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Ian Macfarlane on central bank policies, inflation and China

Edited by Graham Hand

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This is Part 1 of an edited transcript of a Q&A session at the Morningstar Investment Conference on 15 May 2014.

Q: Let's talk about three main topics: central bank policy, emerging markets with a focus on China, and then a look at Australia.

Since 2009, central banks' primary role has been stimulating economies through monetary easing. Can you talk us through how this works.

IM: I hope it doesn't sound too much like an economics lesson. I think of the effects of monetary easing in two parts. The first part is the effect on the real economy, output and employment. There are four channels there: lower interest rates change the economics of some investment plans and lead to new investments; second, there are other aspects of the economy which are interest-rate sensitive such as residential construction, which picks up quickly after an easing; and third, the effect on people who have mortgages (but note only one-third of households have mortgages). When rates go down disposable income goes up so they spend more on consumption. The fourth is that as interest rates go down, other things being equal, the exchange rate may go down, which increases prospects for export industries, and those parts of the domestic economy competing against imports.

That's the first part, which I describe as the real economy. It increases spending and income and it's the one everyone focusses on.

The second is the financial part, which is becoming more important. When interest rates go down, simple interest rate products like bank deposits become less attractive, and we see a search for yield. Funds move into equities, property and riskier forms of lending, and this drives up asset prices.

The issue for the US is that the Fed funds rate is effectively zero. It is having an effect and the economy is recovering, although not particularly quickly. So the first channel is working but not as strongly as hoped. The second channel is definitely working, where US equities are at an all-time high. This is the challenge for central banks, and what they fear is that you could end up with an asset price bubble before the real economy is back to full capacity. That's a worry. It's probably not going to happen but there is that risk. Part of the reason is that too much weight has been placed on monetary policy. In a perfect world, you would use more fiscal policy, but a number of countries already had large deficits going into the crisis, more debt than they wanted. This over-reliance on monetary policy has created the added risks.

Q: If you'd asked a group of investment bankers about the major consequence of over-stimulating, they might have said inflation. But there is little evidence of increasing inflation. Is monetarism dead? Where is the economic theory?

IM: Well, monetarism is dead. No doubt about it. You saw what has happened in the US where the money base has quadrupled over the last four to five years, but there's been virtually no inflation at all. In fact, there's been more fear of deflation. The relationship between monetary aggregates and inflation has completely broken down. It broke down in the late 1980's. It was replaced by inflation-targeting, that the best thing a central bank could do was achieve low inflation. It improves your chances of having a long, sustainable expansion.

Let's get onto forward guidance. Most of the time, during my period, transparency of monetary policy consisted of when you changed the cash rate (which they call the Fed funds rate in America), the central bank would put out a statement explaining why they did it. But you weren't expected to say what you would do in the future. And I actually think it's very difficult to do that, because most of the time you don't know. There's nothing worse than putting out something that you don't personally believe in. In the US and UK, having lowered interest rates to zero and done everything they can to stimulate the economy, and it didn't seem to be working very well, there was a reach out for other things like quantitative easing.

The other thing they did was say we won't tighten rates until some trigger point is reached. The point they chose was the unemployment rate going down to 6.5% in the US. What happened? The unemployment rate has gone down to 6.5% and they haven't tightened, so that forward guidance was not very useful. They lost faith in the unemployment rate as a general indicator of the health of the economy. They still have lots of excess capacity.

Q: Let's turn to China. Can we believe the growth numbers, and what are their chances of avoiding some sort of crash based on credit conditions?

IM: Can we believe the numbers? Well, they're not as good as ours, but I've seen two phases of people criticising China's numbers. The first phase they used to say China must be growing faster than they claim. If you look at all the sub components – consumption, investments, exports - they are growing faster than GDP. Now we hear the argument the other way. Surely it's not growing as fast as they claim it is. I think it is. I think they make a genuine effort with the resources they have to estimate GDP growth rate, and if you don't like that, there are other things to look at such as the amount of steel produced or the rate of export growth which are easier to measure. Usually you'll get something that's not too different from GDP. So you can, by and large, accept their figures.

