FM FINANCIAL

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Summer is over and the days will begin to cool down now that autumn is here, but things are just beginning to heat up on investment markets. While the Reserve Bank's decision to cut the cash rate to 2.25 per cent in February is a blow to anyone dependent on income from their investments, it has reignited local share and property markets.

The residential property boom shows no sign of a slowdown, especially in metropolitan Sydney and Melbourne where investors continue to drive prices to new highs. And after a lacklustre 2014 Australia's sharemarket is nudging 6000 points, a level not seen since 2007.

After shares pulled back last year on the back of falling commodity prices, optimism appears to be building among local investors. The February company reporting season revealed no nasty surprises while in Europe tensions have eased after Greece was granted an extension of its debt bailout.

Oil prices also appear to have established a new base at around US$50 a barrel. Any further falls would be a drag on inflation and the local oil and gas sector.

In the US, Federal Reserve chairwoman Janet Yellen gave an upbeat account of the US economy to the Senate Banking Committee in the last week of February. She hinted that US interest rates could be on the rise later this year if economic conditions continue to improve.
Finally, In news closer to FM, we would like to congratulate Leanne Newman - the winner of our iPad referral competition!
As always, if you would like to discuss the contents of this newsletter don't hesitate to call our office.

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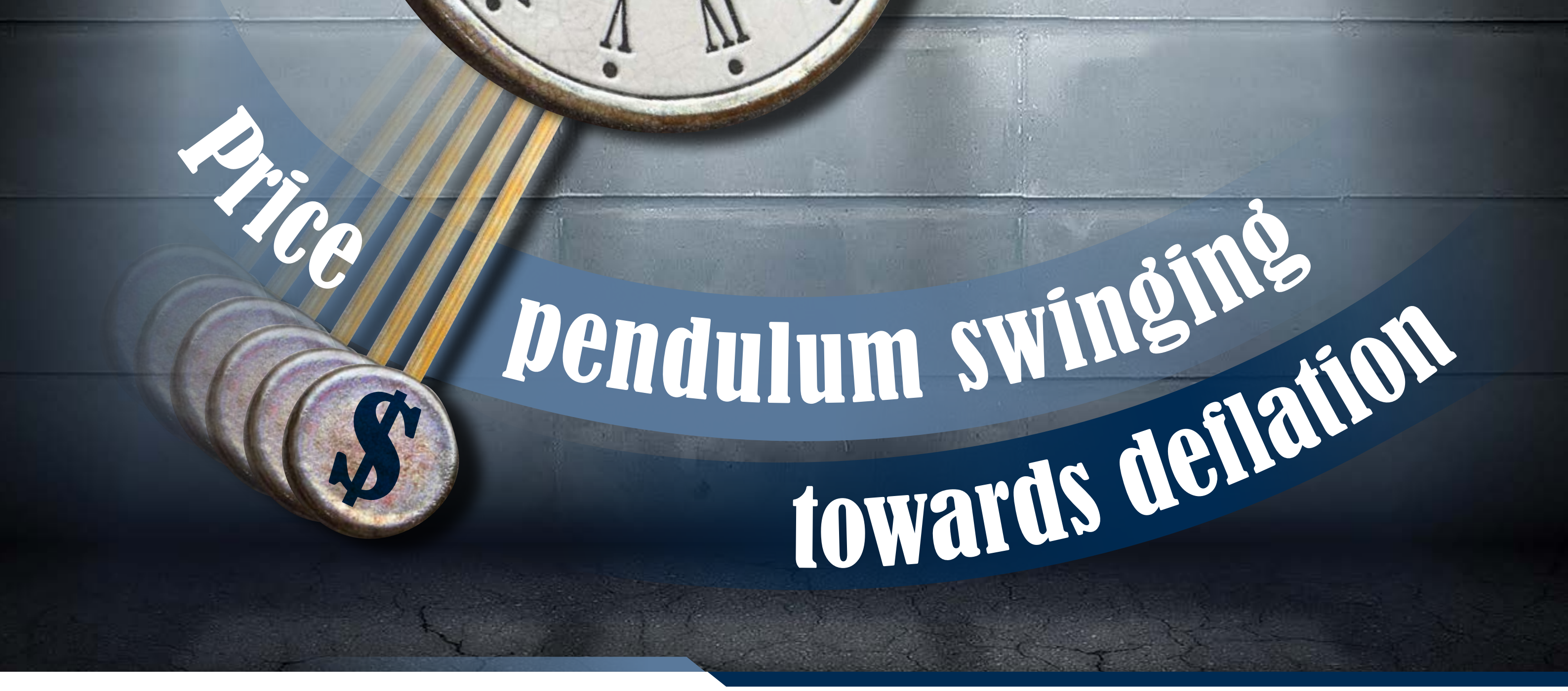

Price pendulum swinging towards deflation

An interest rate cut and lower prices for petrol and consumer goods are a welcome sign that inflation is well and truly under control. Yet this run of good news for Australian consumers is part of a global trend that is raising concerns that the price pendulum has swung too far.

