HEART Financial Advisers

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THE FIVE REASONS WHY THE $A IS LIKELY TO RISE FURTHER – IF RECESSION IS AVOIDED

INSIDE

KEY POINTS

- After a soft patch since 2021, there is good reason to expect the $A to rise into next year: it's undervalued; interest rate differentials look likely to shift in favour of Australia; sentiment towards the $A is negative; commodities still look to have entered a new super cycle; and Australia is a long way from the current account deficits of the past.
- There is a case for Australian-based investors to remain tilted a bit to hedged global investments but while maintaining a still decent exposure to foreign currency.
- The main downside risks for the $A would be if there is a recession or a new Trump trade war.

BY DR SHANE OLIVER

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Introduction

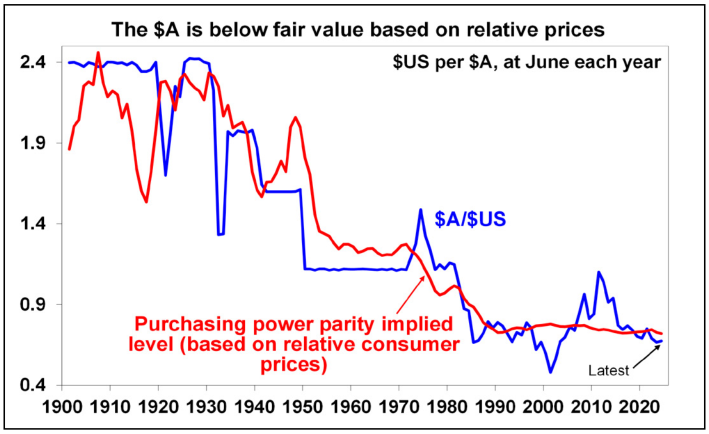
Changes in the value of the Australian dollar are important as they impact Australia's international export competitiveness and the cost of imports, including that of going on an

> **Way back in 1901 one $A bought $US2.40 (after converting from pounds to $A pre 1966), but it was a long downhill ride to a low around $US0.48 a century later.**

overseas holiday. They are also important for investors as they directly impact the value of international investments and indirectly impact the performance of domestic assets like shares via the impact on Australia's competitiveness. But currency movements are also notoriously hard to forecast. Late last year it seemed the $A was at last on a recovery path but it topped out in December and slid back to $US0.64. Lately it's been looking stronger again getting above $US0.67. So maybe the five reasons we thought would drive the $A higher in a note last November (see here) are at last starting to work?

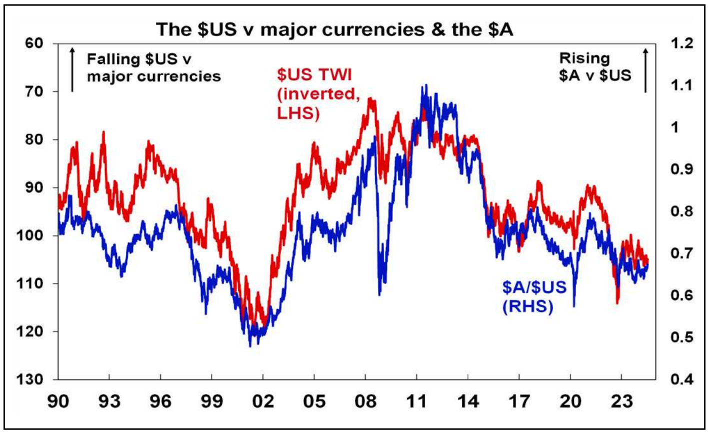
The $A has been weak since the mining boom ended

But first some history. Way back in 1901 one $A bought $US2.40 (after converting from pounds to $A pre 1966), but it was a long downhill ride to a low around $US0.48 a century later. See the blue line in next chart.



Source: RBA, ABS, AMP

Thanks to the mining boom of the 2000s, the $A clawed back to $US1.1 by 2011, its highest since the 1981. But since 2011, the $A has been mostly in a downtrend again briefly hitting a low around $US0.57 in the pandemic after which there was a nice rebound into 2021 up to near $US0.80 but with weakness quickly resuming. The key drivers of the weakness since 2011 have been: the end of the commodity boom; increasing worries about the outlook for China which takes around 35% of Australia's goods exports; a narrowing gap between Australian and US interest rates (which makes it less attractive for investors to park their cash in Australian dollars); and a long term upswing in the value of the $US generally. See the next chart.



