

Market Update & Outlook

July 2011

- German economy accelerates while Greece suffers
- Japan shows signs of improvement
- RBA holds off rate rise

What's inside?

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The pulse

- ↓ WTI Oil 3 Month Futures
7.1% to \$95.4 per barrel
- ↓ Gold
2.3%

Term Deposit Returns – After Tax and Forecast Inflation, what's left?

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Currently, with large sums of money invested in term deposits post the Global Financial Crisis (GFC) and with inflation being monitored closely in many countries across the globe, the question needs to be raised, are these good investments and is it where investors should be invested.

Typically, a fixed interest or cash type of investment forms part of the defensive side of the portfolio and depending on an investors risk profile may be either a higher or lower portion. These type of investments tend to be less susceptible to fluctuations in value and is often seen as having less risk as opposed to the more aggressive investments or asset classes.

If an investor invests \$50,000 and receives \$75,000 back, is this a good investment? The answer can be either yes or no. It depends on three main factors; timeframe, inflation and taxation. As with all investments these factors are critical and term deposits are no different.

Inflation and the Time Value of Money

What is important to understand is that investment returns after taxation need to be greater than inflation or you are effectively losing money. That is, the value of your money is effectively depreciating. In general terms, inflation refers to a general increase in the level of prices of goods and services over a period of time.

In simple terms, if you have \$100 today, you will need greater than \$100 in the future to purchase the same amount of goods or services if inflation occurs, which over the long term is a near certainty.

In Australia, inflation is normally controlled through the manipulation of interest rates by the Reserve Bank of Australia (RBA). This is known as monetary policy and with the RBA either increasing or decreasing rates, this trickles through to interest rates on loans and deposits from and to financial institutions such as the banks and credit unions.

Therefore, with talk that the RBA will lift rates at some point in the future, this indicates that inflation is moving to the upper limit of their targeted 2% to 3% bandwidth. With the RBA looking ahead and concluding that inflation is more likely to rise than fall over the coming years, it is important to determine how this may impact term deposits.

However, before we look at how inflation and taxation can impact term deposit returns, it is important to understand what is currently being forecast. For the 2012 financial year, NAB Economics forecast an underlying inflation rate of 2.7% and a headline inflation rate of 3.1%. They also forecast an increase in the official cash rate of up to half a percent by the end of the current financial year which is currently sitting at 4.75%. So what can this mean for term deposits?

Take the following example:

If inflation is 3% per annum and the timeframe is 10 years then;

$$\$100 \times (1 + 3/100)^{10} = \$134.39$$

What this means is that even at the moderate inflation rate of 3% per annum, you will need \$134.39 in ten years time to purchase the same amount of goods or services you can now purchase for \$100. So what this means for investment returns is that in ten years time, your after tax returns from your investments needs to leave you with at least \$134.39 per \$100 invested or you are worse off than you currently are.

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The table below shows the effect of different inflation rates over a ten year period. It shows the number of times your wealth needs to increase by to maintain the same purchasing power ten years into the future.

Inflation rate	Timeframe (years)	Increase in wealth required (no. of times)
1%	10	1.1046
2%	10	1.2190
3%	10	1.3439
4%	10	1.4802
5%	10	1.6289

Source: ThreeSixty

What is Interest Really Worth?

While finding investments that beat an inflation rate of 3% per annum over the long term may seem relatively easy, when you overlay this with taxation, the situation can become more difficult especially if you are on the top marginal rate of tax.

Furthermore, with term deposits, interest is usually not reinvested as it can't be added to an existing term deposit (unless you are rolling over upon maturity) and usually investors, particularly pensioners, live off the interest. What this means is that the capital is not growing at all and the purchasing power is diminishing.

The table below shows the effect of taxation on term deposit returns. In the example below it is assumed the term deposit has an initial balance of \$100,000 and earns 6% per annum with the interest reinvested at this same rate. Taxation is charged at 46.5% and is paid on the same day the interest is received. Note in practice there will be a delay between receiving the interest and paying the applicable tax. In contrast, a zero tax environment example has also been used.

What the table below tells us is that at the end of ten years, a client's investment has only earned \$13,807.57 above inflation. Effectively this investment has only resulted in an after-tax return above inflation of approximately 1.3% per annum if all interest is reinvested at the initial rate of 6% per annum. If no tax is paid, then the investor has earned \$44,693.13 above inflation.

