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Weekly Review

WEALTH

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– Issue – 10 Feb. 2017

Most of the Government's major superannuation changes go live on July 1. Some are good, some bad, so you need to know what steps to take before they come into effect.

BY BRUCE BRAMMALL • EUREKA REPORT • 9 FEBRUARY 2017

Super nutshell: What you need to know

Bless life's simple things. Damn those who want to complicate them.

Getting money into super, for some time, has been relatively simple. But as we know, change is coming.

Key Point

- ***Those who want to make the most of the higher CC and NCC limits for the FY17 need to start putting thought into it now. It can take some planning.***

Now seems like a good time to review the Turnbull Government's changes that specifically relate to how one gets money into super, before and after the 'Big Bang' changes that come into force on July 1.

And to recap on some items you should have on your 'to do' list for prior to June 30.

Let's start with the general understanding of what the Government is trying to do. It wants to stop the growth of monstrous super funds for the "wealthy". It has determined that "enough" in super is $1.6 million. So, getting money into super once you've got 'enough' is going to be made harder.

There are two main types of contributions that can be made to super – concessional and non-concessional.

Concessional contributions (CCs)

Concessional contributions are those that have not been taxed before entering super. So, instead of being taxed at up to top marginal tax rate (of 49 per cent), they are taxed at 15 per cent.

Because of the big potential tax break, the Government restricts how much money you can put in to super via CCs.

In the current financial year, those aged 50 or over can contribute up to $35,000 for the current year, while those aged under 50 can contribute $30,000.

From July 1, all age groups, if eligible to contribute, will have the same – reduced – limit of $25,000.

CCs include the Superannuation Guarantee (SG) payments that employers make for their staff. The current rate for that is 9.5 per cent of your salary. If you're earning $100,000 a year, then your employer is supposed to be contribute $9500 to your super fund.

That $9500 is taxed at 15 per cent on the way into the super fund, instead of being taxed at 39 per cent, which is the marginal tax rate for someone earning $100,000.

Contributions made via salary sacrifice also count as CCs. So, if our $100,000-a-year employee wanted to get more into super in FY17, they could salary sacrifice $20,500 (if they were under 50) and $25,500 (for the over 50s).

From next year, they will be limited to $25,000 in total, so they will only be able to salary sacrifice $15,500.

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That's for employees. For the self-employed, it's a little different.

If you have made yourself an employee of your own company, then you need to pay yourself SG, as per above.

But large numbers of self-employed don't pay themselves a salary. They take profits, or drawings, instead.

The truly self-employed can make CCs at any time of the financial year. (They operate under the same general caps as employees, as for the CC limits.)

The big changes from July 1 are twofold, as they relate to CCs – one good, one bad. The bad is the reduction in CC limits to a flat $25,000 for everyone.

The good is that it will no longer be only the self-employed who can make contributions at any time of the year.

Those who are employees will be able to make contributions to super and claim a tax deduction, without it having to go via SG or salary sacrifice contributions.

This removes a ridiculous anomaly that has always existed. Previously, if your employer gave you SG, but didn't allow you to do salary sacrifice (it is not compulsory to offer it to employees), then you were restricted to simply your SG contributions to super.

This idiocy goes on July 1.

How will it work? If you're an employee earning $100,000 a year and have spare cash flow of, say, $10,000, then you could contribute the $10,000 to super. It would be taxed at 15 per cent on the way in, meaning $8500 would end up in your super fund. However, on that $10,000, you could claim a tax deduction at your marginal tax rate, meaning you would get a tax return of approximately $3900 for the contribution to your super.

Another improvement – although it doesn't kick in until July 1, 2018 – will be ability to do five-year catch-ups on CCs. If you have not used up your cap of $25,000 in previous years (going back a maximum of five years), you will be able to make extra contributions to make up for it. Technically, if you made no contributions in the first four years, you could make $125,000 (5 x $25,000) in the fifth year.

Non-concessional contributions (NCCs)

NCCs are amounts that don't get taxed on the way in to superannuation, ostensibly because it is after-tax money and has been fully taxed outside of super.

NCCs are where the wealthy have been able to create particularly large super fund balances. They allow, potentially, huge contributions into super.

Currently, the limits for NCCs are $180,000 a year, with the ability to pull forward two more coming years to put up to $540,000 into super in one hit. Couples could, therefore, get as much as $1.08m into super ($540,000 each) by June 30.

These rules still apply for FY2017. That is, if you're eligible (largely, for those 64 and under) you can get up to $540,000 into super this year. See an advisor if this is something you think you should be considering.

But the ability to use NCCs to lift your super balance is going to be curtailed.

In last year's Budget, the plan was to limit everyone to a maximum lifetime limit of $500,000 for NCCs. This was axed during negotiations.

The $180,000 limit will now be reduced to $100,000 a year from July 1. The three-year pull-forward provisions remain in place, but with an obviously reduced maximum of $300,000 for the three years.

> **The ability to use non-concessional contributions to lift your super balance is going to be curtailed.**

Further, you will not be able to make any NCCs if your combined super balance (if you have more than one account) is more than $1.6 million.