Australian inflation fell to 1.7 per cent in 2014. Prices were lower for petrol, clothing, computers, household appliances and furniture. This was surprising given that the Australian dollar fell sharply in the December quarter and many of these goods are imported.

There were also moves in the other direction, with price rises for childcare, education, insurance and financial services. But the price falls for imported goods indicate that Australia is importing lower prices from overseas where inflation is very low and even negative in some countries.

What is deflation?

It is difficult to imagine anyone being worried about cheaper goods. Yet persistent price falls can be bad news if shoppers and businesses stop spending in anticipation of lower prices ahead.

Deflation occurs when falling prices for goods and services drag the inflation rate below zero. Europe and Ireland are already in this position despite the best efforts of central bankers to stimulate spending and inflation by cutting interest rates to close to zero.

Deflation increases the real value of money because you can buy more goods with the same amount of money. It also increases the real value of debt.

What causes it?

Deflation is relatively rare but when it does happen it is often at a time of technological change. For decades now rising speeds and falling costs of computing and the internet have been transforming the global economy and the pricing of goods.

Since the 1960s the price of one unit of computing power, measured by floating point operations per second, or FLOPS, has fallen from US$8.3 trillion in today's money to US8c. This fuels productivity and cuts the cost of doing business.

Deflation can also be caused by a drop in demand for goods and services. This can be a symptom of rising unemployment, forcing businesses to lower prices to entice people to buy their products.

Fighting deflation

Central banks generally cut interest rates as their first line of defence against deflation to stimulate growth and encourage people to spend now rather than waiting for prices to fall further.

But interest rates can only be cut to zero. That's why central banks in the US, Japan and now Europe have moved to the second line of defence by increasing money supply. Or in modern economic speak, quantitative easing.

Since the global financial crisis trillions of dollars have been injected into the global economy, the most recent being a $1.4 trillion bond-buying program announced by the European Central Bank. But despite this and record low interest rates many developed economies are struggling to get inflation off the floor.

The hunt for yield

The recent move by the European Central Bank will make Australian shares and bonds more attractive to overseas investors, thanks to our falling dollar and relatively high interest rates.

While our cash rate is the lowest since 1958 and bond rates have also slipped, they are significantly higher than the zero rates on offer elsewhere.

The hunt for yield is also likely to intensify for Australian investors after the Reserve Bank cut the cash rate to 2.25 per cent driving rates for term deposits below three per cent.

By comparison, shares in the big four banks, Telstra and Wesfarmers offer dividend yields, including franking credits, of between six and eight per cent.

While deflation is not a pressing issue for Australia, it is occurring in parts of Europe and this will have flow-on effects for global markets.

If you would like to discuss your investment strategy in the light of issues raised in this article please give us a call.

THE GOOD THE BAD & THE UGLY

For many people, debt is a dirty word. But not all debt is created equal. There's good debt and there's bad debt, and then there's the good debt that can get pretty ugly if it's not managed properly. Learning to use debt intelligently could make all the difference to your personal bottom line.

Good debt

Debt is considered good when it helps you buy wealth building assets. That can be an asset that grows in value over time and/or provides you with income.

Borrowing is often referred to as leverage because it helps you get more for your money.

Shares and property are regarded as growth assets because, when chosen well, they should grow in value over time. Shares can also offer regular dividend income while investment property provides rental income. In both cases, the income you receive can be used to help meet your loan repayments.

In many instances you can also claim a tax deduction on the interest paid on your investment loan.

Bad debt

Debt is bad for your wealth when you borrow to buy assets that fall in value, don't provide any income and are not tax deductible.

Using a credit card or a personal loan to pay for holidays or expensive toys is an example of bad debt.

The trouble with bad debt is that you can often be paying for it long after the holiday has worn off or that new car has halved in value. If your bad debt is on a credit card, then it can be all too easy to let the debt roll over each month.

When bad debt turns good

Used well, bad debt can be put to good use. If you are disciplined and pay off your credit card in full each month this can help you manage your cash flow. It might also allow you to leave money sitting longer in a high interest savings account.

