POINTS OF **INTEREST**

Issue 28

Spring 2019

Welcome to the Spring edition of our quarterly assessment of Australian and global economic and market developments. For this edition, we address the geopolitical issues impacting on global economic conditions as well as our regular commentary on the Australian sharemarket and interest rates. Additionally, we take a brief look at the Reserve Bank Governor's recent address in Armidale and our modest role in it.

EXECUTIVE **SUMMARY**

- **The Australian sharemarket posted a new record high in July before ending the quarter at 6683 points on the ASX 200 Index**
- **The Reserve Bank of Australia has continued with its easing of interest rates to end the quarter at 1.00% for the official cash rate (since lowered to 0.75% p.a.)**
- **Geopolitical issues – the US/China trade war and Brexit - continue to negatively impact on confidence levels**

BAIOCCHI GRIFFIN
PRIVATE WEALTH

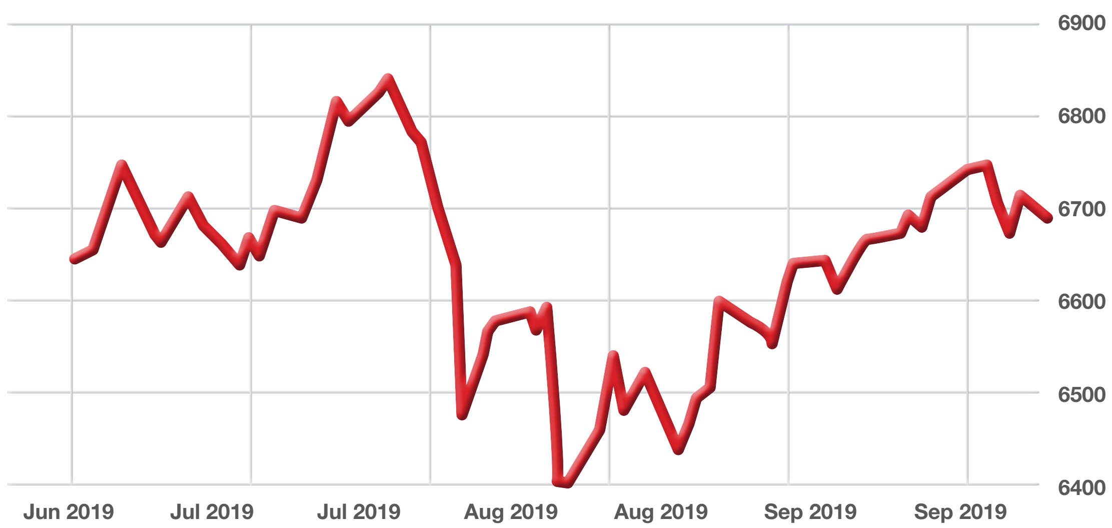
INVESTMENT PORTFOLIO MANAGERS

Geopolitics and struggling confidence levels weigh heavy

The dominant global economic theme for the last quarter has been a heightened focus on geopolitical issues that are impacting confidence levels both domestically and around the world. These concerns have seen the Australian interest rate outlook move more fully to a continued decline in rates. Notably, while often a boost for sharemarket returns, record low interest rates are not resulting in a 'text book' response from the sharemarket. But first, let's look at the Australian sharemarket for the September quarter.

Australian shares

After cresting a record high of 6,845 points in late July, the ASX Top 200 (companies) Index ended the quarter at 6683.3 points – 69 points higher than the end of June position. Quite surprisingly, the record high seemed to come and go without the usual fanfare associated with such events in some sections of the media. While index records come and go, it has taken more than a decade for the pre-Global Financial Crisis (GFC) high point to be eclipsed. Such a long period reflects the overall impact of the downturn resultant of the GFC. However, looking only at share price movements is neglecting to take full account of market returns which of course includes dividend payments. Since the GFC, generally speaking, dividends have continued to be paid at better than pre-GFC levels and this is the aspect of share investing which has a strong influence on our selection of companies for our clients' portfolios.