Last minute opportunities

Those who want to make the most of the higher CC and NCC limits for the FY17 need to start putting thought into it now. It can take some planning, potentially even the sale of some assets, where appropriate. Speak to an advisor about how you can make the most of these strategies in the lead up to June 30.

*Bruce Brammall is a licensed financial advisor, a mortgage broker and an expert on self-managed super funds. He is a regular contributor to Eureka Report. To contact Bruce, please **click here**.*

Eureka Report is hosting a live webcast to go over all the recent and impending pension changes.

EUREKA REPORT • 8 FEBRUARY 2017

Webcast: Understand the new pension rules

Australia's pensions landscape is undergoing a permanent transformation, and millions of Australians will ultimately be impacted.

Just over three months ago legislation was passed in the federal Parliament that, from July 1 this year, will force many people in retirement to make major changes to their pension assets structures.

A large number of individuals and couples will need to take action before then to reorganise their asset holdings, to avoid being penalised for having too much in their pension account.

The changes are not only highly complex, but potentially detrimental to those who don't seek professional advice.

And it's also just over a month since the introduction of new Age Pension assets test measures that have negatively affected many individuals and couples previously entitled to receive either a full or part pension.

Those affected by this change, of which there are many more, should also be aware of strategies that can be deployed to limit the downside of holding assets that will reduce or eliminate their pension entitlements.

If you are in retirement already receiving a self-funded pension or the Age Pension, or receiving a transition to retirement pension, Eureka Report is hosting a live webcast to go over all the recent and impending changes on Thursday, February 16.

Hear from our experts

Licensed financial advisors Bruce Brammall and Max Newnham will fully explain the new pension rules, and the implications for retirees.

Attendees will also be able to ask their questions, and receive live responses.

Register today

Click here to register for this important live webcast today, and feel free to send in your questions beforehand so our advisors can provide you with a considered response.

To access superannuation a member must meet one of a number of conditions of release.

BY MAX NEWNHAM • EUREKA REPORT • 9 FEBRUARY 2017

Tax with Max: Tipping the pensions cap

***Q.** My wife and I have an SMSF with blue chip shares valued at approximately $2 million. We also have approximately $200,000 in a savings account in our fund. I would like to commence an account-based pension in order to help me clear some debts amounting to nearly $300,000.*

I am almost 69 years and still fully employed earning gross $200,000 per annum and don't wish to resign from my position of full time work as yet. Can I commence an ABP without resigning from my job?

A. To access superannuation a member must meet one of a number of conditions of release, which differ according to a person's age. Not taking into account a person's ability to start a transition to retirement pension, which is available to anyone aged under 65, the most common condition for someone under 60 is to retire. The definition of retirement is working less than 10 hours a week.

For someone aged 60 up to 64, the retirement condition of release applies if their employment is terminated. This could be any employment such as a part-time job while still continuing with full-time employment.

The main condition of release is attaining the age of 65. This means in your situation, as you are over 65, you can start an account based pension without resigning your job. It would be best if you do this as soon as possible so that your super fund will not pay tax on the income earned to support the pension.

I know of many cases of where members start a pension from July 1 in a financial year and only receive one lump sum pension payment, to make sure that they meet the minimum annual pension requirement, which results in their account having been in pension phase for the entire financial year. You should speak to an SMSF super specialist to discuss your various options.

***Q.** I moved all of my SMSF funds into a pension account several years ago and the balance now exceeds $1.6m. Will I be able to roll the excess back into an accumulation fund within the SMSF if I don't pass the work test?*

A. The work test only applies to someone making super contributions once they have turned 65. There is nothing stopping anyone commuting all or some of an account based pension account and rolling it back into an accumulation account.

What you must be careful is to make sure that you roll back the excess over $1.6m into an accumulation account before July 1, 2017.

B. understand that if I do not remove the amount that exceeds the $1.6m pension transfer limit I pay tax on any income received on this amount. Is this at normal marginal rates or at some penalty rate of tax on the deemed earnings? What is the deeming rate, and how is it determined what my earnings are on the first $1.6m versus my earnings on the balance?

A. There are a number of provisions in the legislation to assist superannuation members to ensure that they do not exceed the Pension Transfer Cap by July 1, 2017. Where a member's balance exceeds the $1.6m limit by less than $100,000 at June 30, 2017 no excess transfer balance tax is payable and there is no notional income calculated on the excess.

Where the excess over the PTC is $100,000 or more at June 30, 2017, excess transfer balance tax is payable on the notional earnings on the excess. The excess transfer balance tax will be levied at 15 per cent of the notional earnings for any excess periods in the 2018 financial year. From July 1, 2018, the tax will be 15 per cent for the first breach and then 30 per cent for each subsequent breach.

The notional earnings are only calculated on the amount that exceeds the PTC. It is calculated on a daily basis on the notional earnings for the period from when the excess occurred until the date of when the ATO issues a determination notice advising the member of the excess.

Notional earnings are calculated on what is known as the General Interest Charge (GIC). This is a penalty interest that has been used by the ATO since July 1, 1999. The GIC is updated quarterly and generally announced two weeks before the start of each quarter.

