Fourth Quarter FY19

# Quarterly Review

EL&C Baillieu
1889 ONWARD

## Market Review

Quarterly Investment market review covering Australian and global stock markets, bonds, commodities and currencies.

**+7.1%**

Globally, the Australian equity market was the standout performer, buoyed by the global rally, surprise LNP federal election victory, RBA rate cut and surging iron ore prices.

## Quarterly Strategy

A look at whether the Australian housing downturn could be at a trough and a discussion on what could drive the ASX 200 index higher.

**4.0%**

The ASX 200 rally has lifted absolute valuations to above-average levels, though when compared to record low rates valuation remains attractive. The income offered by the ASX 200 also remains attractive.

## Financial Planning

An in-depth look at superannuation contributions and some of the proposed changes from the 2019 federal budget.

**$25,000**

The concessional contribution cap for 2019-20 is $25,000 per person.

# Investment Market Review

## The surprise Morrison-LNP election victory, an RBA rate cut and surging iron ore prices helped drive the ASX 200 higher.

**Australian equities**

The Australian equity market was the standout performer among major global markets, with the S&P/ASX 200 rising 7.1% in the quarter. It was buoyed by the global rally, surprise LNP federal election victory, an RBA rate cut and APRA easing a lending guideline.

Nonetheless, we believe the market is looking across the valley of Australia's slowest growth since the global financial crisis, rising profit warnings and headwinds to growth. This optimism is reflected in an above-average ~16x forward earnings for the ASX 200 – a tighter than normal 5% discount to the US – and in forecasts of mid-to-high single digit earnings growth.

It was a positive quarter for the financials sector, rising 9.0%. Unsurprisingly, the big banks were the biggest beneficiaries of the Coalition election win, as sentiment received a boost from the removed uncertainty surrounding negative gearing and capital gains tax had the Australian Labor won government. In-line to better-than-expected reports in early May also helped.

Commonwealth Bank (CBA) was the standout, jumping 17.2% in the quarter, while the remainder of the big four banks were up between 9.4% and 13.4%.

Insurance Australia Group (IAG) jumped 7.6%, while market darling Macquarie Group (MQG) took a breather, declining 0.2% for the quarter after warning of a softer profit outlook.

Telstra (TLS) rallied 17.2% after reaffirming its full-year guidance in late May. The company also benefitted from the ACCC's decision to oppose the proposed merger of TPG and Vodafone, although this decision is being appealed through the courts. Nevertheless, sentiment towards the telco giant has improved.

CSL (CSL) drove strong gains for the healthcare sector, with the stock rising 10.3% for the quarter.

The materials sector added 7.3% as the heavyweight miners were boosted by a surging iron ore price. BHP Group (BHP) and Rio Tinto (RIO) rose 6.9% and 6% respectively, while iron ore miner Fortescue Metals Group (FMG) surged 36.1%.

The gold miners had a solid quarter, with Northern Star (NST) and Newcrest Mining (NCM) rising 30.2% and 25.3% respectively.

South32 (S32) fell 14.8% as coal and base metal prices came under pressure.

Elsewhere, Dulux Group (DLX) jumped 31.8% after it received a takeover proposal from Nippon Paint.

Despite the headwinds facing the Australian consumer, the consumer staples sector performed admirably with a gain of 5.9% for the quarter. Woolworths Group (WOW) rose 9.3%, while Coles (COL) surged 12.7% after providing a strategy update that was largely positive, driven by the absence of an explicit profit reset, a capital expenditure outlook within expectations, maintenance of dividend guidance, and a strategy that did not deviate too far from the norm.

In the industrials sector (+7.5%), Transurban Group (TCL) was the best performing large cap, rising 13.9% as investors were attracted to bond proxy type stocks given the low and declining interest rate environment. Meanwhile, Brambles (BXB) rose 9.5%.

Goodman Group (GMG) outperformed in the property sector, rising 13.7% after it reported a strong 3QFY19 operational update in May. At the other end of the spectrum, Scentre Group (SCG) declined 6.6% despite announcing asset sales and a buyback worth up to $800mn.

| S&P/ASX 200 Sectors | 30/06/19 | 3 mth | 12 mth |
|---|---|---|---|
| Financials | 6353.9 | 9.0% | 2.2% |
| Consumer Discretionary | 2445.8 | 5.2% | -0.6% |
| Consumer Staples | 11402.0 | 5.9% | 0.9% |
| Materials | 14050.7 | 7.3% | 14.5% |
| Energy | 10946.3 | -0.4% | -9.1% |
| Healthcare | 33577.4 | 10.6% | 10.9% |
| Industrials | 6751.6 | 7.5% | 14.8% |
| Information Technology | 1330.6 | 3.9% | 17.8% |
| A-REITs | 1604.8 | 2.4% | 13.9% |
| Utilities | 8201.0 | 0.7% | 0.1% |
| Telecoms | 1326.4 | 12.7% | 34.8% |

**Global equities**

The MSCI World Index rose 3.3% as major central banks became dovish/eased policy concurrently, trying to support weakening global economic data that is being weighed down by the uncertainty being caused by the trade war standoff between the US and China.

Outside of Australia, the US was the best performer in the June quarter. The broad-based S&P 500 index rose 3.8%, while the technology-heavy NASDAQ finished up 3.6%.

For the six months, it was the best first half of the year for US stocks since the dotcom boom 22 years ago. The S&P 500 surged 17.0% during this period.

Expectations for a China-US trade deal ebbed and flowed during the period, with the most recent development being a 'truce' agreement between US President Donald Trump and his Chinese counterpart Xi Jinping during their meeting at the G20 summit in Japan. While agreeing to restart negotiations, Trump said he would hold off on imposing further tariffs of $300bn worth of Chinese imports while allowing some US companies to continue to deal with Chinese technology company, Huawei.

The uncertainty surrounding the trade war has caused weakness in economic data globally. Consequently, the US Federal Reserve Board has looked to sure up the economy, becoming more dovish throughout the quarter. Markets are currently expecting a 25 basis point 'insurance' cut from the US Federal Reserve in the coming months.

From a markets perspective, it certainly feels like investors are looking across the valley of economic weakness and hoping rate cuts and a potential trade deal will see the economic backdrop improve markedly.

In the UK and Europe, the FTSE 100 index rose 2.0% while the STOXX 600 index was up 1.5%. Brexit and leadership concerns continue to cast a shadow over the UK market, while in Europe the uncertainty over the trade war has had a significant impact, especially in the region's biggest economy, Germany – an export driven economy highly reliant on global trade.

At the European Central Bank's (ECB) June meeting, ECB president Mario Draghi said the bank was ready to "use all the instruments that are in the toolbox" if the slowdown in the bloc's export-driven manufacturing sector began to infect other parts of the economy. A recent survey suggests the market is expecting an interest rate cut in the August/September period.

