

From Greek tragedy to the Italian Job!

In 2003, a modern version of the 1969 movie *'The Italian Job'* was filmed and while it was not a total flop at the box office, it certainly did not capture the 'cult' following of its predecessor. The movie is about a plan to steal the payroll of the Turin-based automaker Fiat, and smuggle it out of Italy. The movie is famous for its ending, when the get-away bus (carrying a large amount of gold) veers off the road and ends up with its tail hanging off a cliff.



The movie ends with Michael Caine saying, *'lads I've got a plan'*, but the audience never finds out what the plan is and whether the robbers survive or go down with the gold!

Crises everywhere – except the data...

Clearly movie making is not an exact science, and neither for that matter, is economics. In August, September and early October 2011 there was a plethora of differing views from experts that the global economic recovery was rapidly deteriorating. Europe has its debt crisis, America had a jobless crisis and corporate profits appeared to be at crisis levels. US Federal Reserve Chairman Ben Bernanke bluntly warned the US Congress in October that the US economic recovery *'is close to faltering'*.

Despite all the pessimism, all the weak sentiment and all the volatility, the only thing missing to support this deteriorating sentiment was the data to confirm it. Indeed economic data in the US, France and Germany has been much better than expected and is certainly not reflective of an economy (or economies) that are on the brink of recession. More heartening is that the latest improvements in the economic data contrasts markedly with the persistent pattern of bad news that came out during 2008/09, when the global economy was on its knees and recorded its largest contraction in 65 years.

Are we optimists or pessimists?

This better-than-expected data has been a springboard for global markets to recover in late October, overshadowing the unprecedented drops that we witnessed in August and September. Some investors may view a recovery of 10%-15% since early October as evidence that the negative sentiment was overdone. Alternatively, some may view the recovery as a sign that optimism about Europe is overdone. The extent to who is right in the long-run is likely to be determined by whether the European 'rescue package' reduces Government funding pressure and bank balance sheet pressure in a sustained and viable way.

The European 'rescue package'

Three key themes have dominated the ongoing discussions among European authorities, (i) Greece and Italy, (ii) bank recapitalisation and (iii) Government bond market stabilisation. The plan to recapitalise Europe's banks seems to be well progressed. Whilst the details remain scant, it appears European banks will write 50% of their Greek Government debt off their balance sheets.

These write-offs are limited to the private sector and would reduce total Greek Government debt by about one-quarter. The challenge is then for these European banks to replace around 110 billion Euros of capital in the next nine months.

They will either do this themselves by raising the funds through the various global capital markets, via the Government in the country that they reside, or if all else fails, via the European Fiscal Sustainability Fund (EFSF).

2.05/202 Jells Road

PO Box 3034

Wheelers Hill Victoria 3150

p: (03) 9574 8300

f: (03) 9574 9231

e: advice@sifp.com.au

w: www.sifp.com.au

The European woes! (continued)

Greece may be the word, but is not the only problem

Despite recent threats of a Greek referendum relating to the austerity measures and some changes amongst their political leaders, Greece is well behind its reform process program and the need to reduce its Government debt (which is expected to reach 181% of output in 2012).

But excess Government debt is not a problem that is just limited to Greece. At the end of 2007, there were 11 countries listed by the International Monetary Fund that had debt levels that were considered to be unsustainable. By the end of 2012, the number of countries had risen to 18 and six of the seven recent additions are European.



The Italian Job 2011 style

The surprising thing about the latest market rally is that the European package up until recent times, has solely focused on Greece. One word that had been missing from this package is contagion. Whilst Greece appears to be getting resolved, the spotlight has been turned on Italy and their debt issues (forecast to be 120% of GDP at end of 2012 and whose debt is five times larger than Greece) and is starting on Belgium (109%), the USA (103%), Portugal (95%) and the UK and France (both 87%).

Pressure is building in Italy

At the end of 2010, Greece was only a USD\$305 billion economy. Given that annual Italian economic output was USD\$2.1 trillion at the end of 2010 (putting it six and a half times larger than Greece's), it is far more important. Whatever they do now, the European authorities have to ensure that Italy is completely funded as its impact on financial markets will be much larger.