The GIC was originally based on the 13-week Treasury Note rate with eight percentage point added to that rate. It is now based on the 90-day Bank Accepted Bill rate with the uplift factor being reduced to 7 per cent.

> **Where a member's balance exceeds the $1.6m limit by less than $100,000 at June 30, 2017 no excess transfer balance tax is payable.**

In addition to paying the excess transfer balance tax the super fund must either payout the excess PTC plus the notional earnings on the excess, or have the combined total rolled back into an accumulation account for the member.

Q. *I am 73, fully retired, have an SMSF with funds over the $1.6m cap and it is in the pension phase. I do not receive any aged pension. As well as that I have a defined benefit super pension of around $25,000 per year. I am wondering whether the two super funds will be treated separately or somehow combined for the purpose of applying the cap?*

A. There is a special section of the new legislation relating to the introduction of the PTC for defined benefit income streams. Under the legislation there are two categories of defined income streams:

- lifetime pensions and annuities regardless of when they started, and
- lifetime expectancy and market linked pensions annuities where the income stream existed on June 30, 2017.

For people that only receive a defined benefit income stream, and do not have any other superannuation balances, the excess of their defined benefit income over $100,000 is taxed differently to amounts received under $100,000 a year.

Where the income stream is paid from a taxed superannuation source half of the excess over $100,000 is added to the taxable income of the member. Where the income stream is paid from an untaxed superannuation source all of the excess over the $100,000 is added to the taxable income of the member.

For people like you that have an account based pension and also receive a defined benefit income stream, a value is placed on the defined benefit income stream to arrive at a total for their superannuation pension assets.

The value placed on a defined benefit income stream is 16 times the annual entitlement. You will need to multiply your annual defined benefit pension by 16 and add this to the total value of your account based pension.

For example if your account based pension has a value at June 30, 2017 of $1.8 million, and you are receiving a defined benefit income stream of $20,000 a year that has a value of $320,000, the total value of your superannuation pension accounts is $2.12m.

As you cannot commute your lifetime pension I believe you will be required to either payout or rollover the $512,000 excess from your account based pension. This will need to be done before July 1, 2017 so that your SMSF can get the benefit of the CGT relief and avoid having to roll out the notional earnings on the excess.

*Max Newnham is a partner with **TaxBiz Australia**, a chartered accounting firm specialising in small businesses and SMSFs.*

Got a question for the Tax with Max column? Email: ***askmax@eurekareport.com.au***

Investors are facing a new cash crunch at the hands of the major banks and other lenders, which are quietly lifting their variable interest rates.

BY TONY KAYE • EUREKA REPORT • 9 FEBRUARY 2017

Rates robbery: Don't get caught

That the Reserve Bank would keep official interest rates on hold at 1.5 per cent on Tuesday was the big non-news story of the week.

Yet, right under the central bank's nose, and borrowers' noses for that matter, banks and other lenders have been overtly lifting their mortgage interest rates since late last year.

First came fixed rates, with Australia's major banks increasing their rates on two, three, four and five-year loans for investors and owner-occupiers.

The banks have cited increases in their long-term financing costs as the primary reason for the fixed-rate rises.

Residential variable rate movements since Oct 16

NUMBER OF COMPANIES	30
NUMBER PRODUCT INCREASES	35
NUMBER PRODUCT DECREASES	7
AVERAGE MARKET MOVEMENT	0.06%
AVERAGE MAJORS MOVEMENT	0.00%

Investment variable rate movements since Oct 16

NUMBER OF COMPANIES	34
NUMBER PRODUCT INCREASES	35
NUMBER PRODUCT DECREASES	7
AVERAGE MARKET MOVEMENT	0.04%
AVERAGE MAJORS MOVEMENT	0.10%

Those higher financing costs relate to the banks' own cost of borrowings on overseas capital markets, primarily in the United States, where the Federal Reserve Bank has started hiking up official interest rates. It expects to announce more rate increases this year.

But, now, Australian lenders are beginning to lift their variable mortgage rates as well, despite expectations by many economists that the RBA will actually move to cut the official cash rate during this year.

This week *Eureka Report* asked financial research firm Canstar to search its database for lenders that had increased their variable loans rate over recent months.

Canstar found that more than 30 lenders have increased both their investment and residential lending rates outside of the RBA's rates cycle, with an average 10 basis points rise by the big banks on investment property loans.

The above data is based on standard variable loan amounts of $350,000 on an 80 per cent loan-to-valuation ratio with principal and interest repayments.

"The major banks have increased investment rates but not residential rates, whereas the rest of the market does not appear to have discriminated between residential and investment," says Canstar's group executive, financial services, Stephen Mickenbecker.

"The upward movement by the major banks exceeds the market average. This suggests that the 10 per cent cap on investment is biting and as they are having to ration investment lending, they are taking the opportunity to use the price lever. This is no doubt some of the heavy lifting in preserving margin."

