# Firstlinks
a Morningstar company

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### Contents

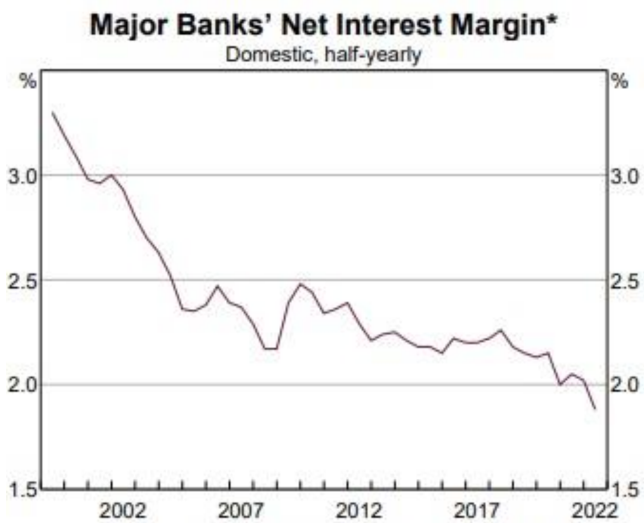


### Editorial

If you are wondering whether bankers are really so mean as to withhold interest rate increases on deposit accounts to make more profits, the answer is yes. I have sat on the Pricing Committees of three banks and this is a time to restore bank margins. I can quote **John Maynard Keynes** because I was a 'banker' for 20 years, and some of our pricing decisions were embarrassing and even nasty and took advantage of what we called 'retail inertia' (the decisions rather than the people were nasty).

*"Capitalism is the extraordinary belief that the nastiest of men, for the nastiest of reasons, will somehow work for the benefit of us all."*

The vast majority of depositors either don't know how much their accounts earn or can't be bothered to change and hundreds of billions of dollars sits in savings regardless of the rate paid. The bankers take advantage of this and (as we used to say) 'milk' the basic transaction and savings accounts. In 2021, when cash and term rates fell to almost zero, there was nowhere to go on deposit accounts as rates could not move negative. At the same time, competition in the mortgage market intensified, and these factors drove a margin fall which the banks will now recover.




* Data for a given period relate to banks' public profit reports released in that half; IFRS basis from 2006, AGAAP prior; excludes St George Bank and Bankwest prior to the first half of 2009.

Sources: Banks' financial reports; RBA

On the loan side, the five largest banks took little time on Tuesday this week to pass on the 0.25% cash rate increase into their variable rate mortgages. These major pricing decisions are always approved at Managing Director level, but the Pricing Committees were ready to press the button with pre-approval for whatever the Reserve Bank decided.

Depending on competition and success in holding back deposit rate increases, the major banks should be able to extract about 0.1% margin improvement for every 0.5% increase in the cash rate. Equity investors have flocked back to bank shares this week, not only due to expected margin improvements but also confidence that bad debts will not rise in a recession.

The interest rate on my SMSF's transaction account, which is holding more cash than ever, confirms I must find another home. Based on conversations during my presentation to the **Australian Shareholders Association** a couple of weeks ago, many SMSF trustees are in the same boat, holding lots of cash. Everyone needs to check their rates.

The Reserve Bank cash rate is now 2.6%, yet my bank is paying zero for balances below $10,000, and 0.7% to 0.8% for amounts below $100,000.

| Balance | |
|---|---|
| Up to $9,999.99 | N/A |
| $10,000 to $19,999.99 | 0.40% p.a. |
| $20,000 to $49,999.99 | 0.70% p.a. |
| $50,000 to $99,999.99 | 0.80% p.a. |
| $100,000 to $249,999.99 | 1.25% p.a. |
| $250,000 to $499,999.99 | 1.50% p.a. |
| $500,000 and over | 1.65% p.a. |

Of course, the banks will say there are alternatives, but they often come with well-designed hurdles to reduce their cost. Take the **CBA Goalsaver** account, which pays a decent 2.1% on all balances. However, nearly all of it depends on depositor behaviour and earning a 'bonus':

*"Earn a variable bonus interest rate when you grow your savings balance each calendar month (excluding interest and bank-initiated transactions) ... The standard variable interest rate of 0.15% p.a. will apply if you don't meet the bonus interest conditions."*

Make one withdrawal which reduces the monthly balance and there goes the 2%. Same with **NAB's iSaver**. It starts out well with an 'introductory' 2.3% for four months, but remember that 2.3% for four months is only 0.76% per annum. Then reality kicks is as the 'bonus' is lost:

*"0.85% p.a. base variable rate + 1.45% p.a. fixed margin for 4 months. After 4 months, the base variable rate of 0.85% p.a. will apply."*

NAB has said its deposit rates are "*under review*" - yes, with a plan to not do much - and no rates were increased at the same time as the loan rate announcements.

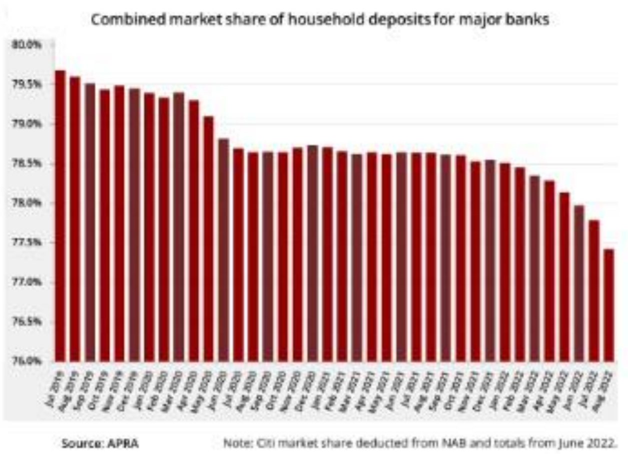
**Macquarie Bank** is moving more into the retail space with a new Savings Account and a 'welcome rate' of 3.7% for four months, but only on the first $250,000. Then it reverts to 2.75% or 2.35% for up to $500,000 and a miserly 1.5% over $1 million. It is, of course, only available to new customers. Banks do not reward loyalty.

**ING Bank** is expected to grab headlines with a new savings rate this week at around 4%, but there will be rules including making at least five card transactions a month and depositing $1,000 each month.

None of this happens by accident, and it's not a way to encourage people to save more, however it is presented. It's designed to attract new deposits without paying existing savers, and then making sure those new customers do not cost too much. For savers, it's time-consuming to shift money around every few months or monitor whether their account will earn a 'bonus'.

Of course, there are smaller banks more reliant on the retail market and depositors are protected by the Financial Claims Scheme guaranteeing $250,000 per person per institution. Unfortunately, banks like **Judo** and **MyState** are more competitive in term deposits (such as a decent 3.6% for 12 months) which reduces liquidity if the money is needed quickly for another investment. There is also the pain of going through an account-opening process with all the ID and paperwork.

According to the newsletter **Banking Day**, the four majors are deliberately conceding ground on deposits to preserve margins, as shown in their share of household deposits.




Banking Day says:

*"In August two of the major banks – Westpac and ANZ – suffered a net outflow of deposits as savers chased better deals at other institutions. According to APRA data, Westpac's total deposits base contracted by more than A$3 billion in August while ANZ lost more than $2 billion of deposits."*

More than at any time for at least 10 years, savers should take an active decision on their cash. Don't wait for your bank to meet the market, and the incentive to move will only increase. Despite the Reserve Bank slowing the pace of rate increases this week, the cash futures rate for mid-2023 is still around 3.6%.

**In this week's edition ...**

The majority of Firstlinks' readers have no intention of applying for the age pension, as our research shows a high proportion of self-funded retirees in our audience. The pension is not a level of retirement income to aspire to. However, most Australians will receive a full or part pension for many decades to come, and many older retirees worry about 'running out of money'.

What if, when a couple became eligible for the age pension, the Government offered a choice of $1 million or the current pension rate? Seems an easy decision - become an instant millionaire. Yet it's close to a line ball decision mathematically based on demographics, as the full age pension for a couple is over $40,000 a year forever, plus many other benefits and concessions. For a couple that also owns their own house and can access the equity in it, they are overstating the fear of actually 'running out of money'.

**Kaye Fallick** is more concerned about the lack of education, as many retirees are not receiving the financial skills and access to advice needed to take advantage of pension and superannuation opportunities. She asks what happened to all the schemes of the last 20 years that were supposed to help.

Along similar lines, **Tim Howard of BT Financial Group** checks in with his advisers to find the most-common topics for discussion with clients in recent months. These five items show the benefits of advice and why retirees need to know what is available. In the context of the first article above, it's good to see home equity access on the list. Is it finally coming out of the shadows as a retirement income device?

Then two articles from leading fund managers on how they identify companies and construct their portfolios.