Meanwhile, Japan's Nikkei 225 index finished the quarter 0.3% firmer, while the Shanghai Composite was the worst performer, down 3.6%. Being an export driven economy like Germany, Japan also suffered from trade war concerns. In China, the economy continues to slow as the manufacturing sector is hit hard by the recent increases in tariffs.

| Key Markets | 30/06/19 | 3 mth | 12 mth |
|---|---|---|---|
| MSCI World (USD) | 2178.3 | 3.3% | 4.3% |
| S&P 500 (USD) | 2941.8 | 3.8% | 8.2% |
| NASDAQ Composite (USD) | 8006.2 | 3.6% | 6.6% |
| STOXX 600 (EUR) | 384.9 | 1.5% | 1.3% |
| FTSE 100 (GBP) | 7425.6 | 2.0% | -2.8% |
| Nikkei 225 (JPY) | 21275.9 | 0.3% | -4.6% |
| Shanghai Composite | 2978.9 | -3.6% | 4.6% |
| S&P/ASX 200 | 6618.8 | 7.1% | 6.8% |
| MSCI Emerging Markets (USD) | 1054.9 | -0.3% | -1.4% |

For the six months, it was the best first half of the year for US stocks since the dotcom boom 22 years ago

### Bonds

Global bonds moved higher during the quarter, as central banks became more dovish in their assessments of the global economy. The Australian 10-year bonds were the best performer, as the yield fell 45 basis points, while the US 10-year yield wasn't far behind, falling 40 basis points. 10-year German bunds rose too, with yields falling 26 basis points, while Japanese 10-year bonds rose modestly.

| Bonds | 30/06/19 yield | 3 mth (chg in bps) | 12 mth (chg in bps) |
|---|---|---|---|
| US 10 Year | 2.01 | -0.40 | -0.86 |
| UK 10 Year | 0.89 | -0.17 | -0.45 |
| Germany 10 Year | -0.20 | -0.26 | -0.63 |
| Australia 10 Year | 1.32 | -0.45 | -1.31 |
| Japan 10 Year | -0.16 | -0.08 | -0.19 |

### Commodities

Iron ore was the standout performer for the quarter, surging 32% to US$116.50/t, as ongoing supply issues in Brazil coupled with strong Chinese steel demand boosted prices.

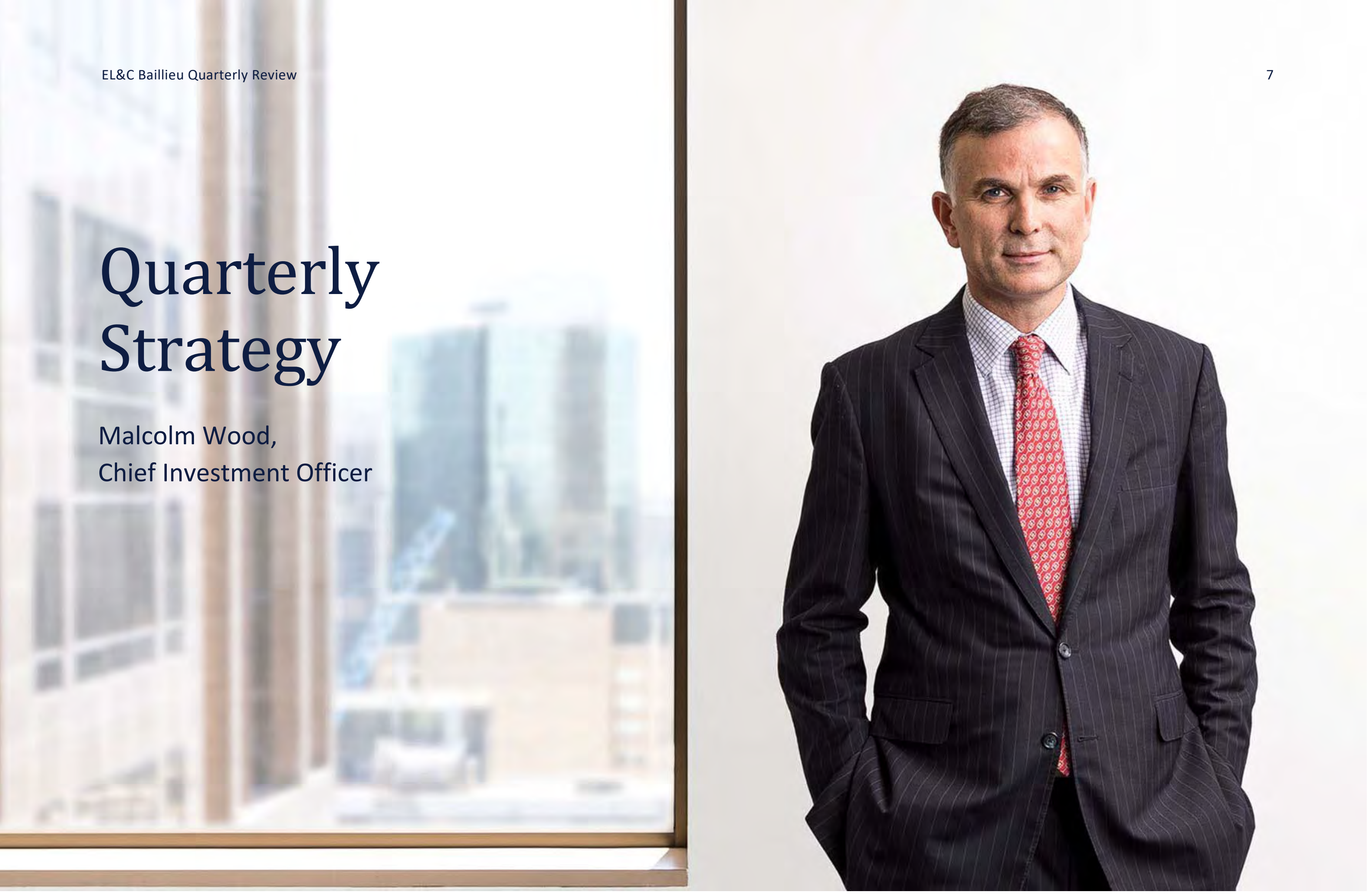
Gold made a major breakout late in the period, rising 9.3% to US$1,413.7/oz – near five-year highs – as geopolitical tensions in the Middle East spurred safe-haven demand. Copper was down 7.8%, in line with the slowdown in global growth, while Brent and WTI crude oil eked out gains of 2.7% and 2.8% respectively in volatile trade.

| Commodity | 30/06/19 | 3 mth | YTD |
|---|---|---|---|
| LME Copper (US$/t) | 5982.0 | -7.8% | -9.7% |
| LME Aluminium (US$/t) | 1779.8 | -6.0% | -17.4% |
| Gold (US$/oz) | 1413.7 | 9.3% | 12.7% |
| Oil — WTI (US$/bbl) | 58.5 | -2.8% | -21.1% |
| Oil — Brent (US$/bbl) | 66.6 | -2.7% | -16.2% |
| Iron Ore CFR China | 116.5 | 32.0% | 77.9% |

### Currencies

Among major currencies, the Japanese yen and British pound sterling slid 2.7% and 2.6% respectively against the US dollar. Elsewhere, the Australian dollar lost 1.1% versus the greenback while the euro rose a modest 1.4%.

| Currency (vs USD) | 30/06/19 | 3 mth | YTD |
|---|---|---|---|
| Australian Dollar | 0.7020 | -1.1% | -5.2% |
| Japanese Yen | 107.85 | -2.7% | -2.6% |
| Euro | 1.1373 | 1.4% | -2.7% |
| British Pound | 1.2696 | -2.6% | -3.9% |
| China Renminbi | 6.8668 | 2.3% | 3.7% |