Know you rates

Interestingly, online home loan provider UBank released its own research this week showing 85 per cent of Australians don't know what interest rates they are paying on their mortgages.

UBank chief executive Lee Hatton says actively monitoring and seeking the best rate should be a priority for homeowners.

"Buying a home is one of the biggest investments of your life, so it's really important that you find the right loan that suits your individual needs. Simply knowing your exact home loan rate and managing it closely could save you thousands of dollars a year."

Canstar's data shows the upward rate movements have generally been 10 to 15 basis points for both residential and investment loans.

But it hasn't all been one-way traffic, with some lenders producing decreases as well to remain competitive with other loan product providers.

> **The upward movement by the major banks exceeds the market average.**

In more recent moves on residential loans, RESI cut its variable rate by 25 basis points to 3.99 per cent, while Macquarie Credit Union went even further in dropping its rate by 60 basis points to 3.69 per cent.

In investment loans, Macquarie dropped its variable rate by 60 basis points to 3.88 per cent, Firstmac by 28 basis points to 4.09 per cent, **loans.com.au** by 30 basis points to 3.79 per cent, and Qudos Bank by 55 basis points to 4.39 per cent, putting them all well inside the market.

"There's been interesting moves by some of the smaller players. Some residential mortgage backed bond rates have come off in recent months, and I suspect that some of these guys have been able to fund favourably," says Mickenbecker.

Our miners are grinning from ear to ear, and so soon will be the Federal Treasurer. But commodity prices now appear to be normalising.

BY CALLAM PICKERING • EUREKA REPORT • 8 FEBRUARY 2017

Getting a handle on Australia's trade surplus

If you ever wanted evidence on the influence commodity prices can have on the Australian economy then you only need to look at the latest set of data on international trade. Higher commodity prices pushed Australia to a record trade surplus of $3.55 billion in December (compared with the previous record of $2.23bn in February 2009).

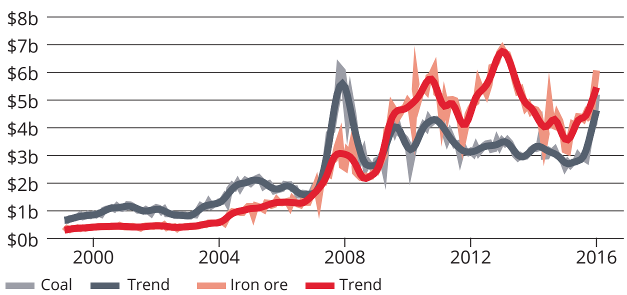
Key Point

- ***Although average export prices should rise further, this is already built into forecasts of income and profitability for firms in the iron ore and coal sectors.***

The value of iron ore and coal exports has increased by 90 and 100 per cent, respectively, over the past year. Collectively they have accounted for 67 per cent of the improvement in the trade balance over the past two months and 70 per cent of the improvement over the past 12 months.

Needless to say, our miners are grinning from ear to ear. It's been a tough few years for the mining sector; sector income fell by 23 per cent between March 2014 and 2016, with operating profit falling by 40 per cent over the same period.

Chart 1: Australian iron ore & coal exports – monthly; seasonally-adjusted & trend



Source: ABS; via CP Economics

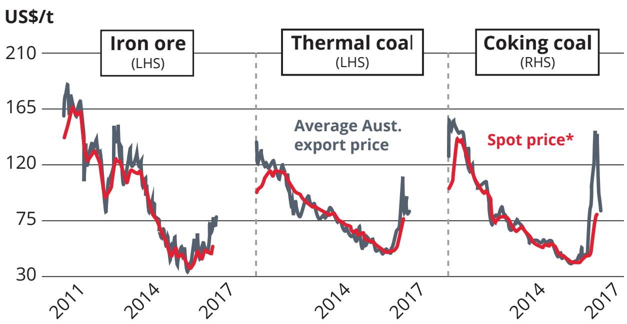
Low commodity prices and high costs posed an existential threat for many Australian miners. A change in their fortunes arrived just in time to stave off those concerns.

The good news is that the trade balance should improve further in January. According to the Reserve Bank of Australia, who calculate a monthly measure of Australian commodity prices, commodity prices rose by a further 4.1 per cent in January in Australian dollar terms.

It is important to note that there is a clear difference between export prices and spot prices for iron ore and coal markets. Spot prices are market-based and fluctuate in the same manner as the ASX200; by comparison, average export prices are largely determined by contract prices that are set between firms.

As contracts are renewed or renegotiated the average export price chases the spot prices. The graph below compares average export prices and spot prices for iron ore, thermal coal and coking coal.

Chart 2: Bulk commodity prices; free on board basis



* Iron ore fines, Newcastle thermal coal and premium hard coking coal
Source: ABS; Bloomberg; IHS; RBA

Based on this data, we can conclude that average export prices will continue to rise throughout the first quarter of this year. This will be tempered somewhat by recent weakness in thermal and coking coal prices.

Coking coal futures have fallen to around $US169 per tonne for February, while thermal coal is currently at prices a little under $US82. Both prices remain above the average export price contained in the graph above, but this suggests that export prices may begin to stabilise by the end of the March quarter.

