logical financial management

# Logical Thoughts

## LATEST SUPER STRATEGIES TO REV UP RETIREMENT

Changes to the work test rules that came into effect from 1 July 2022 give more people the opportunity to utilise the tax advantageous structure of super, even if they are no longer working.

### Non-concessional contributions

From 1 July 2022 anyone **under age 75** can make non-concessional contributions without needing to work. Non-concessional contributions are personal or member contributions made on an after tax basis.

The amount of these contributions that can be made is limited based on:

- The contributions caps;
- The individual's Total Super Balance.

The contribution cap is $110,000 for 2022/23. Two future years' worth of non-concessional contributions can be brought forward to be able to contribute $330,000 over a consecutive three year period. A person's total super balance may also restrict how much they can contribute:

| Total Super Balance as at 30 June 2022 | Maximum possible contribution * |
|---|---|
| Less than $1.48m | $330,000 |
| $1.48m to under $1.59m | $220,000 |
| $1.59m to under $1.7m | $110,000 |
| $1.7m or more | $0 |

* Assuming no bring-forward period has previously been triggered.

## Personal Deductible Contributions

An individual may be able to make a personal contribution to super and claim a tax deduction for doing so. These can now be made up to age 67 (previously age 65) without meeting the work test. Between 67 and 75 a person must still meet the work test.

These types of contributions are counted as a Concessional Contribution (discussed further below) and are therefore capped.

The tax deduction will be denied if the person has insufficient taxable income to utilise the deduction, in which case that portion then is categorised as a non-concessional contribution.

## Super Catch-up Contributions

Generally, the concessional contributions (or pre-tax contributions) are capped at $27,500 pa. For some people, who haven't utilised their caps in previous years, they may be able to 'catch up' and contribute more than the single year cap.

As a refresher, concessional contributions include:

- Employer SG contributions
- Pre-tax salary sacrifice contributions
- Personal contributions claimed as a tax deduction

For 2022/23 the total of these contributions should not exceed $27,500. Concessional contributions are taxed by the super fund at up to 15% (and an additional 15% tax is applied to higher income earners earning over $250,000).

The eligibility criteria to make a contribution utilising carry-forward concessional contributions are fairly straight forward. The individual must:

- be eligible to make a super contribution, and
- have a total superannuation balance of **under $500,000** at the end of 30 June in the previous financial year, and
- have previously accrued unused cap amounts (since 1 July 2018) in one or more of the financial years preceding the year the concessional contribution is made, and
- make concessional contributions that equal or exceed the standard annual concessional contributions cap in that year.

The carry-forward concessional cap is automatically applied when a person makes a concessional contribution that exceeds their standard annual concessional cap, as long as they meet the eligibility criteria.

There is:

- No additional form to submit before making the concessional contribution
- No need for the super fund to be notified prior to making the contribution
- No additional processes involved to apply the carry-forward concessional rule

Carry-forward concessional contributions may enable a person to top up their super with concessional contributions, where they have spent time out of the workforce or previously couldn't afford to make additional contributions. In addition, they may provide strategic opportunities to make higher amounts of personal deductible contributions in financial years where they may have a higher level of taxable income, for example, due to assessable capital gains.

## Keeping Track of Contributions

The ATO online services site, accessible through myGov, allows you to look up your superannuation information such as the amount of non-concessional contributions remaining, carry forward unused concessional contributions and total superannuation balance.

Whilst the system is not perfect, due to delays in reporting of contributions, it is important to regularly check what the ATO have reported before utilising the above strategies.

## Bringing it all together

Olivia is age 65 and been retired for a few years. She held an investment unit which has just been sold and has proceeds of $800,000 and an assessable capital gain of $160,000. She has an account based pension with a balance of $450,000 and no other income. Her previous super contributions have been:

| Year | Concessional Contributions | Non-concessional contributions |
|---|---|---|
| 2017-18 | $7,000 | $30,000 |
| 2018-19 | $8,000 | $0 |
| 2019-20 | $4,000 | $130,000 |
| 2020-21 | $0 | $0 |
| 2021-22 | $0 | $0 |

Excluding Medicare Levy, the tax payable on the capital gain from selling the investment unit will be $44,267. Olivia is thinking she will invest the funds in her personal name in term deposits. She would like to know how much of the $800,000 proceeds can be put into super.