# Quarterly Strategy

Malcolm Wood,
Chief Investment Officer

## Could the Australian housing downturn be at a trough?

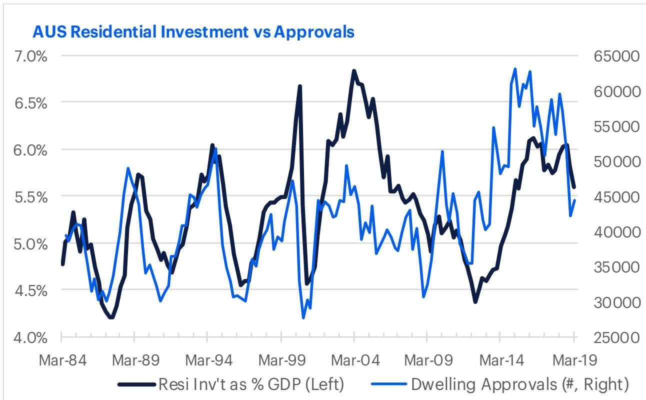
A case can be made for a trough in the Australian housing market, driven by a combination of the surprise Morrison-LNP election victory removing the risk of an ALP tax increase, RBA rate cuts and an easing of an APRA macro-prudential guideline.

Since the election, the auction clearance rate has improved to an average 57.3%, while the decline in CoreLogic's home price index narrowed to just 0.1% in June, though cleared auction volumes are still down 15% YoY. Against this improvement, however, remain the headwinds of record new supply still to be delivered, still elevated valuations, record household leverage and the unwind of record investor speculation. We conclude that if mid-2019 proves to be the trough of the housing downturn, it will be a very elongated U-shaped trough, as further adjustments are still required. More likely, the pace of decline will moderate, leaving the trough at moderately lower levels in 2H20.

### The housing downturn to date

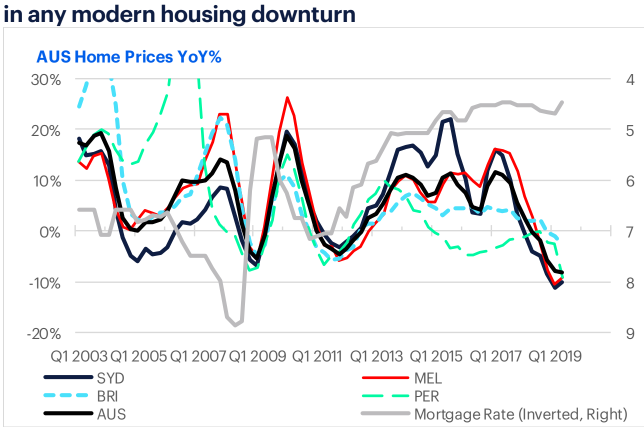
Lead indicators of the Australian housing market have declined significantly since peaking in 2016-17, though most of the negative economic impact is still to be seen. Dwelling approvals, for example, have fallen from a record peak of 248k annual rate in mid-2016 (62k per quarter) to as low as 174k (44k pq), a decline of ~30% (figure 1). This is at the low-end of the 38% average decline seen in the past four housing downturns since the early 1990s. Furthermore, because of the record pipeline of dwellings under construction, residential investment has only fallen ~5% from peak levels, taking

**Fig.1: Dwelling approvals have fallen as much as 29.5%, but residential investment is only down 5%**




Source: Datastream, EL&C Baillieu

**Fig.2: Home prices have fallen 10.2%, a deeper decline than in any modern housing downturn**




Source: Datastream, CoreLogic, EL&C Baillieu

0.15 percentage points (ppts) off GDP growth, again at the low-end of the four-cycle average decline of 18%.

Second, home prices have fallen 10.2% from peak levels, a deeper decline than the ~5% declines seen in the 2008-09 and 2010-11 pullbacks (figure 2). However, the negative wealth effect from falling home prices has so far been muted, with the savings rate rising just 0.3ppts (2.5% to 2.8%) after a decline of 6.6ppts from 9.1% in 2011. By contrast, the savings rate rose dramatically following the GFC and in 2000-02 (9/11), but more moderately in the mid-1990's cycle.

Housing transaction volumes have declined significantly. NSW land transfer data points to a 39% decline (figure 3). GDP ownership transfer costs have fallen 27% in real terms from 2Q17 levels, taking 0.1ppts off growth over the past year.

Fourth, housing credit has slowed, with investor finance down 47.7% from its recent peak while owner-occupier finance has fallen 17.9% (figure 4). Growth in the stock of housing credit has slowed to a record low 3.7% YoY.

### The case for a housing market trough

A trough in the housing market could be driven by four factors:

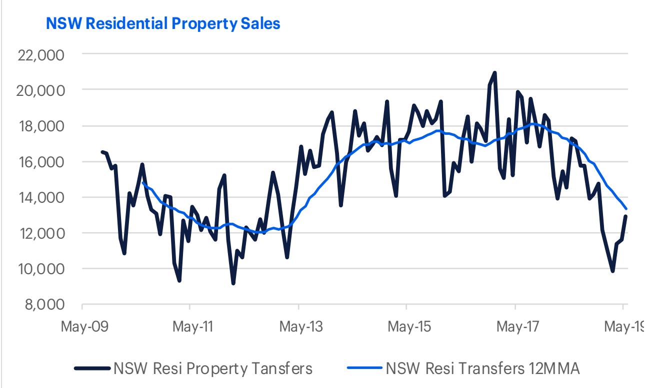
Morrison-LNP surprise election victory: The victory removed the risks of ALP plans to curtail negative gearing and increase the capital gains tax rate. That said, the housing downturn to date seems to largely reflect deteriorating fundamentals rather than fears of a change of government and policy change.

RBA rate cuts: Lowering mortgage rates and improving affordability (RBA has cut rates by 50bps). We expect 100bps of cuts to "effective zero" of 0.5%, with mortgage rates to decline ~60-70bps. This is much smaller than the 200-425bps of RBA rate cuts (average 306bps) and 200-396bps in mortgage rate cuts (average 309bps) in the past four rate housing cycles since the early 1990s.

APRA easing macro-prudential guidelines: APRA proposes relaxing a loan serviceability assessment guideline that currently requires a minimum floor of 7% and a buffer of at least 2% above the loan product rate, replacing it with just a rate buffer of 2.5%. This could increase available loan size by ~15%, helping some home purchasers at the margin.

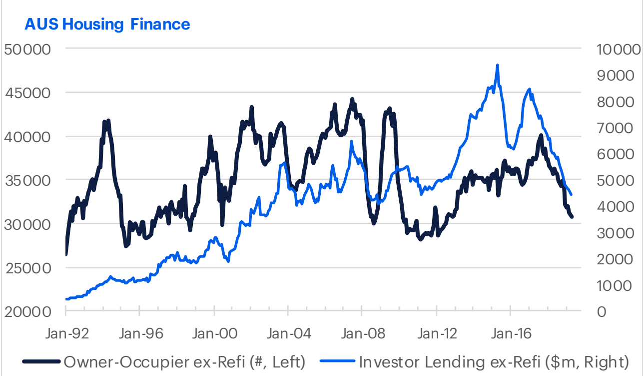
The adjustment to date: reducing market imbalances. As noted above, however, much of the adjustment so far have been in lead indicators, not real economic activity.