The other question I get is what are we going to do when China collapses. My answer was always that I don't think it will collapse, and so far that's been right. We hear a lot about imbalances in the Chinese economy and especially that there's been excessive credit expansion. There is obviously some proof to that, in that in the financial crisis, those countries like Australia that could expand fiscal policy did so by increasing government expenditure. The Chinese approach is to tap the banks on the shoulder and tell them to lend more. Which they did. They still have a legacy of a lot of loans out there, some of dubious quality.

But for the big four or five state banks, I don't think they'll get into trouble. They'll be able to handle the inevitable bad loans. All banks have bad loans. Plus the central government has the resources. The main issue is shadow banking, which is anything other than banking. These are pools of funds available for lending at much higher interest rates than major banks, and the Chinese government is determined to slow it down. There are a variety of things they can do. You will notice for the first time insolvencies, where small financial institutions are failing. This is very unusual in China, in a communist country, the concept of failure did not exist. This was one of the problems in trying to contain shadow banking – people thought you could earn 12% in you went to one of these shadow banks because there was no concept of failure. The government is selectively letting a very small number of shadow bank securities fail. Not necessarily losing all their capital, but perhaps missing out on the final coupon. Some of the securities were issued though ICBC, a big retail bank. As usual in China, these things can be carefully controlled. In other countries, a couple of failures might be the sign of something very bad, but it's really part of many policies to get a proper capital market where there are a range of returns for risk. So don't be alarmed if you read more stories like this.

In Part 2 next week, Ian Macfarlane shares his views on emerging markets, Australian banks being 'too big to fail', Fed expansion and residential property prices.

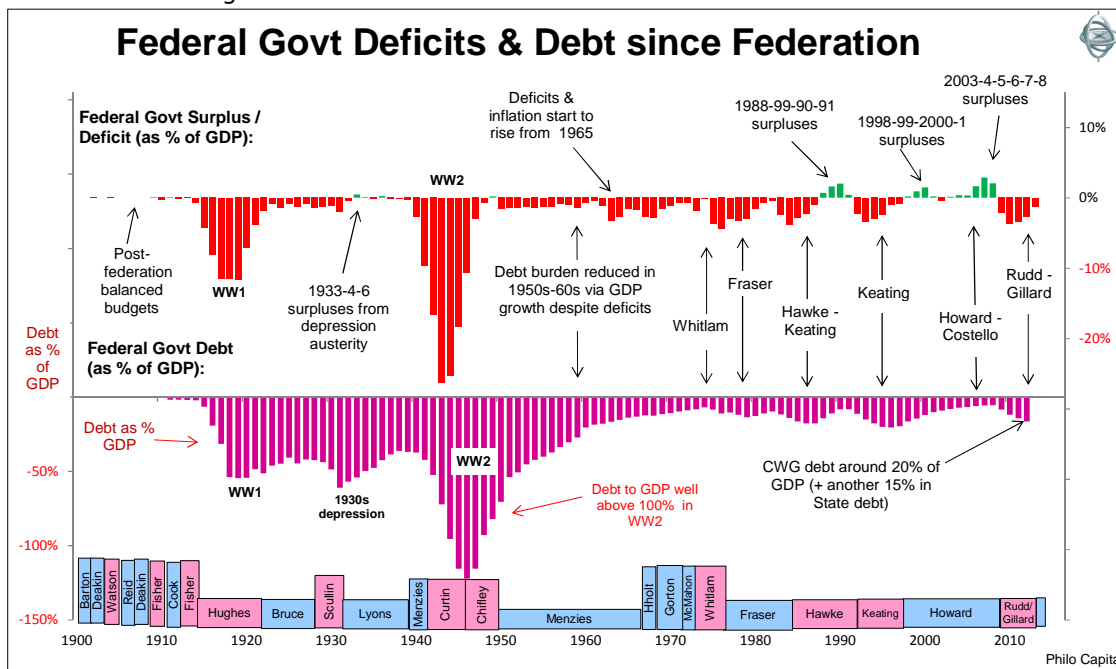
Part 2, Running up and paying off government debt

Ashley Owen

In Part 1, we looked at the record of Labor (or left-leaning) and Liberal (or right-leaning) governments in running government surpluses or deficits. Both sides have run few government surpluses since Federation, and Labor ran more frequent and larger deficits than Liberal governments.