ASX200 Index: 1 July 2019 – 30 September 2019

Source: Trading Economics

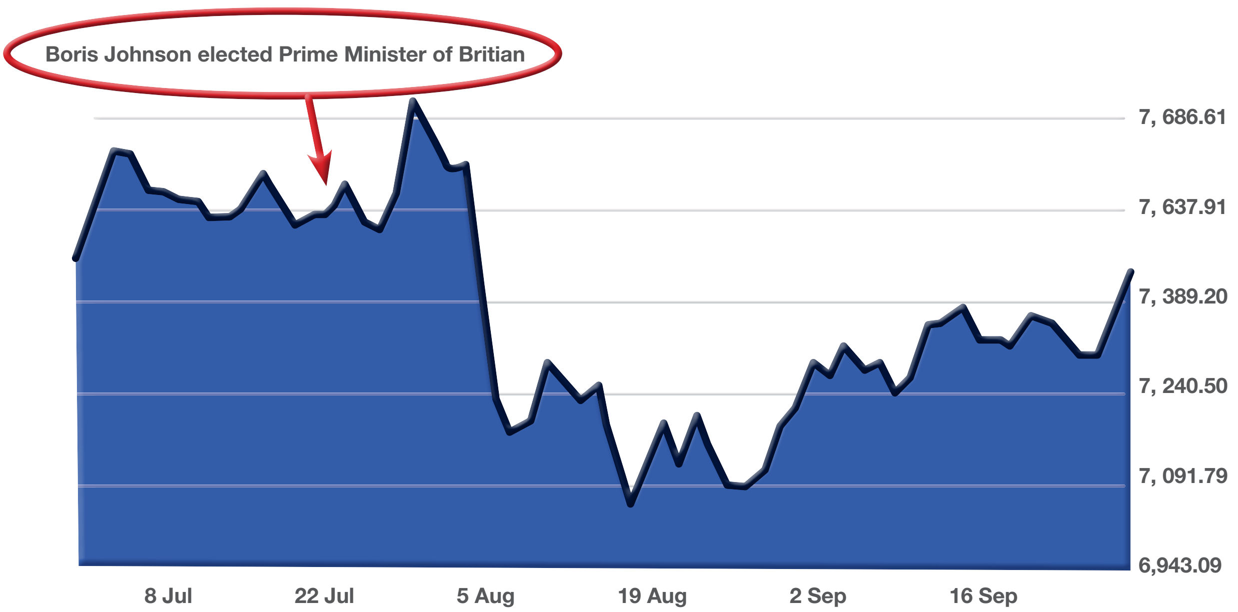
The Australian market continues to be shadowed by declining levels of consumer and business confidence. This is despite an interest rate environment which is otherwise very positive for both business and consumers (covered in more detail later). The one-off tax rebate of around $1,000 paid to many Australians in the September quarter has failed to appear in retail sales. The Reserve Bank of Australia has concluded that for many, the rebate has been either saved or used to reduce debt. It should be mentioned that for individuals, saving or reducing debt are perfectly appropriate actions. However, this is not the result the government was seeking in announcing the rebate in the May Budget Statement. In part, it seems evident, the low confidence levels are being influenced by geopolitical problems in the northern hemisphere.

Geopolitics

The ongoing trade dispute between the United States and China – the so-called 'trade war' – and Britain's (and the European Union's) Brexit negotiation problems continue to weigh heavy on business and consumer confidence. Backgrounding the US/China dispute are heightened concerns – whether justified or not – about the growing influence of a China on the rise in both economic and military spheres. By the end of the quarter the rhetoric on both sides led many observers to remain pessimistic about prospects for a quick resolution.

Brexit drags on laboriously toward some form of conclusion that, in itself, will not resolve the negative impact it has had on sentiment, generally. If the 31 October deadline set by Prime Minister Boris Johnson is not achieved – 'deal or no deal' – the uncertainty will continue. If Britain does leave the EU on 31 October, uncertainty will continue while businesses and consumers come to terms with a new economic future. In addition, regardless of the eventual outcome, for some time to come, Britain will likely remain a nation divided by leavers and 'remainers' which perhaps does not augur well on several fronts.

Boris Johnson's election as Prime Minister of Britain was announced on 23 July. With an initial 1% lift in the London FTSE 100 (likely in the belief that there would soon be a resolution to the Brexit negotiations saga, one way or the other), the index finished the quarter about 1% lower.



London: FTSE 100 Index

Source: London Stock Exchange

Uncertainty

As we sometimes comment, investment markets detest uncertainty simply because it increases risk. There is no quick term solution to either Brexit or China/US trade problems. Amid a potpourri of domestic economic issues for Australians, the northern hemisphere geopolitical issues, which seem to lead every news bulletin, are likely to be weighing heavy on the outlooks of businesses and consumers generally. That said, geopolitical influences have always been with us and always will. Indeed, we have witnessed many such events over thirty years in business; it is perhaps one of the very few certainties of investing.