**Marcus Burns and Matthew Booker of Spheria** look at how bubbles develop, especially in small listed companies, and how to avoid these overvalued companies whose share prices are more about hype than profits. And **Brad Kinkelaar of Barrow Hanley** describes why value investing has recovered ground in the last year and the sectors he is investing in.

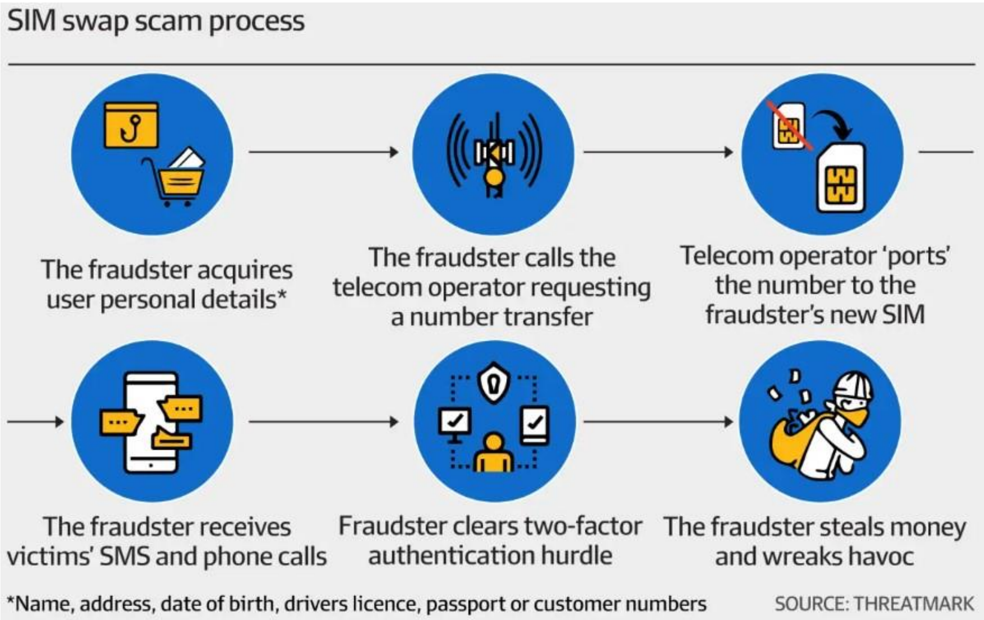
Central bankers and investors are hoping high energy prices will be transitory, but what is happening in Europe and the consequences over a cold winter show the reliance on Russia for gas was a terrible mistake. **Michael Collins** explains why energy prices will stay higher for longer.

And still on global geopolitics, **John West** looks at Australia's most important trading partner, China, and reviews the power of its political elite. China will hold only the 20th National Congress of the Communist Party in a few weeks' time on 16 October, but not everyone will be happy to extend Xi's term of office.

This week's White Paper is from **Cromwell Property Group**, explaining how ESG principles can guide investment decisions in commercial property, especially within a reuse-adapt-develop framework.

Finally, the **Optus** hack is a warning about online security, and we all need to focus more on password management and two-factor authentication (2FA). However, a security specialist sent me this graphic explaining how a fraudster acquiring personal details can arrange for the 'second factor' (such as receiving a code on a phone) can be sent to another phone. It's why access to personal details is especially worrying.

**Graham Hand**



## Homeowner retirees should not 'run out of money'

Graham Hand

When an Australian couple becomes eligible for the age pension, it's almost equivalent to the government handing them $1 million, plus other benefits. While top of the list of worries for many retirees is that they will 'run out of money', what many really mean is they will not have enough money for the lifestyle they want. A homeowner receiving a full pension and access to home equity should not literally 'run out of money'.

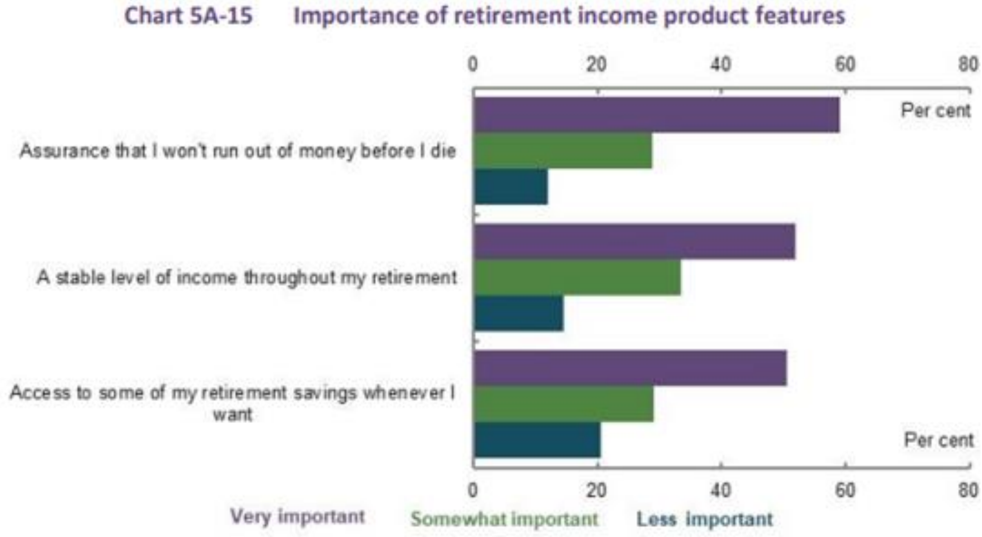
The fear leads to underspending in retirement with most people dying with a substantial amount of their wealth intact. The Retirement Income Review Final Report in July 2020 reported (page 432):

*"Data provided by a large superannuation fund found members who died left 90% of the balance they had at retirement. Another study found a similar result: at death, age pensioners leave around 90% of the assessable assets they had at the point of retirement."*

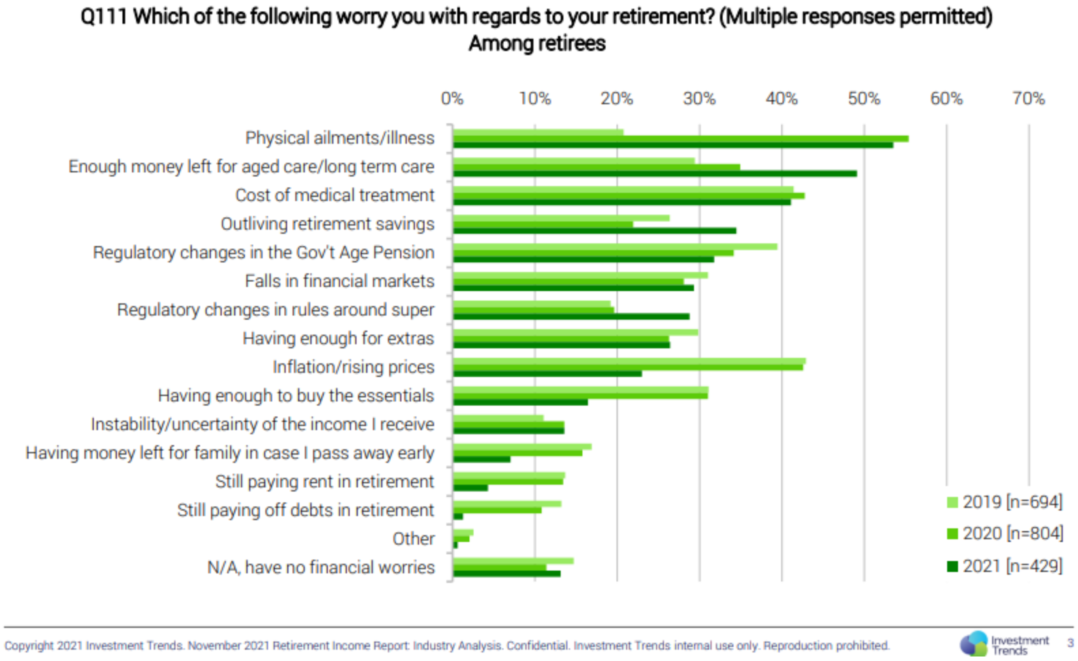
A study by Allianz Retire+ claimed 61% of people fear running out of money more than they fear death. However, the age pension system, concessions on services, access to free or low-cost health care and home equity release schemes provide a significant backstop for retiree homeowners. These are not factored in sufficiently when they fear their own money dwindling.

But it remains a common concern. The Retirement Income Review included a survey of over 1,000 people over the age of 55, who identify "*Assurance that I won't run out of money before I die*" as the main reason they may consider retirement income products.

In research by Investment Trends, '*outliving retirement savings*' ranked fourth among retirement worries, nominated by about 35% of respondents in 2021, after medical issues and aged care.




More than 1,000 survey respondents aged 55 and over. Source: (Mercer, 2019a, p. 3).