This week we focus on the lower section of Chart 1, showing Commonwealth government debt as a per cent of GDP (Gross Domestic Product, or national output, income and expenditure).

Chart 1: Federal government deficits and debt since Federation



Funding the war efforts

The main debt build-ups were caused by the massive deficit spending war efforts in the two World Wars. Both happened to be on Labor's watch, but both were bi-partisan, and so should not be attributed to Labor profligacy.

The debt-to-GDP ratio also increased during the 1930s depression, but it was not due to deficit spending. Between 1929 and 1932 the nominal level of debt was actually *reduced* by 15% but the level of national income (GDP) contracted by even more, a staggering 31% (half of which was due to a real GDP contraction and the other half price deflation in the depression), so the debt to GDP ratio increased even though the amount of debt fell.

Australia did not adopt a Keynesian deficit spending spree during the 1930s depression like the US because we simply were not able to. The Commonwealth and state governments had run out of credit in foreign debt markets by 1929, and the government's then wholly-owned Commonwealth Bank refused to lend it more money. The only option was to stick to the savage and deflationary austerity of the 1931 'Premiers' Plan' and force all holders of domestic government debt into a 22.5% haircut restructure deal (a-la the Greek restructure in the recent European sovereign debt crisis).

Much like the Abbott Liberal Government today, the break-away United Australia Party won the 1931 election on promises to abandon Labor's austerity plan but, immediately after being elected, ditched those promises, endorsed Labor's austerity plan and cut spending savagely. The difference was that in 1931 nobody would lend to Australia. The spending cuts, together with interest savings from the debt restructure 'haircut', resulted in three government surpluses - in 1933, 1934 and 1936. These can be seen in the top section of Chart 1 above.

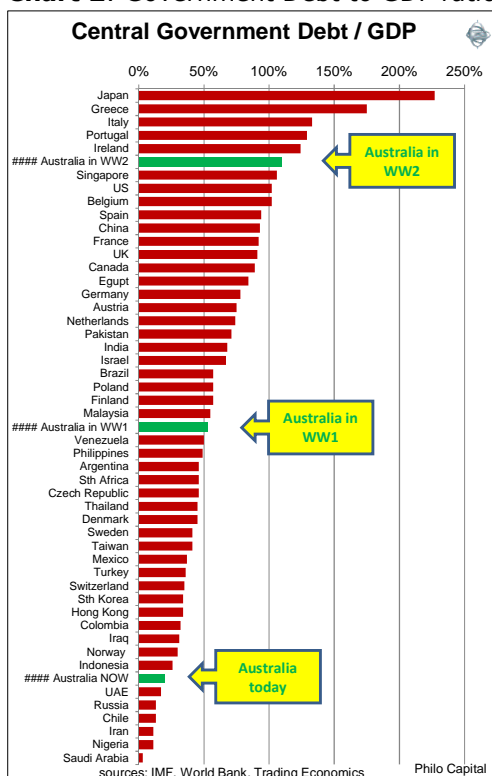
Current level of government debt

Chart 1 also shows that the recent Rudd/Gillard deficits were similar in scale to the Fraser, Hawke and Keating deficit eras. Contrary to popular myth the Whitlam era was not one of high deficits or high debt. The only significant deficit was in 1975, with the budget crisis triggering the controversial sacking of the Whitlam government by Governor General Sir John Kerr on behalf of the Queen.

How does Australia compare?

Chart 2 shows how Australia's level of government debt compares with the rest of the world.