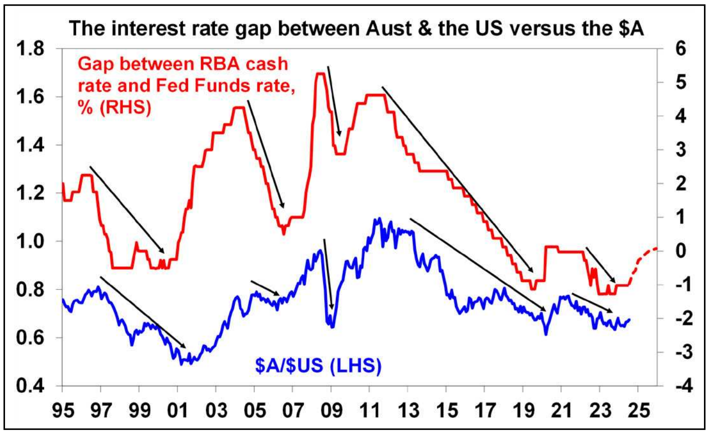
Source: Bloomberg, AMP

But there remain five reasons to expect the $A to rise

Back in November we saw five reasons to expect a higher $A. These largely remain valid and the $A seems to be perking up again.

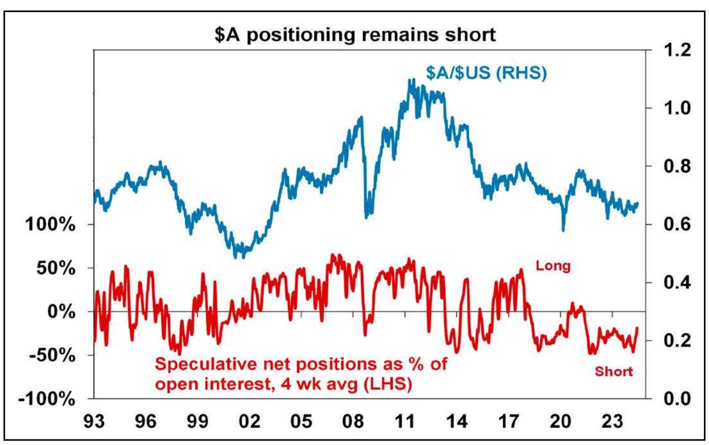
- Firstly, from a long-term perspective the $A remains somewhat cheap. The best guide to this is what is called purchasing power parity (PPP) according to which exchange rates should equalise the price of a basket of goods and services across countries – see the red line in the first chart. If over time Australian prices and costs rise relative to the US, then the value of the $A should fall to maintain its real purchasing power. And vice versa if Australian inflation falls relative to the US. Consistent with this the $A tends to move in line with relative price differentials – or its purchasing power parity implied level – over the long-term. This concept has been popularised over many years by the Big Mac Index in The Economist magazine. Over the last 25 years the $A has swung from being very cheap (with Australia being seen as an old economy in the tech boom) to being very expensive into the early 2010s with the commodity boom. Right now, it's modestly cheap again at just above $US0.67 compared to fair value around $US0.72 on a purchasing power parity basis.
- Second, after much angst not helped by another US inflation scare, relative interest rates might be starting to swing in Australia's favour with increasing signs that the Fed is set to start cutting rates from September whereas there is still a high risk that the RBA will hike rates further. Central banks in Switzerland, Sweden, Canada and the ECB have already started to cut rates. Money mar-

ket expectations show a narrowing of the negative gap between the RBA's cash rate and the Fed Funds rate as the Fed is expected to cut by more than the RBA. As can be seen in the next chart, periods when the gap between the RBA cash rate and the Fed Funds rate falls have seen a fall in the value of the $A (see arrows - and this been the case more recently) whereas periods where the gap is widening have tended to be associated with a rising $A. More broadly the $US is expected to fall further against major currencies as US interest rates top out.