**The retirement income system**

Australia has a complex retirement income system but it is commonly recognised as comprising three components:

1. Age pension, means tested and funded by the Federal Government
2. Superannuation, privately managed with mandated savings
3. Voluntary savings

Given that well over 80% of people over the age of 65 own their home outright, access to the equity should be part of a retirement income discussion.

4. Accessing equity in a family home.

A common mistake in thinking about the age pension is the belief that its purpose is to provide a minimum standard for Australians with limited financial resources. In fact, it is increasingly a supplement in retirement for middle-income earners, with most pension recipients expected to receive a part-pension rather than full pension in future. Furthermore, the majority of Australians will still receive an age pension by 2060 despite the growth of the superannuation system.

**What are the age pension limits and payments?**

Full details of pension rates are on the Department of Social Security website.

Following the latest indexation of pensions in September 2022, the maximum rate rose to $1,026.50 a fortnight for singles and $1,547.60 for a pensioner couple, including pension and energy supplements. **A couple receives an annual pension of over $40,000 a year.**

Most people enter retirement as a couple, and provided the value of their combined assets excluding their own home (see Services Australia for full definitions) is less than $419,000, they will be eligible for a full pension.

Allowances are even more generous on some assets. For example, generally only 60% of the purchase price of a lifetime income stream (such as a lifetime annuity) counts as an asset until age 84, and then only 30% is assessable.

To receive a part pension, their assets (excluding the family home) cannot exceed the levels shown in the second table (right).

Therefore, a retired couple meeting other age (between 65.5 and 67 years old depending on birth date) and income tests can hold up to $935,000 in assets in addition to their family home and still qualify for the age pension.

While it's not a formula for regular business class travel, a new car every couple of years and fine dining each week, owning a home of unlimited value and nearly a million of other assets and still receiving some pension and related benefits seems a decent deal from our social security system.

**Asset levels for full age pension eligibility**

| Your situation | Homeowner | Non-homeowner |
|---|---|---|
| Single | $280,000 | $504,500 |
| A couple, combined | $419,000 | $643,500 |
| A couple, separated due to illness, combined | $419,000 | $643,500 |
| A couple, one partner eligible, combined | $419,000 | $643,500 |

**Asset levels cut offs for part age pension eligibility**

| Your situation | Homeowner | Non-homeowner |
|---|---|---|
| Single | $622,250 | $846,750 |
| A couple, combined | $935,000 | $1,159,500 |
| A couple, separated due to illness, combined | $1,103,500 | $1,328,000 |
| A couple, one partner eligible, combined | $935,000 | $1,159,500 |

**What is a full age pension worth?**

The age pension is a fortnightly payment from the Federal Government, indexed to inflation for life:

*"Indexation occurs in line with increases in the Consumer Price Index (CPI), either yearly or twice yearly. The Pensioner and Beneficiary Living Cost Index (PBLCI) is used to adjust maximum basic rates of pension where movement in the PBLCI is greater than movement in the CPI for an indexation period."*

The calculation of its value is potentially complex and I asked leading actuary, David Knox of Mercer, for a 'back of the envelope' estimate. David replied:

*"Let's keep it simple. The full age pension for a single person is now $26,781. As you know, the age pension will be payable from age 67 from 1 July next year. So for most people who are not yet 67, this is the relevant eligibility age. According to the latest UN data published this year, the current life expectancy for an Australian aged 67 is 20.1 years. It will continue to increase in future years.*

*The age pension is currently indexed to wages or prices so it keeps increasing and we also need a discount rate. Although we can debate the appropriate discount rate, a simple approach is to let the future increases cancel out the discount rate, so that in real terms the pension stays as its current value.*

*Therefore the current value of the future age pension for a single person now aged 67 is $26,781 times 20.1 which is $538,291; or to express in more general terms, the value of the full age pension for a single person is in the order of $540,000."*

Using the same logic, the pension for a couple of $40,237 is worth about **$808,000**, or over 30 years about **$1.2 million**. David's argument of not requiring a discount rate because the payment is indexed is a simple and elegant way to make the calculation.

Therefore, in financial terms, the age pension for a couple is akin to being handed about $1 million on eligibility date, plus other benefits.

**Maximising income in retirement**

The Retirement Income Review, page 133, stresses the need to consider not only the age pension but:

*"Retirees receive a broad range of non-monetary supports, including social transfers in kind, that reduce the level of income required to achieve a particular living standard. When assessing retiree poverty, these supports should be taken into account, including whether retirees are using their assets to fund their retirement. Otherwise, asset-rich households may be counted as 'living in poverty'."*

As Noel Whittaker advises in his tips on earning a pension, while the home is not assessable, furniture, fittings and vehicles are. However, many pensioners make the mistake of valuing them at cost or replacement value, when a 'garage sale' value is fine. As such sales achieve poor results, furniture might be worth only $5,000, nowhere near their cost.

Since every $10,000 of excess assets above the minimum above reduces the pension by $780 a year, the cost of reporting higher asset values than necessary can be significant.

In addition, age pensioners may receive other payments, such as:

- Commonwealth Rent Assistance
- Carer Allowance and Carer Supplement
- Mobility Allowance
- Pensioner Education Supplement
- Family Tax Benefit, if they have dependent children in their care.

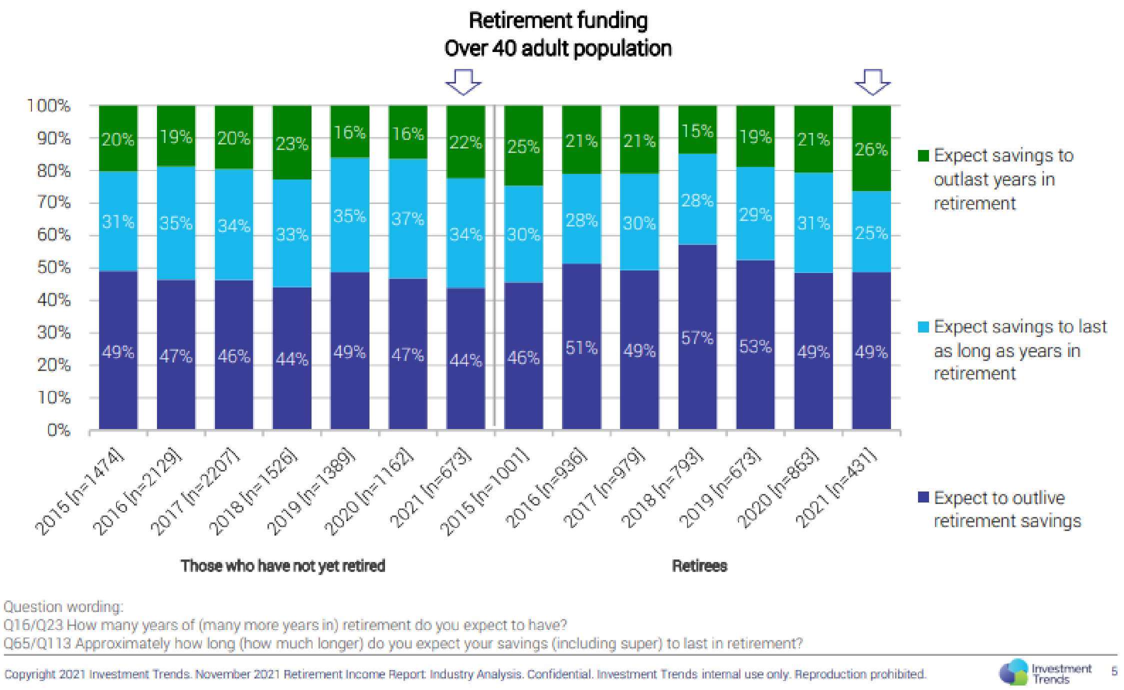
With a Pensioner Concession Card comes a range of other entitlements, including:

- Gas rebate
- Electricity rebate
- Water rebate
- Council rate discount
- Drivers licence and registration concession

Free or subsidised health and aged care services support Australian retirees. Brendan Ryan of Later Life Advice writes an annual checklist in Firstlinks which documents the many benefits from holding a Pensioner Concession card or Commonwealth Seniors Health Card.

**Outliving retirement savings**

In further research by Investment Trends, about 50% of retirees expect to outlive their retirement savings, and the majority of those expect to become dependent on the age pension. While this is not something to aspire to, the social security system protects them.




## Income from home equity access schemes

According to research by National Seniors and Challenger, 85% of retirees outright own their own home, while an additional 7% own a home with a mortgage. Ownership rises with age, as this chart from the report shows.

The home is usually the most valuable asset of the retiree and it needs to be considered in any discussion of retirement income.

The two major benefits of owning a home in retirement are avoiding:

- eviction at the end of short leases, and
- rental payments which can rise on landlord demands.