**Fig.3: Residential property transaction volumes have fallen a sharp 39% to near prior cycle lows**



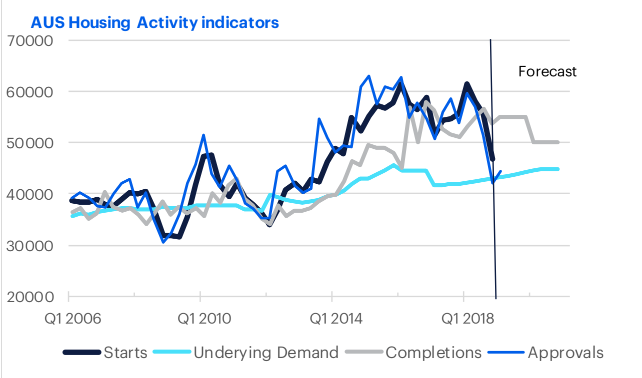

Source: Datastream, EL&C Baillieu

**Fig.4: Housing finance has fallen significantly – investor and owner-occupier are down 47.7% and 17.9% respectively**




Source: Datastream, EL&C Baillieu

**Fig.5: Housing oversupply continues to build as completions and work under construction exceed underlying demand**




Source: Datastream, EL&C Baillieu

## What would a trough at current levels mean?

A trough in housing activity around current levels would stymie a necessary adjustment in the market. First, approvals would be troughing around our estimate of underlying demand – approvals of ~180k pa and completions of 170k pa – meaning the substantial oversupply built up over the past two years, and in the pipeline under construction, would not be worked off (figure 5). The excess supply would represent ~8-9% of the rental property stock, pressuring rents and increasing financial pressure on investors.

Second, current valuations are still extremely high, with the housing stock valued at about 5.0x disposable income, well above the 2004-14 average of 4.6x and the long-term average of 4.0x (figure 6). This is back around the pre-GFC peak and just above the post-GFC peak, and has only ever been exceeded in the past few years.

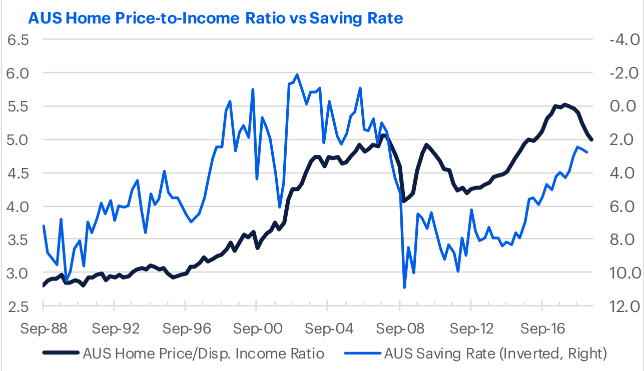
Third, household leverage would remain at a record level of ~190% of income (figure 7). This is most likely unsustainable given the shift from interest-only to interest and principal repayment lending currently underway. APRA data suggests that the share of interest-only mortgages has fallen from a peak of 39.5% in late 2015 to just 23.3% in 1Q19, driving what we estimate has been a 1ppt lift in the debt burden. With interest-only loans averaging just 16% of mortgages since mid-17, the debt burden could rise a further 0.4ppts as this adjustment continues. An Australian debt burden of 17-18% at record low rates would seem unsustainable compared to a pre-GFC peak burden of 13.2% in the US.

Fourth, whilst investor financing has fallen sharply, as a share of total financing, it has only fallen below its long-term average share of 28.5% since late 2018 (figure 8). In our view, the unwind has further to run.

## Looking ahead: RBA-APRA stimulus vs industry headwinds

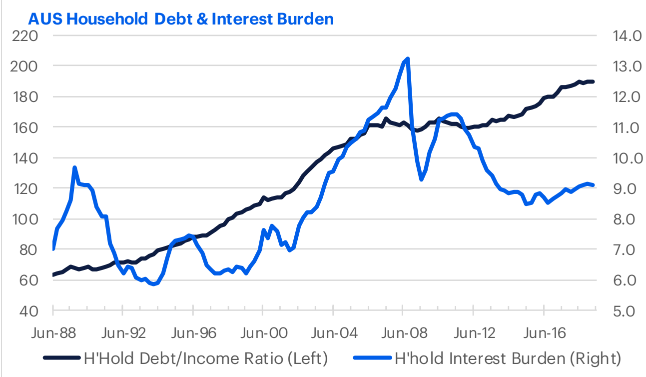
The combination of the Morrison-LNP surprise victory, RBA rate cuts, APRA easing a macro-prudential guideline and the housing downturn to date, could together instill the confidence in homebuyers to create a trough in the housing market. However, the headwinds of record oversupply, extended valuations, record household leverage and the unwind of record investor speculation suggests that the adjustment needs to run much longer. As such, at best we foresee an extended trough if strong demand can absorb the oversupply. More likely, we expect the post-election and rate cut euphoria to fade and another leg lower in the housing market to occur.

