ISSUE 18

POINTS OF INTEREST

AUTUMN 2017

Welcome to the latest edition of our quarterly look at Australian and global economic and market developments. In this issue we discuss the upcoming Federal budget, where we may see changes to tax policy in order to tackle the 'housing affordability crisis'. We also consider the state of the Australian economy and the performance of the stock market over the March quarter.

EXECUTIVE SUMMARY

- Changes to negative gearing and capital gains tax concessions have been mooted as possible tools to deal with ever rising house prices.
- We do not expect significant change however, given that the government has little to gain by pushing house prices lower.
- Internationally, uncertainty and volatility remains high following the election of President Donald Trump.
- Despite the uncertainty, the market recorded a positive return over the March quarter, continuing the strong run over the past 12 months.

The 2017 Federal Budget

It is now only a matter of weeks until the Federal budget is handed down on the 9th of May, which presents as an opportune time to review the state of the Australian economy and consider the challenges which confront policymakers.

With the budget just around the corner, the usual process of media leaks and dropping of hints and titbits by a bevy of frontbench MPs is well underway. The usual tactic in past years has been to convey the impression of a 'tough' budget full of 'difficult choices' in the weeks prior to the handing down of the budget. The general message would be that households and businesses should expect no mercy from a government bent on fixing its finances, and that no stone would be left unturned in the hunt for additional tax revenue or deeper spending cuts. Then, on budget day, bar a few minor tweaks, nothing would really change, everyone would breathe a sigh of relief and the entire process would be quickly forgotten. Nearly all Treasurers behave like this, although former Treasurer Wayne Swan was particularly fond of this approach: promising a budget full of spending cuts and hard decisions, only to deliver a Santa Claus budget – full of gifts for all and sundry.

This year however, we may see several significant legislative changes within the budget; the most likely of these related to the high-profile issue of housing affordability. Discussion and concern over the state of the Australian housing market has reached feverish proportions. The photo below was taken outside a newsagency in Sydney – a housing market which has reached almost unbelievable levels.

On almost a daily basis, a prominent individual, organisation or business offers free advice to the government on how to address housing affordability. Dick Smith[1] and Mark Latham[2] blame increasing numbers of immigrants for pushing up house prices. The NSW government thinks that a hike in stamp duty would help to deter foreign property investors[3], who generally get the blame for pushing house prices beyond hard-working battlers. Cynics might wonder if the state government isn't more focused on boosting its tax take, as opposed to helping make housing more affordable. Some have suggested letting first home owners use their superannuation as a deposit towards a new home[4], while many have come out in favour of making changes to tax legislation to discourage investor demand for property investments, thereby either pushing house prices lower or keeping further increases to a minimum.

In all this noise, there are a few key points which occasionally get lost. The first, is that few people, outside of would-be first homeowners, actually want lower house prices. This is a point we made during our recent client investment function. Existing homeowners certainly don't want to see the value of their homes fall. State governments, heavily reliant on stamp duty as a key source of revenue, have no interest in seeing house prices fall. Local governments similarly benefit from rising property values as a basis for determining rates. Finally, the federal government benefits from higher prices through capital gains taxes levied whenever an investment property is sold.

The second point, is that the housing affordability issue is largely confined to Sydney and Melbourne. Home-owners in places like Brisbane, Darwin and Perth can only wish that house prices were high enough to be considered a national crisis, never mind somewhere like Moranbah in central Queensland, where house prices are nearly 80% below 2012 levels (although that period itself was even less rational than the Sydney property market). Housing markets are very much a local phenomenon, however the issues in Sydney and Melbourne have become of national significance, such that action will be taken to slow all markets, regardless of the appropriateness of the measures in a particular location.

Sydney and Melbourne – a market unto themselves

There is however, little doubt that certain parts of the Australian housing market are overvalued and unaffordable for first home buyers. For many years, we have held the view that house prices in Sydney and Melbourne were at levels that were not justified by the growth in household incomes or the general buoyancy of the Australian economy. The following chart, which unfortunately only runs to mid-2014, shows how the growth in house prices over the last 20 years or so has deviated considerably from growth in household incomes, rents and construction costs. One would expect that there is a strong relationship between house prices and household incomes, which is effectively a measure of the funds available to cover living and housing costs. The missing ingredient is, of course, debt. The disparity between rising house prices and little growth in household incomes has been filled by the increased use of debt. Where, 30 years ago, the average mortgage was around 30% of household income, the ratio of debt to income is now around 150%.