The dashed part of the rate gap line reflects money mkt expectations.
Source: Bloomberg, AMP

Third, global sentiment towards the $A remains somewhat negative, and this is reflected in short or underweight positions. In other words, many of those who want to sell the $A may have already done so, and this leaves it susceptible to a further rally if there is any good news.

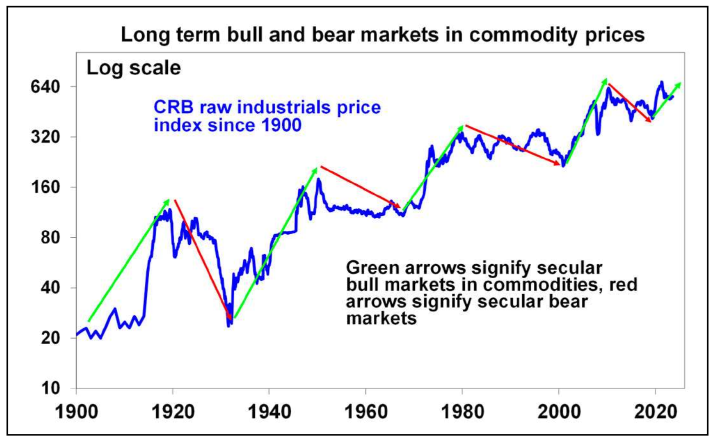


Source: Bloomberg, AMP

Fourth, commodity prices look to be embarking on a new super cycle. The key drivers are the trend to onshoring reflecting a desire to avoid a rerun of pandemic supply disruptions and increased nationalism, the demand for clean energy and vehicles and increasing global defence spending all of which require new metal intensive investment

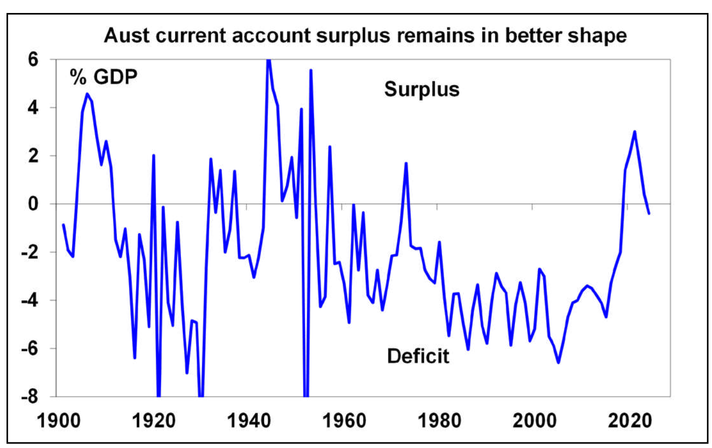
" Australia' current account surplus has slipped back into a small deficit as commodity prices have cooled and services imports have risen (particularly, Australian's travelling overseas) but it remains much better than it used to be over the decades prior to the pandemic.

compounded by global underinvestment in new commodity supply. This is positive for Australia's industrial commodity exports.



Source: Bloomberg, AMP

Finally, Australia' current account surplus has slipped back into a small deficit as commodity prices have cooled and services imports have risen (particularly, Australian's travelling overseas) but it remains much better than it used to be over the decades prior to the pandemic. A current account around balance means roughly balanced natural transactional demand for and supply of the $A. This is a far stronger position than pre-COVID when there was an excess of supply over demand for the $A which periodically pushed the $A down.



Source: ABS, AMP

Where to from here?

We expect the combination of the Fed cutting earlier and more aggressively than the RBA, a falling $US at a time when the $A is undervalued and positioning towards it is still short, to push the $A up to around or slightly above $US0.70 into next year.

Recession & a new Trump trade war are the main risks

There are two main downside risks for the $A. The first is if the global and/or Australian economies slide into recession - this is not our base case but it's a very high risk. The second big risk would be if Trump is elected and sets off a new global trade war with his campaign plans for 10% tariffs on all imports and a 60% tariff on imports from China. If either or both of these occur it could result in a new leg down in the $A, as it is a growth sensitive currency, and a rebound in the relatively defensive $US.

