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Weekly Review

WEALTH

– Issue –
28 Oct. 2016

We have an economy that is creating jobs, but not high-quality or high-wage jobs. Meanwhile, low inflation looks like it has some way to run.

CALLAM PICKERING • EUREKA REPORT • 26 OCTOBER 2016

Australia's rates reality is lower for longer

The Reserve Bank of Australia appears almost certain to leave interest rates unchanged when it meets on Tuesday. However, recent data on employment and inflation present a compelling case in favour of further cuts next year.

Key Point

- ***The data on employment and inflation suggests that Australia is a number of years away from experiencing higher interest rates.***

Labour market

The Australian Bureau of Statistics (ABS) released its Labour Force Survey last week and it was a disappointing result for investors, with employment growth falling well short of market expectations.

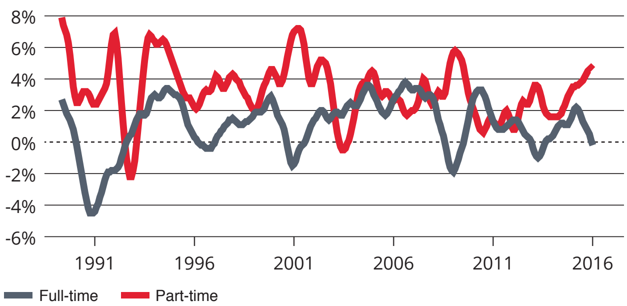
Employment growth has slowed significantly since the beginning of the year. The Australian economy created just 3800 jobs in September on a trend basis and is on track to grow by 90,000-100,000 people in 2016 (compared with 298,800 people last year).

The chief concern is full-time employment. Full-time employment fell by 7900 people in September – the ninth consecutive monthly decline – which was more than offset by a rise in part-time employment.

The graph below shows annual growth for full-time and part-time employment. Full-time employment is down slightly over the past year, while part-time employment is growing at more than 4 per cent.

Full-time employment growth is typically a pro-cyclical indicator, meaning that it does well when economic conditions are strong, whereas part-time employment displays some counter-cyclical tendencies. The current zero to 4 per cent divide has historically been a sign of economic hardship. It occurred during our last recession a quarter-century ago, the aftermath of the dot-com bubble and the global financial crisis.

Chart 1: Australian employment growth (year-ended percentage change; trend)



Source: ABS, CP Economics

Now I'm not predicting a recession – the mining export boom, which admittedly creates few jobs, will ensure that economic growth remains positive – but it does indicate that many Australian corporates remain cautious while others continue to struggle.

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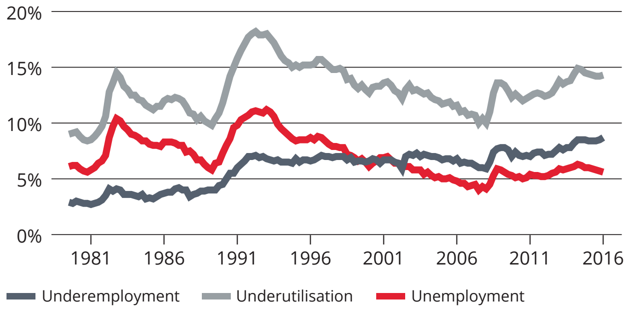
There remains significant spare capacity across Australia's labour market. Hundreds of thousands remain unemployed and many more are underemployed and would, if they could, work more hours.

According to the ABS, the unemployment rate currently sits at 5.6 per cent but the underemployment rate sits at 8.7 per cent. That gives us a total labour under-utilisation rate (unemployment plus underemployment) of 14.3 per cent.

We currently have an economy that is creating jobs but isn't creating the high-quality or high-wage jobs that we have become accustomed to. People have been forced to take on part-time or casual roles because the alternative is unemployment.

Chart 2: Australian unemployment measures (seasonally adjusted)



Source: ABS, CP Economics

None of this is particularly surprising to me. Non-mining investment remains incredibly weak and investment is often the trigger for expansion both physically and in terms of staffing levels. A corporate sector that foregoes investment is a corporate sector that isn't looking to expand or innovate or disrupt their market.

Inflation

A couple of months ago I explained the apparent divergence between what was, at the time, solid employment growth and subdued inflation. That picture has cleared up in recent months as employment growth has eased to a level that is more consistent with a low inflation environment.

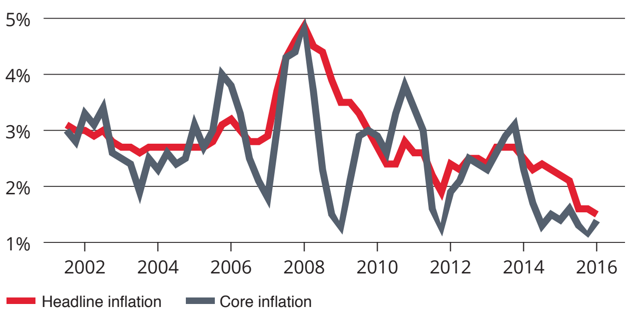
The ABS released new data on consumer prices today (Wednesday) and little has changed on the inflation front.

Headline inflation rose by 0.4 per cent in the September quarter, on a seasonally-adjusted basis, to be 1.4 per cent higher over the year. This result follows a relatively soft first-half of the year, which saw prices rise at an annualised pace of just 1.3 per cent.

The measure that the RBA pays the most attention to is core inflation. This measure removes the impact of volatile items and provides a better guide of underlying inflation. By focusing on this measure the RBA avoids overreacting to a big change in, say, oil or fruit prices.

The ABS publishes two measures of core inflation, a 'trimmed mean' and a 'weighted median' measure. Both measures take a different approach to removing volatile items but typically provide a similar assessment of inflation. As a result, it is quite common to take a simple average of these two measures.

Chart 3: Australian consumer price index (seasonally adjusted; year-ended % change)



Source: ABS, CP Economics

Core inflation rose by 0.3 per cent in the September quarter, following a soft start to the year, to be 1.5 per cent higher over the year. Core inflation currently sits at its lowest level

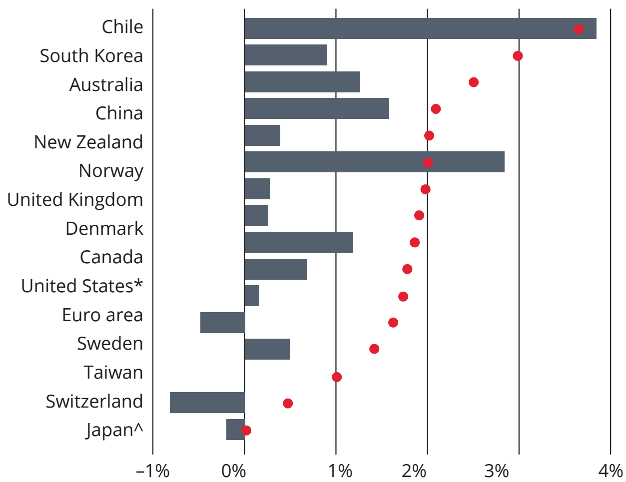
> There remains significant spare capacity across Australia's labour market. Hundreds of thousands remain unemployed and many more are underemployed and would, if they could, work more hours.

in over three decades; creating quite the headache for the RBA and monetary policy.