Interest rates in Australia

In July the official cash rate was lowered to 1.00% p.a. as the Reserve Bank of Australia (RBA) looked to add further stimulus to the economy (reduced to 0.75% p.a. in early October).

As with Newton's Law, which argued that for every action there is an equal and opposite reaction, in economics there are repercussions, both positive and negative, from actions and events. The regular lowering of Australian interest rates has seen the Australian Dollar decline to around the US$0.68 cents mark. On first glance this might be seen as an undesirable outcome, however Australian exports become less attractive when the Dollar is higher against world currencies, especially the $US. Not so long ago the $A was trading above US$1.00 and this was not conducive for export orders. With an elongated drought impacting much of eastern Australia, the last thing rural exporters need is a high $A.

Conversely, a lower Australian Dollar does bring with it an 'imported inflation' impact resultant of imports to Australia requiring more A$ to buy a unit of imported goods. While almost all imports are transacted via forward exchange currency contracts – where importers lock-in a foreign currency price for forward orders to mitigate near to medium term future declines in the A$ – at some point such currency contracts mature and importers are buying foreign goods in, for example, lower A$ values which adds to inflation for a period. It is tempting to think that some imported inflation might be a good outcome however, the type of inflation lift Australia needs now is inflation driven by demand, which would act to stimulate growth.

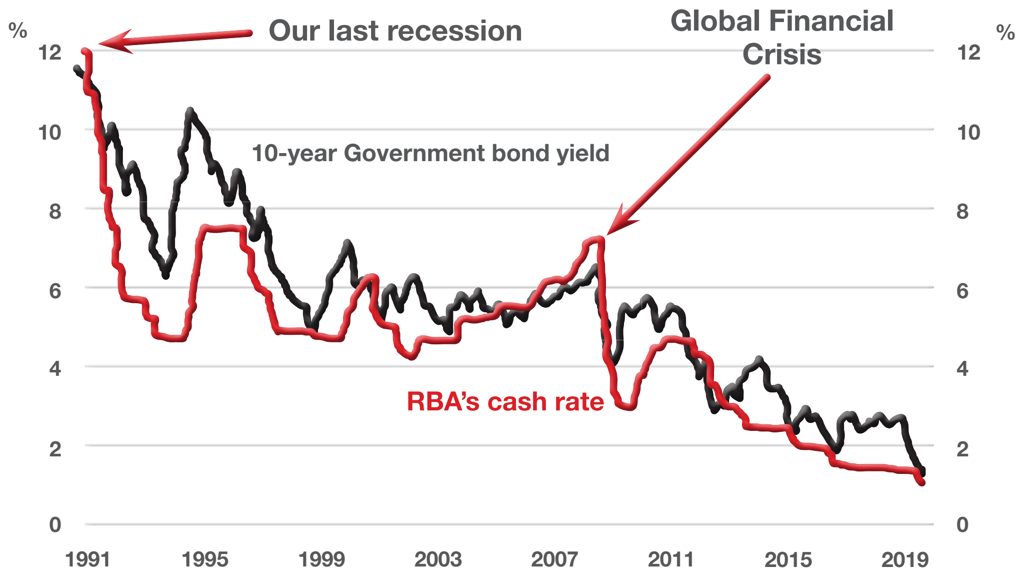
The decline in interest rates to record low levels in Australia is impacting on the fixed interest components of portfolios. The rate decline has been such that a $1 million spread of term deposits in one of the big four banks, would return less than $15,000 a year in interest. Just consider that for a moment, against the backdrop of a 'millionaire' earning less than $15,000 on $1 million of term deposit capital.

Investment	Amount	Expected Yield	Income Return
Cash			
Bank Account	$50,000	1.00%	$500
Total Cash	$50,000	1.00%	$500
Fixed-Interest Securities			
Term Deposit 12 month	$400,000	1.55%	$6,200
Term Deposit 24 month	$300,000	1.50%	$4,500
Term Deposit 36 month	$250,000	1.50%	$3,750
Total Fixed-Interest Securities	$950,000	1.52%	$14,450
Total	**$1,000,000**	**1.50%**	**$14,950**

Source: CBA Term Deposit rates as at 20/09/2019

The decline in interest rates points to the need to be able to generate portfolio income from a range of assets sectors. This is even more important when measured against what is being called a ‘lower for longer’ interest rate environment. While interest rates rise and fall and rise again over time, it is evident that Australia is going to experience a quite lengthy period of low interest rates. There is nothing on the economic horizon which points to anything like a sustained and sizeable increase in interest rates. In fact, at the time of writing, there appears to be growing evidence that another decline in official interest rates by the Reserve Bank of Australia could happen, possibly before the end of the year.