Credit card debt turns ugly when you buy things you can't afford and pay only the minimum repayment each month. Because of the high interest rates that apply to credit cards, your initial debt can balloon and take many years to clear.

When good debt goes sour

Using good debt to pay off bad debt could also cost you dearly. Say you consolidate your debts by increasing your mortgage. The end result could be that you spread the cost of that holiday over 20 years or more, dramatically increasing your total interest payments into the bargain.

The family home

Buying a home to live in will not provide you with income but it can still be regarded as good debt. Not only is it a form of enforced saving but in time it may also be used as leverage to fast track your wealth creation.

Once you build up equity in your home you can use this as security to take out an investment loan. Any income you earn from your investments — your good debt — can be used to make extra repayments on your mortgage. This can accelerate paying off your home loan and free up cash for more investments.

A power of good

Whether debt is good or bad, it's generally wise to clear it as quickly as possible. Pay off your bad debts first - beginning with the debt that has the highest interest rate - as you should be able to take advantage of the tax concessions available on your good debt.

In years gone by it was common to wait until you had saved up for what you wanted. Nowadays the ease of obtaining credit can lead to reckless behaviour. But there's still an important place for good debt.

Given most of us will spend many years in retirement and would like to be self-funded, borrowing to accelerate wealth can be a very successful investment strategy. It's just important to remember to keep bad debt to a minimum and make sure you use good debt wisely — otherwise it can all turn a little ugly.

Property NOT always as safe as houses

Australians' long-lasting love affair with property is a major factor in our increased wealth but there are growing concerns that heavy dependence on a single investment strategy may not be healthy.

Like every asset class, property moves in cycles and the cracks could be starting to appear in a market that has made Australians the richest people in the world.

According to the latest global wealth report from investment bank Credit Suisse, Australians topped the rich list in 2014.[i] But it also revealed that 60 per cent of our wealth was tied up in property. That's not a problem when property values are soaring, but what happens if and when the music stops?

A 'REAL' ASSET

As well as the obsession to own our own home Australians are drawn to real estate as an investment, attracted by the tangible nature of bricks and mortar, the potential for income and some handy tax benefits. There is something about being to drive past your investment that makes it feel like a safe place to park your money.

In recent years the investment choice has been vindicated. Combined capital city home values rose for nearly two and a half years to November 2014, increasing by an impressive 20 per cent, with Sydney and Melbourne the outstanding drivers.[ii]

With domestic and global interest rates at record lows the search for yield has been widespread. Local and international investors have flocked to buy Australian property which is viewed as less volatile than shares and higher growth than cash and bonds.

While the official cash rate stayed at 2.5 per cent for 2014, capital city rental returns for houses were 4 per cent and 4.5 per cent for units.[iii]

MIND THE CYCLE

But property hasn't always been the best place to be. Prior to the latest growth phase property values across the country fell for 18 months.[iv] The outlook is for property price growth to slow once again, albeit off a strong base.[v]

For investors who have only residential property in their portfolio, warning signals about future house prices and rental returns are a timely reminder of the importance of diversification.

Long term data shows that in any given year one asset class may do better than others, but rarely does one asset class take out top honours for more than a year or two running. Only by diversifying your investments across and within asset classes can you be confident of capturing the best returns on offer year in and year out and avoid being wiped out by a single bad investment.

A major downside of real property is that a large portion of your capital is tied up in a single asset that can be difficult to sell in a downturn. What's more, you can't just sell the bathroom to free up cash when you need it. If it is rented there will be tenants to find and repairs and maintenance to keep up-to-date.

UN-REAL PROPERTY

Real property isn't the only option for property lovers. Listed Real Estate Investment Trusts (REITs), which can be bought and sold on the Australian Securities Exchange (ASX), offer a more flexible alternative as well as diversification.

Unlisted managed funds may be another option.

In both cases professionals invest in property across different sectors of the market including residential, retail, industrial and commercial as well as different domestic and international locations. If a downturn is occurring in one sector in one part of the world there is a chance that somewhere else is performing well.

Property investment should always be considered within the broader context of your wealth creation plan.

If you would like to discuss your property investment options as part of a diversified portfolio give us a call.

i http://www.smh.com.au/business/the-economy/property-makes-australians-the-world8217s-richest-says-credit-suisse-20141014-1163ip.html

ii http://www.corelogic.com.au/resources/pdf/reports/qtrly-economic-property-review--nov2014.pdf

iii http://www.corelogic.com.au/resources/pdf/reports/qtrly-economic-property-review--nov2014.pdf p. 8

iv http://www.corelogic.com.au/resources/pdf/reports/qtrly-economic-property-review--nov2014.pdf p. 3

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