Under the no tax scenario the after-tax return above inflation is approximately 3.76% per annum if all interest is reinvested at the initial rate of 6% per annum. Clearly these examples are the extreme end of the spectrum, but it also shows that all things being equal, real rates of returns after tax will be between 1.3% and 3.76% over a ten year period.

Year	Balanced start of year	Tax paid at 46.5%	Balanced end of year after 46.5% tax	Balanced start of year	Tax paid at 0%	Balanced end of year after 0% tax	Balanced required to keep pace with inflation
0	\$100,000.00	-	-	\$100,000.00	-	\$100,000.00	\$100,000.00
1	\$106,000.00	\$2,790.00	\$103,210.00	\$106,000.00	-	\$106,000.00	\$103,000.00
2	\$109,402.60	\$1,582.21	\$107,820.39	\$112,360.00	-	\$112,360.00	\$106,090.00
3	\$114,289.61	\$2,272.46	\$112,017.15	\$119,101.60	-	\$119,101.60	\$109,272.70
4	\$118,738.18	\$2,068.58	\$116,669.60	\$126,247.70	-	\$126,247.70	\$112,550.88
5	\$123,669.77	\$2,293.19	\$121,376.58	\$133,822.56	-	\$133,822.56	\$115,927.41
6	\$128,659.18	\$2,320.07	\$126,339.11	\$141,851.91	-	\$141,851.91	\$119,405.23
7	\$133,919.45	\$2,446.03	\$131,473.42	\$150,363.03	-	\$150,363.03	\$122,987.39
8	\$139,361.83	\$2,530.71	\$136,831.12	\$159,384.81	-	\$159,384.81	\$126,677.01
9	\$145,040.99	\$2,640.81	\$142,400.18	\$168,947.90	-	\$168,947.90	\$130,477.32
10	\$150,944.19	\$2,744.99	\$148,199.20	\$179,084.77	-	\$179,084.77	\$134,391.64

Source: ThreeSixty

Summary

So when investing in term deposits for an extended period of time, investors need to be aware of the impacts that inflation and taxation can have on the returns of term deposits. While term deposits may protect the nominal capital value of an investor's capital, it doesn't necessarily protect the purchasing power of the investor.

Unless an investor has sufficiently large balances in term deposits to live off and are non-tax paying, investors with an investment timeframe of more than a couple of years, should not consider term deposits as a suitable all-in-one solution to their investment needs.

It should also be highlighted that in the post Global Financial Crisis environment, term deposit interest rates have increased due to the need for financial institutions to attract addition funding. Going forward, as the financial institutions attract other sources of funding, it is likely that term deposit interest rates will decline relative to the RBA's official interest rate, which will make term deposits less attractive going forward.

In conclusion, whilst fixed interest and term deposit type products can play an important role in a portfolio, investors should also be aware that as with all investments, there are risks associated in doing so.

Global economies

Debt issues in Europe and the risk of a global economic slowdown dominated the news in June, with risk assets running into the strongest headwinds.

The domestic market together with most major markets recorded losses throughout June although Germany, China and Japan were exceptions.

Firstly in Europe, Greek Prime Minister George Papandreou survived a confidence vote in the country's Parliament and managed to pass his austerity package in the very last days of June despite protests occurring in major cities across Greece.

This has paved the way for the recent tranche of funds provided early in July from the European-IMF €110bn bail-out package.

Furthermore, German Finance Minister, Wolfgang Schaeuble, announced last week that German banks and insurers had agreed on a proposal to reinvest around €2bn from maturing debt holdings into 'new' Greek bonds through 2014 in an effort to help the country avert default.

This follows the French proposal whereby 50% of maturing debt will be rolled into long term bonds with a bonus tied to Greece's economic performance.

Elsewhere in Europe, Moody's rating agency has warned that there will be some Italian bank downgrades in the wake of placing Italy's national rating on review as the Government endeavours to pass fiscal reform and has downgraded Portugal and Ireland to junk status.

Meanwhile, the German economy has continued to accelerate through the June quarter with the country's unemployment rate reaching a post-unification low in May of 7.0%.

Highlighting the differences across the Euro-zone, Greek labour costs fell 6.8% year on year while German labour costs rose 2.9%.

European Central Bank (ECB) head Jean-Claude Trichet signalled at his post-June rates meeting (where rates were left on hold) that an imminent rate rise is on the cards.

