# Monthly Newsletter

## US election aftermath, low interest rates raise risk profile and new initiatives

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Stock markets are not always right but the first reaction to Barack Obama's re-election was decidedly negative – a response to the political landscape. In the first two days after Obama was elected in 2008 the Dow slumped over 900 points. Can we expect a repeat? The 'fiscal cliff' looms and with a Republican House of Representatives the way forward is unclear – a stalemate on Capitol Hill. Will the US climb the cliff or plunge over it? The debt ceiling has to be raised – government debt is currently US$16 trillion. Like it or not government policy can and usually does influence the direction of financial markets. Fiscal policy has a significant influence on GDP and the trend in GDP guides financial markets. The Eurozone mess created by the PIIGS – Portugal, Ireland, Italy, Greece and Spain – evolved from a lack of fiscal responsibility – sustained government spending in excess of tax revenue. Central banks dictate monetary policy but cannot win the battle alone. A radical change in fiscal policy is needed. Tax revenue can be increased in two ways – raise the rate which dulls incentive or increase the taxable pie – grow the economy. Which way will the Obama administration go? The financial markets fear the first option.

While the US situation will have some influence on the performance of Australian markets the change in leadership in China and plans to reinvigorate that economy is likely to be of greater importance. I continue to believe any pull back is a buying opportunity. A defensive stance with solid exposure to sustainable dividend paying stocks is the key although long-term value is available in resource leaders BHP Billiton (BHP), Rio Tinto (RIO) and Woodside (WPL).

**Interest rates and risk exposure**

As I expected the Reserve Bank held fire on Melbourne Cup Day. That is one winner I picked. The less said about the Cup the better. But I do expect a cut on 4 December to provide the economy and the retail sector stimulus for the all-important Christmas trading period. And I think it could well be the end of this rate cut cycle. Official rates will then be equal to post-GFC levels of 3.0% in early April 2009. At this stage I don't see any reason for Australia to have zero or negative real official interest rates. Nor do I expect rates to rise in 2013.

RBA Governor Glenn Stevens put the cat among the pigeons when inferring that in a low interest rate environment, "savers are facing increased incentives to look for assets with higher returns." Low interest rates force investors up the risk curve. They become 'handcuffed volunteers' seeking alternative higher income producing assets to replace falling returns on cash, bonds and bank deposits. Deputy Governor Philip Lowe warned that Australia should not aspire to the very low interest rates set by central banks in Europe, the US and Japan. The Australian economy, monetary and fiscal settings and banking system are in much better shape than the abovementioned. At this stage there is no need to join them and hopefully we will avoid the necessity.

Stevens' comments made headlines in *The Australian Financial Review* of 7 November – 'Upgrade to shares, RBA tells savers'. This puts him at odds with those calling for Self Managed Super Funds to reduce exposure to volatile shares and lift cash and term deposits. The key findings of the September Self Managed Super Fund Investor Intentions Index Investment Trends report revealed that trustees' willingness to hold and accumulate cash remains high. Holdings of cash and term deposits sit at 28% of fund assets, significantly higher than the high single digit cash holdings in professionally managed super funds. The 20% 'gap' comprises bonds and international equities and suggests to me these investments are out of trustees' comfort zone.

I suggest most of the cash was built up at the bottom of the post GFC share market slide. This was a time when annuity advertising was at its peak and in my opinion the worst time to buy

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annuities. People think long-term investment is only for the 40 and below. In fact the life expectancy of a male at 65 is 19 years and for a female 22 years. In respect of a couple now aged 65, there is a 50% chance one will live until at least 90 years of age. Inflation at 2.5% per annum erodes purchasing power by 40% over 20 years. Long term growth assets in a diversified portfolio are required even at 60 plus to ensure a comfortable lifestyle in retirement. Cash, term deposits and bonds will not provide the necessary asset growth or at current interest rates, income. A recent portfolio of Challenger annuities had 75% exposure to fixed interest and cash, with 70% in Australia, 20% in the US and 10% UK/European Union. Only 2% of the portfolio was exposed to equities/other assets. In my opinion that portfolio will not deliver income and growth to finance a comfortable lifestyle for the next 20 years. It missed significant total shareholder returns, some exceeding 40%, from high quality sustainable dividend paying equities like Telstra (TLS), major banks, Ramsay Health Care (RHC), InvoCare (IVC), Coca-Cola Amatil (CCL), Woolworths (WOW) and Wesfarmers (WES) over the last 18 months.