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Market update

Global shares

An improving outlook for global growth and corporate earnings, along with improving business and corporate sentiment has pushed shares higher in 2017. Emerging markets shares also rebounded following a weak finish to 2016. In the US, this favourable backdrop and the continuing, albeit slowing, effects of the 'Trump trade' helped major share market benchmarks reach record highs. Economic data from Europe was supportive, with the Eurozone economic expansion outpacing US economic growth for the first time since 2008.

USA: Major US indices remain close to all-time highs. While corporate earnings remain sound, valuations continue to trade above long-term averages. Some of the lustre has come off President Trump's policies with many details remaining unknown. Economic data remains robust in the US.

China: China's GDP growth target was set at around 6.5 per cent at the National People's Party Congress in March. While we expect some moderation in growth momentum from recent policies targeting property, proactive fiscal policy further boosted by public-private partnerships will provide an offset ahead of the Communist Party Congress later in the year. Based on consensus earnings forecasts, the forward price-earnings ratio for Chinese shares sits below 13 times.

Inside this edition

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Europe & UK: Macro economic data is indicating an ongoing improvement in the Eurozone, however political uncertainty remains high with the upcoming French and German elections. The European Central Bank (ECB) kept monetary policy unchanged at its latest meeting, but there was a notable change in language to a less dovish stance. ECB President Mario Draghi recognised the improvement in the macro data and that the risks to the economic outlook are now less tilted to the downside, as well as there being less of a sense of urgency for the ECB to act.

With Article 50 now triggered, Britain will face tough negotiations ahead. Setbacks are likely, which could have detrimental effects on business sentiment and investment. At the same time, inflation keeps eating into consumers' purchasing power, so household spending is unlikely to pick up in the near term.

Australian shares

Consensus earnings expectations remain positive for FY17, with the share market remaining on track to record some earnings growth for the first time in two years. Much of this has been driven by the commodity and base metal price recoveries in the resources shares. The outlook for many of the other sectors remains more muted.

The recent reporting season delivered a mixed bag in terms of company announcements. Bluescope and CSL both upgraded their FY17 earnings guidance, whilst at the other end of the spectrum, there were a string of profit warnings from the likes of Brambles. Telstra's earnings also disappointed the market. The majority of production reports from the resources and energy sectors either met or exceeded market expectations.

Some caution is warranted around shares exposed to Brexit and those exposed to the Australian consumer as domestic discretionary spending appears to have slowed considerably over the past year.

Cash and fixed interest

The Reserve Bank of Australia (RBA) left the cash rate unchanged at 1.50 per cent in April. The RBA remains relatively upbeat on the prospects for global growth however softness in the labour market remains an area of concern. The RBA welcomed the recently announced macro-prudential measures to "help address the risks associated with high and rising levels of indebtedness". Rates appear set to remain on hold for some time.

In the US, core inflation is inching closer to the Fed's target. With an economy near 'full employment' it is likely the Fed will continue its course of rate hikes in 2017. The move in yields over the second half of 2016 is reflective of improvement in US economic data. Political events will continue to dominate Europe. Core government bond yields have remained largely range bound, but yields could drift gradually higher over the course of the year if political uncertainties are resolved. Credit spreads remain at levels supportive of a more neutral to cautious stance.

Property – AREITs

Rising bond yields have not been friendly to AREITs. However the aggressive sell off has improved value, with AREITs now trading below net asset value (NAV). The fortunes of the AREIT sector will remain, at least in the short term, closely tied to the direction of bond yields.

Office shares are still reporting moderate improvements in like-for-like net property income growth. The Sydney market is expected to experience a historically low supply and vacancy, leading to attractive rental growth. Retail appears to be facing some headwinds. Supply is ramping up in regional space and foreign retailers are driving price deflation. Residential developers continue to deliver strong volume and price momentum but there are some medium term concerns given a huge increase in apartment supply.

Whilst underlying property values are close to mature-cycle levels, bond yields are not at levels that will threaten valuations at this stage. We remain cautious on the long lease expiry shares that are trading at large premiums to net tangible assets. Conversely, we continue to find pockets of value in a number of the smaller trusts that offer attractive yield at reasonable valuations.