What would a rise in the $A mean for investors?

For Australian-based investors, a rise in the $A will reduce the value of international assets (and hence their return), and vice versa for a fall in the $A. The decline in the $A over the last three years has enhanced the returns from global shares in Australian dollar terms. When investing in international assets, an Australian investor has the choice of being hedged (which removes this currency impact) or unhedged (which leaves the investor exposed to $A changes). Given our expectation for the $A to rise further into next year there is a case for investors to stay tilted towards a more hedged exposure of their international investments.

However, this should not be taken to an extreme. First, currency forecasting is hard to get right. And with recession and geopolitical risk remaining high the rebound in the $A could turn out to be short lived. Second, having foreign currency in an investor's portfolio via unhedged foreign investments is a good diversifier if the economic and commodity outlook turns sour as over the last few decades major falls in global shares have tended to see sharp falls in the $A which offsets the fall in global share values for Australian investors. So having an exposure to foreign exchange provides good protection against threats to the global outlook.

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The Money Supply and Inflation Puzzle: What Every Retiree Should Know

BY WEALTH ADVISER

Introduction

Inflation is a pervasive economic force that can significantly impact the financial well-being of retirees. As prices rise over time, the purchasing power of savings and fixed incomes can erode, making it more difficult to maintain a comfortable standard of living. To effectively plan for retirement in an inflationary environment, it is crucial to understand the relationship between money supply and inflation. This article will explore the money supply and inflation connection, analyze current trends, and discuss strategies for generating inflation-adjusted retirement income.

The Money Supply and Inflation Connection

At the heart of the relationship between money supply and inflation lies the MV = PT identity. As explained by Warren Bird in his article "This vital yet 'forgotten' indicator of inflation holds good news," this economic identity states that the nominal value of goods and services produced in an economy (P, for prices, times T for real value of transactions) is equal to the amount of money (M) in circulation and how rapidly it circulates (V, for velocity). When there is excessive money supply growth beyond the capacity of the real economy to keep up, the result is rapidly rising prices for goods and services, or inflation.

Historical examples demonstrate the link between money supply growth and inflation rates. Bird notes that "the sharp increase in Australia's inflation rate in 2022 was both caused by and was predictable because of the surge in money supply growth during 2020." He argues that the Reserve Bank of Australia (RBA) was too slow to respond to the monetary evidence and that tighter policy should have been implemented earlier to bring money supply growth back to acceptable levels.

The Current State of Money Supply and Inflation

Recent trends in money supply growth and inflation rates have been a cause for concern among economists and retirees alike. As Michael O'Neill points out in his article "Inflation uncertainty makes retirement planning harder," when inflation resurfaces, predictions about its trajectory and the path of interest rates can change rapidly. Global inflationary forces, such as supply chain disruptions, geopolitical tensions, and the push to reduce emissions, have contributed to the current inflationary environment.

The Economist has described Australia as having the developed world's most entrenched inflation, with services inflation remaining particularly sticky and problematic. While there is hope that advancements in artificial intelligence (AI) could lead to increased productivity and deflationary pressure, the short-term impact of AI investments may actually contribute to inflation.

Implications for Retirees

Inflation poses significant challenges for retirement planning and income generation. As O'Neill explains, "The closer you get to retirement the more any investing missteps matter. It has always been hard for retirees to work out how much money they need to retire as there are so many variables -- investment performance, health, longevity, unexpected expenses -- the list goes on. Now, with the cost-of-living increasing more quickly, and high uncertainty when inflation will return to normal levels, the sum of money people need to save to live comfortably for the rest of their life, is even harder to estimate."

Retirees are faced with a dilemma: either take on greater investment risk to improve returns and stay ahead of inflation, or invest more conservatively but earn lower real returns and hope that inflation will come down quickly. Relying solely on market-linked investments for inflation protection can be risky, as historical data shows that it can take more than a decade for markets to recoup lost income during periods of high inflation.