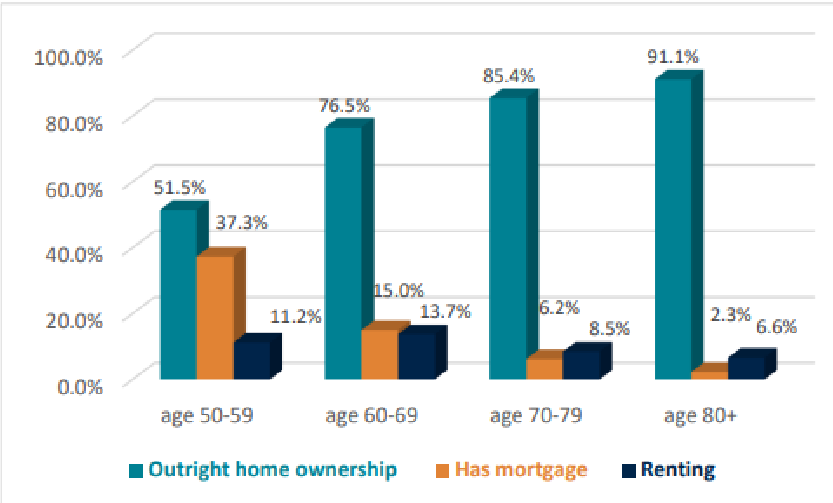



*Figure 10. Home ownership according to age group (n=3020).*

In addition, the equity in a home can be accessed as tax-free retirement income through reverse mortgage schemes, such as offered by the Federal Government in the Home Equity Access Scheme (HEAS). A feature of these schemes is that a lump sum or income stream can be arranged with payment of the loan deferred and paid from the estate after death of the retiree. HEAS is administered by the Department of Human Services through Centrelink.

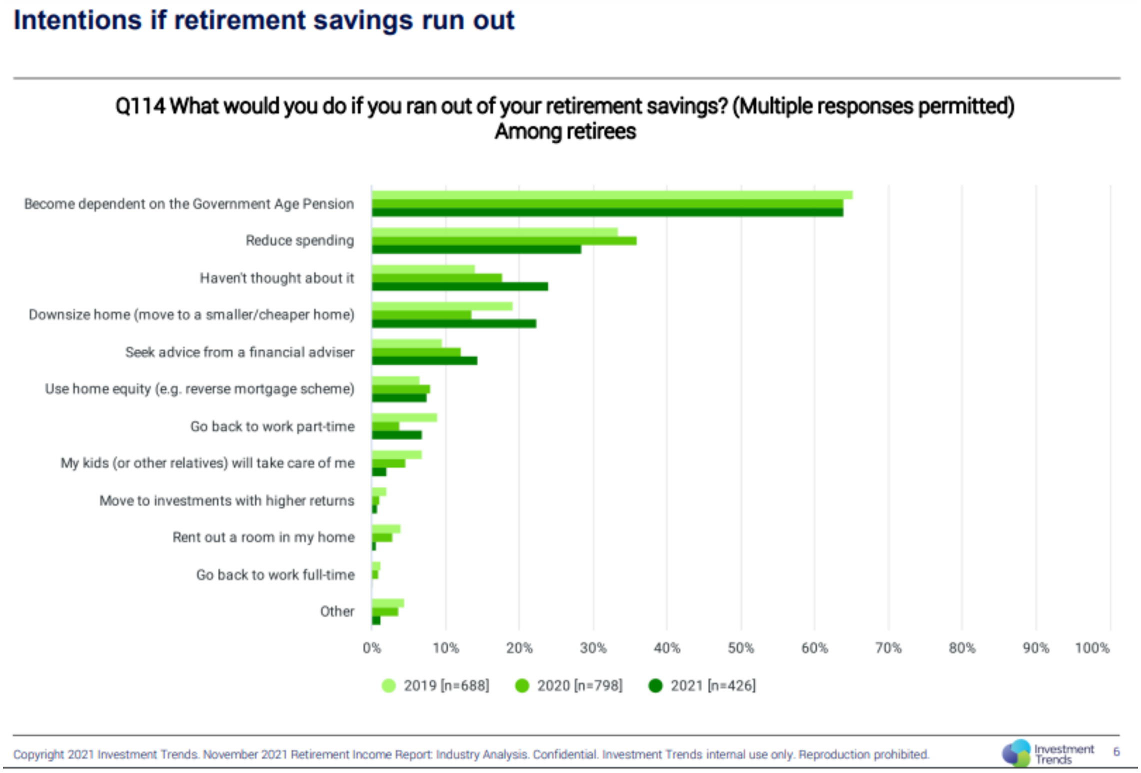
Deborah Ralston, a member of the Retirement Income Review, wrote a detailed article in Firstlinks on accessing equity in the family home. We will not repeat her points here, but in addition to the Government scheme, private providers such as Household Capital and Heartland Finance offer access with different features such as higher limits on borrowing amounts.

Briefly on the HEAS scheme:

- Borrowers must be of age pension age and own real estate in Australia
- Borrowers can either be receiving a qualifying pension, or meet the age pension rules but not receive a pension due to assets or income over the threshold. In other words, a borrower does not need to be receiving the age pension

- The combined loan and pension payment each fortnight cannot exceed 1.5 times the maximum pension rate
- Lump sums can be drawn in advance
- The current rate is 3.95%
- Debt is recovered through the estate when the last borrower dies.

Terms from commercial lenders will differ. Investment Trends research suggests home equity access is low on the list for retirees looking for income if savings run out, nominated by only about 7% of retirees. If savings run out, more popular sources include accessing the age pension, reducing spending and downsizing their home. Home equity is on par with going back to work.




So 'running out of money' means 'running out of retirement savings', it does not allow for accessing the age pension and a regular annual income of $40,000.

**How much income is needed in retirement?**

While not everyone aspires to an extravagant lifestyle in retirement, nobody wants to be poor, especially in old age. The most frequently-used standard for retirement income comes from ASFA, which estimates a modest lifestyle for a homeowner couple at $43,250 or comfortable at $66,725. On this basis, a homeowner couple on a full age pension with no other assets almost achieves a modest lifestyle on the age pension alone, which can be supplemented by accessing home equity.

| Comfortable lifestyle (p. a.) | | Modest lifestyle (p. a.) | |
|---|---|---|---|
| Couple | Single | Couple | Single |
| $66,725 | $47,383 | $43,250 | $30,063 |

This number has recently been challenged as too high by Super Consumers Australia (SCA), as reported in Firstlinks. Whereas ASFA sets a 'comfortable' level of assets required for a couple at $640,000 to give an annual income of $66,725, SCA says only $352,000 is required for its medium spenders requiring $56,000 a year. SCA has an income number of $42,000 as its lower bound for *"you'd like to spend this much in retirement"*.

Either way, for a homeowner with modest living needs, the age pension will go a long way to meeting their needs.

On 2 September 2022, the Government announced an increase to $11,800 in the amount a pensioner can earn before their pension is reduced:

*“Age and Veterans Pensioners will be able to earn an additional $4,000 over this financial year without losing any of their pension due to the Albanese Labor Government providing a one-off income credit designed to give older Australians the option to work and keep more of their money.*

*Following the successful Jobs and Skills Summit in Canberra, an immediate $4,000 income credit will be added to the income banks of Age Pensioners from December to be used this financial year.*

*The temporary income bank top up will increase the amount pensioners can earn from $7,800 to $11,800 this year, before their pension is reduced.”*

Although health, disability or other factors may inhibit a retiree returning to work, there are currently more job vacancies than unemployed people, and with the record-low unemployment rate, the opportunities to supplement income with part-time work are far better than in the past.

**Homeowners not renters**

This article assumes home ownership rather than renting, and the difficulties of living in retirement without owning a home is a major but separate issue. Clearly, a renter may 'run out of money' in covering rent. The Retirement Income Review states:

*"Almost one-quarter of retirees who rent privately are in financial stress. High housing costs are likely to be the primary driver of the financial stress experienced by this group. Renters face higher housing costs than home owners in retirement: an additional $6,900 per year for the median single, and $12,200 per year for the median couple."*

**Providing for aged care**

Aged care is a specialist and complex area, so Rachel Lane from Aged Care Gurus provided this explanation of the cost of aged care.