Chart 2: Government Debt to GDP ratios

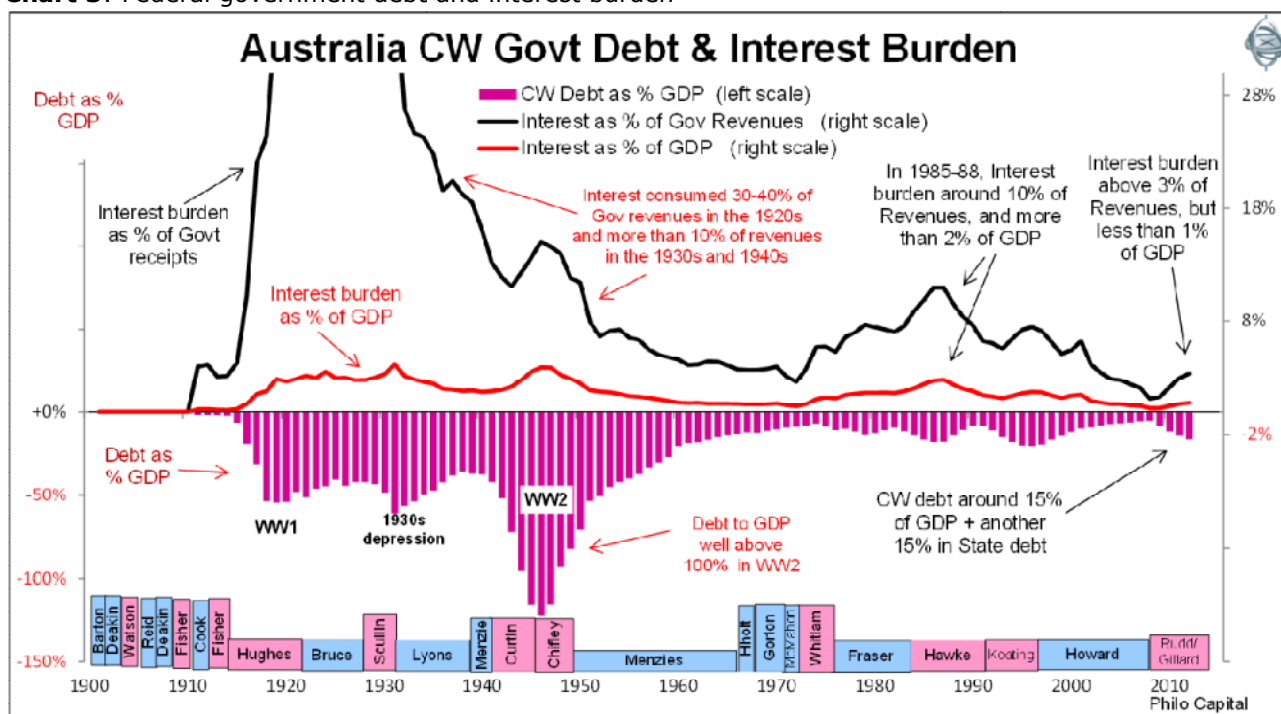


Here we see that even after the post-GFC debt build-up caused by borrowing to fund the Rudd/Gillard deficits, Australia's current level of government debt is very low relative to almost all other countries. Even Australia's war-time debt levels were lower than several countries today – notably Japan and the 'PIIGS'. We reduced our debt levels over time by growing the economy, not by 'paying it off', and so can they.

Debt servicing levels (interest paid to service government debt)

Chart 3 shows the interest burden of the government debt, expressed in terms of interest cost as a percentage of GDP and also interest cost as a percentage of government receipts (mainly tax revenues).

Chart 3: Federal government debt and interest burden



Interest payments on Federal government debt consumed 30-40% of all Federal government revenues in the 1920s (on a par with the European 'PIIGS' and Japan today). Interest was still consuming more than 10% of revenues in the 1930s and 1940s (on a par with the US today). The interest burden was then brought down in the post-war boom in the 1950s and 1960s.

Paying off the debt

The debt service burden relative to national income (shown as the red line in Chart 3) was brought down from its astronomical levels in World War 2 primarily by growing the size the national economy rather than reducing the absolute level of debt, which continued to rise in dollar terms.

In recent years, the interest burden of government debt was at its lowest level ever in 2007-2008, when the level of debt was also at its lowest, but interest costs and debt levels have risen sharply since 2008.