What does Philip Lowe think?

RBA governor Philip Lowe gave a **speech** last week where he provided some insight into the current low inflation environment.

Chart 4: Inflation for select industrialised countries (annual)



* Price index for personal consumption expenditures
^ Excludes estimated effect of the 2014 consumption tax increase
Source: CEIC Data, IMF, RBA, Thomson Reuters

The first point is that low inflation is a global phenomenon and Australia is one of the last advanced economies to suffer. The initial cause varies – for most it is a product of elevated unemployment following the global financial crisis – but in our case low inflation is a product of falling commodity prices. This led to a decline in national income growth that first hit corporate incomes, then wages and finally inflation.

Lowe cites three main reasons for the global low inflation environment.

"The first ... explanation is that the low inflation reflects economic slack in the global competition," he said. "Economic growth has generally disappointed since the global financial crisis, weighed down by an overhang of debt."

As I showed in an earlier graph, there remains a high level of labour under-utilisation in Australia. More people competing for job vacancies means that corporates can afford to be a little frugal and drive a tougher bargain. The end result is weaker wage growth that puts downward pressure on consumer spending and inflation.

- "The second factor is a self-reinforcing dynamic originating from the decline in headline inflation caused by the fall in commodity prices, including oil prices," Lowe said.

According to Lowe, many employees have agreed to smaller wage increases than they have in the past because existing inflation is low. This creates a feedback loop whereby low inflation creates persistently low inflation. This refers to what economists call 'inflation expectations' and the biggest concern for Lowe and the RBA is that households and corporates will begin to expect low inflation and price that into wage negotiations. If that happens the task of returning inflation towards target becomes more difficult.

- "The third factor is that there has been a shift in the perceived pricing power of many workers and businesses," he said.

Lowe believes that this goes above and beyond the rise in the unemployment and underemployment rates. Globalisation, for example, has reduced the bargaining power of many employees and that has led to weaker wage gains.

For decades, workers in the manufacturing sectors across most advanced economies have felt pressure from globalisation and international trade. These days many workers in the service sector are experiencing a similar phenomenon due to improved technology that has created greater competition and lower prices.

> **“Core inflation currently sits at its lowest level in over three decades; creating quite the headache for the RBA and monetary policy.**

From a market perspective, the main benefit of a low inflation environment has been historically low interest rates. Low interest rates will persist until such a time as inflation returns towards more normal levels.

The main downside is that low interest rates reduce the number of high-quality assets that offer a sufficient return. The end result has been a global ‘search for yield’ that has arguably led to risk-taking that wouldn’t otherwise have occurred. Risk has arguably been under-priced across many asset markets.

The data on employment and inflation suggests that Australia is a number of years away from experiencing higher interest rates. Core inflation is likely to remain below the RBA’s 2–3 per cent target band until at least 2018. If this is correct then markets appear to be under-pricing the possibility of further rate cuts next year.

There will be less pressure on the RBA to cut if the Federal Reserve hikes US rates by the end of the year. Nevertheless, it is clear that the processes that led to low inflation in Australia and abroad still have some way to run and the RBA may be forced to bring the cash rate in line with monetary policy in other advanced economies.

A Chinese-induced coal-price recovery had led to the best conditions in the sector for five years.

BY TIM TREADGOLD • EUREKA REPORT • 25 OCTOBER 2016

Coal surge fires up Australian investors

If hard coking coal was a runner in next week's Melbourne Cup the stewards would already have called an inquiry into how a 100–1 long shot six months ago has become a short-odds favourite.

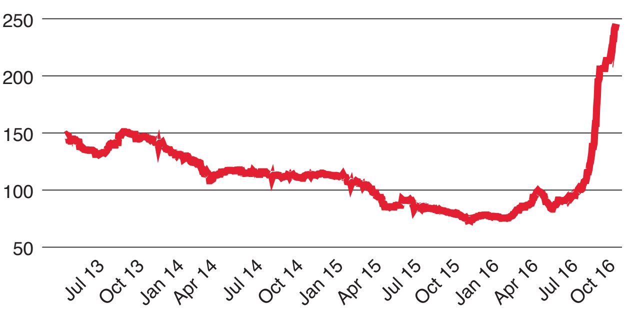
Key Point

- ***A handful of coalmining stocks listed on the Australian stockmarket have surged higher while a group of private coal companies are also looking to rebound.***

The explanation, as is often the case with horses that fly out of nowhere, is that someone gave it an artificial boost to speed up the price, which has rocketed along from $US90 a tonne in March to well over $US200.

With coal, the hypodermic needle is in the hands of the Chinese Government, which forced its domestic coal-mining industry to cut the number of days mines can work in a year from 330 to 276.

Chart 1: Coking coal's new chapter – East coast Australia spot price (2013–present)



Source: Bloomberg, Eureka Report

That classic example of command-economy direction had the desired effect of cutting coal output, partly as an environmental clean-up measure and partly to boost the coal price for loss-making miners.

But it also turned out to be a policy that worked too well, with shortages in the Chinese market for hard coking coal (used to make steel) and thermal coal (used to generate electricity) rising much further than the central government expected. This has forced coal users into the international market, with Australia a first port of call, especially for hard coking (an Australian specialty).

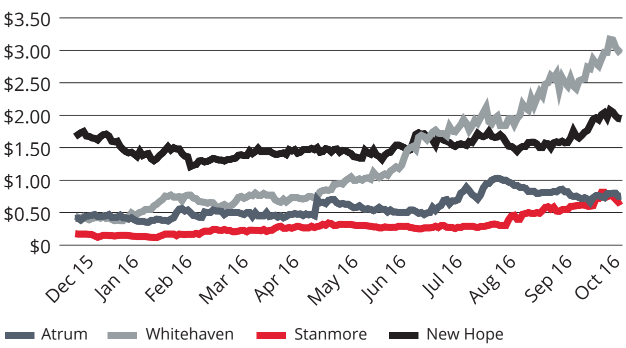
The miraculous recovery in coal prices has turned a demonised mineral into the resource sector's best-performing commodity, leaving previous leaders such as gold, lithium and graphite in its wake.