Strategies for Generating Inflation-Adjusted Retirement Income

To navigate the challenges of retirement in an inflationary environment, retirees can employ several strategies to generate inflation-adjusted income. Social security benefits, which are indexed to inflation, provide a valuable foundation for retirement income. As Bob French notes in his article "How to generate inflation-adjusted income in retirement," "There are a lot of reasons to like social security, but from a financial planning perspective, one of the big ones is that your social security benefits are adjusted for inflation. However big of a piece of your social security benefits make up of your retirement income, you'll always be able to (roughly) buy the same amount of stuff with those benefits."

Beyond social security, retirees can explore annuities and other financial products that offer varying levels of reliability and inflation protection. Income annuities, for example, can be used in a "sequential" manner to top up reliable income over the course of retirement as the impact of inflation is felt. By using multiple annuities over time or partially annuitizing one annuity, retirees can maintain greater control over how their income level evolves to keep pace with inflation.

For those comfortable with a probability-based approach to retirement income, diversifying investments across stocks and bonds can help balance growth and stability. Historical data suggests that a well-diversified portfolio, such as a 60/40 mix of stocks and bonds, has a high probability of outpacing inflation over the long term. However, it is essential to recognize that there is always some risk involved, and no solution is perfect.

Conclusion

Understanding the relationship between money supply and inflation is crucial for retirees seeking to secure their financial future in an inflationary environment. By analyzing historical trends, current economic conditions, and the implications for retirement planning, retirees can develop strategies to generate inflation-adjusted income and maintain their desired standard of living.

A combination of social security benefits, annuities, and diversified investments can help mitigate the risks of inflation and provide a more stable foundation for retirement income. While no solution is perfect, and trade-offs must be considered, a well-informed and proactive approach to retirement planning can help retirees navigate the money supply and inflation puzzle with greater confidence and success.

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Our finances should enable and not dictate our lives

BY MARK LAMONICA, CFA

Republished from firstlinks.com.au

The most motivated and successful people take a problem, outline a solution, and relentlessly pursue it. This is a good model to achieve success. And following it creates momentum. It provides a sense of empowerment as obstacles are overcome. It is self-motivating as each milestone is achieved and each new one appears on the horizon.

The inherent flaw in this approach is that it assumes that the problem we are striving to solve will bring us the results we ultimately want. And we can lose that perspective during the relentless effort to make progress. We can fall into the trap of continuing to add new milestones in a misguided belief that if we can only reach them, we will achieve what we want.

We pursue wealth because we believe our problems will be solved by more money. And to be clear this is not the Communist Manifesto. I am not arguing against building financial assets. They can make a big difference in our lives. Having an emergency fund relieves the debilitating stress of living on the edge of poverty. Amassing wealth brings us material goods and experiences that bring us joy. But more than anything wealth buys time and freedom. Time to do what makes us happy. Freedom to dictate our own schedule and to walk away from jobs and situations that are harmful or make us unhappy.

In saying this I believe that after a certain level of financial security is established the thoughtless pursuit of a higher net worth is counterproductive. We shuffle through life attempting to add zeros to our bank accounts without pausing to ask ourselves if we are measuring financial success in the right way.

Not having 'enough'

Kurt Vonnegut brought his good friend Joseph Heller to a party on Shelter Island off the coast of Long Island in New York. Shelter Island is a popular and expensive location for second homes of the wealthy. At the party Kurt Vonnegut commented that the hedge fund manager hosting the party made more money in a single day than Heller had ever earned from his hit novel Catch-22.

Joseph Heller turned to his friend and said, "Yes, but I have something he will never have - enough."

This quote brings me back to one of those ordinary moments in life that we tend to mythologise into a defining occasion. What I am reminded of is the genesis of my financial philosophy.

I spent my high school years in a town named Greenwich which is a suburb outside of New York City. It was - and is - considered a desirable place to live and had the home prices to match. After I graduated Uni and started working, I had to commute to New York from my parents' house one day. I found myself standing on the freezing cold train platform at 6am glancing around at my fellow commuters.

They stomped their feet to stay warm and prepared to charge onto the always crowded train in the hopes of finding a seat for the 40-minute ride into Grand Central Station. This was likely followed by a 20-minute subway ride to Wall Street.