Indeed Italy is the third biggest European economy and the third largest bond market in the world (after the US and Japan) and with yields rising above 6%, pressure is building. After lots of encouragement, Italy "invited" an IMF quarterly inspection of its economic policy plans. If the Italian Government (now without Silvio Berlusconi) experiences funding pressures, the European Financial Stability Facility (EFSF) which has the mandate to safeguard the financial stability is not large enough to prevent any market run on Italy. Clearly the broader the solution, the better it will be for Europe and for markets.

Are there design flaws in the European package?

Although the bank recapitalisation (at around 110 billion Euros) is more than initial estimates, there appears to be two potential headwinds. Firstly, as banks have extended time to restructure their balance sheet following the write-off and capital raisings, it is likely that some banks may opt to reduce their lending, rather than issue more shares. This decision would further tighten credit conditions in an extremely fragile region and place more downward pressure on already anaemic growth prospects.

Meanwhile, fund manager UBS recently highlighted that the European plan doesn't cover the capital needs of Spanish banks, who need a buffer of around 150 billion Euros against probable property-related credit losses. Consequently, the second headwind is that the European bank recapitalisation plan may cause some problems for the recovery and may need more capital to help regional banks.

Will Europe drag the US down?

Although the US economy has been stronger than expected, investors are concerned that Europe will drag the US into recession. However, the US economy coped easily with Japan experiencing little growth over the past 20 years and there appears to be surprising strength in the US manufacturing and auto sectors thanks to the devaluation of the \$US and continued support from US Government authorities. In addition, corporate America is performing reasonably well and earnings results in the latest profit reporting season have been solid to date.

The earnings environment after 1983 was fuelled by leverage

Although markets have partially recovered, the earnings environment has completely changed. Over 25 years to 2008, above average earnings growth was driven by the largest leverage (borrowing) boom in history, where credit growth was averaging 15% (driving bank profits structurally higher), asset prices were rising, incomes were strong but regulation was declining. While rising leverage was the foundation for all these trends, each factors existence reinforced the others. In the years since 2008, we have seen a significant reversal in the debt levels and lack of regulation. This will position us all well for the years to come.

The European woes! (continued)

Despite the recovery, don't get carried away with the outlook

The keystone to this trend was rising leverage and asset prices. Eventually though, as is the case of all asset bubbles in history, the quality of bank lending began to deteriorate and over the past three years some of the leverage has unwound and earnings growth has slowed. Periods of deleveraging are characterised by lower economic growth, lower earnings and share price growth and increased contribution to investment returns from income.

Productive enterprise is yielding more than term deposits

Over the past two years, many investors have been increasingly attracted to income as a way to reduce risk and boost returns. At the end of 2010, deposit rates (around 6.3%) were well above their five year and ten year averages (around 5.5%). This above average result was driven by some concerns that bank funding was too dependent on global wholesale funding markets which can dry up quickly as seen during the GFC in 2008/09.

Back then, 45% of bank funding came from deposits, now its 60%. However, with Australia's national savings rate at 12% and domestic credit growth currently only at 3%, banks have too much money. Consequently, the premium that term deposits had over the RBA Target Cash Rate has halved over the course of 2011. In contrast, the yield premium of shares has doubled over the same period and is well above its 10-year average and is more than term deposits for the first time since the GFC. As an example of this, the big four banks are returning distributions to their shareholders of between 7% and 8% whilst returning just 5.5% to their banking clients on a term deposit.

Operating profit has almost doubled since 2005, but who is receiving more profit share?

The key to income payments and growth is earnings. Since 2005, operating profits (that is, profit before interest and tax) in the Australian sharemarket have doubled to AUD\$100 billion. Shareholders and bond holders are receiving a larger share of this profit pool. Industrial companies have clearly reduced their investment growth and increased their payout ratios to reward investors whilst resource companies have had to fund more of their investment off their balance sheet and have reduced their payout ratios to shareholders and bond holders as a result.