*"If you are moving into an aged care home you will be asked to complete a combined income and asset assessment. This assessment is used to work out how much funding the government will provide to the facility for your accommodation and care.*

*The residential aged care means test is a complicated formula that uses a combination of an asset test and income test (with the outcome of each test added together), to calculate your cost of care.*

***Income test***

*50c per dollar of income above*
*$30,204/year single*
*$29,632/year member of a couple*

***Asset test***

*17.5% of $55,000–$186,331*
*1% of $186,331–$448,994*
*2% of above $448,994*

*People with a calculated amount below $63/day are considered financially disadvantaged, or ‘low means’. They have some or all of their accommodation cost subsidised by the government.*

*Most people have a calculated amount above $63/day, meaning that they need to pay the market price for their accommodation. The amount above $63/day is their contribution to their care, which is known as the means-tested care fee.*

*There is an annual limit of $30,574 that applies to the Means Tested Care Fee*

*There is a lifetime limit on means tested fees across Home Care and Residential Aged Care of $73,378.*

*Special rules apply to the assessment of your former home. As general rule, your home will be included in your aged care assets up to the capped value of $186,331 unless a protected person lives there in which case it is exempt.*

*A protected person includes: your partner or dependent child, a carer who is eligible for an Australian Income Support Payment who has been living in the home for at least 2 years or a close relative is eligible for an Australian Income Support Payment who has been living in the home for at least 5 years.*

*If the value of your home is less than the $186,331 cap then the market value of the home will be used in the assessment. In most cases the market value will be far greater than the cap.*

*Under the pension assets test the full value of your home is exempt for 2 years from the date you or your partner leave the home (whichever is later). When the 2-year exemption ends the home is included in your assessable assets at the market value but your pension assessment changes from a homeowner to a non-homeowner giving you an asset test threshold and cut off that is $224,500 higher.*

*While the asset value of the home receives special treatment for both pension and aged care means testing it is important to know that if you receive rent from the home it is assessable income for both pension and aged care means tests."*

**Planning for retirement**

For many homeowning couples, $40,000 a year plus other benefits paid to concession holders, supplemented by a home equity access scheme, will finance an acceptable standard of living. While it is not much to aspire to for anyone with the ability to save more, the present system suggests homeowners are placing too much fear on 'running out of money'.

For those who plan to run down their savings to qualify for a full pension, such as by spending money on holidays, increasing living expenses or renovating the family home (but not giving money away as that falls foul of the gifting rules), here is a warning from Noel Whittaker:

*"Think about it. If you spend $100,000 renovating your home, your pension may increase by just $7,800 a year, but it would take almost 13 years of the increased pension to get the $100,000 back. Of course, the benefit of money spent should be taken into account too – money on improving your house or travelling could have huge benefits for you. The main thing is not to spend money with the sole purpose of getting a bigger age pension."*

While there is some risk that future age pension payments will be less generous, a change seems unlikely while the cohort of retirees represent such a large voting block. As the franking credit debate proved in 2019, it's not only older people who vote against change, but their children want their entitlements protected.

*Graham Hand is Editor-At-Large for Firstlinks. This article is general information and does not consider the circumstances of any person. Thanks to Rachel Lane, David Knox and Noel Whittaker for additional input.*

## The five most common topics for advisers and their clients

### Tim Howard

Imminent regulatory changes are top of mind for advisers looking for strategies to help clients make the most of their retirement savings and ease cost of living pressures. This article discusses the most common technical and regulatory topics that advisers have been asking BT's technical team during the July-September 2022 quarter:

- The Commonwealth Seniors Health Card
- Downsizer contributions into super
- The Home Equity Access Scheme
- Increase to the transfer balance cap, and
- Work test requirements.

**1. Income thresholds for Seniors Health Card increase by more than 50%**

For the first time in over 20 years, the income thresholds for the Commonwealth Seniors Health Card will be raised (outside of indexation), pending legislation which is currently in Parliament.

If passed, the income thresholds for singles will increase to $90,000 from the current $61,284; for couples, the increase is $144,000, from $98,054 currently.

Becoming eligible for the Commonwealth Seniors Health Card gives individuals access to valuable concessions, such as cheaper medicine under the Pharmaceutical Benefits Scheme. Visits to the doctors can potentially be bulk-billed and people can receive a refund of medical costs when they reach the Medicare safety net. Additionally, card holders may also receive economic support payments which were worth $1,000 across 2020 and 2021.

Around 44,000 more Australians are expected to qualify for the Seniors Health Card, if the bill passes.

Unfortunately, the Bill was not passed during the recently concluded sittings. The commencement date for these changes has been adjusted from 20 September 2022, with the changes to apply for applications made at least seven days after the Bill receives Royal Assent. With parliament not due to resume until the Budget sittings at the end of October, the increased threshold won't have application until at least November 2022.

**2. Downsizers**

More Australians are expected to be able to make a downsizer contribution into super – up to $300,000 per person of $600,000 for a couple – with the eligibility age expected to reduce to 55 years, from the current 60 years, in coming months.

Advisers with clients who are about to turn 55 years of age, and are planning to sell their home, may wish to consider the timing of the legislation. Again, this amending legislation is currently in Parliament and with a commencement date of the beginning of the first quarter after Royal Assent, the earliest commencement date will now 1 January 2023.

To be able to contribute proceeds from a property sale into their super, amongst other requirements, clients need to have owned their home for 10 years or more. A downsizer contribution doesn't count towards any other contribution caps and can still be made even if a person has total super savings greater than $1.7 million.

**Downsizer example: sale of home**

Roger is 61 years old and married to Mandy who is 55 years old. They live in their home purchased over 15 years ago. They are looking to sell their home to downsize to a more manageable sized property near their children and grandchildren.

Should they sell their home for $1 million under current rules, only Roger would be eligible to contribute up to $300,000 to super as a downsizer contribution, within 90 days of receipt of the proceeds. Under the new rules both Roger and Mandy could contribute up to $300,000 to super each as downsizer contributions.

Importantly, both Roger and Mandy would be eligible to contribute even where their home was owned in only one of their names. Additionally, three is no requirement to purchase a new home and the amount contributed can be from the sale proceeds or other savings they may have.

**3. Home Equity Access Scheme**

Considerably more senior Australians are participating in the Home Equity Access Scheme (HEAS), and take-up is expected to increase due to recent changes which have made the scheme more flexible.

The HEAS allows Australians who are of age pension age, to enhance their income in retirement by accessing the equity in a property they own. Prior to 1 July, an eligible person could only receive their loan amount as a fortnightly payment. Similar to what is generally available from a commercial reverse mortgage, lump sum advance payments are now also an option under the scheme. Any lump sum is capped at 50% of the participant's maximum pension rate.

Alternatively, a scheme participant may choose to take a partial lump sum amount and then the remainder as a fortnightly payment.

While the HEAS may suit some senior Australians, there are many considerations that should be weighed up. Using an existing property as security for a HEAS loan has the potential to impact on estate planning, so some Australians who are eligible may be hesitant about taking part in the scheme.

**HEAS example: pension and lump sum**

Margaret is aged 70 and a single homeowner receiving the full age pension. She could choose to apply for the HEAS using her home as security for the loan.

Under the HEAS, Margaret could receive 50% of the maximum pension rate as a lump sum advance or as a fortnightly payment. She could also choose any combination of these two options providing the total amount she draws does not exceed 50% of the maximum pension rate.

If Margaret was a part-age pensioner, she could receive up to 50% of the maximum pension as a lump sum and top-up her fortnightly age pension with an additional amount, so long as these two amounts, plus her rate of part-age pension does not exceed 150% of the maximum pension rate.

**4. Inflation set to increase transfer balance cap to $1.8 million**

Based on the current trajectory of the Consumer Price Index, the general transfer balance cap is expected to increase to $1.8 million from 1 July 2023, unless legislative changes are introduced.

The transfer balance cap limits the amount of superannuation that can be transferred to tax-free retirement income streams, with the general cap currently $1.7 million.

High net worth individuals who aren't in a hurry to start a pension may want to hold off until 1 July next year; although it's worth noting that, with Australia's inflation reaching its highest level in over 20 years, there is a possibility that the Federal Government could make changes to indexation of certain thresholds such as the transfer balance cap.

**5. Work test requirements**

The application of the work test rules is consistently one of the most popular technical topics among advisers.

Individuals aged between 67 and 74 who have recently retired may still be eligible to make personal deductible contributions to super, if they meet certain eligibility criteria around their previous year of work and their total super balance.

Generally, to claim a deduction for a personal contribution, if a super fund member is between the ages of 67 and 74 they 'must have been gainfully employed for at least 40 hours in any period of 30 consecutive days during the financial year in which the contribution was made.' [Income Tax Assessment Act 1997 – SECT 290.165 (1A) (a)]

An exemption to the work test applies only if the person meets another set of criteria. People who have not been gainfully employed during the financial year can still make a personal deductible contribution if: they met the work test in the financial year immediately prior to the year of the contribution; *and* they have a total super balance of less than $300,000 at the end of the previous financial year; *and* they had not previously used the work test exemption in a previous financial year to make a contribution to any regulated super fund.

The work test exemption provides an opportunity for recent retirees to potentially make personal deductible contributions to super at a time when such contributions were previously off the table, as illustrated in the example below.

**Work test example: sale of an asset**

Joanne is 70 years old, retired, and has recently sold an investment property in the 2022-23 financial year, resulting in a taxable capital gain of $250,000. Joanne had $290,000 in super on 30 June 2022.