An upshot of the Chinese-induced coal-price recovery is that the handful of coalmining stocks listed on the Australian stockmarket have surged higher while a group of private coal companies, mostly run by people from earlier coal booms, are enjoying an unexpected boost.

The tear-away leader among ASX-listed stocks is Whitehaven Coal, which has rocketed up from 35c in January to recent sales at $2.99. Last week it hit a three-year high of $3.25.

New Hope Corporation has also reacted positively to the higher coal price, reaching a 12-month high of $2.13 last week before easing back to $1.95. Stanmore rushed up from 12c to 84c before easing back to 66c, and Atrum ran from 34c to $1.07 before settling at 75c.

Chart 2: Australian coking coal stocks (year-to-date)



Investment bank analysts who follow coal, and there aren't many thanks to it being a politically and environmentally incorrect fossil fuel, do not believe that the higher prices are sustainable.

The consensus view of Whitehaven is that it will fall back to $2.46, with Macquarie leading the negative view with a target-price tip of $1.50.

> **"With coal, the hypodermic needle is in the hands of the Chinese Government, which forced its domestic coal-mining industry to cut the number of days mines can work in a year from 330 to 276.**

Investors emerge from the coal dust

Interesting as the fate of the listed coal stocks might be, there is a far more interesting race being run in the background with the gathering of old coal hands making a return to an industry where they made fortunes in the last boom.

Nathan Tinkler, a man who made a billion dollars and then lost it with ill-timed bets, is back in the game despite being officially declared bankrupt. He effectively controls 37 per cent of Australian Pacific Coal which has risen from half-a-cent to 2.6c, valuing the business at $112 million and his stake at $41m.

The key to Tinkler's return is the Dartbrook mine in the Hunter Valley of NSW, which was sold to Australian Pacific by one of the world's mining majors, Anglo American, at the low point in the coal-price cycle as part of a debt reduction drive and because it wanted to focus on diamonds, copper and platinum.

Barry Tudor, the man behind Gloucester Coal in its heyday before it was acquired by China's Yancoal in 2012, is back with a new runner called Pembroke Resources. It is in the final stages of acquiring the Olive Downs coking-coal mine from US-based Peabody Energy, which is currently trading under Chapter 11 bankruptcy protection.

Edek Choros, a man valued by *BRW* magazine at $310m in 2012 thanks to his stake in Ambre Energy, is reported to be making a return through a private company called Batchfire Resources ,which is said to be negotiating the purchase of Anglo American's Callide mine in central Queensland.

This theme of yesterday's coal stars making a return to the industry thanks to mining majors getting out is repeated in the ASX-listed Malabar Coal, which has brought together heavy hitters in Hans Mende, Tony Haggarty and Andy Plummer.

Haggarty and Plummer were best known for their leading roles in Excel Coal and the early days of Whitehaven.

Mende is a serial coal and iron ore investor who first made his name as an executive of the German industrial conglomerate, Thyssen.

In Australia, Mende's master company, AMCI, has held major interests in a range of companies that included Aquila Resources, Felix Resources, Whitehaven, and Gloucester. At one stage he formed a joint venture with former BHP Billiton chief executive, Brian Gilbertson, to try and build a big position in the world's manganese mining industry.

The keys to Malabar are its undeveloped coking coal project in the Hunter Valley called Spur Hill, which is adjacent to another undeveloped project being offered for sale by Anglo Coal called Drayton South.

The combination of Spur Hill and Drayton South could create a world-class coking coal project, and who better to do that than Mende, Haggarty and Plummer?

How long will the coal show last?

For most investors the revival of interest in coal will be of limited interest until the actions of the Chinese Government are better understood.

The production limits imposed earlier this year are being lifted for some types of thermal coal, which could see its price fall back to where they were earlier this year.

Coking coal could stay higher for longer, which is why producers of the material, including BHP Billiton and Wesfarmers, are enjoying a tailwind in their share prices.

For true believers in coal the current conditions are the best for five years.

For Australia, the coal-price boom is leading to forecasts of the country's trade deficit being wiped out, thanks to coal representing 10 per cent of national exports, with the extra earnings a potential threat to the value of the dollar which could be pushed up to US90c (and more) if coal prices stay high.

Exchange rate parity with the US dollar is also a possibility if the coal boom continues.

For environmentalists the return of coal is their worst nightmare. Having demonised the industry as a prime cause of climate change they are now struggling to explain the price surge.

Oddly, and ironically, it is the environmental protesters who have played a role in the return of coal with their objections to new coal mines being developed and old mines expanded.

The protests have effectively limited coal supply – and there's no better way to create a price boom than reduced supply meeting strong demand.

Click here *to watch myself and Eureka editor Tony Kaye discuss why the coal price is surging.*

Tatts note holders have been given no invitation to redeem, while Tabcorp's will find their paper

BY PHILIP BAYLEY • EUREKA REPORT • 24 OCTOBER 2016

Gambling with note holders

Tabcorp Holdings Limited and Tatts Group Limited advised the ASX last Wednesday of their intention to combine to create a new $11.3 billion diversified gambling and entertainment business. The announcement followed a request to halt trading in each company's shares the day before.

Key Point

- ***Tatts note holders will, in all likelihood, be better-off. If there are any noteholders who have reason to be put out, it is the Tabcorp note holders.***

Interestingly, the requests for a trading halt only applied to the shares of each company and not to their ASX-listed debt securities. Yet the debt securities of each have change-of-control clauses that permit note holders to request redemption of their notes upon the occurrence of such an event.

Was this an oversight or was it assumed that note holders would be unlikely to exercise their right to request redemption in the event that they are successful in their bid to combine their operations? The answer is probably the latter.

Along with the announcement of the intention to combine delivered to the ASX, was a 16-page PowerPoint presentation and a 96-page Merger Implementation Deed and other appended documents. None of these make any reference to the note holders of either entity.

For both Tabcorp and Tatts, a change of control requires a transfer of more than 50 per cent of their voting shares to a person and associated entities. The proposed combination will see Tabcorp issue shares and cash to acquire the issued capital of Tatts.

And while Tatts shareholders will hold 58 per cent of the issued capital of the combined entity, the Chairman and CEO of Tabcorp will continue on in those roles. This is a takeover of Tatts by Tabcorp.

In what may be a passing reference to Tatts note holders, clause 8.3 of the Merger Implementation Deed requires Tatts to contact all landlords and other parties with whom contractual arrangements include a change of control clause and seek their agreement to continue existing arrangements with the new entity.