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http://www.abc.net.au/news/2017-03-14/nsw-government-might-raise-stamp-duty-for-foreign-investment/8352392
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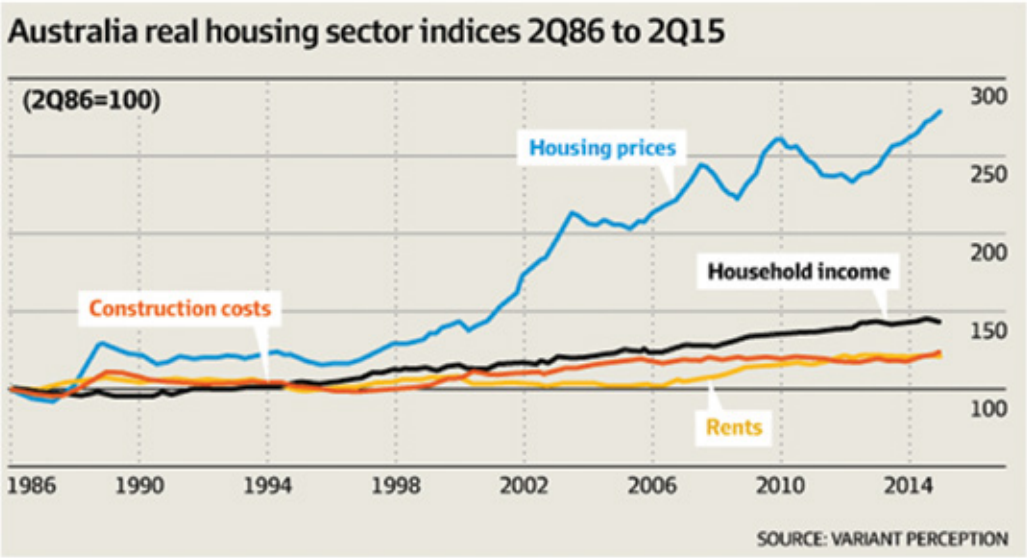


As for the federal budget, consideration is being given to using tax legislation to tackle the housing affordability crisis (or at least, that's the way it would be presented). The most likely candidates are changes to the capital gains tax (CGT) concessions and negative gearing. In both instances the apparent beneficiaries are portrayed to be evil, money-hungry property investors who are depriving young families out of the opportunity to own their own home. The reality is a little less clear cut. Changes to capital gains tax concessions (principally the ability to ignore 50% of the gain on an asset held for more than 12 months) will impact every type of investor, not just the 'evil' property ones. Investors in shares and bonds also benefit from the 50% CGT concession, so any change to the current tax legislation could be a raid on people's investments and superannuation too.

Similarly the uninformed debate over negative gearing. Apparently the words 'negative gearing' do not even appear in the Income Tax Assessment Act. Negative gearing is simply a description of a situation where an investor (in property, shares or bonds – it doesn't matter) has borrowed some or all of the funds to make the investments, and the income generated by the investment is less than the interest costs of the debt. The issue arises from the fact that interest on debt is tax-deductible when the debt is used to earn interest, dividend or other investment income. Making changes to negative gearing really mean making changes to the tax deductible nature of interest. Is the Federal government contemplating removing the ability of businesses to deduct their interest payments from their taxable income? One would hardly think so.