Joanne was previously a self-employed freelance writer and has had sporadic work patterns over the last 5 years. She did not work more than seven to eight hours a week (i.e. did not meet the work test) between the 2017-18, to the 2020-21 financial years, however as a result of a full-time contract during August 2021, she did meet the work test within the 2021-22 financial year.

Whilst Joanne is eligible to make a bring-forward contribution in the 2022-23 financial to contribute up to $330,000 as a non-concessional contribution to super, she may consider using her carry forward concessional cap space, and then claim a tax deduction for this contribution to reduce her taxable income due to the capital gain from the sale of her investment property.

While Joanne did not meet the work test for several years, this doesn't preclude her from meeting the requirements for the work test exemption. She firstly met the work test in the financial year immediately prior to the year of contribution, and secondly, she has not used the work test exemption previously (noting it wasn't available to use prior to 1 July 2019).

*Tim Howard is a member of BT's technical team who field over 2,000 queries from advisers every quarter regarding superannuation, tax and social security.*

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## How to identify overvalued small cap companies

### Marcus Burns, Matthew Booker

Investors are in a difficult period, and it's vital to get the fundamentals right, particularly in the small cap part of the market. Companies need to generate strong cash flows after capital expenditures and stock-based compensation, and the cash flows must be sustainable. For investors, a resilient market position and growth in that market are worth paying for.

Small caps also need a valuation anchor, a reason to buy the company underpinned by a favourable estimate of value. We want to know what the company is worth through the cycle. We don't want to rely on finding a 'greater fool', someone foolish willing to buy a company that lacks substance.

Bubbles regularly occur in small caps, where assets are completely overvalued. In small caps, relatively modest amounts of money can move around the market capitalisations of companies. Passive money from index buying and even retail money can also swing prices around.

**Examples of past and future bubbles**

One example is BNPL, the Buy Now Pay Later sector. We did a lot of research on the sector and could not get comfortable with even low valuations. Afterpay came on the scene in 2018 but we could not see how the business model would make money. To date, it never has. At the time and in subsequent years, the market was looking for high growth and the narrative was good, they were penetrating markets and increasing revenues.

But then came a plethora of other stocks doing a similar thing – Sezzle, Zip, QuadPay - all IPO-ing and creating a huge bubble of enthusiasm. Any small cap fund manager not owning any of these stocks was hurt for a while and clients questioned their sanity. But eventually, when there was no business model and no cash flow coming through, they were found out. The tide went out and they were swimming naked, to paraphrase Warren Buffett.

We believe interest rates going up is also like the tide going out. Economic gravity is reestablished and valuations and fundamentals are coming back to the fore.

**Bubbles: When a bubble bursts...**

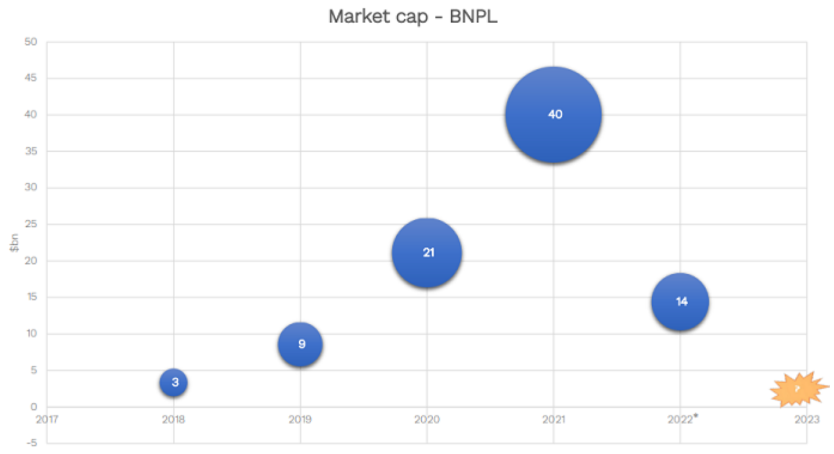



*Chart Source: Bloomberg. *2022 captures market cap from 1/1/2022 to 10/8/2022. Stocks include: APT/SQ1, ZIP, HUM, SZL, SPT*

We believe another bubble is forming in small cap lithium stocks. The following chart shows the market capitalisation of lithium stocks over the last few years. While lithium is in high demand now and there is a focus on EVs for a cleaner future, many of these names do not produce positive cash flows or earnings. Of the nine or so stocks that comprise this market capitalisation, only one makes money. The other eight are currently exploring, with in many cases, many billions of dollars of valuation ascribed to those assets. We don’t think that's sustainable long term.

**Bubbles: Will lithium be next?**

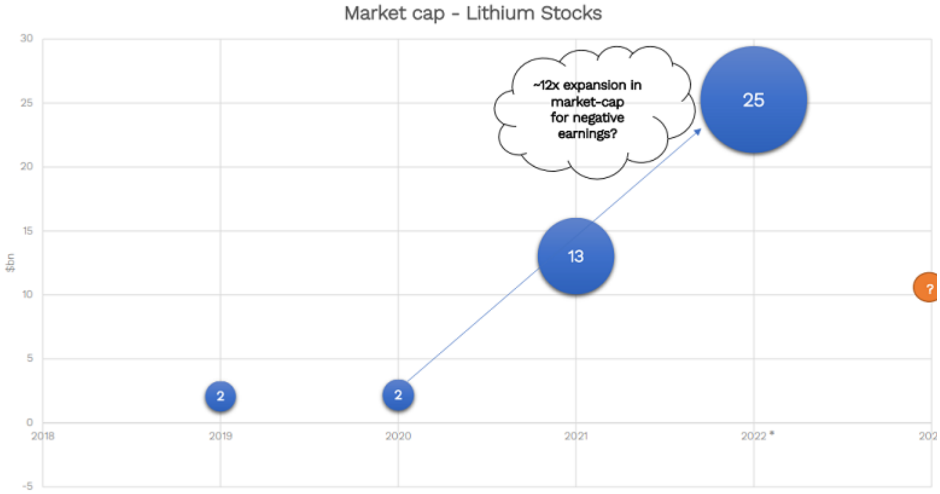
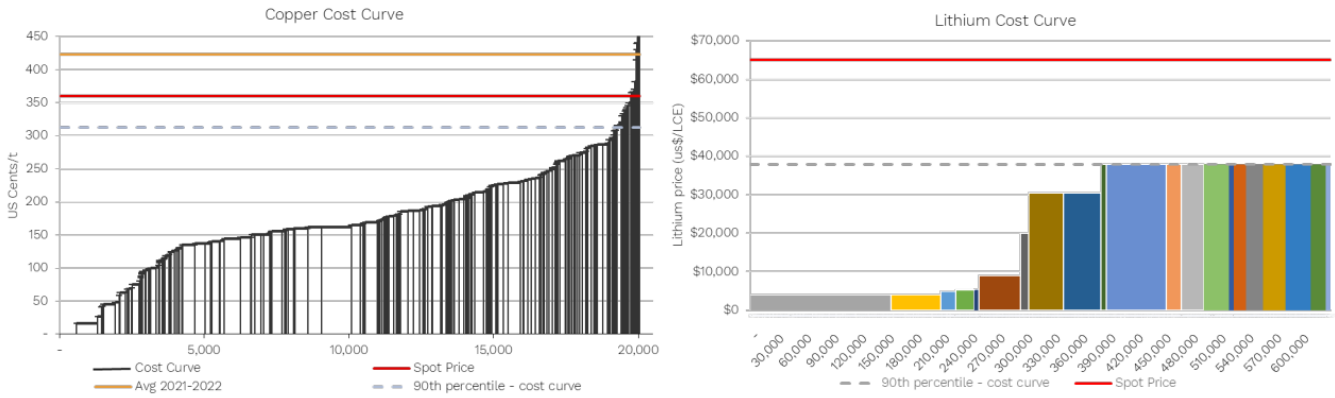



*Chart Source: Bloomberg. *2022 captures 1/1/2022 to 10/8/2022. Stocks include: PLS, AKE, LTR, CXO, LKE, VUL, PSC, ARG, SYA*

Consider the copper cost curve and what it reveals about Economics 101. The highest-cost marginal producers set the price in the long-term equilibrium, and the copper price shows where the high-cost players are.

**Copper and lithium cost curves and production costs**




*Source: Bloomberg, UBS and Canaccord (2022)*

The lithium market is different. It's nascent on the supply side but with strong demand growth which is overriding and outweighing the lack of supply. But the supply response is coming with new mines opening and production coming online. It will catch up at some point. At the moment, the low-cost operators are the brine producers in Latin America. The high-cost end of the market are the Australian lithium hard rock miners, and their costs are hugely higher. As the market expands, these operators will set the price.