However, Australia's interest burden in recent years (at around 1% of GDP and 3-4% of tax receipts) is no higher than it was in the 1950s to the 1970s. This is partly due to the relatively low level of debt, and also partly due to the relatively low interest rates today.

Some conclusions

- The current level of Commonwealth government debt relative to national income is modest, and is lower than almost any other time since World War 1. It is also lower than almost all other countries in the world today. The only times it was lower than today's levels was in the late 1960s to mid-1970s, and in the late 1980s.

- Current interest burden on Commonwealth debt (as a % of national income and also as a % of government receipts) is also very modest, and is lower than almost any other time since before World War 1. World War funding was bi-partisan.
- Although market yields on government bonds have been rising since July 2012 from their ultra-low post-GFC levels, rising bond yields don't translate into higher interest payments on the bonds until each bond series matures and is re-financed, which in many cases is more than a decade into the future. Hence the government's recent shift to longer bond maturities in order to lock in lower interest rates for longer.
- Governments generally do not reduce debt levels by 'paying off debt' per se, but instead the size of the economy grows and that reduces the ratio of debt to national income. The two occasions when governments did actually pay off debt with government surpluses were in the 1930s depression (under Labor) and in the late 1990s to 2000s (under Liberal).

In Part 3, we will look at what really matters to investors - the impact of government deficits and surpluses on stock market returns, under Labor and Liberal governments.

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Technical versus fundamental analysis in equity markets

Roger Montgomery

Investors have many different characteristics. At one extreme, high frequency traders rely on technology to place orders with lightning speed and eke out a small percentage profit on huge numbers of small trades in the margin between buyer and seller. At the other extreme, patient, long-term value investors are happy to leave a good stock in the bottom drawer for years or decades, and allow compound returns to work their magic. In between these extremes, there are perhaps as many different investment styles as there are individual investors.

One of the major differences divides technical investors (or chartists), who work on the assumption that historical price movements reveal likely future movements, from fundamental (or value) investors, whose focus is future profitability and cash flow. Certainly, there are investors who employ both styles, but most people tend to identify with one or the other. Working out where you sit is one of the more important choices an investor makes.

The two approaches enjoy different levels of acceptance in different parts of the market. Charting can be a relatively simple way to assess the investment merits of a company. Time-poor investors can make decisions more easily and entrepreneurs can design trading 'systems' for such time-poor investors. As a result, charting enjoys good support amongst retail investors, and receives quite a few column inches in mainstream media.

In the professional funds management arena, the norm is for analysts and portfolio managers to spend large amounts of time studying the details of company financials and business models. Montgomery Investment Management, along with most of our colleagues in the industry, sits firmly in this fundamental camp. We do this with the expectation that investing time and effort into having deeper insight into a business will yield better investment decisions.

A good question for investors and fund manager clients to ask is: does this extra effort and cost add enough value to be worthwhile? If a simple approach delivers reasonable results, why bother with the hard way?

There may be no single right answer. Any investment approach needs to fit the personal style of the investor using it. For example, if you have perfectionist tendencies and time on your hands, you will want to follow a different path to someone with a short attention span and other things to do. However, there are some reference points that are relevant to all investors.

Firstly, returns. How much value can be delivered by charting? Many people have a strong view that it adds either: a) zero value, or b) quite a lot of value, but based on academic research, the correct answer is probably: c) neither (depending on exactly what we mean by charting).

Over the years, charting has generally not enjoyed a high level of credibility in academic circles, but a seminal piece of work was published in August 2000 by Andrew Lo, Harry Mamaysky and Jiang Wang at MIT. Using sophisticated techniques, these researchers examined the merits of a wide range of shapes and patterns, and they found a few surprises.

Their work confirmed the widely-held view that traditional charting concepts like support and resistance do not have practical value. However, they showed that two technical indicators – momentum and reversal – do have value. Put simply, they (as well as other researchers) confirmed that stocks that have performed well in the recent past (typically up to 12 months) tend to perform well in the future, whereas stocks that have performed well over longer periods of time (3-5 years) tend to underperform in future. These so called 'anomalies' are now widely accepted as real, and it is possible to construct profitable trading strategies that exploit them.