I couldn't help but think that the men and women on that platform had 'made it' in every conventional sense. They likely lived in expensive houses and had all the trappings of wealth along with the requisite high paying jobs needed to support that lifestyle.

The pathway those men and women took to that platform was probably similar. They worked hard to earn promotions and higher salaries. The higher salaries facilitated increased borrowing power. They financed a starter home and a car. Soon they had a bigger home in a better suburb with a nicer car in the driveway. Eventually they ended up in Greenwich.

Each step on this ladder meant more obligations. My interpretation of my brief time on that train platform and the myth I created in my mind was that these people were sacrificing freedom by not having 'enough'. This may have been their dream and I respect that. My caricature of people I don't know may come across as critical. But we can just as easily be motivated by what we don't want to become as what we do. And I wanted to follow a different pathway.

I saw the trappings of success simply as traps that kept those people coming back to that platform day after day. Buying the material possessions that denoted success including the big mortgage just seemed like a pathway to lock me into a life that I didn't want.

What I wanted was freedom. And I wanted to convert my labour into financial assets that enabled that freedom.

How does not having 'enough' impact our investing approach?

Not having 'enough' means we haven't properly defined our goals. And when it comes to investing our goals may be expressed in financial terms but they need to be aligned with our life goals.

I speak to a lot of investors. If I ask them about their goals, I repeatedly hear the same thing. They tell me they want to be rich. They tell me they want the most money possible. Fair enough. There are few people that would rather have less money than more money.

The issue is that when your goal is to have the most money possible it starts to dictate your actions. If you want the most money possible you should always be in the best investments. This mindset is counterproductive.

A goal of having the most money possible makes it more likely you panic when markets drop. It makes it more likely you fall victim to greed when markets surge.

It means you trade frequently because you are always trying to position your portfolio perfectly. It means you fall prey to recency bias and chase performance.

For most people the results are predictable. Returns are lower. Tax outcomes are worse. Transaction costs are higher. And ultimately this pursuit of the most money possible takes people to a very different outcome.

The larger issue is that this view of financial success drives the way many investors approach money. It ignores the true value of money as an enabler of security and happiness. Money and wealth are a means to an end. Treating it that way can change your relationship with money and the decision-making process for your own finances.

Why build wealth?

The real question for each of us is why we build wealth in the first place. And I had trouble articulating this for a long time. I just saw the pathway others pursued and I knew it wasn't for me. Eventually I came to the philosophy that continues to guide my own investing and view of my finances.

Many investors tend to think the biggest problem is finding the right investments to buy. This leads people down strange paths. They stare at stock charts trying to manifest the direction of prices. They sell in May and go away. They nervously await signs of a Santa Claus rally with more excitement than a kid on Christmas morning. They search for clues in each utterance by a central banker. In short, they do everything possible to make sense of short-term randomness.

I've developed a different view. My view is not for everyone. That is because each of us is different. What isn't different is the need to align our investing and financial approach to the lives we want. Our financial choices should enable our lives. Not dictate them.

My investing principals are the following.

1. My own vision of financial success is using my financial resources to enable freedom. To me this is freedom from worry and freedom from the burdens of committing time and efforts to things that aren't important to me - it is the freedom of choice. This is not synonymous with growing my net worth.
2. I focus on growing the portion of my salary going to discretionary spending. I don't use salary increases to fund

more fixed obligations and instead pay for experiences. I actively battle against lifestyle creep that doesn't bring me joy and simply resets my expectations for a life I don't want. This gives me choice over my spending which to me is true independence.

3. I use my savings and investments to provide cash flow. The more cash coming into my bank account the more options I have. Those options provide freedom. And I spend some of this money now on things I love like travel. This is why I'm an income investor and the value of my portfolio is a secondary concern. This has made me a better investor. I don't chase each shiny new 'can't miss' investment. Building an income stream takes patience as the incremental impacts of savings, dividend reinvestment and dividend increases work their magic. It keeps me focused on the long-term, tax minimisation and low transaction costs.