Thus, Tatts may contact note holders and seek their agreement not to request redemption. But they may not, because to do so would invite requests for incentives to remain note holders.

From a practical perspective there appears to be no reason why Tatts note holders should seek redemption, if the combination proceeds.

Prior to the announcement, the notes were trading at a premium to face value, at $104.70. The next day they were still marked at the same level, and redemption will only return $100.00.

The notes are senior ranking and therefore will rank ahead of the Tabcorp subordinated notes in the combined entity, and the combined entity is expected to have an investment grade credit rating. Tatts is unrated by the major rating agencies and S&P virtually confirmed the expectation of an investment grade rating on the same day.

Thus, Tatts note holders will in all likelihood be better-off under the combined entity than they are now. And if they did seek redemption, where would they invest the proceeds?

The Tatts notes are one of only two senior ranking ASX-listed notes issued by non-financial companies and even among financial issuers there are only another two listed issues.

If there are any noteholders who have reason to be put out, it is the Tabcorp note holders. The Tatts noteholders will become a new group of creditors to rank ahead of them in the combined entity.

From an economic perspective, the Tabcorp subordinated note holders will be further subordinated, although from a legal perspective nothing will change. Realisation of the greater economic subordination may see the price of the Tabcorp subordinated notes fall from the current $100.81 but the Tabcorp note holders will not have grounds to request early redemption.

The combination of Tabcorp and Tatts is not au fait a compli. The combination must be approved by Tatts shareholders, the ACCC, and various state regulators and licensing bodies. Completion of the combination, if approved by all is not expected until mid-2017.

Philip Bayley is a former director of Standard & Poor's and now works as an independent consultant to debt capital market participants. He is associated with Australia Ratings.

A number of recent Government changes to superannuation have negative consequences.

BY JORDAN GEORGE • EUREKA REPORT • 27 OCTOBER 2016

What SMSF trustees really need

What's that old saying – lies, dammed lies, and statistics. Well, here's a set of numbers that tell it as it is, and for SMSF trustees, especially those approaching retirement, they make for compelling reading.

Key Point

- ***The SMSF Association-Rice Warner study shows people have a good understanding about the superannuation system. What they need, though, is certainty.***

What's that old saying – lies, dammed lies, and statistics. Well, here's a set of numbers that tell it as it is, and for SMSF trustees, especially those approaching retirement, they make for compelling reading.

The SMSF Association and the actuarial consultancy firm Rice Warner conducted some research into SMSF contributions and came up with some startling revelations. Some of it had been known anecdotally, but this 18-page report produced some hard data around SMSF contributions, both concessional and non-concessional.

To take the former first, it has long been the Association's argument that the concessional contribution cap should be at least $35,000, and that the carry forward of concessional contributions should be extended. This concessional cap is particularly important for people as they approach retirement. So, as the report shows, the Federal Government's decision to reduce the concessional cap to $25,000 will have a deleterious effect on those looking to have a secure and dignified retirement.

In 2015, the report pored over data from 14,351 members and 7593 SMSFs – valid and statistically significant numbers. What it found was that if the $25,000 cap had been introduced in that year, it would have affected 1983 members or 13.8 per cent of the sample – amounting to about $30 million in contributions for that year.

In respect to the carry-forward of contributions, the data shows that by extending the limit from $500,000 to $750,000, it would benefit 13 per cent of those surveyed, of which, and this is important, half would be women. Certainly it is a measure that would go a long way towards building adequacy for women in retirement.

The Association firmly believes that this change to $750,000 would increase the effectiveness of the Government's carry forward policy and deliver better results for people who have had volatile incomes throughout their careers and are trying to build adequate retirement savings.

What the report also shows is that an estimated 21 per cent of those surveyed in 2015 will be hurt by the Government's decision to limit the tax-free earnings in retirement to super account balances of $1.6m. Assuming an earnings rate of 5 per cent a year (generous in the current low interest rate environment), it allows people an annual income supported by superannuation of $80,000 a year. While a reasonable amount, it is a complex measure and refining the concessions for retirement phase could be done far more efficiently.

On the non-concessional front, the research conclusively shows that people only begin making significant voluntary contributions to superannuation from their mid-50s onwards. Commonsense suggests this would be the case – and now there is statistical evidence to support it.

The report argues this increase in non-concessional contributions later in people's working lives can largely be explained by three factors. First, most members will experience income growth over their career that will flow through as higher mandatory and voluntary contributions. Second, disposable income increases as mortgages are paid off and children leave home. Third, there is a strong tendency for members to connect more strongly with their superannuation funding adequacy as they approach retirement; it becomes a more immediate issue and access to the funds becomes more imminent.

To these three reasons, a fourth can be added. For women, in particular, who have often experienced broken work patterns, the latter stage of their working lives are uninterrupted, providing the opportunity to pour extra dollars into superannuation. Certainly the report highlights the fact that women's contribution patterns show that they are engaged with their superannuation in an SMSF, and this particularly applies when they are in the 60-plus age group.

> **The Federal Government's decision to reduce the concessional cap to $25,000 will have a deleterious effect on those looking to have a secure and dignified retirement.**

None of this should be surprising. Earlier Association research undertaken with the Commonwealth Bank shows women, especially women in the SMSF sector, are increasingly confident of taking control of their superannuation. This particularly applies to Gen X and Y where women have had a career focus throughout their working lives and have the confidence and education to take control of their retirement income strategies.

In a very real sense, policymakers should take heart from these statistics. They suggest many people understand what is involved to be adequately prepared for their retirement years, especially when longevity is added to the equation, and are taking concrete steps to achieve this outcome.

What they need, and what only government can provide, is to have certainty around the superannuation system. So leaving individual policies aside, what needs to be done as the first stepping stone to providing this security is to have legislation that defines the superannuation objective. That's the challenge for our policymakers, because if they get it right it will give much-needed clarity to the policies required to achieve this objective.

Jordan George is head of policy at the SMSF Association.

The wonders of modern medicine mean many more Australians are now living to ripe old ages. The only problem is, we don't have enough progeny to support our current retirement system.

BY BRUCE BRAMMALL • EUREKA REPORT • 28 OCTOBER 2016

Living longer is a super problem

A note to all Australians aged in their mid-to-late 40s and over … you have a problem. And it's big.

You didn't have enough sex when you were younger. Selfish.

Key Point

- ***Lower contribution limits and taxed pensions will be followed by harsher measures in years to come, says survey.***

Your lack of action led to a diminished production output (of children). With development lag time, there were fewer adults in the future (roughly, now). And your bad example is now feeding on itself, with your children following or likely to follow the same pattern.

