NEWSLETTER

August 2019

WINGS ADVISORY

Introduction

Last month, we brought you a comprehensive analysis of the share market's performance for the financial year just ended. This month we look at Australia's largest asset class, residential property – while also observing that our share market reached record new heights during July 2019. We also take a look at deeming, which has been in the news of late.

Famous (Australian) People in Finance – The Reserve Bank Board

OK. So the Reserve Bank is not a person. But it is run by people, and those people have an enormous influence on the Australian economy – as we discuss in this month's newsletter.

The current members of the Reserve Bank Board are: Phillip Lowe (Governor); Guy Debelle (Deputy Governor); Mark Barnaba; Wendy Craik; Philip Gaetjens; Ian Harper; Allan Moss; Carol Schwartz and Catherine Tanna. These people meet on the first Tuesday of each month - including November, Melbourne Cup Day – and decide what should happen to interest rates in the Australian economy. Board meeting minutes are released soon after each meeting and these minutes provide terrific insight into the Board's perspective on the current state of the Australian economy.

Alex Huang

07 3613 7332

alex@wingsadvisory.com

www.wingsadvisory.com

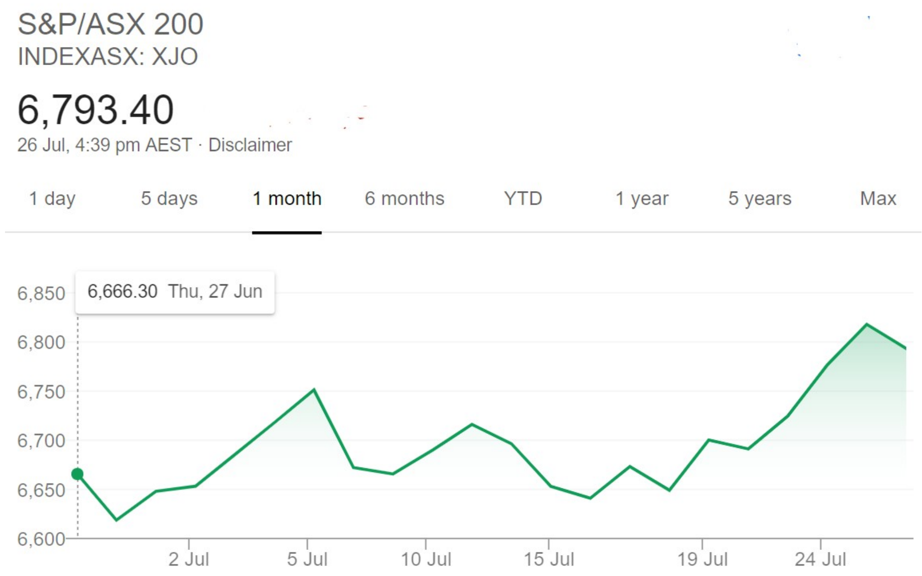
Maggie Drossos

07 3613 7332

maggie@wingsadvisory.com

The Share Market

Let's start with a brief summary of the share market for the month of July 2019. As measured by the ASX 200 index, the market rose from 6666 points on June 27 to close at 6793 points on July 26. This is an increase of 1.9% - which is actually a substantial increase in prices over such a short time period. The market is now trading at prices higher than it reached in October 2007, just before the global financial crisis started to impact on market prices. Here is how it looks graphically, with thanks to Google and the ASX:



As we reported in our last newsletter, the average dividend yield on Australian shares is approximately 4%. On a month by month basis, this suggests a monthly dividend yield of 0.33%. Combined with capital growth of 1.9%, the average share market investor can be expected to have made about 2.2% for the month of July.

If that was you, then please don't think that this is going to happen every month for the rest of your investing life! If our regular newsletters prove anything, it is that markets can move in both directions. Watch this space to see where August takes your sharemarket investments.

The Residential Property Market

The residential property market represents Australia's largest asset class. As we have reported previously, prices fell on average across Australia through the 12 months to the end of June 2019. According to property researcher Corelogic, dwelling prices fell by an average of 8.0% in capital cities across the country. Interestingly, regional property prices only fell by 3.1% in the same period. However, most Australians live in cities, which means that the average change in dwelling prices across the whole country for the year was a fall of 6.9%.