I understand that this concept is different from what we are typically told. We are told to focus on our net worth. To use debt as an enabler of acquiring more assets. To find tax minimisation strategies involving negative gearing to sacrifice current cash flow for a lower tax rate. To focus on growth investing when we are young and only worry about income when we are retired.

We are told someday this will pay off. Someday we will be able to sell our assets to fund the experiences we really want now. That when we sell those assets, we will still be young enough to enjoy the experiences they buy. And on we trudge, buffeted by the headwinds, towards an unappraised mirage of financial success.

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Q&A: Ask a Question

Question 1

I keep seeing on the news that inflation is recently quite high. How is high inflation impacting the value of my share portfolio?

It can significantly impact your portfolio in several ways. Firstly, it can lead to higher interest rates as central banks attempt to control inflation. Elevated interest rates increase the borrowing costs for companies, which can reduce their profitability and subsequently lower share prices, especially for companies with high debt levels or those in interest-rate-sensitive sectors like real estate or utilities. This environment can also dampen consumer spending, affecting retail and discretionary sectors negatively.

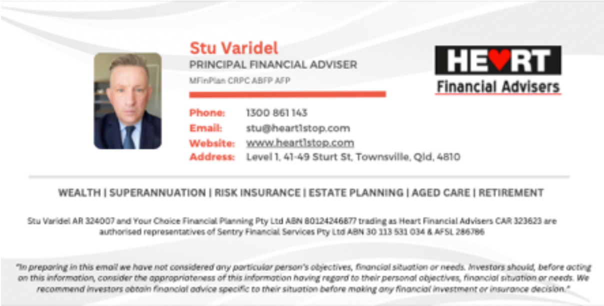
For shares specifically, a company that previously reported strong nominal earnings, but has not outpaced inflation then the real rate of return has reduced, leading to customer dissatisfaction and potential selloffs of their stock. Stock market volatility often increases in periods of high inflation, and this causes uncertainty about the future. In summary high inflation can adversely affect your share portfolio by increasing borrowing costs, eroding real earnings and dividends and requires careful risk management and diversification strategies to navigate successfully.

We strongly encourage you to speak with your financial adviser to ensure that your investment portfolio has been managed to consider inflation and can weather its effects. .

Question 2

My retired friend told me that he is receiving income from his super via an account-based pension. What is an account-based pension, and how do they work?

An account-based pension is a regular income stream bought with money from your super when you retire. It allows you to choose: how much you want to transfer to the 'pension phase' (subject to the balance transfer cap), the size and frequency of your payments (within the minimum or maximum allowed), how you want your super invested (through your fund).



The ATO prescribes minimum payment rates for account-based pensions. In FY25 if you are aged between 65-74 you must withdraw a minimum of 5% of your total super balance. There are many advantages but perhaps the most important is that investment earnings are tax free, and the returns are added to your account.

Please speak to your financial adviser to determine whether an account based pension is appropriate for your current financial situation, needs and objectives.

Question 3

My husband and I are planning to travel overseas for the next few years as part of our retirement. We have used an SMSF for our retirement funds but I recall there are issues with using one while living abroad. What are some things that we should be aware of?

If you plan to live overseas and you have an SMSF, you need to consider whether you can continue to manage it as a complying super fund. If your SMSF becomes non-complying, it may result in the loss of tax concessions, administrative penalties, personally and to your SMSF, and/or the forced wind up of your fund.

The main consideration while you are living overseas is your SMSF must meet the residency test rules. The SMSF's ongoing management, administration and decision making must usually be conducted in Australia. Trustees of the fund can temporarily perform this function outside of Australia for up to two years only. Returning to Australia briefly each year for one week won't satisfy the residency rule in relation to on-going management and decision making occurring in Australia

Another rule to be aware of, is the fund's active members must be Australian residents and they must hold at least 50% of fund assets (or at least 50% of the amounts payable to members). If you are thinking of moving overseas for an extended period, you do not want to risk breaching the rules and should seek professional advice about maintaining your residency status as failure to do so may result in income being taxed at the top marginal tax rate of 45% or SMSF assets being frozen.

If you have a question that you would like to see answered in **Wealth Adviser**, please send it through to **centraladvice@wtfglimited.com.**