On this basis, there is value in technical analysis. However, that value is somewhat limited. Different studies show different results, but as a general observation, after allowing for trading costs and risk it is not entirely clear that reversal strategies work in the real world, and there have been extended periods when momentum strategies haven't worked, notably around the time of the GFC.

While esoteric concepts like 'head and shoulders' patterns are unlikely to help much in the real world, there probably is merit in the old adage 'the trend is your friend', and having a disciplined approach to trend-following appears to be a simple and legitimate way to generate returns that beat the market by a noticeable margin. However, the upside is less than compelling, and there is another saying about rich chartists being a very rare breed.

While it is easy to draw up a long list of spectacularly successful and wealthy fundamental investors, coming up with a list of comparable technical analysts would be rather more challenging. Accordingly, if your aspirations for investment success lie beyond 'a noticeable margin' then you may be better off putting in the hard yards of fundamental analysis, or find a good manager to do it for you.

Roger Montgomery is the Founder and Chief Investment Officer at The Montgomery Fund, and author of the bestseller 'Value.able'

How much money do you need to retire?

Noel Whittaker

A common question is "how much do I need to retire?" Unfortunately, it's impossible to give a simple answer because the amount of money needed depends on a wide range of variables that include how long you will live, the state of your health, the rate of inflation, the earnings on the assets you own and how often your children put their hands out for help.

A good rule of thumb is that you need capital of 15 times your planned expenditure. For example, if you require \$40,000 a year when you retire, you should be trying to accumulate \$600,000 in financial assets.

A bonus is our generous welfare system, that allows a couple to live in a luxury mansion, have more than \$700,000 in other assets and still get a part age pension and all the fringe benefits.

Furthermore, as your assets diminish, you qualify for a larger pension, which tends to reduce the rate at which you run down your portfolio.

One of the best ways to boost the money you will have in retirement is to work a little longer and because of the way compounding works the benefits can be dramatic. Consider a person who is aged 58 and who has \$300,000 in superannuation. If they retired immediately they would be lucky if their superannuation lasted to age 66 if they withdrew \$40,000 a year and it earned 7%. However, working just two more years full time to age 60 would mean two more years of growth and contributions – by age 60 the balance could be \$400,000. Their money may then last till age 72, or six years longer for working another two.

That is probably still way short of what they will need, so let's recalculate the numbers on the assumption they will work to age 65. If they started with \$400,000 at age 60, and salary sacrificed the maximum allowable of \$35,000 a year, they should have \$750,000 at age 65.

This would probably last them for life.

There is a growing consensus that working longer is not just good for your pocket, it's also good for your health. A recent study by the UK-based Institute of Economic Affairs and the Age Endeavour Fellowship, titled, [*Work Longer, Live Healthier: The Relationship Between Economic Activity, Health And Government Policy*](#), shows there is a small boost in health immediately after retirement but that, over the longer term, there is a significant deterioration.

It suggests retirement increases the likelihood of suffering from clinical depression by 40% and the chance of having at least one diagnosed physical condition by about 60%. The probability of taking medication for such a condition rises by about 60% as well, according to the findings. People who are retired are 40% less likely than others to describe themselves as being in very good or excellent health.

At first glance this recent research appears to contradict the work done by Sing Lin, Ph.D, which was based on the number of pension cheques sent to retirees of Boeing Aerospace. It showed that the average lifespan for people who retired at 50 was 86, whereas those who retired at age 65 had an average lifespan of 66.8. This apparent paradox is not hard to explain. The Boeing study pointed out that those who resigned at a relatively young age did not sit around and do nothing. They worked at a slower pace at jobs they found fulfilling and stimulating.

There is a wealth of other research that shows that happy and active retirees have emotional and financial security as well as a broad range of interests. A person who is confident enough in their future to leave a career with a major corporation at age 50 is more likely to have this than one who hangs on to age 65 because there is nothing else in their life. In life, and in your investment portfolio, diversification is the key. And making sure you have enough money to enjoy it.