In addition, most people live in Australia's two largest capital cities, Sydney and Melbourne. For the 12 months to June 2019, dwelling prices in Sydney fell an average of 9.9%, closely followed by Melbourne where property prices fell by an average of 9.2%. Perth and Darwin also had years of substantial negative change, with prices falling by 9.1% and 9.3% respectively. Of the capital cities, only Hobart (2.9%) and Canberra (1.4%) saw prices rise in the 12-month period.

Here is a summary of the annual change in dwelling values and the median home price in each of Australia's capital cities for the year ending June 2019. Once again, our thanks to Corelogic for providing the research.

City	Annual percentage change	Median value as at June 30, 2019
Sydney	-9.9%	$777,693
Melbourne	-9.2%	$619,383
Brisbane	-2.6%	$486,121
Adelaide	-0.3%	$430,654
Perth	-9.1%	$439,732
Hobart	2.9%	$453,033
Darwin	-9.3%	$387,382
Canberra	1.4%	6.0%
Combined capitals	-8.0%	$590,431

Of course, what happened in the 12 months to the end of June 2019 is now an historic record. Many analysts believe that residential property prices have either become very close to or reached the bottom of their downward turn. As evidence, they point to the fact that for the month of June property prices actually rose very slightly in both Sydney and Melbourne. Sydney prices rose by 0.1%. The figure for Melbourne was 0.2%. The effect of this is that national prices only fell by -0.2% for that month. In the context of the huge fall in prices over the previous 11 months this represents a substantial change in direction in the trend of residential property prices.

A number of factors seem to be at play the change in demand for residential property. One of these is low interest rates. At its meeting on June 4, 2019, the board of the Reserve Bank of Australia decided to lower the target cash rate to 1.25%. This was the first change in more than two years. While it did not affect the prices in June, it's interesting that the Reserve Bank Board again lowered the target cash rate at its meeting on July 2, 2019. The target cash rate is now 1.0% - the lowest that it has ever been.

RESERVE BANK OF AUSTRALIA

Most lenders have passed at least a substantial part of this lower interest rate on to borrowers. This has an obvious impact on people's preparedness to borrow and their capacity to pay interest on their debt.

Another factor is a slight growth in real wages across Australia. Real wage growth is the increase in average employment income after the effects of inflation are taken into account. As we have discussed previously, it is the link between property prices and real wages that dictates how affordable property is at any given point in time. When property prices are higher relative to real wages, property becomes less affordable – and vice versa. In the nine months to March 2019, real wages grew by 2.3% (once again, according to the Reserve Bank of Australia). While this figure is not high, in the context of falls of almost 10% in the median price of dwellings in our two largest markets, this rate of change suggests that housing affordability improved by 13% across the period.

A third factor that undoubtedly affects consumer sentiment was a signal given by the Australian Prudential Regulation Authority (APRA) in May 2019 that it was considering changing its requirement that banks calculate a potential borrower's ability to service a loan using a representative interest rate of 7%. Such a change would allow the fall in actual interest rates to lead directly to an increase in borrowing ability on the part of market entrance. Therefore, lenders become able to make larger loans.

APRA
Australian Prudential Regulation Authority

APRA requires banks to use a higher rate of interest than is currently being charged to calculate whether a borrower can service a loan. APRA is relaxing this higher rate, making it easier for borrowers to get a loan.

Whether property prices have reached the bottom and turned again will be seen over the coming 12 months. But given the rate of change at the end of the 2019 financial year, combined with improved borrowing conditions and gentle improvements in employment income, it would take an astounding change of momentum for prices to fall by anything like the extent to which they fell in the financial year just ended. The market may well have bottomed out, especially in the markets where it has fallen the most.

Tell 'Em They're Deeming

In both June and July the Reserve Bank of Australia's Board reduced the target cash rate such that it now sits at an all-time low of 1.0%. In the previous section we discussed how this change leads to lower interest rates being charged to home loan borrowers, which should see an increase in demand for residential property - something that seems to be being borne out by the figures for June 2019.