We believe the lithium price will probably fall to around $40,000 per ton in the long term, and the high-cost miners will be in a difficult equation. The money to be made is at the low end of the cost curve, and that's the brine producers. We think a bubble has formed here.

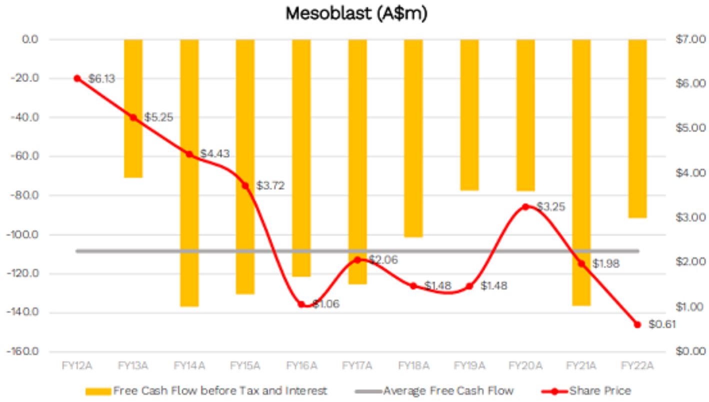
**Prospects for two high-profile small caps**

In addition to these avoiding bubbles, we also flag a couple of stocks that have been prevalent in micros and smalls for a long period of time that have limped on through multiple capital raisings. Mesoblast is really a gold stock masquerading as a biotechnology name, claiming everything from a cure for cancer to a cure for COVID using stem cells. While we like new ideas, we also look for proven commercial development of any technology.

This chart shows the cash flow consumption over the last decade. It's been almost $100 million a year of R&D effort. And to date, there's no commercial cash-earning business after burning through around $1 billion. The only thing compounding are the shares on issue. A buyer 10 years ago has lost about 90%. Obviously, there are periods of enthusiasm where it trades well, followed by a large rights issue. Investors should look through the fundamentals for actual cash flows and strong businesses.

In contrast, a stock we do own has a good history of cash flow generation. NZME, New Zealand Media and Entertainment, is the Number One masthead in New Zealand. It owns the leading set of newspapers in New Zealand, the number one radio business, and operates the digital license for iHeartRadio. That gives it growth as well.

**Example of a cash burner company**



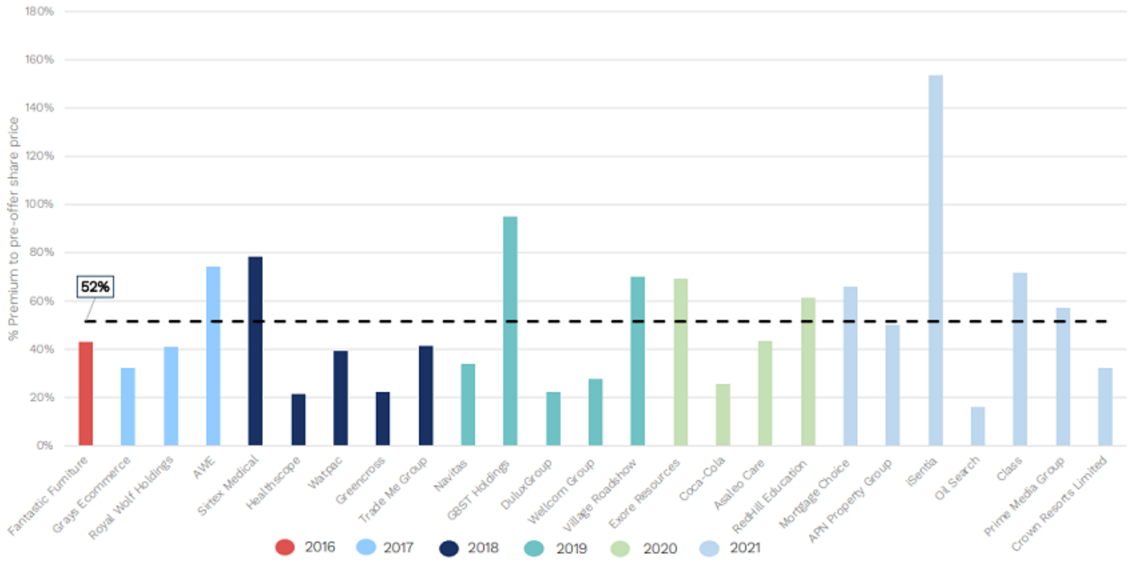

*Source: Morningstar, IRESS, Spheria*

The big kicker is the digital side of the business, called OneRoof, which is similar to Domain in Australia. It's the number two player in the market behind TradeMe, similar to how REA in Australia is ahead of Domain. We see upside in the property digital market because New Zealand has lagged Australia in developing the potential. The market is going from print to digital with a lot of money to be made and a valuable position going forward. This is in addition to its main masthead where digital subscriptions are outweighing deliveries of the print edition. While the company is going from old world to new world, it's trading at about four times earnings, and we think it will rerate at significantly higher levels.

**Takeover potential in the small cap market**

What happens in the small cap sector if the price re-rating does not occur? For quality companies, it's always worth looking at the takeover potential. We have seen 25 takeovers in six years at the small end of the market. The last big one was Class, a leading player in the SMSF software market. It was a subscription business with a great cash flow, a strong balance sheet and the valuation was attractive.

**Small cap takeovers over time, % premium**




*Source: IRESS*

**Investing in small caps**

Over a long period of time, by avoiding the bubbles and not trying to time the market, identifying enduring businesses with good economics will eventually be recognised by the market mechanism either through takeovers or through dividends or buybacks or just share price appreciation. Our approach is to sort through a big universe of stocks using good technology and our team of analysts, and discard a lot of areas that don't make cash and earnings. Avoid the hype and focus on conservatively-geared businesses that make good cash flows.

*Marcus Burns and Matthew Booker are Portfolio Managers at Spheria Asset Management, an affiliate manager of Pinnacle Investment Management. Pinnacle is a sponsor of Firstlinks. This article is for general information purposes only and does not consider any person's objectives, financial situation or needs, and because of that, reliance should not be placed on this information as the basis for making an investment, financial or other decision.*

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## Financial literacy for older Australians has gone nowhere

### Kaye Fallick

In 2004, I attended the launch of the Federal Government's *Consumer and Financial Literacy Taskforce* (CFLT). The event, held at the State Library in Victoria, featured the 'who's who' of financial services. 'Money' host, Paul Clitheroe, was the newly-appointed chair and Mal Brough was the Finance Minister in the Howard Government who held responsibility for the outcomes.

The future of financial literacy for all Australians looked rosy indeed.

A report (shared by Assistant Treasurer, Helen Coonan, June 2004) had identified a major absence of consumer financial literacy and the taskforce had been formed to fix it. During the launch, I asked which specific cohorts would be a focus for this new initiative. The answer was that high school children, Indigenous Australians and those of a cultural or linguistically diverse (CALD) background had been identified as most at risk of low financial literacy.

Fair enough. I then asked, given the demographic spike of some 5.4 million baby boomers hurtling towards retirement, if pre-retirees with scant financial literacy might also become a priority.

*"Yes, that's a good idea, they're definitely on our radar*", was the reply from the Chair.

Well, here we are nearly two decades later and it's fair to ask how these ambitions have helped financial literacy for retirees in the meantime. Have we made any progress at all?

I fear not. There's a big fat zero on the Taskforce's report card.

**Where is the financial education?**

Along the way we've seen a steady stream of government enquiries, many for all the right reasons. Some were politically charged, such as the Tim Wilson-led 'retiree tax' parliamentary enquiry which was a thinly-veiled campaign vehicle for the Liberal Party during the 2019 election year (I can say this as I attended one of the local town hall meetings).

The Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry had a broad scope and was forced on a government reluctant to reveal the depths of financial impropriety, which it ultimately did. We've also seen initiatives such as Financial Adviser Standards and Ethics Authority (FASEA) come and go with little real impact.

Are consumers any better off, especially as the Quality of Advice Review from lawyer Michelle Levy proposes to unwind some of the consumer protections brought in over the last decade?

Depending upon the esteem in which you hold financial advisers, you may view the departure of nearly 40% of advisers from the industry in the past few years as a good or bad thing. Either way, the number of providers of financial advice has shrunk dramatically and it's hard to see what has replaced this service.

**Understanding superannuation is essential**

When the Taskforce was launched in 2004 and compulsory super was just over a decade down the track, there was $649 million of savings held in superannuation. Today that amount is $3.3 trillion, dwarfing nearly all other pots of money in the Australian economy.

It's easy to think of this money in its aggregated form, but this is essentially the life savings of nearly 16 million individual men and women.

Commentators still cling to the Association of Super Funds Australia (ASFA) estimates for 'comfortable' retirements, which means that the oft-quoted target of a $1 million nest egg is generally accepted as necessary to lead a reasonable retirement lifestyle. But this is at odds with ASFA's own measurements of actual savings: an average nest egg at retirement of $310,240 for males and $246,632 for females or, worse still, the median amounts of $138,337 and $107,897 respectively.