This means fewer grandchildren for you (collectively). I'm sure grandchildren are nice and all, and fun to have around the house on Christmas morning. But that's not why you should want more of them. Indeed, you need more of them to pay for your retirement.

This "reproduction strike" that has been going on for some decades is what is behind the phenomenon we know as the "ageing population".

There's not enough young people who are working and earning (and paying taxes) to pay for older people in retirement. It's no laughing matter.

Ageing problems ahead

It has always concerned me that my generation (Generation X) was having to fund its own retirement through the superannuation guarantee and also be working to fund the Boomers' retirement.

But it wasn't until reading a recent annual superannuation report that I realised how much my generation is also going to be in deep trouble when we're getting old and grey.

The Mercer Melbourne Global Pension Index 2016 paints the picture well.

This annual survey's main purpose is to plot how well the retirement systems for a group of selected nations are travelling. And whether they are getting better or worse each year.

For your information, Australia's retirement system got worse during the year. It is still ranked third of the 27 countries surveyed. Not a bad result, but down from holding the silver medal that we had a few years ago. More on this later.

The MMGPI went into some detail about the impact of how longer life expectancies and falling global fertility rates are going to hit these 27 countries. And what would need to be done to restrict what could be a devastating financial impact on those economies.

Doing the numbers

In my column last week (***Super: It's time to move on***), when I said that the changes to our super – to reduce super contribution limits and restrict the amount tax-free in pension – were coming from Treasury, it is these sorts of statistics that Treasury is relying on in recommending to successive governments to temper the generosity of super.

- Life expectancy for newborn Australians has risen by about 10 years in the last 40 years.
- Life expectancy for those aged 65 has increased by six years in the last 40 years.
- Fertility rates in Australia have fallen from around 3.8 children in the early 80s to around 1.8 now. This is expected to fall further by 2030.

As a result, the "old age dependency" ratio will increase markedly in the coming decades. This is calculated by dividing the number of people over 60 by the number of people of working age, aged 20-64, then multiplying it by 100.

Australia, at the moment, is sitting with a score of a little over 20. By 2040, it is estimated that this will have hit the high 30s.

Not enough people earning, producing and paying taxes to pay for the rising cost of looking after older Australians in their retirement.

How does restricting the amount of money that Australians can get into super help this situation? What about introducing a cap on how much money you can have tax-free in super?

Well, to many it would seem counter-intuitive. "Why not let Australians get more into super to be able to further look after themselves and be less of a burden on the working generation?"

> **“ Governments have already moved to have access to thegovernment age pension pushed back from 65 to 67. Expect this to be pushed out a little further in the coming decade or so.**

Sure, but the more money that is sitting in a completely tax-free environment (pension phase), the less tax that is being raised for the public purse to be used where needed.

If you don't like the current solution of restricted contribution limits and tax-free pension fund sizes, then you might change your mind when you consider what is likely to be coming down the pipeline.

The MMGPI has been running for eight years. And, in recent years, the survey's authors have recommended a near identical course of action as being required to make Australia's retirement incomes system more sustainable.

The institute recommends the following:

- That part of all retirement benefits be taken as a compulsory pension.
- That labour force participation be increased, as life expectancies rise. That is, push out the retirement age, or age at which access to the age pension is achieved.
- Push back the age at which access to a superannuation pension can be taken.

Table 1: Scoring world pension and retirement income systems

The following table compares the results for the 25 countries from 2015 to 2016. Comments in respect of each country are made in Chapter 5.

Country	Total		Adequacy		Sustainability		Integrity	
	2015	2016	2015	2016	2015	2016	2015	2016
Australia	79.6	77.9	81.2	76.0	72.1	74.1	87.6	86.1
Austria	52.2	51.7	67.6	67.4	17.2	16.0	76.8	76.7
Brazil	53.2	55.1	64.6	67.9	24.5	29.2	75.1	70.7
Canada	70.0	66.4	79.4	68.0	56.2	58.8	74.3	74.5
Chile	69.1	66.4	62.8	56.5	65.0	68.4	84.8	79.6
China	48.0	45.2	62.7	58.2	29.8	29.7	50.0	46.0
Denmark	81.7	80.5	77.2	75.8	84.7	85.3	84.5	81.4
Finland	73.0	72.9	70.7	70.6	61.8	62.2	92.4	91.5
France	57.4	56.4	77.2	75.2	36.6	35.2	54.9	55.8
Germany	62.0	59.0	76.0	70.4	36.8	35.8	75.0	73.1
India	40.3	43.4	30.0	39.5	39.9	40.9	57.6	53.4
Indonesia	48.2	48.3	41.3	41.0	40.1	43.0	70.8	67.3
Ireland	63.1	62.0	77.0	76.2	36.2	34.8	78.5	77.3
Italy	50.9	49.5	68.4	65.5	12.1	13.5	77.4	74.4
Japan	44.1	43.2	48.8	48.5	26.5	24.4	61.2	60.9
Korea	43.8	46.0	43.9	46.5	41.6	43.9	46.8	48.1
Mexico	52.1	44.3	56.4	38.5	53.5	53.6	43.4	40.7
Netherlands	80.5	80.1	80.5	78.2	74.3	77.0	89.3	87.7
Poland	56.2	54.4	61.8	57.9	40.6	41.2	69.0	67.3
Singapore	64.7	67.0	55.7	61.4	65.9	66.8	77.2	76.1
South Africa	53.4	48.6	47.3	34.0	43.0	44.7	77.7	77.3
Sweden	74.2	71.4	71.1	67.6	72.6	69.5	81.5	80.3
Switzerland	74.2	68.6	73.9	60.5	68.4	67.4	82.9	83.5
UK	65.0	60.1	64.2	55.5	51.3	48.8	85.5	83.2
USA	56.3	56.4	55.1	53.5	54.4	57.1	61.1	59.9
Average	**60.5**	**59.0**	**63.8**	**60.4**	**48.2**	**48.9**	**72.6**	**70.9**

Source: Australian Centre for Financial Studies, Melbourne Global Pension Index 2016.

Pushing back the pension

Governments have already moved to have access to the government age pension pushed back from 65 to 67. Expect this to be pushed out a little further in the coming decade or so.

The earliest age at which superannuation can be accessed is in the process of moving from age 55 to 60, for those born from 1 July 1964 and later. It would seem almost certain that as life expectancies rise, so will this age limit.

Interestingly, Australia's world ranking took a hit during the survey. While Australia maintained its spot in third place among the surveyed nations, its core score fell nearly 2 percentage points, from 79.6 to 77.9.

Overall, this gave Australia's retirement/pension system a B+. Only Denmark (80.5) and The Netherlands (80.1) scored better.