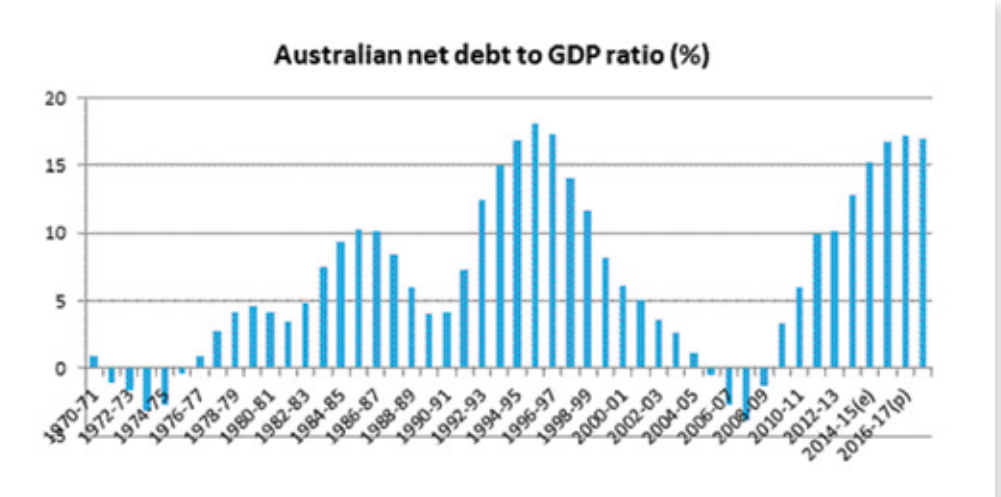
The obvious problem with tinkering with negative gearing or the capital gains tax concession is that the impact of any such changes are highly unpredictable. The government's real fear is that any such changes actually do push house prices lower. If that was the case no doubt a bevy of Liberal and National Party MPs will be looking for alternative employment after the next election. The government's dilemma is that it needs to be seen to be doing something about house prices, without actually doing anything about house prices. No wonder the Opposition is goading the government to abolish negative gearing and the CGT concessions. Over two thirds of Australians already own a home and each one of them has a vote, one they would probably be unwilling to direct in favour of a government who helped to push house prices lower.

Policy vacuum

As we have written many times, many of the current economic problems which Australia faces (not least the parlous state of the Federal government budget) can be sheeted home to the preference of successive governments to avoid tough decisions over much of the past 20 years. The mining boom and the associated flood of corporate tax revenue led to a culture of throwing money at problems, rather than making tough or difficult policy decisions. Some lessons appear to have been learned however, with Treasurer Scott Morrison apparently quarantining the expected $4 billion boon from recent higher commodity prices towards debt reduction, as opposed to funding further handouts and expenditure. Such an approach is a wise one, as recent years have shown us that commodity prices (and the associated tax revenues) wax and wane on a regular basis.

Unfortunately, the past tendency to make long term spending commitments, funded by temporary increases in tax revenue, is a problem which the current Federal government is still unable to resolve. That's not to suggest that the Australian government's debt position is at critical levels. While it is true that government debt seems higher now than at any other time, it's important to bear in mind that if the economy keeps growing year after year (which it has, at least for the past 26 years in a row, a global record), then so can the sustainable level of government debt. What's important is not the absolute level of debt (be it $500 billion or $750 billion), but how this figure compares to the size of the economy.

As shown in the chart below, government net debt to GDP (the preferred measure of indebtedness) is high, but no higher than the mid-1990's and the world didn't end then either. There is little dry powder however, should the Federal government be called upon to fire the fiscal cannon (another global financial crisis, for example), a fact that is assuredly not lost on Turnbull, Morrison and Co.



On to the Federal budget then, and let us see what surprises lay in store for long-suffering taxpayers, who, as always, bear the burden of political follies both past and present.

The stock market over the past quarter

The stock market's performance over the first quarter of 2017 was in marked contrast to the same period in 2016. Then, the ASX 200 Index fell by 4%, which was a credible performance after falling by around 10% in the first six weeks of the year.

This quarter however, markets in both Australia and the rest of the world have performed strongly, with the benchmark ASX 200 Index up by nearly 4%, continuing the trend of positive returns since the election of President Donald Trump in November last year. It was a volatile quarter however, with a near 10% turnaround from the low in early February.

Markets around the world have placed great faith in the ability of President Trump to jumpstart US economic growth, faith which was sorely tested by Trump's failure to push through legislation to abolish 'Obamacare'.