**Fig.6: Home price-to-income valuation remains elevated, moderating to around the pre- and post-GFC peaks**



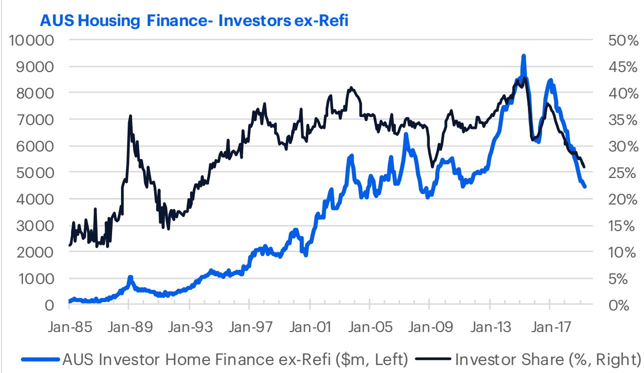

Source: Datastream, RBA, EL&C Baillieu

**Fig.7: AUS household leverage ratio is a record 190% – it is yet to adjust at all!**

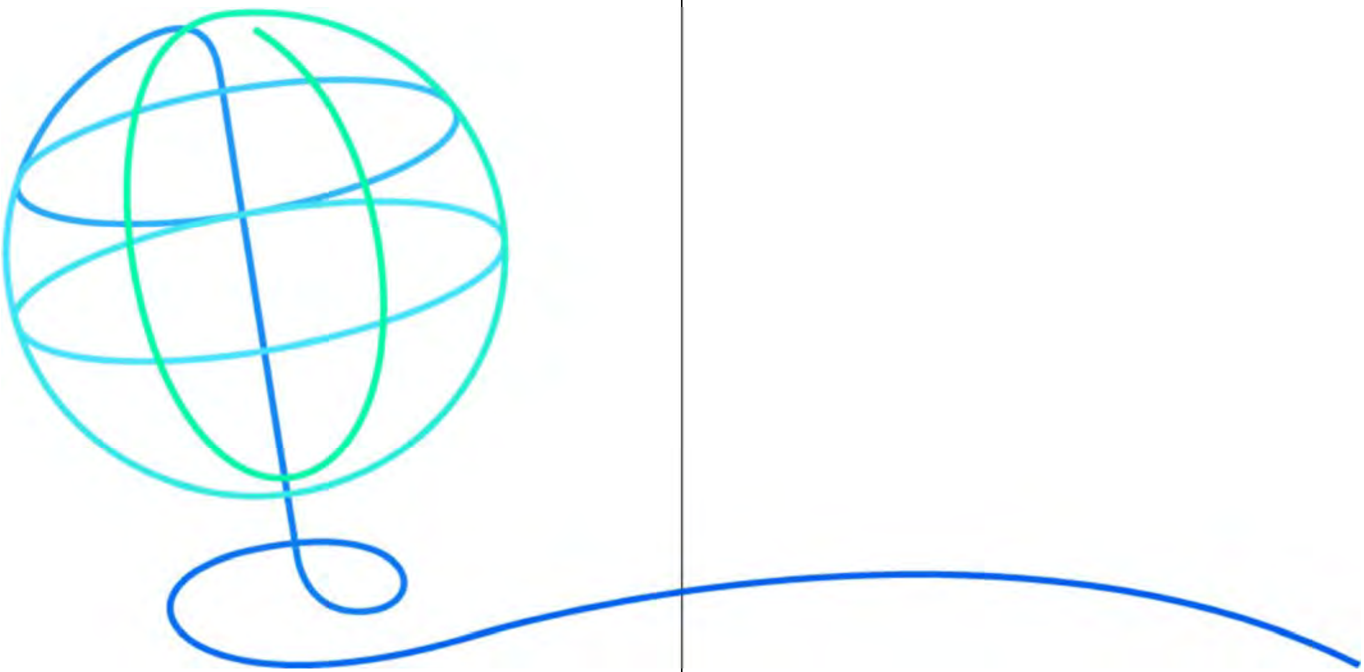



Source: Datastream, EL&C Baillieu

**Fig.8: Investor finance, whilst down 47.7% from peak levels, has only been below its long-term avg. share since Oct-18**




Source: Datastream, EL&C Baillieu



## What could drive the ASX 200 much higher?

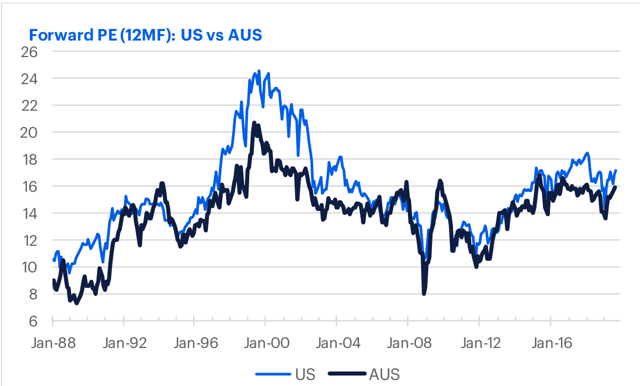
The ASX 200 has rallied a very strong 17% in 2019, more than recovering the pullback of late 2018 and moving to within ~2% of its record high. Beyond the backdrop of a global rally, driven by a pivot in US Fed policy (from tightening to a bias to ease) and an on-again, off-again easing of US-China trade tensions, the surprise Morrison-LNP election victory, RBA rate cuts and surging iron ore prices have helped drive the ASX 200 higher. What could drive the market materially higher yet again? On our analysis, valuation is unattractive, earnings are at risk of downgrades, and further RBA rate cuts are now largely discounted. The most likely catalysts for a further rally would include significant additional fiscal stimulus, which seems unlikely unless the data deteriorates materially, a recovery in housing despite a relatively small RBA easing cycle, and/or the weight of money inflows from zero or near zero-paying bank deposit accounts into equities.

**Valuation unattractive**

The ASX 200 rally has lifted absolute valuations to above-average levels, though when compared to record low rates valuation remains attractive. At about 16.0x forward earnings, the PE is about 1.5 points above the long-term average. Over the past 30 years, apart from the TMT bubble period, the ASX 200 has failed to sustain a PE above 16x (figure 9).

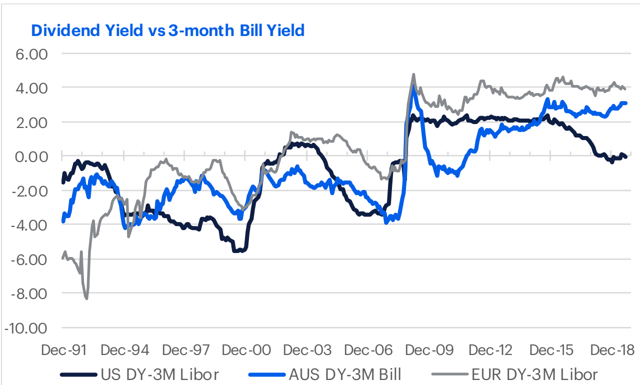
When compared to the US S&P 500, the ASX200 is on a 7% PE discount, modestly narrower than the 10% long-term average. Using US sector weights, however, the ASX 200 is trading on a forward PE of 20.1x, an expensive 20% premium to the US.

**Fig.9: AUS forward PE is at a relatively high 16x – in the past 30 years it has only held this level during the TMT Bubble**




Source: Datastream, EL&C Baillieu

**Fig.10: The dividend yield-bill yield gap is around record levels at about 3.0%**




Source: Datastream, EL&C Baillieu

That said, the income offered by the ASX 200 remains attractive, even with the dividend yield moderately below its long-term average at 4.0%. When compared to bank bills at 1.15% - and headed lower - and the 10-year bond yield at 1.3% (both record lows) the yield gap is around record levels (figure 10). Using the earnings yield, as opposed to the dividend yield, generates similar results – when compared to defensive asset alternatives, the equity market is unusually attractive. In our view, this limits the risk of high absolute valuations.

**Earnings risks**

Earnings growth is being pressured by Australia's economic slowdown – 1Q19 real GDP growth of 1.8% YoY is a post-GFC low, whilst the 1.2% annual rate of growth over the past three quarters is a 20-year low. Reflective of the slowdown, most measures of business conditions have fallen to five-year lows (figure 11). Also consistent with the slowdown has been a plethora of profit warnings leading into the full year reporting season, with ~55 warnings to date (~14% of the index). Whilst dominated by the consumer and housing-related sectors, the warnings have been broad-based.

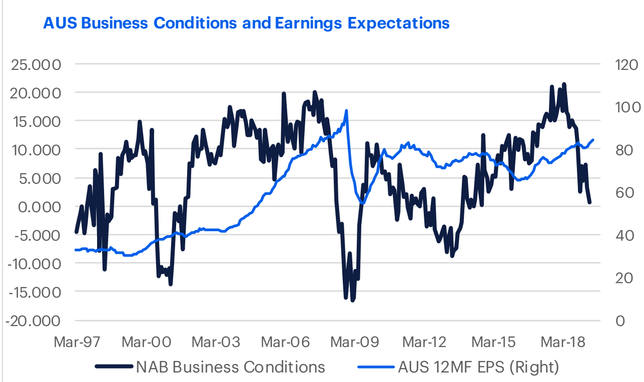
Despite this, the earnings momentum for the ASX 200 has proven resilient, fuelled by a surge in materials sector earnings expectations on the back of a spike in the iron ore price. Indeed, whilst 12-month forward earnings forecasts for the ASX 200 have risen 4.6% YoY, the materials sector has more than driven the rise, with earnings expectations up 32% YoY. Outside of materials, three sectors have seen earnings expectations rise – healthcare up almost 10% YoY, IT 6% YoY and energy 5% YoY – while the remaining seven sectors have seen estimates fall from 0-8% YoY.