Implications for investors

The key question in this environment for investors is how to have exposure to productive enterprise whilst managing the risk of this exposure. Regardless of whether you invest in equities, credit securities or other assets, the best defence against market volatility is 'quality'. Listed companies with a strong balance sheet, consistency in cash flow generation and reliable earnings growth are likely to outperform their peers with weak business models and weaker balance sheets. It is our role at Securinvest to select those fund managers who identify these companies.

Although Australia's economic outlook is considerably brighter than Europe's or the US's, domestic investors are unlikely to avoid the global trends and markets will remain volatile in the period ahead. Income is one way to offset price volatility and its growing importance as a source of total return is not a new paradigm but an old paradigm that had been the case for the 100 years before 1983.

Centrelink Assistance

For those clients nearing retirement (or who may have already retired), there is a chance that you may need to deal with Centrelink.

Currently, if you are a homeowner couple that receives (or is deemed to receive) income of less than around \$2,500 per fortnight or have assets valued at around \$1,000,000 (excluding your family home), you may be eligible to receive a part pension.

For a large number of our clients, we provide a basic level 'Correspondence Nominee Service' that allows us to update their asset and income information to Centrelink when required. For others, we can assist in the process of registering, documenting and then securing an Aged Pension for them.

The process and paperwork involved can be daunting, particularly if there were companies or private trusts in place prior to retirement.

Please contact us to discuss the range of services we can offer you or even your family members to remove some of the stress and confusion that may arise.



How much is enough?



According to a recent survey published in the Sydney Morning Herald, more than three-quarters of Australians won't have enough superannuation to last them throughout their retirement. The report by Deloitte's, also says that the gradual increase in compulsory superannuation contributions (as outlined by Minister Bill Shorten) to 12 per cent by 2019 won't benefit retirees until well after 2030.

By 2030, the Baby Boomer generation will be out of the workforce and account for over two-thirds of retirees. Gen Y will make up 50 per cent of the workforce, followed by Gen X at 38 per cent and the post-Y "Generation Z" at 12 per cent.

The estimated super balance for a single male to live a modest lifestyle in retirement is \$280,000, according to the Association of Superannuation Funds of Australia (ASFA). Deloitte Actuaries and Consultants partner Stephen Huppert said the average retirement balance for a single male in 2030 would be only \$217,000, meaning he had a 78 per cent chance of living longer than his super could support. "Clearly, Australians will be relying on the age pension for some time into the future," he said. "So, it is important that any proposals to deal with the ageing demographic consider the superannuation system and the social security system in unison".

ASFA estimates that for a comfortable retirement lifestyle - where retirees are able to enjoy some luxuries - a 65-year-old male needs \$40,000 a year or a \$540,000 lump sum. A female needs a \$595,000 lump sum due to her longer life expectancy, while a couple need \$680,000. Deloitte partner Wayne Walker said the federal government's increase in the Superannuation Guarantee (SG) to 12 per cent, from the current employer contribution of nine per cent, would deliver an extra \$408 billion into super by 2030. "We will not see the full impact of SG going to 12 per cent for a generation and of itself it is not sufficient to help those people retiring in the next 20 years," he said.

As always, if you are concerned about your overall superannuation nest egg or looking to increase the amount saved for retirement, please feel free to contact your financial adviser.

Contributions into Superannuation

For those clients aged over 50, it is worth reminding that this current financial year is the last financial year that you may be able to contribute up to \$50,000 into Superannuation. The types of contributions counted toward this limit are called 'concessional' and include employer and salary sacrifice contributions amongst others. To take advantage of the current rules, speak to your adviser before they change.

The proposed future rules also place a further restriction on higher contributions if you have a super balance of over \$500,000. Although not yet legislated, the rules may change yet again! It is important to review your options with your adviser well before June next year to ensure your strategy considers the latest updates in this area.

Merry Xmas

On behalf of everyone at Securinvest Financial Planners, we wish you and your families a safe and enjoyable Xmas and a prosperous 2012



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