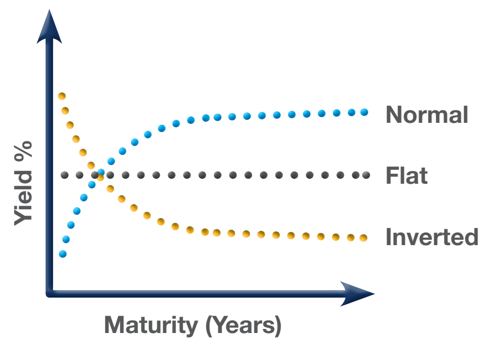
The following chart maps Australian cash and 10-year bond rates since the early 1990s. As you can see, there has been an overall trend of declining interest rates for both short and long term deposits. This graph hopefully helps to illustrate why Australia is entirely unlikely to see a return to higher interest rates in the foreseeable future. Each time interest rates were lowered in that chart period, it was because of the need to stimulate the economy by making it cheaper for businesses and consumers to borrow.



Australian Interest Rates: 1991 - 2019

Source: RBL

Beside the chart, we have pointed out that Australia currently has a so-called ‘flat yield curve’. A ‘normal’ yield curve is where an investor receives a higher return for the risk of investing over a longer term.



Yield Curve Patterns

Source: Baiocchi Griffin Private Wealth

Normally, the interest rate on say a 5-year term deposit is much higher than the rate for an at call account, for example. The higher rate is compensation for the risk of tying up capital for a longer term. However, the chart reveals that there is circa 0.14% p.a. ‘reward’ for buying a 10-year bond compared to a cash at-call account. These are unusual times although we have not yet arrived at an ‘abnormal’ yield curve setting where short term rates exceed long term rates.

Onward to 2020

In the three months since we last reported to you, not a lot has changed in our outlook as to what 2020 might hold in store for our clients. The strong shadow of geopolitical issues at play around the world suggests that businesses and consumers will tend to remain cautious in their outlooks for some time yet. While, at the time of writing, there appears to be the beginning of the end to the China-USA trade war, a full unwinding of the dispute is not yet in sight. Mindful that a US election will be held in a little over a year, we suspect the trade dispute posturing for political gains will be present for some time to come, thus dragging the stand-off over an even longer period.

Then there is the, at the time of writing, planned unravelling of Britain’s economic and social inter-connectedness with the European Union which will usher in a substantial change to the way both the United Kingdom and the EU function in the future. It is difficult to believe that the separation is entirely good news for either.

Domestically, a backdrop of declining consumer confidence – underwritten by a reluctance to spend, consumers instead preferring to save and/or reduce their debts – is feeding into a cautious outlook from the business sector. While borrowing rates are at record low levels, this alone has not yet been enough to spur the economy into higher growth. Continued low inflation will not bring about a lift in interest rates which would otherwise enhance returns from the interest-bearing components of portfolios.

We will not be surprised if the Reserve Bank of Australia reduces official interest rates by yet another 0.25% by the end of the year. Ironically, it appears that the consumers who have benefited the most from such low interest rates, home loan borrowers, are the ones most likely to be pessimistic about the near-term outlook for the economy.

It concerns us that the falling consumer and business confidence levels will take some time to turn around. Extremely low interest rates – that could go lower yet – are uncharted waters for Australia and a broad lack of confidence is being influenced by a range of factors. If the latest and further declines in official interest rates do not reverse the current sentiment, there really is only one ‘card’ that can be played to avoid negative interest rates. That would be for the government to act to stimulate the economy through an injection of cash to areas which could give a quick impetus to demand. Major infrastructure projects have very long lead times (several years is common) before they are ‘shovel ready’ and so, such spending would need to be in areas such as funding to, as one example, local governments for road repairs/upgrades. However, such a spending impetus would involve political factors which can be relied upon to complicate things even more.

In light of these conditions, we are anticipating modest overall returns ahead for portfolios into 2020. Mindful that almost all our portfolios are structured to deliver sustainable income over time, we remain focused on maintaining the income generation and longer-term capital stability for our clients.