But lower interest rates are not good for everybody. People relying on interest earned on bank deposits and similar investments for their income experience a fall in income when interest rates are lowered. Amongst others, this impacts particularly on self-funded retirees – especially those who are holding at least some of their wealth in interest-bearing investments such as bank accounts or term deposits. That is to say, most of them.

Many self-funded retirees also receive a part age pension. Recipients of the age pension must report their financial assets to Centrelink at least once a year. Centrelink then assumes that the recipient is achieving a particular rate of income return on these financial assets. This assumption is known as 'deeming' and the assumed rate of income return is known as the 'deeming rate.' By multiplying the deeming rate by the value of the relevant assets, Centrelink establishes an amount of income that it *deems* the pension recipient to have received. The effect of this deemed income is to reduce the amount of age pension payable by Centrelink.

It is important to note that the deeming rate is not the same as the actual amount that a recipient earns from their investments. People can, and normally do, earn a different level of actual income than the income that they are deemed to have earned by Centrelink. By assuming a standard rate of income return, Centrelink avoids the burden of recipients having to report their actual income return periodically. In this way, deeming an assumed rate of return makes the age pension administratively easier.

Centrelink use a deeming rate to assume how much investment income age pensioners receive on their assets.

Centrelink also argues that using a deemed rate of return rather than an actual rate of return will discourage people from making investments that are specifically intended to have a particular effect on their aged pension. That is, deeming should stop people from investing specifically to lower their income return so as to qualify for a higher rate of age pension. To give a simple example, different companies whose shares are listed on the Australian Stock Exchange pay different rates of income return depending on the nature of their business and other factors. An aged pension recipient who wished to minimise their investment income (so as to minimise the impact of that investment income on their age pension) might be encouraged to invest in companies that pay lower rates of dividend. Centrelink argue that this would artificially increase the amount of age pension it then has to pay these various recipients.

The link between the amount of age pension payable and the deeming rate is negative. That is, a higher rate of deemed income will lead to a lower level of age pension being paid. A fall in the deeming rate will lead to eligible recipients receiving more as age pension benefits.

The assumed rate of investment return - the deeming rate - is set by the Commonwealth Minister for Social Services. That minister is currently South Australian Senator Anne Ruston.

For deeming to be a valid and appropriate way of managing eligibility for the aged pension, it is important that the deeming rate used relates accurately to income that is actually available in Australia's various investment markets. As we say above, higher deeming rates lead to lower aged care benefits. So, if the deeming rate used is inappropriately high, people receive less age pension than they otherwise should.

This became an issue in June when interest rates were reduced. This reduction meant that age pension recipients who held income-bearing investments such as bank accounts or term deposits experienced a reduction in their actual income. But this reduction was not automatically balanced by an increase in age pension because deeming rates are not set by the Reserve Bank of Australia's Board. So, deeming rates did not change when interest rates fell.

For the deeming system to remain fair, the deeming rate and the actual rates of income return available need to be in balance.

Put simply, the fall in interest rates meant that aged pension recipients received less actual income on their actual investments. But the deeming rate had not changed and so Centrelink basically assumed that their income remained unchanged. Those recipients did not experience any increase in their age pension, even though their non-pension income had fallen. Overall, they were now worse off.

This has now changed. As of 1 July, the highest deeming rate has fallen from 3.25% to 3%. (The change was actually announced on July 15, but it is going to take effect from July 1). This will flow through to provide an increase in age pension for all eligible Centrelink recipients whose income is affected by holding financial assets to which the deeming rules apply.

Deeming can be complicated and it is always important that you maximise your Centrelink benefits. If you think that the deeming rules affect you or someone you love, please do not hesitate to get in touch with us. We can help you ensure that you take full advantage of the recent changes in deeming rates and receive the maximum Centrelink benefits which you are entitled.

The Legal Stuff

General Advice Warning

The above suggestions may not be suitable to you. They contain general advice which does not take into consideration any of your personal circumstances. All strategies and information provided on this website are general advice only.

We recommend you seek personal financial, legal, credit and/or taxation advice prior to acting on anything you see on this website.

Contact Details

Address	Level 34, 1 Eagle Street Brisbane QLD 4000
Phone	07 3613 7332
Website	www.wingsadvisory.com
Email	info@wingsadvisory.com

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