June market performance

Equity Markets - Price Indices	Index	At Close 30/06/11	% Change 1 Month	% Change 12 Months
Australia	All Ordinaries	4659.79	-2.70%	7.75%
Japan	Nikkei	9816.09	1.26%	4.62%
Hong Kong	Hang Seng	22398.10	-5.43%	11.27%
UK	FTSE 100	5945.71	-0.74%	20.92%
Germany	DAX	7376.24	1.13%	23.65%
US	Dow Jones	12414.34	-1.24%	27.01%
EMU*	Euro 100	2303.78	-2.49%	10.41%
World**	MSCI – Ex Aus (Gross)	915.54	-1.73%	19.87%

Property - Price Index	Index	At Close 30/06/11	% Change 1 Month	% Change 12 Months
Listed Trusts	S&P/ASX 300 A-REITS	831.29	-2.26%	-0.06%

Interest Rates	% At Close 30/06/11	% At Close 31/05/11	% At Close 30/06/10
Aust 90 day Bank Bills	5.03%	5.02%	4.92%
Australian 10 year Bonds	5.21%	5.22%	5.09%
US 90 day T Bill	0.02%	0.05%	0.18%
US 10 year Bonds	3.16%	3.06%	2.93%

Currency***		At Close 30/06/11	% Change 1 Month	% Change 12 Months
US dollar	A\$/US\$	1.07	0.44%	27.49%
British pound	A\$/STG	0.67	2.93%	18.70%
Euro	A\$/euro	0.74	-0.26%	7.58%
Japanese yen	A\$/yen	86.36	-0.74%	16.13%
Trade-weighted Index		77.80	0.13%	15.60%

* Top 100 European stocks trading on the FTSE ** Price Index – Source: www.msci.com

*** All foreign exchange rates rounded to two decimal places

Source: Iress Market Technology

Past performance is not a reliable indicator of future performance.

The July meeting didn't disappoint with a 0.25% increase in interest rates.

While the ECB are likely to lift rates again, the Bank of England (BoE) is likely to leave rates unchanged for some period of time.

Retail sales volumes in the UK declined by half a percent in May and Gross Domestic Product growth was left unrevised at 0.5% in the first quarter after a similar fall in Q4.

Moving to the US, some recent data released show continued signs that US consumer spending has continued to lose growth traction in recent months.

The labour market recovery also appears to have stalled and housing remains weak with sentiment at all time lows and prices still under some pressure.

However, more recently, a leading manufacturing index rose unexpectedly in June compared to May and was above the expected consensus. This is the first rise since February and the result suggests there is life in the US economy yet.

On the employment front, US non-farm payroll employment growth slowed in May and was well below expectations. Instead of remaining steady or even edging lower, the US unemployment rate rose to 9.1% from 9.0%.

At its latest meeting, the Federal Reserve (Fed) maintained its funds rate at 0-0.25%, holding to its mantra of keeping rates at such exceptionally low levels for an "extended" period.

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Meanwhile, there has still been no legislative approval to lift the current debt ceiling.

Congressional Republicans and the Administration have still yet to come to any agreement over what combination of tax rises and spending cuts will be implemented to reduce the country's deficit and restrict growth in US Government debt.

In Japan, after having slumped in March in the wake of the devastating earthquake and tsunami, industrial production has been showing encouraging signs of recovery increasing by 5.7% in May after a 1.6% gain in April.

A recent business survey for June, the Shoko-Chukin Bank survey of small business confidence, pointed to a further recovery of manufacturing activity indicating that activity levels are recovering towards pre-quake levels.

Lastly, on the domestic front, employment rose only slightly in May after the fall in April.

Full-time employment fell for the second month in a row and the unemployment rate remained steady at 4.9%.

Most leading indicators of labour demand point to a flatter employment outlook in the months ahead.

Supporting this, the most recent results for the NAB Business Survey showed that business conditions eased in May to a level that has been consistent with slightly less than average growth in domestic demand.

Looking towards monetary policy, minutes from the Reserve Bank of Australia's (RBA) June Board meeting suggest rate hikes are still a little way off and the RBA has left rates on hold at 4.75%.

Contributing to the lack of urgency to increase rates included softer local data outside the resources sector and concerns about global growth related to European Sovereign debt.

Big movers this month

Going up – Utilities +2.0%

Going down – Energy -8.7%

Also of concern was recent softness in global economic data, falling asset prices (housing and equities) and underlying inflation in Australia which is in the bottom half of the target band.

However, the RBA still expects to tighten rates ahead, saying that it expects a gradual pick-up in inflation. This means 'further tightening in monetary policy would be necessary at some point'.

Equity markets

Most major market indices continued their reversal which began in May throughout the month of June as sovereign debt and the threat of a global economic slowdown persisted.