Looking forward, the earnings outlook will be primarily determined by the impact of the current monetary and fiscal stimulus. A post-election and rate cut bounce in business confidence, off six-year lows, suggests business is hopeful of a recovery (figure 12). In our view, however, the stimulus will be more than offset by the headwinds of the housing downturn, squeezed households, five emerging headwinds to growth and the jobs risks associated with stall-speed growth. These headwinds should impede the transmission mechanisms for monetary policy, whilst the fiscal tax cuts are modest in size, and the terms of trade impact is being muted by cautious mining capex plans.

**Rate cuts are largely discounted**

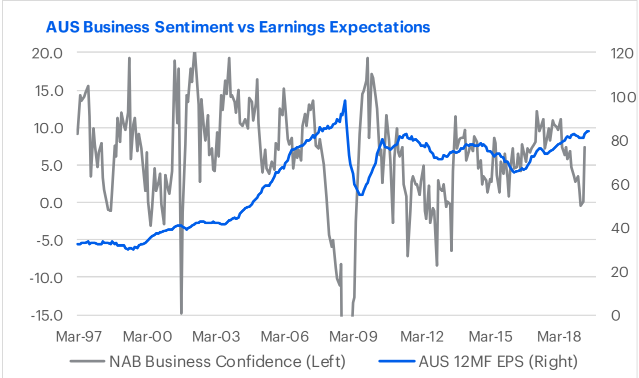
After a three-year hiatus, the RBA has made 25bps rate cuts at consecutive meetings, taking the cash rate to a record low 1.0% (figure 13). Whilst we expect the growth headwinds to force the RBA to deliver another 50bps of cuts, taking rates to "effective zero", the fixed-income markets already appear to be largely discounting such moves. Indeed, the three-year bond at just 0.92% and the 10-year bond at 1.3% imply that cash rates are expected to fall to 50-75bps and stay there for an

**Fig.11: AUS business conditions have fallen to a five-year low, pointing to downward pressure in earnings**




Source: Datastream, EL&C Baillieu

**Fig.12: AUS business confidence has seen a post-election, RBA rate cut bounce, pointing to business hopes for a recovery**




Source: Datastream, EL&C Baillieu

extended period. This suggests that fixed income markets are sceptical that the RBA's rate cuts will ignite a recovery – a divergent view to the earnings optimism and elevated valuations of the equity market.

The key market positive from low rates is likely to be the persistence of inflows from low-yielding cash and fixed income instruments into equities (figure 14). With record low cash rates for the past six years already, we would expect even lower rates to continue the flow, rather than drive a new boom.

### Possible drivers of a higher market

Possible drivers of a still higher ASX 200 could include significant additional fiscal stimulus, a larger-than-expected impact from the policy stimulus underway, and/or an unexpected surge in cash inflows into the market.

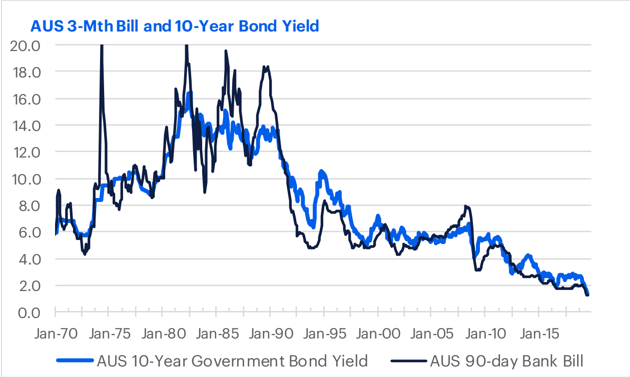
Australia's fiscal position is currently the best in more than a decade (figure 15). Over the first 11 months of FY19 the underlying deficit was just $115 million, implying a small deficit for the fiscal year just completed, better than the $4.2 billion deficit forecast in the April 2019 budget. This positive surprise is being partly driven by the surge in the iron ore price. With the price now substantially higher than the US$80/t assumed in the budget for FY20, we estimate a federal windfall of ~A$3.7 billion for every US$10/t improvement in the average selling price. A combination of weaker growth and this windfall could encourage the federal government to launch a much larger fiscal stimulus.

Monetary stimulus may also be surprisingly effective. The 50bps of RBA cuts to date has led to a slightly higher-than-expected 43bps pass-through into mortgage rates. At face value this is a much smaller easing cycle than the 200-425bps of official cuts or 200-396bps of cuts to mortgage rates in the four easing cycles since the early 1990s. That said, auction clearance rates since the mid-May election have risen to an average 57.3%, although cleared volumes remain soft, down ~15% YoY. The pace of decline in CoreLogic's home price index in June also slowed to just 0.1% MoM, the smallest pace of decline in 18 months. If this better tone persists, the impact of the rate cuts may prove to be better-than-expected.

The funds flow into equities on the back of "zero" RBA rates may prove more significant than expected. From a super fund perspective, cash allocations are already at a record low ~11% and defensive asset allocations appear extremely low. A 1% shift into equities would represent an inflow of about $28 billion. Given the surge in A-REIT capital raisings in the past six weeks totalling $2.4 billion alone, however, inflows of this magnitude into the market could well be met with increased equity supply.

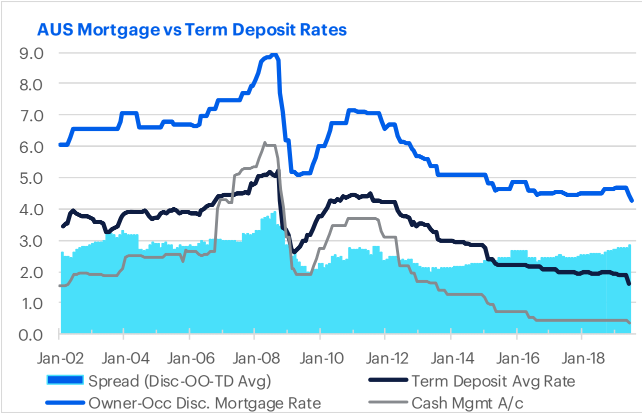
Outside super, cash allocations to bank deposits are a much larger $1.1 trillion and are at the long-term average 21% share of household financial assets (figure 16). Funds could be shifted out of deposits earning zero or near

**Fig.13: AUS bank bill and bond yields, at record lows for several years, have moved to new record lows**




Source: Datastream, EL&C Baillieu

**Fig.14: AUS savings and term deposit rates fell 10-50bps in June (with more to follow in July), punishing cash returns for investors**




Source: Datastream, EL&C Baillieu

Possible drivers of a still higher ASX 200 could include significant additional fiscal stimulus, a larger-than-expected impact from the policy stimulus underway, and/or an unexpected surge in cash inflows into the market.

zero into equities. A return to a pre-GFC extreme allocation of just ~15% would represent a potential inflow of ~$250 billion into equities. Given term deposit rates fell in June and could be expected to decline a similar amount in July, the average TD could soon be ~1.3%, an impetus for such inflows (see again figure 14). Against this, investors need to recognise that low rates signal economic weakness and other markets that have moved to zero rates have not traded on 16x-plus valuations, with Europe and Japan currently on 13.8x and 12.1x respectively.