Source: Zurich

Speak to your financial planner to discuss your investment options

APRA's needle just popped the housing bubble

It is said that a bubble is just a bull market that you're not in. A pithy one liner that neatly captures the fine line between good fundamentals and overvalued assets.

One way of looking at this housing bubble is to flip the question on its head: Given we have some of the most highly valued housing markets in the world (chart below), is the rest of the world just stupid? Is the sum of all the other views on housing misguided and we in Australia have found a new way of generating long term sustainable wealth? The most likely answer is no.

The calamitous end to US housing stocks in 2007, has some similarities to now in Australia: regulatory bodies had become concerned and were raising interest rates; a very high portion of loans were on their version of interest only loans; and, importantly, supply had caught up and gone into oversupply.

A lot of people claim now it was obvious it was a bubble, but large segments did not believe this to be the case.

Table 1

Balance	750,000	750,000	750,000	750,000	750,000	750,000
Fixed Term	1	2	3	4	5	6
Total Term	30	29	28	27	26	25
Mortgage	5.00%	4.75%	4.50%	4.25%	4.00%	3.75%
Ann. Pmt - IO	-$37,500	-$35,625	-$33,750	-$31,875	-$30,000	-$28,125
Ann. Pmt - P&I	-$49,037	-$49,345	-$50,025	-$51,156	-$52,846	-$55,251
Step-Up	31%	39%	48%	60%	76%	96%

Source: Morgan Stanley

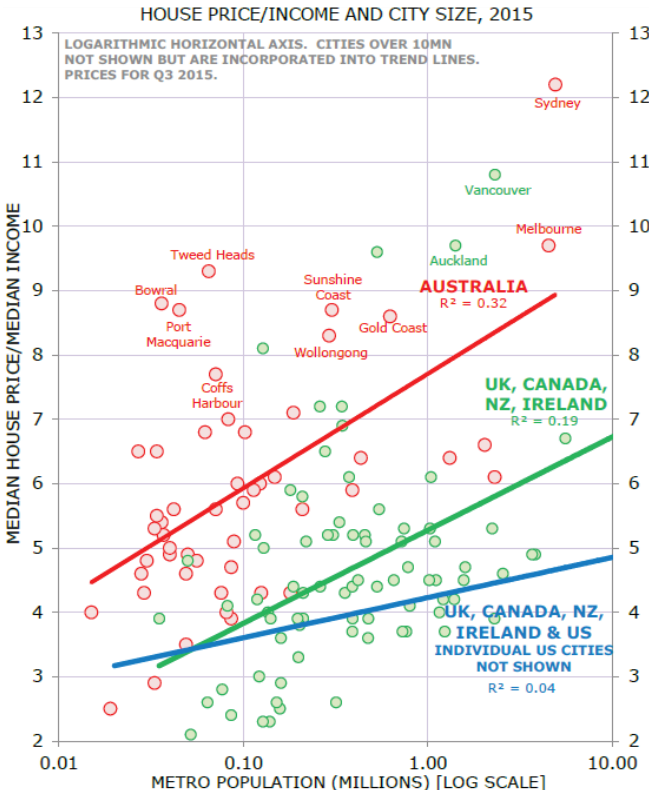
It is within this context that the recent announcements by the Australian Prudential Regulatory Authority (APRA) are so important. In response to the increasing concerns about the Sydney (also Melbourne) housing market, a raft of measures to reduce the amount of bank lending was announced in early April. These included measures to limit further lending to investors beyond the previously announced "speed limit" of 10 per cent loan growth for investors; and to increase scrutiny of stated incomes and further stress tests on borrowers.

But the most important part relates to the new cap on Interest Only (IO) loans to 30 per cent of all loans (it is currently closer to 40 per cent on average). The reason why APRA's move is potentially so important is that for investors who have multiple properties, the move to force repayment of principal will see their repayments balloon. Table 1 is a worked example of what moving to principal and interest does to the repayment schedule for a borrower with a loan book of $750k.