Australian equities

	Index/Benchmark (% pa)	1 Yr	3 Yrs	5 Yrs	7 Yrs
Australian	S&P/ASX 300 Acc.	11.90%	0.26%	2.37%	8.38%
	S&P/ASX 50 Acc.	11.17%	1.12%	2.87%	8.51%
	S&P/ASX Small Ordinaries Acc.	16.41%	-2.59%	1.21%	7.85%

The ASX 200 closed out the month of May at 4,708. In June, the ASX 200 breached the 4,500 mark to a low of 4,452 on 20 June—the first time the index has been at this level since the beginning of September last year—and closed out the month at 4,608.

To 30 June 2011, the ASX 200 fell 2.1% for the month but has gained 7.1% over the year.

Sector	1 Mth %	3 Mths %	1 Yr %
Energy	-8.7%	-11.5%	9.3%
Materials	-2.4%	-5.9%	20.5%
Industrial	-2.6%	-5.2%	16.1%
Consumer Discretionary	-3.0%	-7.8%	-0.3%
Consumer Staples	0.6%	2.1%	11.4%
Health Care	-1.9%	-4.3%	8.1%
Financials	-0.3%	-3.3%	10.6%
Info Tech	-5.6%	-8.8%	-13.8%
Telcos	-4.1%	3.1%	-0.7%
Utilities	2.0%	4.7%	14.6%
Property	-0.8%	-0.5%	5.9%

Global equities

	Index/Benchmark (% pa)	1 Yr	3 Yrs	5 Yrs	7 Yrs
Global	MSCI World Ex Aus Acc. (\$A)	2.66%	-3.28%	-5.15%	-1.17%
	MSCI World Index Hedged (\$A)	23.52%	-1.11%	-0.11%	3.61%
	MSCI World Small Cap (\$A)	9.19%	3.20%	-2.98%	1.72%
Emerging	MSCI Emerging Mkts Free	0.83%	0.49%	3.57%	10.68%
	MSCI AC Far East Free (ex Japan)	1.01%	3.87%	3.49%	8.06%

In the US, the Dow Jones fell 1.2% over the month of June but has increased by 27.0% over the year.

With the Fed maintaining rates at the current level in its last meeting, it also reduced forecasts for growth and nudged up forecasts for unemployment.

However, Fed Chairman Ben Bernanke believes the current weakness in the US economy would likely be temporary.

With the German economy continuing to perform well despite the issues in broader Europe, the German DAX was also one of the best performers over the month returning a positive 1.1% and a positive 23.7% for the year.

In comparison, the Euro STOXX Index fell 2.7% for the month of June and was the worst performer of the major indices. Over the year, the index has returned a positive 8.5%.

Property

	Index/Benchmark (% pa)	1Yr	3 Yrs	5 Yrs	7 Yrs
Australian	S&P/ASX 300 A-REIT Acc	5.87%	-9.65%	-10.32%	-2.95%
Global	UBS Global Investors Index	8.62%	-1.51%	-6.59%	N/A

The S&P/ASX 300 A-REIT Accumulation Index was 0.77% lower over June, but outperformed its global counterpart by 2.07%. However, over a one, three and five year period, global property continues to outperform compared to its domestic counterpart.

Fixed interest

	Index/Benchmark (% pa)	1 Yr	3 Yrs	5 Yrs	7 Yrs
Australian	UBS Composite 0 + Years	5.55%	8.05%	6.50%	6.23%
	Australian 90 Day Bank Bill	4.91%	4.57%	5.46%	5.50%
Global	BarCap Global Aggregate Index	-12.81%	2.24%	-0.45%	0.62%
	BarCap Global Ag.,. Index Hedged	6.93%	9.45%	8.38%	7.51%

Australian bonds gained 0.55% over June and have returned 5.55% over the last 12 months.

Globally, hedging helped provide a positive return over the month of June with the Barclays Capital (BarCap) Global Aggregate Index (Hedged) returning 0.2% compared to its unhedged counterpart returning -0.4%. However, more noticeable, over the year, the indices have returned 6.93% and -12.81% respectively which is a difference in returns of 19.74%.

Australian dollar (AUD)

The Australian Dollar increased half a percent over the month of June, however intra-month trade was much more volatile.

The Australian Dollar closed the month of May at 1.0672 to the US Dollar and trended down for the majority of June to hit a low of around 1.0400 during trade on 27th June.

The AUD bounced from the low point in the last few days of June after there was more certainty surrounding the Greek situation to close the month at 1.0722.