Olivia could:

- Utilise her catch-up contributions and make a personal deductible contribution to super of $111,000. This will reduce her taxable income to $49,000 ($160,000 - $111,000) and her personal tax payable to $6,392. Contributions tax will be a maximum of $16,650.
- Make a non-concessional contribution of $110,000 this financial year.
- Make a non-concessional contribution of $330,000 next financial year.
- Use the new super balance to commence an account based pension.

Benefits of the strategy:

- Total tax saved on the sale of the investment unit = $23,445 ($21,225 in PAYG tax plus $2,220 in Medicare Levy)
- Total amount contributed to super = $551,000
- Ongoing tax savings each year by having the additional amount in an account based pension where the income and capital gains are tax free, instead of invested personally where income is taxed at marginal tax rates.

**Tips & Traps!**

- The order of the contributions is important. If Olivia makes the non-concessional contribution of $330,000 this financial year, she cannot make any further contributions over the next two financial years. If she made the $110,000 non-concessional contribution this year, she could make the $330,000 next FY.

- Whilst next financial year Olivia has scope to make concessional contributions of $27,500, she is not working so can't salary sacrifice. Nor does she have any other taxable income to utilise a personal tax deduction on a super contribution.

- Olivia cannot add the contributions to her existing account based pension. However she could open a new super account to make the contributions into, and then rollover both the new account and existing account based pension together to create a new account based pension.

# TIGHTENING INTO A SERIOUS DOWNTURN

## Background

A rally in both public equity and bond markets in July and the first half of August did not last, it was a false start, and prices across the globe resumed their slide in the second half of August and through to the end of September, hitting year-to-date lows.

The prime reason for these drops has been the likelihood that interest rates will tighten more than previously expected...and quicker, as inflation in most countries proves to be more persistent than central banks and investors thought.

The slide in global markets gathered pace late in September as the UK Government announced tax cuts that sent the sterling to a record low and UK gilts (bonds) sold off heavily with the Bank of England intervening to stabilise the country's financial system (gilt market which was threatening the financial problems for UK pension funds).

In this October 'Logical Thoughts' we will delve further into inflation and interest rates, the UK Government 'mini-budget' policy missteps and what we consider the great unknown but may yet cause the next step down in financial markets…. quantitative tightening (QT). We conclude with some comments and implications for our clients.

## 1. Inflation and interest rates push markets lower

In an effort to slow down inflation, Central banks around the world continue to aggressively lift interest rates, leaving investors nervous about the impact this will have on financial markets and global economies.

The main concern is that investors and Central Banks have been unable to quantify the change in inflation and seem at loss when it comes to where inflation might go after the next three months.

This was highlighted by the release of the United States (US) August 2022 inflation numbers. Of particular concern and unexpected by investors was the following:

- US core inflation rate exceeded the monthly average of the past year;
- The rise was broad based across various core inflation components (energy services, food, medical care and shelter/owners' equivalent rent);
- Inflation was embedded in components outside the control of central banks.

The 'data dependent' US Federal Reserve Bank (US Fed) reacted to these inflation numbers by lifting rates by 0.75% to 3.0-3.25% range. However, the Fed's maintained their hawkish stance (will continue to lift interest rates) which weighed heavily on markets in September.

The Chairman of the US Fed, Jerome Powell's comments that there "isn't a painless way to get inflation down," that "the housing market may have to go through a correction," and that there will "very likely be some softening in the labour market" all point to a clear effort to change the market's mindset and flush out any hope of a change in interest rate policy i.e. they will cease lifting interest rates.

The interest rate outlook in the US is that November is now expected to see another 0.75% hike, with 0.50% more in December and 0.25% in February. **This implies rates peak at 4.5% to 4.75%.**

The US Fed also increased their expected unemployment rate at the end of 2023 from 3.9% to 4.4%. Such a move would be consistent with a recession, **suggesting that they are prepared to keep hiking rates into a recession.**

The market's fear is that the pace of hikes is too quick to be able to assess their impact and the Fed is therefore making a significant policy mistake that sends the economy into recession and may trigger some form of financial shock. In response, the Fed is saying this is not a mistake. Rather, it is what needs to happen to solve the inflation problem.