Argentina, Japan and India took out the bottom three slots.

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****.*

It is usually best if a lump sum is used to pay off a mortgage rather than deposited into a mortgage offset account.

BY MAX NEWNHAM • EUREKA REPORT • 24 OCTOBER 2016

Tax with Max: Assets test strategies

Q. *I am 67 and my wife is 57. I receive a small service pension from the department of Veterans Affairs. My wife is considering retiring shortly and will receive approximately $50,000 in long service leave and annual leave entitlements as a lump sum. We still have a small mortgage on our house.*

Will it be best if she deposits the money into a mortgage offset facility, which will reduce the monthly interest payable, or to pay off our mortgage, which has a redraw facility, with regard to Centrelink rules?

Answer: There are two tests that can affect your decision about what you do with the lump sum that your wife will receive. Under both of these tests it will be best if the lump sum is used to pay off your mortgage rather than depositing it into a mortgage offset account.

Under the assets test the value of a person's principal residence is not counted. In addition, any loans secured against the residence are also not counted. This means when a person or a couple use their home as security for an investment loan the full value of the investments are counted under the assets test, and not the net value after deducting the loan balance.

When there is a redraw facility on a home loan, this is not counted as an asset. Where a mortgage offset account is used, because the funds in this account can be withdrawn at any time, the value of the account is counted under the assets test.

Because the mortgage offset account is counted as a separate asset the value is also taken into account to calculate the deemed income that you will be earning. If the lump sum is instead paid off the mortgage the funds received will not be counted under the income test.

Another possible option for the $50,000 lump sum is to make a non-concessional super contribution for your wife. As she is not yet of age pension age the value of her superannuation is not counted under the assets test.

This strategy is particularly effective where the interest rate paid on your home loan is much less than the income rate earned by the superannuation fund. Before taking any action you should seek professional advice to work out what is your best option.

Q. *My wife and I each have account-based pensions worth in total $950,000 within our SMSF that were started in 2014 when we both turned 65. Can you please tell me what will be the effect on the small age pension that we both receive once the new asset test rules apply from January 1, 2017?*

Answer: There will be two results from the new rules that apply to the assets test from January 1, 2017. As a result of the pension reduction factor increasing from $1.50 per every $1000 over the lower asset limit up to $3.00, a couple's entitlement to the age pension ceases once their assets exceed approximately $816,000.

As a result of the combined value of your superannuation accounts being $950,000 this will mean that you will no longer receive the age pension from January 1, 2017, but you will retain the Health Care Card.

Currently anyone who is not in receipt of an age pension is entitled to a Commonwealth Seniors Health Card if they pass the income test. Under that test a couple receive the CSHC if their annual income is less than $84,472.

As the health care card is one of the most prized possessions of anyone receiving the age pension the government has announced anyone that loses this card, as a result of the change to the assets test, will effectively receive a CSHC without any income test applying in the future.

Another result of you losing the age pension will be the current treatment of your account-based pension, under the income test, will no longer apply if you become eligible for the age pension in the future. As you qualified for the age pension prior to January 1, 2015 the amount you receive from your account-based pensions are not counted under the income test.

Under this old test the amount counted by Centrelink was the value of the account-based pension decreased by a deductible purchase price. The purchase price was calculated by dividing the value of your account-based pension at the time it was commenced by your life expectancies.

As a result of losing the age pension, and when you become eligible under the assets test to receive it again, rather than a net account-based pension being counted under the income test the value of your pensions will have the deeming rates applied.

> **When a person or a couple use their home as security for an investment loan the full value of the investments are counted under the assets test, and not the net value after deducting the loan balance.**

The current income test means the age pension ceases once a couple's combined annual income exceeds $75,357. Under the deeming rates that apply currently, a couple whose only financial assets are their superannuation can have up to approximately $2.35 million in superannuation and still receive a small pension. This means that you should not be disadvantaged by the new income rules that will apply to your account-based pensions.

Q. *My husband turns 65 in November and is not working. I am 54, earning $130,000 a year, but wish to retire within a few months. We have an SMSF in which my husband's pension account has $890,000 and my accumulation account has $422,000.*

I have $30,000 in my savings account and my husband has a total of $170,000 in various industry super funds. Other than our home, we have no other assets.

In order for my husband to qualify for the age pension once I stop working, we would like to withdraw $540,000 in the current financial year from his pension account, and put it as a non-concessional contribution into my accumulation account.

We have not yet lodged our 2016 SMSF tax return, but our 2015 SMSF tax return was lodged in June 2016. It showed $180,000 as a non-concessional contribution in my husband's name.

I requested our accountant to amend this 2015 tax return to put the $180,000 into my accumulation account instead. He said that this is not advisable because the ATO would ask a lot of questions and possibly do an audit on us. Is our accountant right, and is our retirement strategy sound?

Answer: On a number of levels what you are proposing is not a sound retirement strategy. Your accountant is correct that by amending the 2015 return you could be selected for an audit by the ATO. In addition, you face a problem with having the auditor of your fund agreeing to the change.

Your strategy is also unsound because of the new non-concessional contribution limits that will apply if the government's superannuation changes are passed by both houses of federal Parliament. Under those changes the maximum that you could contribute as a non-concessional contribution for the 2017 financial year is $380,000.

If you want to at least have your husband receive a small age pension your best option will be to have him withdraw $380,000 from superannuation, you make this as a non-concessional super contribution, and leave your superannuation in accumulation phase. This should mean your assets counted by Centrelink will be below the $816,000 assets test pension cut-off threshold.

Plans for new lithium mines are being unveiled on an almost daily basis, with the unconventional

BY TIM TREADGOLD • EUREKA REPORT • 21 OCTOBER 2016

Electric blues: Lithium takes a stumble

Stock market bubbles do not always pop. Some recede gently as the hot air escapes, which is what has been happening in lithium, a metal that has been hot in too many ways, including being blamed for the batteries in Samsung mobile phones catching fire.

Key Point

- ***The critical element of lithium is that it is not a rare element, it's just that no-one has really looked for it because a big market had not been developed.***

Samsung's crisis with the lithium-ion batteries in its Galaxy Note7 has been just one issue for investors in lithium to consider as the share prices of most Australian explorers exposed to the metal have steadily declined over the past three months.

Since Eureka Report asked a critical question on June 15 (***Is lithium out of power?***) much of the heat has gone out of the lithium boom, with little chance of a revival as fresh lithium supplies are rushed into the market to meet a surge in demand.