The Governor and low interest rates

In September the Armidale Business Chamber invited Ray Griffin to moderate a Question & Answer session with the Governor of the Reserve Bank of Australia, Dr Philip Lowe. The Governor provided attendees with a formal Economic Update presentation and then took questions from the audience for an extended period. The event was very well attended by people from the Armidale, Tamworth and greater New England business sector along with academics and students from the University of New England plus high school economics students.

A recurrent theme in Dr Lowe's address was that Australia is likely to experience a low interest rate environment for some years to come. He pointed to the global interest rate conditions and the domestic economy – especially a reluctance by Australians to increase consumption in response to record low rates – as key drivers for the current interest rate conditions. Dr Lowe argued that while Australia is enjoying a six-year low in unemployment, the rate should be closer to 3% of the workforce. At 5.3%, the Governor emphasised, the unemployment rate is still too high to drive higher wages growth.

From our perspective, the conditions outlined by Dr Lowe point to our long-held view that generating income yield across investment sectors is the preferred approach to long term investing. Investors who rely solely on interest bearing investments, such as term deposits to generate their income, in retirement for example, are subject to a 'roller coaster' pattern of income. Ironically, what is positive for the economy – low interest rates – is the opposite for investors reliant on interest to meet all their income needs.

This in turn points to our preferred approach to delivering income for our clients from across a range of investment sectors to reduce reliance on 'pure' interest rate investments. Dividends from shares held in strong businesses and rental income from well structured property investments help to provide a blended income stream which is not reliant on a single sector; in short, our approach is aimed at reducing income risk for our clients.

Dr Philip Lowe, Governor of the Reserve Bank of Australia, fields a question from Ray Griffin at the Armidale Business Chamber Question & Answer Session in early October.

Seminar Series

Finally for this edition, we mention that the record low in interest rates has prompted us to develop a seminar titled: ***'Retirement Income in a Low Interest Rate World'***. We held the first edition of the seminar in Armidale in early October and will be taking it to Inverell, Moree and Tamworth over the next month or so. Ray Griffin speaks to the problem of low interest rates as well as providing information about strategies to manage the substantial challenge confronting retirees and those retiring soon while Michelle Higgerson presents a detailed explanation of how we manage the risk of investing for our clients. Michelle has been with us since May of last year and as such we now have additional capacity in our business.

You are very welcome to attend a seminar and you are most welcome to bring family/friends along if you wish.

For catering purposes, please call us on 6766 9000 to register for the town of your choice. There is no cost to attend.

TOWN	DATE	TIME	VENUE
Inverell	Friday 1 November	11:00 - 12:30	Inverell RSM Club
Moree	Friday 8 November	11:00 - 12:30	The Max Function & Conference Centre
Tamworth	Monday 25 November	11:00 - 12:30	Tamworth Regional Art Gallery (next to BGPW)

BAIOCCHI GRIFFIN PRIVATE WEALTH

Retirement Income in a Low Interest Rate World

Raymond Griffin MBA (Exec), Dip Fin Serv, GAICD

Michelle Higgerson B. Bus, Grad. Cert. Fin Plan, CFP

Inverell
Friday: 1 November 2019

Moree
Friday: 8 November 2019

Tamworth
Friday: 25 November 2019

BAIOCCHI GRIFFIN
PRIVATE WEALTH

BAIOCCHI GRIFFIN
PRIVATE WEALTH


Justin Baiocchi


Ray Griffin


Michelle Higgerson

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.

Thank you for your continued business with us.

With kind regards,

Justin and Ray

FACTS & FIGURES AT A GLANCE

	Rate / Value	Change from last reading
Australian inflation rate (annual)	1.60 % (June)	Unchanged
Australian unemployment rate	5.30%	Unchanged
RBA Cash rate	1.00% p.a. (now 0.75% p.a.)	- 0.25%
ASX 200 Index	6688.3	+ 69.5
Australian $ vs. US $	$0.6751	-$0.0272
Australian $ vs. UK £	£0.5484	-£0.01
Australian $ vs. Euro €	€0.6188	-€0.0027

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.

BaiocchiGriffinPrivateWealth   www.bgprivatewealth.com.au

T: 02 6766 9000 | F: 02 6766 9779 | Email: enquiries@bgprivatewealth.com.au | PO Box 590 Tamworth NSW 2340