Given landlords are unlikely to put up rents by 30%-100%, particularly given the new supply coming online later this year. The more likely outcome suggests some investors become forced sellers later this year to reduce their outstanding loan book, adding to supply of properties that hit the market in 2017 and 2018.

Could 2017 be looked back as the "obvious" peak when supply collided with reduced borrowing capacity and overvalued assets?

Source: Morphic Asset Management



Source: Minack Advisors

Speak to your financial planner to discuss your property and investment options

End of financial year strategies

June 30 is fast approaching but there's still time to consider the strategies available to you to build your wealth. Below are simple tips that could help maximise what you've got this financial year.

1

Pay interest in advance

Borrowing to invest may be a tax-effective means of wealth accumulation. This type of strategy lets you purchase property, shares, or any other asset that generates assessable income, bring forward next year's interest cost, and claim a tax deduction for those costs this financial year.

2

Make a concessional contribution to super

If you are self-employed, or earning less than 10 per cent of your income from an employer, you can generally claim a tax deduction for personal super contributions up to $30,000 if you are under age 50 and $35,000 if 50 or older. As from 1 July 2017 all individuals under age 75* will be able to claim an income tax deduction up to a maximum of $25,000.

* individuals aged between 65 and 74 can only make a contribution if they are gainfully employed.

3

Government Co-Contribution

To be eligible to receive the co-contribution, you must earn less than $51,021 and make after tax contributions.

If you earn less than $36,021 and make after tax contributions to super of $1,000, you could be eligible for the maximum co-contribution of $500. This amount reduces by 3.333 cents for every dollar of income over $36,021 and phases out completely once you earn $51,021.

4

Protect your income and save on tax

Income protection insurance can pay a monthly benefit of up to 75 per cent of your salary if you are unable to work due to illness or injury, with the premiums being tax deductible. Paying premiums in advance enables you to bring forward the following financial year's premiums to claim a tax deduction this financial year.

After July 1, consider the following:

Have your key financial goals changed?

Our lives are not constant and our goals and can change greatly from year to year. Major life events such as serious illness, the birth of a child, or the death of a parent or spouse can all result in significant changes to our wealth management goals.

Salary sacrifice arrangements

Have you reviewed your salary sacrifice arrangements to ensure you do not exceed the reduced maximum of $25,000 per annum from 1 July 2017.

Prioritise your goals

It's important to be realistic about how soon you can accomplish your financial objectives. For example, reducing credit card debt is likely to be a short-term goal, whereas saving for a home deposit would often be a medium-term. Paying off your mortgage and providing for retirement are long-term goals.

Be investment savvy

Make sure that your investments support your appetite for risk and your objectives. A tailored analysis will address your individual risk preferences. Regular portfolio reviews with your adviser are essential to determine any sell-downs or top-ups that would benefit you.

Do you need to change your financial strategy?

Licensed advisers have the tools and knowledge to create projections that take into account changes to your goals, risk level, and the timeframes for achieving them. These projections will help you to see where your plans for savings, assets or investment contributions may need updating.

The Government superannuation reforms announced last year have become law and most are set to commence from 1 July 2017. Some of the other key changes that you need to be aware of are:

- The Non-Concessional Contribution cap will be $100,000 per year, down from $180,000 each year.
- If your total super balance exceeds $1.6 million, you will not be able to make any non-concessional contributions.
- Currently earnings on Transition to Retirement Income schemes are tax-free. From 1 July 2017, Investment earnings will be taxed at 15 per cent.

Despite these changes, it must be remembered that superannuation still remains a highly tax-effective saving system. That's why it's important you are aware of the changes that are being made and can make informed decisions on how they fit in with your retirement plans.

Source: Zurich

Speak to your financial planner to discuss your strategies and plan ahead for the next financial year

Buy/sell agreement to cover your business

What would happen to your business if you or your business partner passed away?

If you passed away tomorrow, would your family want to take over your role in the business? What about if you become totally and permanently disabled and can never work again, would you prefer to sell your share of the business? Alternatively, if your business partner passed, would you want their family taking control of their share of the business? Could you afford to buy them out? What if they do not want to sell?