### *UK tax cuts results in rare Bank of England intervention – policy misstep?*

What happened?

A UK government 'mini' budget triggered the rout and demonstrated the currently fragile state of the financial system. The Bank of England (BoE) launched an emergency UK government bond-buying plan – to prevent borrowing costs from spiralling out of control and stave off a "material risk to UK financial stability" and maintain the solvency in the pension fund system.

The BoE said it was stepping in to buy up to £65 billion worth of government bonds – known as gilts – at an "urgent pace", after fears over the economic policies of new Prime Minister Liz Truss and her finance minister Kwasi Kwarteng sent GBP sterling tumbling, and sparked a sell-off in the gilts market.

The market turmoil had forced pension funds to sell government bonds to head off worries over their solvency – but this threatened them with severe losses and also created a downward spiral in gilt prices, as more were offloaded.

### *What triggered the intervention by the Bank of England?*

The scale of fiscal stimulus in the new UK Chancellor's "mini" budget went beyond most expectations (inflationary). The biggest package of unfunded tax cuts in half a century.

The government will spend GBP45bn*. Most expected something in the order of GBP30bn. This comes on the heels of the energy pricing policy freeze, which is expected to cost at least GBP60bn in its first year.

This largesse has been widely condemned on the premise that such strong fiscal expansion in an inflationary environment will only force the BoE to raise rates more aggressively.

UK government bond yields surged 35-50bps across yield curve in short order. The UK 5-year bond was yielding below 2% on 15th August and is now 4.15%. This highlights perfectly why government bonds in general are showing on paper capital losses...*why buy a bond for 100 par value paying 2%, when you can buy new bonds being issued at 100 par value at 4.15%. Hence the 2% bonds trade on the market at a substantially lower price to reflect an equivalent yield of 4.15% marked to market (hope that makes sense?).*

**The broader fear is loss of confidence in the UK. This is reflected in currency markets, where the GBP fell 5% against the USD over the week to reach record lows.**

### *Issues with UK Pension Funds*

The issue is many UK pension funds hold their long-dated exposure via synthetic 30-yr government bonds. This theoretically matches their long-dated liabilities. The problem is that there is a liquidity mismatch. When the bonds start falling, the funds are forced sellers of bonds to raise the liquidity to meet the margin call. This was reinforced by broader positioning in the market.

At one point the UK 30-year bond had fallen almost 50% in value since August, with the yield rising from 2.5% to north of 5.0%.

The BoE intervened, promising to buy bonds to ensure the market was functioning. Their quantitative easing (QE) did the job, with UK 30-yr yields rallying back to 3.8% yield by the end of week. It also saw the British pound bounce back from 1.05 to 1.11 versus the US dollar. This coincided with a broader fall in the latter.

**The high income tax cut (only a small component of overall package) just rescinded overnight and thus GBP has now recovered further.*

## 2. The big unknown - Quantitative Tightening (QT)

While most of the focus is on interest rates, one should not ignore what is happening in the unconventional monetary policy sphere – that of quantitative tightening (QT) – the shrinking of the Fed's balance sheet. Recall the massive expansion of the balance sheet between 2020 and 2022, which saw total assets increase from US$4.2 trillion in January 2020 to a

peak just shy of US$9 trillion in April 2022, provided the oxygen that ignited markets and fuelled significant gains in risk assets including equities, bonds, and residential housing.

In May, the New York Federal Reserve projected the US Fed would shrink its balance sheet by US$2.5 trillion by 2025. If that transpires, **it will be tantamount to a de facto increase in interest rates of around 3.0%, in addition to the increase in rates via conventional methods.**

With the surprise strength of inflationary forces, the price-agnostic buying of US Treasuries and mortgage-backed securities has ceased and the great unwind has started but is in its infancy. The intentions to shrink the balance sheet, to which the Fed is committed, are yet to be reflected in asset prices, but eventually they will, perhaps painfully. The punch bowl has been removed. The previous quantitative easing (QE) buying significantly reduced liquidity in the bond markets and forced institutional investors out of a traditional market to fund riskier enterprises.