Some of the biggest share-price falls have been in the lithium leaders. Orocobre, an Australian business producing lithium in South America, is down by 31 per cent from $4.65 in mid-June to $3.19. Pilbara Minerals is down by 30 per cent from 64.5c to 45.5c. Galaxy Resources (which has recently merged with General Mining) is down by 35 per cent from 50c to 32.5c.

has withdrawn its offending phone from the market, but only after US airlines banned its carriage. This decision followed an earlier aviation issue with lithium-ion batteries in the early versions of Boeing's 787 Dreamliner, which was grounded until problems with its batteries were overcome.

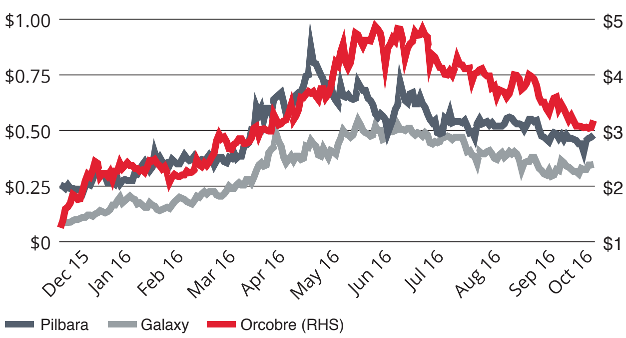
Burning batteries are a sobering reminder that lithium is not a conventional metal. In its pure form it floats on water, and combusts on exposure to moist air, properties that makers of rival energy storage systems have been quick to point out, including the zinc-based Redflow ZCell.

Competing technologies aside, a more important challenge for lithium and its producers is that rising supply seems certain to satisfy – if not flood – demand over the next 12–18 months.

Plans for new lithium mines are being unveiled on an almost daily basis in many countries with Canada and Australia leading the way, but with Europe and Africa catching up.

Any new mines, or brine processing facilities based on the lithium in salt lakes, will have to compete with entrenched producers of the metal such as China's Tianqi and Albemarle of the US which control the big Greenbushes mine in Western Australia, as well as brine operations in South America.

Chart 1: Australian lithium stocks, share prices (year to date)



Source: Bloomberg, Eureka Report

Last week, as news of Samsung's burning batteries was being absorbed by investors, Tianqi started construction of a $400 million lithium processing facility at Kwinana, south of Perth, with the aim being to add value to expanded output from its Greenbushes mine.

The chief executive of Tianqi, Vivian Wu, said at a function to mark the start of work that she was not expecting a flood of new lithium to hit the market because producing the metal was actually a lot harder than is widely believed.

"People tend to assume that it's simple, but from past experience we know that with a lot of projects it's going to

> **Burning batteries are a sobering reminder that lithium is not a conventional metal.**

take a lot longer and be a lot harder to produce good quality stuff," Wu said.

There's no doubt that Wu knows her lithium and her comments about there not being a flood could be seen as a positive for the sector – while her warning about how difficult it can be to achieve high quality lithium should be seen as a warning that not everyone is going to succeed.

Rounding off a week when lithium was in the news for good and bad reasons was a fresh alert from analysts at the international investment advisory firm Bernstein.

Three words sum up Bernstein's view of lithium: "The big short."

If that wasn't enough to make investors with an appetite for lithium think twice the next comment should do the trick: "The lithium frenzy should all end in tears."

Broken into three parts the Bernstein research paper looks firstly at what seems to be "an apparently very compelling bull case" based on rising demand for long-life electricity storage batteries in electric cars as well as for home and commercial use.

The second part of the research note is: "...an expanding supply side with no barriers to entry."

"Lithium is not rare," Bernstein said. "Quite the opposite actually: at the current production rate the reserve base equates to 431 years of supply. This compared with 39 years for copper and 15 years for zinc."

Finishing off its sharply-worded attack on lithium is Bernstein's third point, technology developments: "Technology breakthroughs to take lithium prices down to the floor," was the key comment on technology.

What Bernstein means is that technology developments will make lithium easier to produce as rival electricity storage systems are also likely to hit the market.

"While the supply base of lithium is already significant, we believe it can expand further with a number of technological breakthroughs being developed, as we write."

Bernstein, of course, might be wrong with its gloomy prognosis but for me the critical element of lithium is that it is not a rare element, it's just that no-one has really looked for it because a big market had not been developed.

Greenbushes, for example, stockpiled its lithium for decades while it focused on tin and tantalum in the same ore-body. Today, lithium is on top – but those high-grade stockpiles are sitting on the surface waiting to be treated and they are some of the richest lithium material in the world, and already mined.

As has been said before; lithium burns, in more ways than one.

ANZ has added another green bond while NAB has joined the space, which is gaining popularity around the world.

BY PHIL BAYLEY • EUREKA REPORT • 28 OCTOBER 2016

The rise of listed green bonds

In the domestic corporate bond market, institutional investors have been able to buy green bonds or climate bonds, as they are sometimes referred to, since the World Bank issued green bonds in April 2014. That said, the market has not turned green and issuance has been limited to five issues that have raised a total of $2.3 billion, to date.

Key Point

- ***The latest listing of exchange traded bonds takes the total offering to 49 – with green bonds from NAB and ANZ featured in the new tranche.***

Green bonds have been beyond the reach of retail investors, until now. The Australian Corporate Bond Company, the creator of exchange-traded bonds (XTBs) listed on the ASX, has just released 10 new XTBs, including two green XTBs.

Green bonds are bonds issued to fund green projects, are certified to be in compliance with international climate bonds standards, and are aimed at socially responsible investors. Apart from the World Bank, the German development bank, KfW, NAB, ANZ and Westpac have issued green bonds in the domestic market.

Green bonds generally do not provide issuers with cheaper funds in the Australian market, as the bonds price at the same level as the issuer's ordinary bonds but arguably provide the opportunity to reach a broader range of investors. However, there was an issue of asset backed securities in 2015 that achieved more favourable pricing than identical securities that were not certified green.

Around the world, green bonds are gaining popularity and the definition of green is expanding.

Earlier this year, Moody's Investors Service reported that record green bond issuance of $US20.3bn was seen in the second quarter of this year, and annual issuance was poised to reach $US75bn. Renewable energy projects accounted for 38 per cent of the issuance, energy efficiency 24 per cent, and clean transportation 17 per cent.

Moody's noted that in June, the International Capital Markets Association announced updates to the Green Bond Principals, which included expansion of the range of acceptable uses for green bond proceeds to include projects with social objectives. Social benefit bonds have also been issued in Australia but the relatively few issues have been largely restricted to sophisticated, socially responsible investors.

XTBs created by the Australian Corporate Bond Company were launched in May last year. At the time, 17 separate classes of XTBs were listed on the ASX. Each class of XTBs represented an underlying corporate bond obtained from the wholesale market.