It may be tempting to invest heavily in mining equities but investors should be cautious. Although average export prices

> **The media focuses almost entirely on real GDP as a measure of economic growth and living standards. This is hugely problematic.**

should rise further, this is already built into forecasts of income and profitability for firms in the iron ore and coal sectors (***Investors face a new mining squeeze***, February 7). At this stage you could even argue that the main risk to those forecasts lies on the downside, given the speed with which prices appear to be normalising.

Impact on economic growth

As many of you are aware the Australian economy contracted by 0.5 per cent in the September quarter – just the fourth quarterly decline in the past 25 years – which has raised speculation that we could be on the verge of recession.

The good news is that this is unlikely, particularly given the retail sector expanded at its fastest pace in two years during the December quarter. But the trade figures released last week may complicate things somewhat.

A record trade surplus is unambiguously good for the Australian economy but it may not be recorded that way in the national accounts.

The reason is that real gross domestic product (GDP), the most widely cited measure of economic growth, concerns itself with the volume of goods and services sold or produced rather than the value of those goods and services.

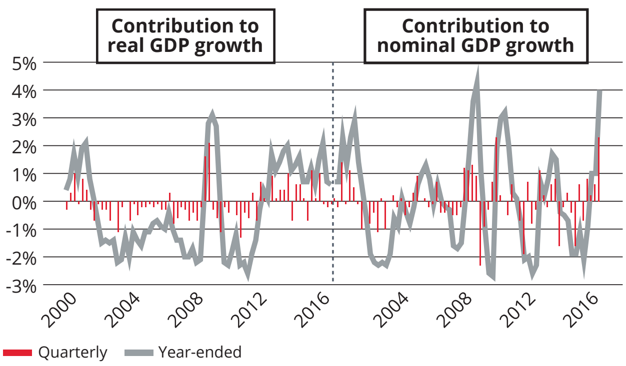
The value of exports rose by 12.2 per cent during the December quarter but the volume of exports rose by just 0.6 per cent. The change in export prices accounts for the difference.

With import volumes rising we actually find ourselves in a situation where net exports may subtract from quarterly growth. By my calculations, net exports will subtract 0.1 percentage points from real GDP growth in the December quarter.

By comparison, the value of net exports will contribute 2.3 percentage points to nominal GDP growth. That is a huge result; not unprecedented but certainly at the upper end of what we have experienced in the past. It's a great result for Australian miners, national income growth and the federal budget.

The data on export volumes is basically saying that conditions deteriorated across the mining sector during the December quarter. But we know that this is patently false.

Chart 3:Australian international trade*



* Latest outcome an estimate
Source: ABS; via CP Economics

It's not uncommon for export volumes to provide false signals on the health of Australian miners. Export volumes rose sharply throughout 2014 and 2015 but many miners sat on the verge of bankruptcy.

Yet the media focuses almost entirely on real GDP as a measure of economic growth and living standards. This is hugely problematic for a small, open economy where trade is concentrated in volatile commodity markets.

The reality is that the economy is not as weak right now as indicated by measures of real GDP. In fact the economy today is significantly stronger than it was two years ago when many media outlets were talking up the strength of the economy.

At least one investment bank is bullish on the resources sector, despite recent share price bonanzas.

BY TIM TREADGOLD • EUREKA REPORT • 7 FEBRUARY 2017

Investors face a new mining squeeze

Investors who sold their resource stocks 12 months ago because they believed the boom had been consigned to the pages of the history books now face the exquisite pain of being 'squeezed in' to try and catch a remarkable resources revival.

Key Point

- ***If late arrivals to the resources recovery do get squeezed in, that could propel share prices higher. But it could also be sowing the seeds of a future correction.***

Their problem is that rally, which has lifted mining leaders such as BHP Billiton and Rio Tinto by 60 per cent and 70 per cent, respectively, since this time last year might not continue. To buy into some mining stocks now risks paying too much.

It is also possible that the resources sector will continue to perform strongly, but on balance it seems that the best of the recovery is factored into share prices.

Iron ore and coal prices are driving interest in resources, with an export surge also starting to be felt in Australia's terms of trade and the value of the dollar, the latter of which has risen from US72 cents at the start 2016 to around US76.6c today.

The first of large-scale exports from new LNG projects in Queensland and WA are also driving the dollar higher.

Last week saw a significant set of numbers from the Australian Bureau of Statistics, notably record resources exports in December – with the $13.4 billion of metals, coal and gas overtaking a previous record of $12.4bn set in December 2013.

It prompted one investment bank to express optimism that rebirth of the boom had further to run. Deutsche listed five reasons for investors to "stay dug into miners", but it also saw potential a problem for late arrivals – investors who might pay too much as they are squeezed in.

