Australian parents feel the urge to subsidise their adult children's lifestyles[1], especially as home ownership moves beyond many young peoples' reach. The main problem with supporting adult children is that, in many cases, the support of your children financially draws away resources that you may need to fund your retirement.

While it's natural to want to ensure your children's financial security, regardless of their age, is it possible to do so without sacrificing your retirement situation?

We say yes, but consider these points first:

Can you afford it?

If you're approaching retirement. There's limited opportunity left for accumulating superannuation savings so any deviation from your retirement strategy could have dire consequences.

If you're already retired. Withdrawing a lump sum can potentially reduce your pension payments or erode your savings all together. With life expectancy rising, we face the reality of outliving our savings. What then?

It's important to remember that **whilst students can take out a loan for their education, parents cannot take out a loan for retirement.** It's important to put your financial security first. This will not only minimise the potential for creating dependency issues for your children and reduce the potential for you becoming a financial burden for your children later in life, but it will also reduce the likelihood of setting up your kids for failure if they can see you setting a good financial example[2].

Gifting and loaning

Gifting cash to your family carries no tax implications, however, when gifting assets like property or shares the Australian Tax Office (ATO) considers it the same as you selling the asset which could attract capital gains tax.

If gifting money or assets while receiving government benefits, the gift may still count towards your income and assets tests leaving you worse off if the amount of your benefit includes assets you no longer own[3].

Consider lending the money rather than gifting it for the following reasons:

- It's not poor parenting to consider your own needs too!

- Children may become dependent on the additional money; there's a difference between supporting your child's lifestyle and enabling it.
- Some kids come to expect handouts from the Bank of Mum and Dad. Certainly, give them a helping hand, but ensure you teach them independence. A loan should be a once-off thing, perhaps with interest.
- If you have more than one child, lending money and agreeing on a repayment plan removes the risk of being seen to favour one over the other.

Get the legals right!

When lending money to children, it's critical to document the details and have all parties in agreement, to reduce any possible misunderstandings down the track. Financial abuse appears to be the most common form of abuse experienced by elderly people[4]. Ensuring the right legal arrangements are in place up front can help reduce this risk.

It's natural to want to assist the kids, and it's true: you'll always feel responsible for their wellbeing. But think of yourself too – you've earned your retirement!

Nobody wins if you outlive your money, so plan today for what you'll need in the future. You'll stay on top of your retirement finances and live your best life – whatever that means for you.

By discussing your needs with us, you can set realistic retirement goals that may include helping your adult children but not at the expense of your retirement dreams.

[1] <https://www.finder.com.au/parents-helping-kids-financially>

[2] <https://www.goodfinancialcents.com/supporting-adult-children-can-ruin-retirement/>

[3] <https://www.servicesaustralia.gov.au/gifting>

[4] <https://aifs.gov.au/research/research-reports/elder-abuse-understanding-issues-frameworks-and-responses>



THE INFLATION EFFECT ON THE VALUE OF SAVINGS

Inflation devalues the purchasing power of your money. How will inflation impact the value of your savings, particularly if you're still being highly conservative and holding a large portion of your portfolio in cash waiting for the economy to 'get back on track'?

Now and then

A good place to start is by looking back at how inflation has affected the cost of living in Australia. The Reserve Bank of Australia (RBA) has a handy calculator on its website (www.rba.gov.au) that tells us how the cost of a 'basket of goods and services' has changed over a chosen timeframe. It's a great eye-opener.

How much?!

According to the RBA inflation calculator, one hundred dollars worth of goods purchased in 1980 cost \$440 in 2020! One hundred dollars spent in 2000 cost \$162.43 in 2020. That may not seem much BUT when you realise that the increase over that time was 62.4% you might be a bit more concerned. Over the 20 years, this averages out to just 2.5% per year, which is within the RBA's target range. But how could this impact your savings in the current economy?

During periods of high inflation, which we are currently experiencing, the purchasing power of money held in cash reduces faster. With most term deposits currently earning less than 3% pa interest, apply the current inflation rate of just over 6% to this and you'll realise that these accounts are not earning any real returns; in fact, most are losing value. **This is why it's so important to be vigilant about how inflation may affect your super in the lead up to and during your retirement.**

Every investment must meet your own individual needs, now and in the future. If you would like to learn more about how to manage the impact of inflation on your savings or your retirement, speak to us. We may not have a crystal ball, but we do have a good understanding of how all this works!



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Equity markets have bounced from the oversold levels in June but as a result are now less compelling, as they are trading close to long term average valuation levels (with added risk). We suspect we are probably in a trading range for a while until we get a better idea of how high cash rates need to go to get inflation under control. Markets seem to be expecting the US Fed to start lowering rates in 2023 but that is far from certain. They have not given any indication that they are going to pivot to a less hawkish stance. In fact, they have come out and jaw boned markets when they have got too exuberant. So, unless valuations improve again, or we get some resolution on inflation we are going to be pretty cautious going forward.

We continue to believe you should hold a mixture of equity styles such as Value/Cyclicals and Growth. While Value has been a huge winner so far in 2022, we expect this will turn, unpredictably.



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