There is a legal document that can create an obligation for a party to sell upon a trigger event such as passing away or becoming totally and permanently disabled. This is known as a buy/sell agreement.

Put simply, a buy/sell agreement is like a will for a business. When the agreement is well-executed and funded, it is an effective mechanism for business owners to transfer share and/or control if something should happen to one of them. And, unlike a handshake agreement, a good buy/sell agreement provides transparency and certainty to all parties involved.

But to work effectively a buy/sell agreement needs to be funded. In other words, the surviving owner will often need the funds to buy the departing owner's interest in the business. There could be a range of funding options, including drawing on business or personal assets or taking out a loan, however, to avoid having to find this money at such a stressful time, funding with an insurance policy can be an effective and relatively inexpensive option.

Case study – how an insurance funded buy/sell agreement could be used.

Nick and Tom are 50/50 business partners in a company worth $6 million. Nick passes away and his shares pass to his wife Jan as per his will. Tom needs to find $3 million to buy out Jan. But Jan may think the business is worth more and ask for $4 million, or she may wish to take up a principal position in the business, replacing Nick. Jan has no legal obligation to sell the shares to Tom, and Tom has no obligation to buy the shares from Jan. This is where a buy/sell agreement comes in.

Let's assume that Nick and Tom had a legally binding buy/sell agreement in force at the time of Nick's death, which was funded with insurance. In accordance with this buy/sell agreement, Nick took out a $3,000,000 life insurance policy in line with the value of his share in the business. Nick passes away and, Jen, as the nominated beneficiary is paid $3,000,000 tax free.

Tom then triggers an option in the buy/sell agreement that requires Jen to transfer the shares she has inherited to himself. But unlike an ordinary share purchase transaction, Tom doesn't actually have to outlay $3 million on settlement. That's because the buy/sell agreement recognises the $3 million insurance policy proceeds received by Jen as consideration for the sale of the shares. In other words, Jen is deemed to have received $3 million in sale proceeds by virtue of her being the nominated beneficiary on Nick's life insurance policy.

In the end, Jen has received $3million tax free for transferring the shares that she inherited from Nick, to Tom. Meanwhile, Tom has assumed full control of the company as the sole shareholder/director.

There are alternative insurance policy ownership options that can be used, but their appropriateness will always depend on personal circumstances.

You should speak to your financial planner to see if this is applies to you and your business

Source: AIA

Lower portfolio volatility? It's in the bank.

Most retirees want a steady income and some ability to withstand market volatility. But what should they do when some of their best income shares – banks, for example – are volatile?

Domestic bank shares are a key source of income for Australian retirees because of the relatively high dividends they pay. But there's a downside as banks account for a large part of the Australian share market (just over a third of the S&P/ASX 300 Index), they tend to reflect the market's inherent volatility (which is caused by a significant exposure to the perennially volatile resources sector). So while the income that bank shares pay is attractive, their capital value can be unstable.

This is a problem for retirees, because they meet their day-to-day living expenses out of total portfolio returns. When markets fall, their cash withdrawals continue to eat into the capital component of their portfolios as well as the income component.

The result—likely to be exacerbated for investors with high exposures to bank shares—might be a decline in capital levels that will never recover, and which might be detrimental to retirees' long-term investment goals.

Selling bank shares to reduce portfolio volatility would be like throwing the baby out with the bath water, however, as it would mean forgoing an attractive income stream. This is especially true as, contrary to many people's perceptions, bank dividend payments are relatively robust.

Bank dividends: the safety nets

True, ANZ cut its dividend last year and even recent strength in bank shares (and the market generally) hasn't totally dispelled concerns that dividend ratios might come under pressure from deteriorating bank fundamentals and new capital adequacy requirements.