The reasons behind Deutsche Bank's optimism are:

- Miners still being in an **earnings upgrade cycle**. "Share prices look to be pricing in earnings forecasts but spot (short-term) prices imply large upgrades to forecasts of more than 50 per cent. Many resource companies are on single digit pre-earnings ratios using spot prices."
- **Free cash flows** reaching record highs; meaning there's "plenty coming to shareholders. High commodity prices and restrained capital investment should create record free cash flow."
- **Underweight investors** might be squeezed in. "The data shows limited buying of non-financials by foreign investors, consistent with our impression of light positioning in resources. That's understandable; with many stocks in the investible universe it's easy for foreign investors to avoid stocks that over the past year have risen a lot, have high price-earnings ratios and aren't that popular with analysts."
- **China's cyclical upturn** "looks to have momentum".
- The **China over-investment** story seems "exaggerated".

If late arrivals to the resources recovery do get squeezed in, that could propel share prices higher. But it could also be sowing the seeds of a future correction.

The resources boom isn't over; it just took a breather for a couple of years, with the next wave all about cash generation from invested capital.

The rise of US yields is driving up yields around the world. Expect higher volatility in global rates, amplified by geopolitical risks and commodity price movements.

BY MORGANE DELLEDONNE • EUREKA REPORT • 8 FEBRUARY 2017

What is behind the rise of global bond yields?

Since last November, investors' sentiment has turned into 'risk-on' mode, favouring risky assets and equities relative to bonds. The rise in global yields and the steepening of yield curves has fuelled fears about the end of the 35-year bond bull market.

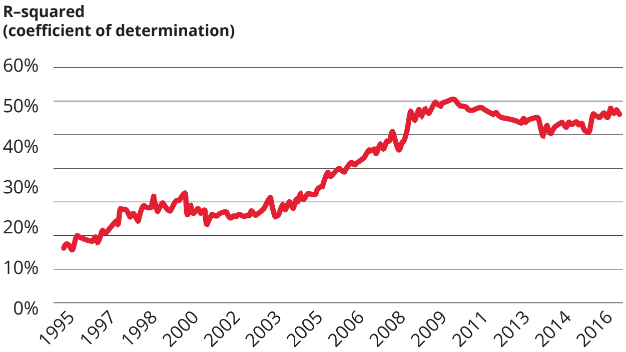
Key Point

- ***Structural headwinds and accommodative foreign monetary policies will likely limit the rise of US yields over the medium term.***

US yields drive up global yields

Since the early 2000s, the rise of global financial integration (i.e. the increased movements of capital between economies) has been reflected in higher co-movement in global yields. The chart below shows that almost 60 per cent of the changes in bond yields of advanced economies – the US, UK, Germany and Japan – may be explained by a common factor.

Chart 1: 60% of US yields may be explained by moves in other major bond yields



Source: Bloomberg, ETF Securities as of close of 1 Feb 2017
Notes: The chart shows a 5yr rolling regression of monthly changes in US 10yr yields that captures the monthly changes in Japan, German and UK 10yr yields.

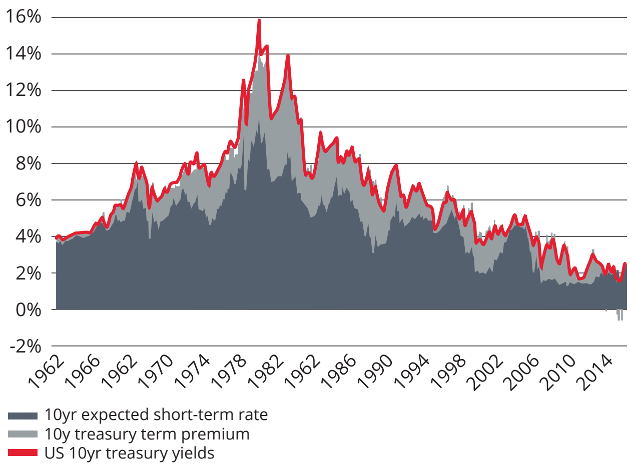
The recent rise of global yields was predominantly driven by the rise of US yields along with cyclical factors (inflation, geopolitical risk, market volatility, etc). However, we believe the ongoing accommodative monetary policies in Europe and Japan are likely to keep bond yields low in these regions, limiting the rise of US yields over the medium term.

What is driving US yields higher?

Long-term bonds yields are a function of expected future short-term interest rates and the bond term premium that investors require to buy long-term bonds rather than roll over a series of shorter maturity bonds (i.e. inflation risk premium).

The trend decline in global yields in the past 35 years mostly reflects the trend decline in bond term premium, while expected short-term interest rates fluctuate along with the changes in monetary policies.

Chart 2: Decomposition of 10yr treasury yields



Expected short-term rates started to increase in December 2013 when the US Federal Reserve announced the tapering of its monthly bond purchases. However, US bond term premiums continued to decline and then slipped into negative territory in the first half of 2016 – for the first time in history. Deflation fears fuelled by the 70 per cent drop in energy prices between 2014 and 2015 negatively affected inflation risk premiums, which declined from 0.5 per cent to -0.5 per cent. The sustained rebound in energy prices since February 2016 enabled inflation premiums to bounce back in the fourth quarter of 2016, leaving both forces – bond term premium and expected short-term rates – trending upward. As a result, US long-term yields started to rise.