**Conclusion**

The ASX 200 has performed strongly, buoyed by the global rally, the Morrison-LNP surprise election victory, RBA rate cuts and surging iron ore prices. However, the rally has pushed market valuations to unattractive levels, while earnings risks are high, reflective of the soft economy.

Meanwhile, the probable RBA easing cycle of 75-100bps is largely discounted. In our view, this leaves the most likely catalysts for further upside as additional fiscal stimulus, which is unlikely without greater economic weakness, as well as unexpected policy effectiveness and/or overwhelming inflows from near-zero deposit rates into equities.

Our view is more conservative. We expect soft earnings and a modest PE derating to pull the market moderately lower on a 12-month view.

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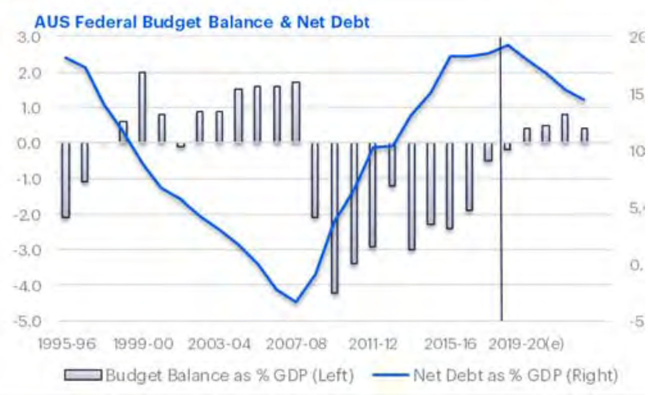
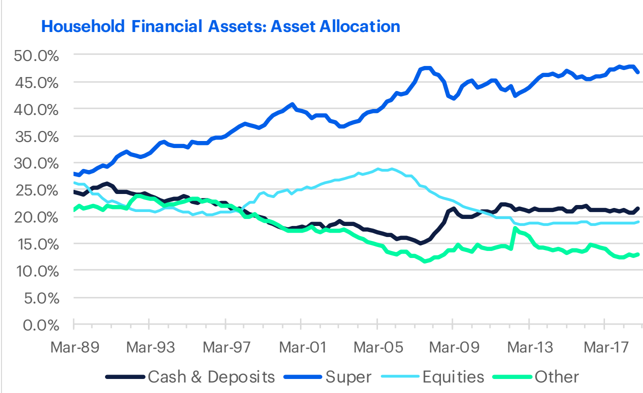
**Fig.15: AUS' underlying budget is close to balance, the best in more than a decade**




Source: Datastream, EL&C Baillieu

**Fig.16: AUS household financial asset allocation – cash weighting is at the long-term average 21%**




Source: RBA, EL&C Baillieu

# Financial Planning

Stephen Godfrey,
Head of Financial Planning

## Super contributions

In recent years, superannuation has undergone a substantial amount of change – something that is a constant source of frustration for clients and advisers alike.

Consistent sources of confusion are how to move money into superannuation, how much can an individual contribute and what are the restrictions and age requirements around contributions.

With the start of a new financial year, now is an opportune time to run through the ways in which you can move money into superannuation and the restrictions and requirements around contributions.

A lot of discussions we have with clients are about how the rules change as they get older. As such, this article will also cover the impact of age on an individual's ability to contribute money to superannuation.

In addition to discussing the current rules, we refer to some of the 2019 federal budget proposals that were made by the government prior to the election. With the re-election of the Coalition, it means that these proposals may become law in the near future.

Finally, throughout this document we will talk about something called the Total Superannuation Balance (TSB). This is the total balance of a member across all existing superannuation policies and accounts. This amount is quite important when assessing whether an individual is eligible to make a contribution and how much that can be.

### Types of contributions and how much you can contribute

Broadly, there are three types of contributions available for individuals to contribute money into super:

**1. Concessional contributions (CC) or before-tax contributions**

Concessional contributions receive a 'concessional' tax treatment, which means they are contributions made into your account from money that generally has not yet been taxed – so it's before-tax. That's why concessional contributions are often referred to as being before-tax contributions.

Common examples of concessional contributions include:

- compulsory employer superannuation guarantee contributions;
- salary sacrifice arrangements; and
- any personal super contributions that can be claimed as a tax deduction.

**The concessional contribution cap for 2019-20 is $25,000 per person.**

Starting from 1 July 2018, individuals are able to carry forward their unused concessional contributions cap for up to five financial years to use in a future financial year (Table 1). This can now be applied in the current (2019-20) financial year. i.e. up to $50,000 can be made concessionally if $0 had been made during the 2018-19 financial year.

**2. Non-concessional contributions (NCC) or after-tax contributions**

Non-concessional (after-tax) contributions are personal contributions made to a superannuation fund where there is no tax deduction claimed (Table 2). These are often called 'voluntary' contributions and can be either a large lump sum or small regular amounts.

Members under age 65 at any time in a financial year may bring forward future annual NCC cap entitlements, based on their total superannuation balance as at 30 June of the prior financial year (Table 3). This is known as the bring-forward rule.

This means some individuals, depending on their total superannuation balance and prior years contributions, may be able to contribute $300,000 in one financial year.

The total superannuation balance must be less than $1.6 million at prior 30 June, otherwise the NCC cap is nil for that year.

**3. Downsizer contribution**

This is a contribution that became available from 1 July 2018 and allows individuals aged over 65 who sell their home, or a property that meets the criteria, to make a one-off contribution of up to $300,000 per person (depending on the value of the property) without meeting the work test and irrespective of their total superannuation balance.

There is some quite specific criteria required for this contribution. Please refer to our *Taking Stock* article dated 20 February 2018 for further details.

This means some individuals, depending on their total superannuation balance and prior years contributions, may be able to contribute $300,000 in one financial year.