Based on Alliance Bernstein's research into Australian banks:

- The size of dividend cuts that might be required to create a more sustainable payout level would leave the banks still looking fairly attractive as dividend yield plays
- The boards of major banks are reluctant to cut dividends aggressively because doing so would reduce their ability to distribute valuable franking credits (they view franking credits as a key part of the value they generate for shareholders and see it as their duty to distribute them)
- Banks possess some structural limits to the rate of decline in their profitability. Helped by their profitability and cash flow, the banks are major borrowers from overseas—and this helps to finance the country's current account deficit and significant accumulated debt. Consequently, governments understand that any appreciable adjustment to the banks' profitability must be made gradually for fear of the economic consequence
- Following an increase in their capital levels in recent years, banks are in a better position to withstand downturns than they were in the past.

In light of this, the challenge for retirees is to hang on to their bank shares but somehow dampen their volatility.

The solution lies in addressing the problem at the portfolio level, rather than at the level of individual share holdings.

Winning more by losing less

One way to do this is to incorporate into the portfolio an allocation to a low-volatility shares fund or strategy that can help to offset volatility from bank shares. Ideally such a strategy should "win more by losing less"—that is, lose less than the market when the market falls and participate as much as possible in the upside when the market recovers.

In this way a retiree's portfolio can recover relatively quickly from a market drawdown, because it has lost less ground to begin with and can recapture a significant proportion on the rebound. Research shows that, over time, this strategy should generate returns comparable to the market, but with a smoother ride.

A portfolio of Australian shares constructed according to these principles would naturally be underweight financials and resources, thus reducing volatility.

And so it should be possible for a retiree to continue to enjoy relatively high bank dividends with the shares' volatility offset to some degree at the portfolio level.

Source: AB

Speak to your financial planner to discuss how you can minimise volatility in your portfolio

Choosing a wine like a professional

Top tips to stand you in good stead when you next go to a restaurant or are buying wine in a bottle shop.

Choosing a good drop from a restaurant's wine list can be a battlefield if you don't know your stuff.

More often than not, your decision can end up being based on price alone and, thanks to the significant mark-up on restaurant wines, this tactic can leave you with a sour taste in your mouth.

So, it can pay to do your homework and knowing which Australian regions are most renowned for each of the wine varieties is a good place to start. ARIA Group operate two renowned restaurants in Sydney and Brisbane. ARIA's Sommelier, Matthew Dunne, believes the best regions for some of the major varieties are as follows:

How to choose

Dunne explains that the structure of a wine list is generally based on three important factors: style, price and region. Decide what type of wine you are interested in based on your mood and what type of food you will eat. Then choose a price bracket you are comfortable with and stick to it. If you are still feeling uncertain, then the best option is to ask the waiter or the sommelier, if the restaurant has one, what they think. A good sommelier will take into account your budget, the food you will be eating and your declared preferences. Another way to broaden your tastes is to choose a wine by the glass. These are becoming an increasingly popular option and allow those who don't want a whole bottle to access excellent wines.

What to look for

Balance and length on the palate are the qualities you should keep an eye out for when choosing a wine, according to Dunne.

Food pairing

The main consideration is that the flavours of the food should not overpower the taste of the wine, ideally they should complement each other. Foods with a powerful flavour go well with wines that have a stronger taste. The opposite also applies.

For red meat, think Shiraz or Cabernet Sauvignon.

For fish, a lighter tasting wine like Sauvignon Blanc is a good choice.

Grilled foods go well with Pinot.

For salads and other light foods, try Rosé.

Of course, this is just a starting point so you can then begin to map out and explore your own references. Ultimately, it should come down to what you enjoy drinking.

Other tips

We've all been there – lured to purchase something based on the label. But when it comes to wine, the picture on the bottle isn't always a good plan. Another trap for the unwary is the bargain bin at the bottle shop – there is probably a reason the wine is being sold cheaply and it is unlikely to be because it is terrific. A more modern way to help you choose is to use one of the many mobile apps available that can read wine labels and offer ratings and reviews. Another tip is to buy a case rather than a single bottle as you can save a significant amount of money and bring previously unaffordable wines into your price bracket. Finally, if you are very enthusiastic to learn more about wine, then joining a local wine club or society is a great idea as you'll be able to meet like-minded people and get an opportunity to try a wide variety of wines. When it comes to wine, as with many interests, you never stop learning.

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WMA-21994