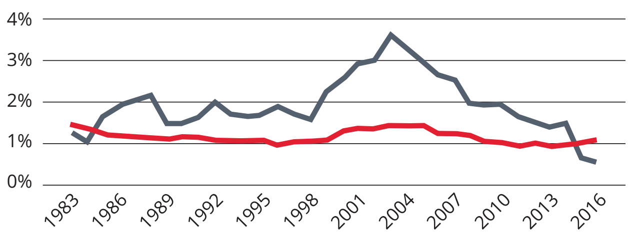
> “ **The recent rise of global yields was predominantly driven by the rise of US yields along with cyclical factors.**

We evaluate the current mispricing of the 10-year Treasury yield at 10 basis points tighter than its estimated value, based on the gap between the current 10-year yields and the sum of its two components. Thus, we believe most of the expected three rate hikes from the Fed this year have already been priced into 10-year yields. However, we expect higher rates volatility amplified by elevated volatility in energy prices and geopolitical risks. The MOVE index (an indicator of bond markets volatility) has increased 20 per cent since the fourth quarter of 2016.

Structural headwinds push yields down

The recent tightening in US financial conditions has been driven by the prospect of a better economic outlook in the US, reflecting current expectations of larger fiscal policy stimulus. In our opinion, the efficiency of the fiscal stimulus and its effects on bond markets will crucially depend on its fiscal neutrality and on its capacity to boost productivity and labour force growth. While labour force growth has rebounded since 2012 under the accommodative monetary policy of the Fed, US productivity growth remains low from a historical perspective and continues to weigh on the economy.

Chart 3: Productivity and labour force influence the long trend in potential output



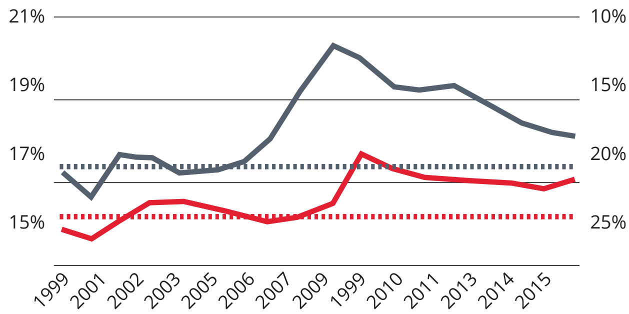
US productivity growth (% yoy) US labour force growth (% yoy)

Source: Bloomberg, ETFs Securities as of close 6 Feb 2017

Historical data reveals a strong positive relationship between investment and labour productivity.

The decline trend of investment in advanced economies can be partly explained by high credit constraints. The Debt Service Ratio (DSR) or the share of income used to service debt has not yet returned to the pre-crisis levels, weighing on consumption and investment.

Chart 4: Debt level in advanced economies push investment and real yields lower



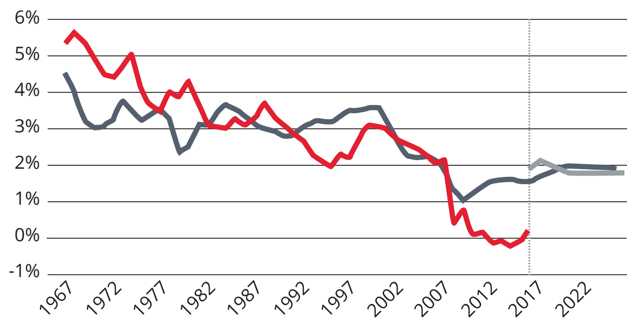
Debt service ratio (%)
Investment (%GDP, reversed axis – RHS)

Source: Bank of International Settlements, Bloomberg, ETF Securities as of close 1 Feb 2017

Subdued long-term economic trend limit yields' rise

The gradual decline in the US GDP growth trend has led to a gradual similar decline in the neutral real interest rate (i.e. the Federal Funds Rate that neither stimulates nor restrains economic growth) which, in turn, has caused the decline in long-term interest rates.

Chart 5: Neutral real rate and US potential real GDP growth



US potential real GDP growth
Laubach-Williams neutral real rate
FOMC long-run projections of Real GDP growth (%)

Source: CBO, FOMC, ETF Securities as of close 3 Feb 2017

“Deflation fears fuelled by the 70 per cent drop in energy prices between 2014 and 2015 negatively affected inflation risk premiums.

The US Congressional Budget Office forecasts a stable 2 per cent potential real GDP growth – the highest level of real GDP that can be sustained over the long term – for the US economy over the next 10 years. Accordingly, the neutral real interest rate for the US is expected to pick up and move in tandem with the potential real GDP. Although, both remain lower from a historical perspective.

This analysis is consistent with the gradual downward revision of long-run projections from the Federal Open Market Committee (FOMC). From 2012 to today, the FOMC gradually revised downward its estimates for the long-run potential GDP growth rate and the terminal fed funds rate (or neutral interest rate) from 2.4 per cent to 1.8 per cent and from 4.25 per cent to 3 per cent respectively. Fed Chair Janet Yellen reiterated on January 1 that the Fed expects to increase the Federal Funds Rate target a few times a year until, by the end of 2019, it is close to its longer-run neutral rate of 3 per cent. Accordingly, we expect the Fed to hike rates three times this year.