The underlying bonds offered are senior ranking, unsecured bonds issued by Australian listed companies and are more than one year old. Investors benefit from being able to buy senior ranking bonds – which are as rare as hens teeth among the other debt securities listed on the ASX – from the continuous disclose requirement imposed on the Australian companies, and from the seasoning of the bonds in the wholesale market.

The initial XTBs covered bonds issued by Aurizon Holdings, BHP Billiton, Crown Resorts, Dexus Property Group, General Property Trust, Incitec Pivot, Lend Lease, Mirvac Group, Novion Property Group, Scentre Group, Stockland Trust, Telstra, Wesfarmers and Woolworths. The XTBs function in the same way as an exchange traded fund.

The latest listing of another 10 XTBs takes the total offering to 49 and the new XTBs are backed by bonds issued by ANZ, Bank of Queensland, Macquarie Bank, NAB, and Westpac. The green bonds that have been included are the ANZ June 2020 bonds and the NAB December 2021 bonds.

The ANZ June 2020 bonds carry a fixed coupon of 3.25 per cent per annum and based on their listing price, will yield 2.326 per cent per annum until maturity. The NAB December 2021 bonds pay a coupon of 4.00 per cent per annum and come with a prospective yield to maturity of 2.539 per cent per annum.

The ticker codes for these XTBs are YTMANZ and YTMNA1. The ticker codes for all XTBs begin with YTM typically followed by three letters representing the issuer of the underlying bonds.

Brokers such as Bell Potter and Morgans include the XTBs on their daily fixed income rate sheets. Each XTB has a face value of $100.00.

Philip Bayley is a former director of Standard & Poor's and now works as an independent consultant to debt capital market participants. He is associated with Australia Ratings.

Increasing demand for Australian minerals is already boosting commodities prices. If it continues, our trade deficit could be reversed quickly.

BY TIM TREADGOLD • EUREKA REPORT • 27 OCTOBER 2016

Watch for the dollar's commodities bounce

It's been three years since anyone worried about the Australian dollar being an economic headwind, rising so high against the US dollar that it damages the competitive edge of exporters.

Key Point

- ***The hidden story behind the latest commodities turnaround is that the Australian dollar will continue to rise, and it's not a stretch for it to top US90 cents.***

But what's happened recently to the price of coal, even if it is a short-term surge, and a similar unexpected rise in the price of iron ore, is coinciding with a rush of liquefied natural gas (LNG) shipments and could be the start of an export-led growth phase for Australia.

An upward trend in the exchange rate can already be seen, and significantly it runs parallel to the resource-sector recovery that can be traced back to mid-January – a time when the dollar was valued at US68.75c and the ASX mining index was at its low of 1639 points.

Since mid-January the mining index has rocketed up by 68 per cent to 2751 and the exchange rate has risen by 11 per cent to around US76.43c.

That rise in the exchange rate has largely been explained as a function of Australia having a more attractive interest rate regime than some other countries with a forecast rise in US rates tipped to push the Australian dollar down.

Important as interest rates are in dictating the flow of money around the world there is an offsetting force developing in Australia as the capital investment phase of the mining boom (now a bust) morphs into the entirely predictable surge in the volume of exports – or tonnes over the wharf to put it more simply.

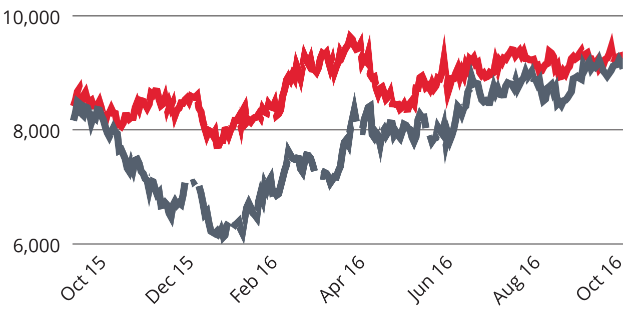
Missing from the resource-sector equation, until now, has been a price recovery to magnify the effects of volume increases – but that might be changing with coal an early warning of the latest turn in the commodity-price cycle.

Forecasts for the Australian dollar rising as high US90c are scarce, but there was one last week from the research director of the US-based Carlyle Group, Jason Thomas, during a visit to Australia.

With close to $US180 billion of assets under management around the world Carlyle is a close observer of exchange rates. And while Thomas's tips for the Australian dollar to reach US85c in the next five years, and perhaps as high as US90c, were based on the US dollar falling, the effect on Australian exporters who mainly sell in US dollars would be the same, whatever the cause.

Analysts at HSBC Bank have been quick to spot what is shaping as a significant improvement in Australia's trading position, telling clients last week that the "coal-price spike shifts the Australian story".

Chart 1: A close correlation



Mining/materials index Australian dollar (USD, RHS)
Source: Bloomberg, Eureka Report

"As we first noted last week the coal price spike could be a big deal for Australia," HSBC said.

"For the past five years, Australia's story has been about absorbing the negative income shock that came from the end of the commodity price super cycle and rebalancing away from mining.

> **While more evidence of a recovery is needed to start getting excited (or dismayed) about the prospect of a higher dollar itis worth looking at the trends which link trade and currency.**

"The lift in commodity prices changes the story. Nominal gross domestic product (GDP), corporate profits, tax revenue and wages growth, and maybe even CPI (consumer price index inflation) could all get a boost. Much depends on how long the price rise is sustained".

Westpac Bank has also noted the changing nature of the trade position as a long-running deficit in the trade balance fades rapidly from a peak of more than $4 billion a month early this year to $2 billion in August, before the effect of the coal-price rise had been felt.

UBS, an investment bank, went a step further late last week as the full impact of the spectacular rise in coal prices was factored into spreadsheets leading to a question: "trade surplus ahead?"

"With the trade deficit already halved this year to $2 billion in August, most of the (coal price) spike was after this. Indeed, given that the recent lift in coal is worth around $3 billion a month, the deficit will likely disappear in coming months, and could even be a surplus," UBS said.

Foreign ownership of many coal assets will trim the full effect locally but the impact of the coal-price rise could be significant.

While more evidence of a recovery is needed to start getting excited (or dismayed) about the prospect of a higher dollar it is worth looking at the trends which link trade and currency.

The last time Australia enjoyed a sustained run of trade surpluses was in 2009 and 2010, a time when the dollar was in the US90c range, heading for a 2011 peak of $US1.09.

We've got a long way to go to get back there, if ever, but it would be wise to keep a keen eye on currency markets as the commodity price-cycle turns in Australia's favour just as the volume-cycle reaches full pitch.