Remember, the Fed has little idea on how QT will play out. Uncharted waters present risk, even for the world's largest central bank. Manipulation of bond prices and yields by the sheer weight and commitment of unparalleled price-insensitive buying can deliver a planned outcome. The reverse behaviour is likely to be much more difficult and deliver an unwanted outcome.

With increasing supply of bonds from the US Treasury to fund a stretched government and in the absence of major buyer (the Fed), meaningfully higher bond yields are a possible outcome. **Higher bond yields are not a friend of risk/growth asset valuations.** The Fed must be careful to remove liquidity from the financial system without impacting the banking sector or the housing industry, which is already reeling from rising mortgage rates.

## 3. Summary Comments

These are some of the major issues confronting global financial markets in the months and years ahead.

- We are experiencing significant and simultaneous declines in both bond and equity prices with better support found in real assets and cash. We believe bonds are better value now and investors should be rewarded in the next 12-24 months as bonds mature at par value and new bonds are purchased at much higher yields.
- Central banks have underestimated inflation and are now attempting to put the inflationary genie back into the bottle even if this means driving their economies into recession.
- We are now witnessing Governments like the UK attempting to somewhat offset higher interest rates (monetary policy) with higher Government spending (fiscal spending). The problem is that this type of spending further fans inflation (known as demand-pull inflation) because government spending is a component of aggregate demand via what is known as the multiplier effect.

- Do not ignore what is happening in the unconventional monetary policy sphere – that of quantitative tightening (QT) – the shrinking of the Fed's balance sheet. If that transpires, it will be tantamount to a de facto increase in interest rates of around 3.0%, in addition to the increase in rates via central banks.
- The US has already experienced a technical recession, and it is just convenient to say it has not. The only reason the Fed would cut rates in 2023 is because the economy would be in recession…and not just a mild one.
- Bond yields hitting new highs for the cycle. The ten-year yield is at decade highs for the first time in forty years, perhaps signalling a regime shift. Higher interest rates means lower valuation ratings and the US equity market is still sitting at higher-than-average Price to Earnings ratios. This means valuation is not a supportive factor.
- Key equity markets in Europe have already broken to new lows and may potentially lead the US down.
- Market breadth remains wide as the index falls. Typically trend shifts are preceded by narrowing markets, which we are yet to see.
- Volatility hasn't yet spiked to levels normally seen near a market bottom.

## 4. Implications for our clients

While investment professionals can speculate on where financial markets will end in 2022 and go in 2023, the simple truth is they don't know the answer. Risks are highly elevated.

However, clients at Logical with intelligently diversified investment portfolios containing multiple asset classes and quality investments should maintain focus on their investment objectives and time horizon for investment.

At Logical, we focus on investing rather than 'trading'. It is during periods of sustained equity and debt market stress where we expect asset classes such as alternatives and unlisted real assets to come to the fore as well as holding higher levels of cash and the like. It is also worth remembering that during periods of high investment market volatility, active investment managers thrive by adding to positions or buying new positions in companies that they wouldn't have whilst prices were higher. Or in some cases these managers can profit by "short selling".

We design and implement bespoke portfolios dependent on the specific requirements we are given.

For example, for those living off investment income, say in retirement, we expect your annual income needs should be largely if not all covered by the investment income generated by your portfolio (including franking tax credits) and it is unlikely that drawdowns of lump sums will need to be made (unless for specific purposes…or living outside ones realistic means and portfolio capability).

We expect these portfolios to continue to generate similar levels of investment income over the next 12 months plus franking tax credits.

For those accumulating for some years prior to needing to rely on personal wealth to support lifestyle, reinvesting your investment income distributions and dividends provides a great opportunity to purchase additional units or shares at lower prices, which means that when the eventual recovery returns, these portfolios recover far quicker in value. We have already seen this strategy in play for 2022 with great success and portfolio investment income is strong but capital values have fallen.

Ultimately, the key to success is understanding the investment strategy employed and agreed upon and then maintaining discipline through good times, indifferent times and bad times…however uncomfortable it may be in the short term.

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