We expect the trend rise of US yields to be gradual over the medium term toward 2019, amid higher volatility. The upside risks to this view would come from a significant and quicker than-expected rebound in productivity growth and inflation.

Morgane Delledonne is associate director and fixed income strategist at ETF Securities.

Since listing in 2013, NAOS Emerging Opportunities has been a star performer.

BY PHILIP BISH • EUREKA REPORT • 9 FEBRUARY 2017

NAOS Emerging Opportunities: A concentrated approach

One of the major advantages of a listed investment company (LIC) is that it offers a diversified portfolio of stocks that are actively managed by a fund manager at a price that should stay reasonably close to its net tangible assets (NTA).

If the stocks are chosen well then that NTA can rise rapidly, and the share price with it – and that's been the case with NAOS Emerging Opportunities Company (ASX:NCC) which has returned an average of 22 per cent a year (before fees and after operating expenses) since it listed in 2013 compared to 3.5 per cent by the Small Ordinaries Accumulation Index.

This is an outperformance of 18.5 per cent per annum when measured before fees and after operating expenses. Of course, four years is a relatively short time in the life of any investment portfolio and it's best to measure performance over longer periods. However, it's still a great start.

Concentration

Evans, chief investment officer of NAOS Asset Management, attributes the performance to a number of factors.

He believes a concentrated portfolio of between 10 and 15 investments is ideal for enabling a good return while minimising risk. **Watch our video interview** with him, where we discuss stocks, markets and NAOS's investment approach.

The concentrated portfolio allows NAOS to have a more intimate understanding of its investments, and this is where NAOS believes it has its competitive advantage. NAOS focuses on emerging companies, which can be overlooked by the broader investment community.

The five largest holdings in the NAOS Emerging Opportunities portfolio are:

- **BSA Limited** (ASX:BSA);
- **Armidale Investment Corporation** (ASX:AIK);
- **Enero Group** (ASX:EGG);
- **MNF Group** (ASX:MNF);
- **CML Group** (ASX:CGR).

Investments

NAOS's two largest holdings are BSA Limited (ASX:BSA) and Armidale Investment Corporation (ASX:AIK).

BSA Limited is a technical services company that provides a range of services and customer solutions. This includes the manufacturing, commissioning and maintenance of heating, ventilation, air conditioning and fire systems for large-scale commercial, residential and industrial buildings. BSA also provides communication, installation and maintenance services for major Australian telcos and media operations. In 2016 it was awarded a five-year NBN infrastructure contract to add to its existing NBN operations and maintenance contract. BSA has also won significant contracts with Foxtel and Ericsson.

Over the last couple of years, Armidale Investment Corporation has grown to be Australia's largest network of asset finance brokers. It is transitioning from being a listed investment company to being an operating company, which means the market will begin to value the stock according to its profitability rather than its NTA.

Risks

The concentrated approach has worked so far for NAOS, but it also brings risks. If one or two of the bigger investments fail, it will have a big impact. This hasn't happened so far, but it may, and overall performance is best measured over much longer periods of time.

> **“Evans believes a concentrated portfolio of between 10 and 15 investments is ideal for enabling a good return while minimising risk.**

The fee structure is fairly standard. The management fee is 1.25 per cent (excluding GST), and performance fees are 15 per cent (excluding GST) of the amount the fund outperforms its index. Any underperformance is carried forward to the following year and needs to be recouped before the manager is entitled to any further performance fees.

NAOS has a policy of shareholder alignment, with directors and staff owning between 15 and 20 per cent of the LIC.

The stock is currently trading at $1.34, in between its pre-tax NTA of $1.39 and its post-tax NTA of $1.27.

We like the LIC and its management style but we’d want to see it at a discount to its post-tax NTA before buying it. In the meantime it’s an interesting one to watch, for its investment selections, and for any potential opportunity this LIC might offer.

More and more investors are dipping their toes into alternative investment strategies.

BY TONY KAYE • EUREKA REPORT • 8 FEBRUARY 2017

The alternative investments universe is expanding

A growing band of Australian investors are broadening their exposures be yond the listed s n $61.7 billion invested in unlisted trusts at the end of September 2016, as well as $6.3 billion in unlisted shares. That's just the tip of the iceberg, with billions of dollars of other private capital continually flowing into unlisted investments.

The universe of unlisted investable assets is also growing exponentially, which is why we sat down with Blue Sky Alternative Investments Managing Director Robert Shand to find out more. With more than $2 billion of private funds under management, he has some interesting pointers for self-managed investors looking to broaden their asset allocation.

Not surprisingly, Shand says Blue Sky's strategy as a listed fund has been built with a long-term focus, which is an attraction for institutional investors, high net worth individuals and family offices alike.

But Blue Sky's investment focus is far from typical, with assets ranging from healthcare and retirement to education, technology, food and water rights.

Watch the video as Shand explains the investment philosophy behind holding these types of unlisted investments.

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