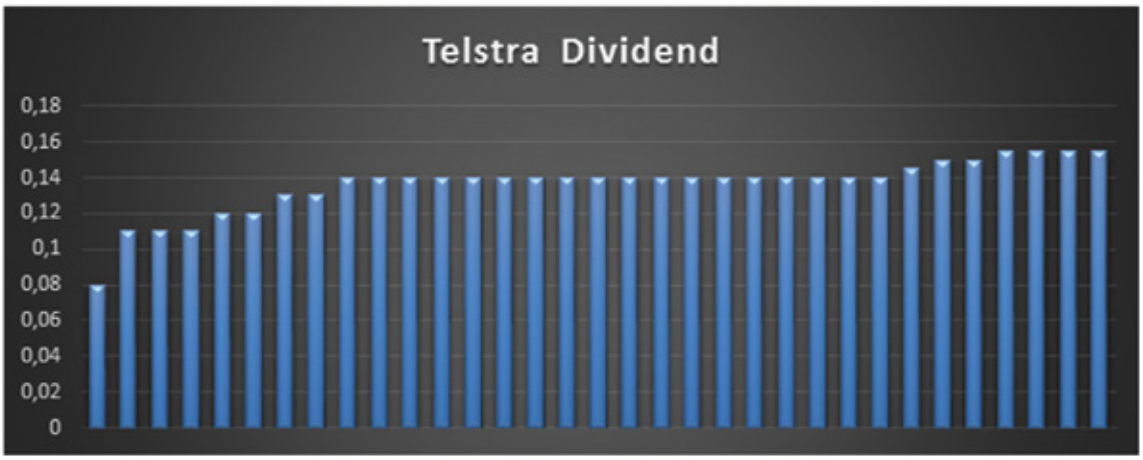
The problem facing Trump is that the repeal of Obamacare contained within it a number of tax changes and savings which were tied up with Trump's impending 'very very big' tax reform package. Share prices in the US may well be factoring in significant reductions in corporate tax rates which may be difficult to deliver.

As we communicated recently to those clients who attended our March economic and investment update, we remain somewhat sceptical of Trump's policy agenda. While short term fiscal stimulus through tax cuts and increased infrastructure spending may have a positive short-term impact on economic growth, we worry about the longer term implications. More specifically, we worry that Trump's policies (if implemented) may lead to higher inflation and correspondingly higher interest rates. This assumes, of course, that his policies which deal with restrictions on trade (such as tariffs and renegotiating NAFTA) do not slow the US economy. All up it's fair to say that the election of Trump has introduced a significant level of uncertainty into global markets, uncertainty which thus far markets are happy to ignore. But for how long we wonder.

Closer to home, the March quarter also saw the majority of Australian companies report their profit results for the first six months of the financial year. On the whole profits were in line with expectations, which were not set overly high. Mining companies, who are enjoying the benefits of a temporary fillip in higher commodity prices, were the primary sources of profit growth, while many other companies struggled to achieve above single digit growth. The large banks, who make up as much as 30% of the entire index, again performed well and were rewarded with significant share price gains. The size and dominance of the Big 4 banks makes them easy targets for both politicians and the media and not a day goes by without some reference to the imminent threat of 'disruption' to their core banking activities. While it is true that new financial activities such as peer to peer lending and crowdfunding may do damage at the margins, one shouldn't assume that the banks would take no action to position themselves to benefit from the increasing 'technologicalisation' of our world.

Of more immediate concern, given its history as a stalwart income stock, has been the poor performance of Telstra's share price. Again, it is fashionable to discount the growth capacity of a supposedly 'boring' company such as Telstra, however, for many investors it is this very boring nature which is attractive. The following chart shows Telstra's dividend over the past 17 years or so. During this period interest rates have fallen considerably, increasing Telstra's attractiveness as an income stock. There is, however, significant change underway in telecommunications, not least the forced transfer of Telstra's fixed line customers to the NBN.

The recent announcement of a fourth competitor to the mobile telephone market also poses an additional risk to Telstra's revenue and profitability. While we have long been advocates of Telstra, we are considering these developments carefully.



As to the year ahead, we expect geo-political uncertainty to continue to impact markets. At some point Donald Trump will need to deliver on his promises or else investors (and voters) may begin to lose faith in his pro-business agenda. Domestically, we expect high quality companies to continue to reward investors, but we remain cautious over the general level of risks which cloud the economic outlook.

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PRIVATE WEALTH

We hope you have enjoyed this edition of our quarterly newsletter. As always, should you have any queries, questions or feedback, please do not hesitate to contact us.

With kind regards,

Justin and Ray

FACTS & FIGURES AT A GLANCE

	Rate / Value	Change from last reading
Australian inflation rate (annual)	1.5% (Dec)	+0.2%
Australian unemployment rate	5.7% (Dec)	-
RBA Cash rate	1.50%	-
ASX 200 Index	5,864	+145 points
Australian $ vs. US $	$0.7644	+0.408c
Australian $ vs. UK £	$0.6126	+0.234c
Australian $ vs. Euro €	$0.7161	+0.289c

This newsletter provides general information only. Before making any financial or investment decisions, we recommend you consult a financial planner to take into account your particular investment objectives, financial situation and individual needs.

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