**Table 1.**

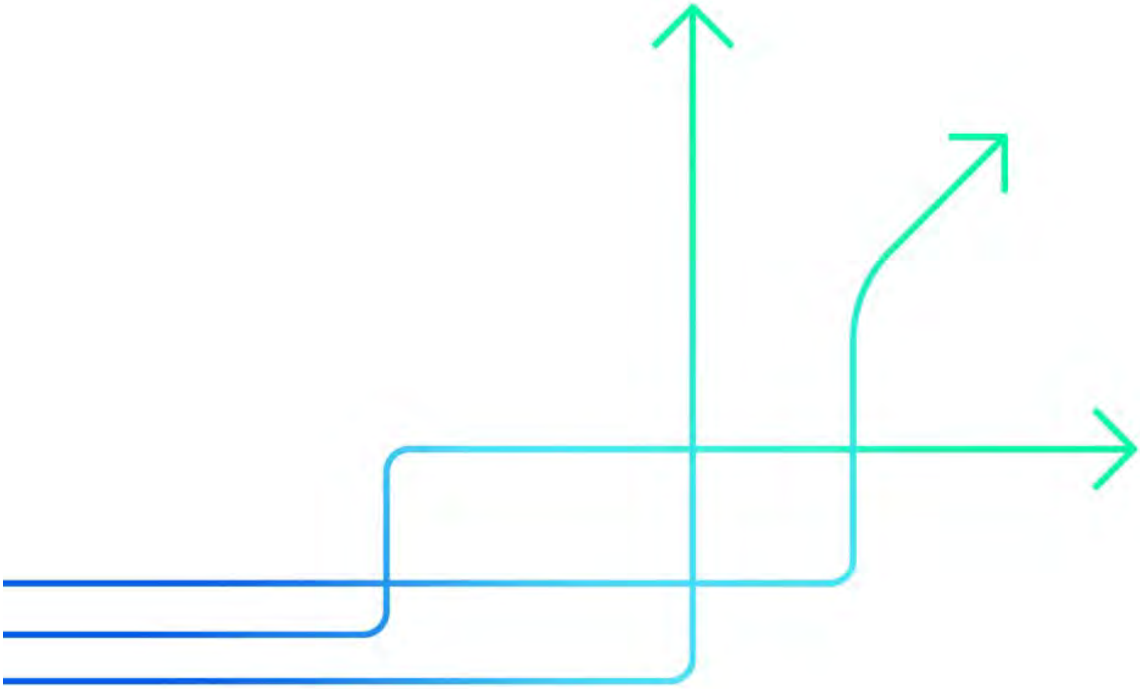
| Carry-forward unused CC cap | |
|---|---|
| Requirements | • Have a TSB of less than $500,000 as at 30 June of the prior year<br>• Have previously unused concessional contributions cap amounts that have accrued in one or more of the previous five financial years |
| Unused CC cap for a financial year | • The amount by which the standard CC cap exceeds an individual’s actual CCs in the financial year |

**Table 2.**

| Standard non-concessional contributions cap for 2019-20 | TSB on 30 June 2019 |
|---|---|
| $100,000 | less than $1.6 million |
| NIL | $1.6 million or more |

**Table 3.**

| TSB at 30 June 2019 | Standard NCC cap for 2019-20 | Allowable number of years bring-forward | Max NCC for 2019-20 including bring-forward (under 65) |
|---|---|---|---|
| < $1.4 million | $100,000 | 2 x $100,000 | $300,000 |
| =/> $1.4 million but < $1.5 million | $100,000 | 1 x $100,000 | $200,000 |
| =/> $1.5 million but < $1.6 million | $100,000 | Nil | $100,000 |
| > $1.6 million | Nil | Nil | Nil |



## Contribution considerations for individuals approaching age 65 and over

<u>1. 'Bring-forward rule' for members approaching age 65 – need to consider eligibility to contribute</u>

Members aged 63 or 64 during 2019–20 may use the 'bring-forward rule' regardless of their intentions for future gainful employment or retirement from the age of 65. However, it is important to understand that a member must be eligible to make non-concessional contributions each time a contribution is made.

Where a member triggers the 'bring-forward rule' in the financial year that they reach age 65, the timing of such contributions will therefore be determined by whether the member has met the work test or work test exemption during the financial year.

If the work test or work test exemption have not been met, the member can only make contributions (and therefore trigger the 'bring-forward rule') prior to reaching age 65. If the work test or work test exemption have been met, however, the member can trigger the 'bring-forward rule' by making after tax contributions at any time during the financial year in which they reach 65 (including contributions made after their 65th birthday).

If the work test or work test exemption have not been met, the member can only make contributions prior to reaching age 65.

***2019 Federal Budget proposal – bring-forward rule extended to people up to 66 years old***

*Currently individuals must be aged under 65 at any time during the financial year to trigger the bring-forward rule.*

*The Government is proposing to change the eligibility to allow people aged under 67 to trigger the non-concessional bring-forward rule. Under current contribution caps, that would enable under 67 year old's to contribute up to $300,000 in one year. It is important to note that the ability for individuals to utilise the bring-forward rule are subject to their total superannuation balance being under $1.6 million on 30 June of the prior year.*

<u>2. Member contributions made by the member – up to age 75</u>

Member contributions made by a member can be made up to and including 28 days after the end of the month in which the individual reaches 75 years old, subject to the work test or work test exemption.

Member contributions, made by the member, include:

- Personal concessional contributions
- Personal non-concessional contributions
- Contributions made under the lifetime CGT cap, whether made by the member or a company or trust

<u>3. Member contributions made by others – up to age 70</u>

Member contributions made by someone else, on behalf of the member, may be made up to age 70, subject to the work test or work test exemption.

Member contributions that are not made by a member include:

- Spouse contributions

***2019 Federal Budget proposal – spouse contributions extended to people up to 74 years of age***

*Under the proposed changes, individuals will be able to contribute to their spouse's superannuation where the receiving spouse is under age 75. In addition, if the receiving spouse is aged 65 or 66, they will no longer need to meet a work test. The work test will continue to apply if the receiving spouse is aged 67 or over.*

4. Work test

The work test must be met in order for the trustee of a super fund to accept member contributions or voluntary employer contributions if the member is 65 or over at the time of the contribution, but is under the maximum age for that type of contribution. The work test does not apply to members who, at the time of the contribution, are:

- under the age of 65; or
- age 65 – 74 and qualify for the work test exemption; or
- age 65 or over and are making downsizer contributions.

A member meets the work test if they have been gainfully employed for at least 40 hours in a period of not more than 30 consecutive days in the financial year. The work test, if applicable, must be met prior to the contribution being made.

Gainfully employed means employed or self-employed for gain or reward in any business, trade, profession, vocation, calling, occupation or employment. The concept of 'gain or reward' envisages receipt of remuneration and, as such, voluntary or charity work arrangements are unlikely to satisfy the definition of gainfully employed.

***2019 Federal Budget proposal – no work test for voluntary contributions by people aged up to 66***

*The Government will allow people aged 65 and 66 to make voluntary contributions to superannuation without meeting the work test from 1 July 2020. Voluntary contributions include:*

- after-tax (non-concessional) contributions;
- tax-deductible (concessional) contributions;
- voluntary employer contributions; and
- spouse contributions.
- Child contributions made by a parent

5. Work test exemption

The work test exemption is intended to give members with low superannuation balances more time to make contributions to superannuation after they have retired.

From 1 July 2019 members aged 65 to 74 who do not meet the work test can make voluntary contributions using the work test exemption if:

- they met the work test in the previous financial year, and
- their total superannuation balance at the end of the previous year is less than $300,000, and
- they have not made use of the work test exemption in a previous financial year.

It is important to note that this is a once in a lifetime exemption and is only available to members who cease work for the last time at age 64 or later. As the exemption is only available for members aged 65 to 74 who meet the work test in the previous financial year, the exemption is only available for those who cease work for the last time on or after age 64.

**Conclusion**

Whilst there have been many changes to the rules and laws governing superannuation in recent years, it still remains a very compelling place to house your retirement savings.

However, the rules governing contributions to superannuation are complex, and it is important that individuals ensure they are eligible to make any contributions.

As always, should you require further information or wish to discuss your situation in more detail, speak to your adviser.

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