Noel Whittaker is the author of Making Money Made Simple and numerous other books on personal finance. His advice is general in nature and readers should seek their own professional advice before making any financial decisions.

Update on super changes, the levy and contribution caps

Gordon Mackenzie

The two changes to superannuation announced in the Federal Budget, one of which is welcome news, were:

- the way excess non concessional contributions are dealt with, and
- the progressive increase of the Superannuation Guarantee will be delayed another year.

A third announcement, the 2% debt levy, is already encouraging the financial planning community to look at ways to avoid it (sigh).

In addition to these Budget changes, the Australian Taxation Office (ATO) recently put the market on notice that it will come down hard on taxpayers using leverage in a superannuation fund to circumvent the contribution limits.

Non-concessional contribution caps

The contributions caps in superannuation limit the amount of tax concessions anyone, no matter how wealthy, can receive from using a low-taxed superannuation fund. One of those limits applies to contributions which, in effect, have not been tax-deductible, and is considered a penalty. It has also been highly problematic for many.

When introduced in 2007, any contributions in excess of the limit were taxed to the member at 46.5%. While that extra tax on excess contributions was said to recapture any tax concessions that had been derived from having the excess in the fund, it was more in the nature of a penalty tax.

Indeed, through one of the other rules relating to this contributions limit, it was not unusual for people to make contributions, say, two years ago and without fully appreciating what they had done earlier, make a contribution now that resulted in an excess non-concessional contribution and a 46.5% tax bill on that excess. It is with some relief, and probably six years too late, that these rules are now changing for the better.

From 1 July 2014 it is proposed that a person who contributes non-concessional contributions in excess of the cap will be required to take it out of the fund. No more 46.5% taxes.

Super Guarantee increase delayed

The increase in the Super Guarantee payment from 9% to 12% will be delayed a year. The super guarantee will not reach 12% now until 2022. However, the increase from the current 9.25% to 9.5% in 2014/2015 will go ahead, and it will remain at this level for four years until the end of the 2017/2018 financial year.

Dealing with the 2% debt levy

I never cease to be amazed by the ingenuity of the financial planning profession (of which I am part, I feel obliged to add). Within a few days of the Government announcing taxpayers over \$180,000 pa will be charged an additional 2% income tax as a levy to cover Australia's debt position, plans surfaced on how to manage around it.

The 2% increase will mean that the highest marginal tax rate for those affected, excluding the Medicare levy, will now be 47%, rather than 45%. However, the FBT rate is staying at 45% until at least the 2014/2015 financial year. The proposed scheme to avoid the levy is to salary sacrifice into taxable fringe benefits, which will be taxed at 45% rather than 47% had it been paid in cash, until 31 March 2015 (the commencement of the new FBT year).

Leveraging around the contribution limits

There has been one other significant tax issue related to superannuation that does not come out of the budget. The ATO has put the market on notice that it is not happy with people using leverage in a superannuation fund to overcome the contribution limits.

In one extreme example, three wealthy brothers all over age 60 who each set up an SMSF then loaned \$10 million to it interest-free. The three SMSFs would then co-invest in a \$30 million commercial property.

There is no deeming of the interest free loan as being a contribution so there were no contribution limit problems and as each brother was over age 60, their SMSFs were in pension mode and no tax was being paid on any rent or gain on sale from the commercial property.

The only risk being run was if they died without a Death Benefit Dependent, when tax would be payable on any benefit payment.

In any case, the ATO is now signalling that this kind of structuring is problematic. Briefly, the ATO is suggesting that the rental income and indeed, any gain made by the SMSF on sale, will be taxed to the fund at 46.5%. Some tax professionals are not sure the ATO's technical analysis of these types of transactions is correct. However, they take the view that the more likely result would be the application of the general anti-avoidance rule, which would seem to directly catch this practice.

Importantly, the views expressed by the ATO are a message to the market that it does have serious concerns with using leverage to get around the contribution limits.

This information is general in nature and readers should seek their own professional advice before making any financial decisions.

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