The gap between rich and poor older Australians has widened considerably since 2004 and our retirement income system supports this gap.

Here's how. The more work income you earn, the more you get from the 'flat' Superannuation Guarantee contribution (SG) rate, currently 10.5%.

Say you are Sally, earning $200,000 p.a., then $21,000 per annum is automatically invested in your nominated super account. This balance will compound nicely. Sally may also contribute extra and be able to afford a good accountant, also perhaps the establishment fees for a SMSF.

Or maybe you're Larry, who does his own tax return, as his salary of $25,000 doesn't allow for outsourced financial assistance. His SG contribution is also 10.5% per year, but only a $2,625 contribution will hit his super account annually. On such a low salary, he's unlikely to make extra contributions. Sure his balance is growing, but far below the rate of Sally's.

Since 2004 there has been a proliferation of fintech products and online advice. Now social media 'influencers' are offering guidance on how to grow your wealth. Not only has this added to the noise and confusion around financial advice, as legally questionable as it might be, such 'influencers' may also have been the preferred source of information for the (predominantly young) superannuants who withdrew funds during the Covid years, reducing their ultimate super savings to a shadow of what they may have been.

**Information needs to reach the right people**

Which brings me to the 2020 report from the Retirement Income Review (RIR) and its findings. It seems to be largely satisfied with our system, albeit noting certain pressure points along the way.

I am surprised. As a long-time observer of consumer confusion over shifting retirement planning goal posts and legislation, unlike the RIR, I am far from satisfied with the status quo.

I think financial planning for retirement in Australia is in dire shape. It feels as though we've been running up and down on the spot for the last 20 or so years.

The need has never been greater - but who is going to break this strife? Australia is predicted to have more than 10 million retirees in the next 20 years, and according to Money magazine, 40% of super funds' assets will then be held by retirees. The RIR has called for much more emphasis on decumulation. That's fine, but the products are complex and product information is even more so. Most Product Disclosure Statements (PDS) can at best be described as the antithesis of plain English.

Some 71% of retirees are still on a full or part age pension. The combined income and assets test for entitlement is far from easy to understand and the application length and process is a nightmare for many, some of whom give up. Others get on the phone and join the 43 million calls a year that Centrelink still can't manage. For those who are - or will be - self-funded and often self-directed investors with the motivation to seek out information, there is a plethora of material. But ASIC finds that most Australians still don't know the difference between general and personal advice nor what they can reasonably expect from the product vendor or adviser.

There is too much at stake to get this wrong. The potential for increased income (and therefore life opportunities) for millions of retirees, not to mention the benefits to the wider economy and health savings, deserves urgent attention.

There is much we could do better, starting with widespread government ownership of the need for improved financial literacy. Consistent, authoritative information could be delivered through TAFE institutions, local governments and workplaces, just as we do with language education. The beleaguered Centrelink Financial Information Service (FISO) offering could also be significantly bolstered.

But who has the political will and energy to change this landscape of confusion and complexity? The answer eludes me. If anyone can see a glimmer of light in this depressing and wasteful scenario, I'd be delighted to hear what it is.

*Kaye Fallick is founder of [STAYINGconnected](STAYINGconnected) website and SuperConnected enews. She has been a commentator on retirement income and ageing demographics since 1999. This article is general information and does not consider the circumstances of any person.*

## Positioning a portfolio for today's market conditions

### Brad Kinkelaar

*Brad Kinkelaar is Senior Managing Director and Lead Portfolio Manager for the Barrow Hanley Global Share Fund. Barrow Hanley Global Investors was founded in 1979 in Dallas, USA, and is now part of Perpetual Asset Management International.*

**Q**: In the last two years, your Global Share Fund is well ahead of its benchmark. What have been the big calls and what are the major themes for the future?

**BK**: Value stocks have seen a resurgence in outperformance this year-to-date on the back of multiple compressions in the higher growth areas of the market, and it's important for managers to perform in line with their style as part of a client's broader asset allocation.

We would not attribute this performance to 'big calls,' as our process looks to find dislocations in the market through a bottom-up, fundamental process. Our holdings in the Industrials and Consumer Discretionary sectors have been strong contributors but for different reasons. Within Industrials, we saw European defence companies offering compelling valuations post the strong run up in cyclical stocks in the latter half of 2020 and early 2021. These stocks have done well on the back of markets that have shunned cyclical stocks. They've also benefitted from the Ukraine war causing European governments to recommit to their defence spending targets and even pull those forward.

Within Consumer Discretionary, it has been a mix where during the Covid-19 crisis cyclical stocks came under meaningful pressure. Further, our underweight to the Financials, Consumer Staples, and Industrials sectors, combined with an underweight to the Information Technology and Communication Services sectors, were further sources of positive relative returns.

Although we do not invest on a thematic basis, the portfolio is broadly tilted more towards defensive and compounding stocks versus cyclical stocks. Defensive stocks have held up well, but we are starting to see more cyclical opportunities.  The Fund is overweight the Consumer Staples, Industrials, and Materials sectors, with a large underweight to the Information Technology sector.

**Q**: You look to exploit market inefficiencies and find mispriced companies. Why do these discounts occur?

**BK**: Markets will tend to trade on short-term news and extrapolate that information into the future, whether positive or negative. For a patient long-term investor, this will always provide opportunities to exploit short-term inefficiencies. Our process takes us to areas of the markets where there are controversies, such as missed earnings, supply chain disruptions, changing macro environment, management missteps, etc. But if we can see a resolution to these controversies over the next three to five years, this allows us to buy companies that are trading at a meaningful discount to our estimate of intrinsic value.

**Q**: As a value investor and stock picker, to what extent do major macro themes play into your company investment decisions?

**BK:** Our investment process is macro aware but not macro driven. We are cognisant of broader macro indicators such as changes in currency rates, PMIs, unemployment rates, interest rates, etc., and will take these factors into account as part of our portfolio construction process and, just as importantly, as part of our bottom-up, fundamental company analysis. We regularly review our investment screens, which tend to act as indicators of dislocations in the market.

**Q**: Do you expect to hold some of the stocks in your portfolio for say 10 years?

**BK**: Where we see a company continuing to compound value greater than what the market is willing to account for, we will be long-term holders. We would expect this to occur more often in the more stable areas of the market such as the Utilities, Health Care, or Consumer Staples sectors. However, we sometimes see this in the more cyclical areas of the market such as Energy. If the company we own continues to compound its earnings power without a commensurate re-rating of the valuation by the market in recognizing that higher earnings power.

**Q**: In your analysis, you look for "*downside protection if company fundamentals fail to improve.*" Can you give examples of such protection?

**BK**: We spend as much time on what could go wrong with our investment as what could go right. This is instrumental in assessing not only the risk/reward potential of the company but also in establishing the weighting of the security in the portfolio. During the COVID crisis we undertook a full reassessment of every name in the portfolio to confirm that our downside estimates were reasonable and that the companies we owned could survive economic lockdowns. One company was closely tied to consumer spending but it had the cash on the balance sheet and length of cash burn before needing to tap the bond or equity markets. We were patient during this period in not selling or adding to the position until we could see improvement or deterioration. Company management was able to obtain favourable financing in the debt market without diluting existing shareholder equity. With a stronger balance sheet, we added to our position and and the stock meaningfully rerated higher.

**Q**: Have you sold a stock recently that did not work out as well as expected and taught you something about your investment process?

**BK**: We have recently sold a position where our original thesis centred on the company having undergone a series of divestitures and restructuring initiatives, leaving the company primarily focused on its healthcare business while completely exiting its consumer electronics businesses. We believe this transition was not fully appreciated by the market. However, the company is currently involved in a product recall of one of its healthcare devices and the risk of high recall costs and costly potential litigation have caused the stock price to meaningfully underperform. Accordingly, the investment thesis has transitioned from business fundamentals to product recall and litigation and is something we are no longer willing to bet on. Our experiences with these problems have taught us that the market can extend the duration and magnitude of these losses.

**Q**: How do you decide if a company has a quality management team when many CEOs are skilled presenters and talkers?

**BK**: The risk when talking with management is getting caught up in a good story or relying on promises when management cannot deliver. Investors cannot rely fully on company management plans, projections, etc, exclusively as part of the analysis. We do additional channel checking with either customers, suppliers, competitors, industry sources, and so one, and we have a long history in these industries or with these company management teams. It's important to be objective in assessing results.

**Q**: What gives you confidence that the value market we have seen of late will not be short lived as we have seen over the last 10+ years?

**BK**: If you look back over the last 10+ years, there was little change in the overall economic backdrop, with low interest rates, low inflation and below-trend economic growth, all of which favoured growth stocks which are seen as long duration assets. This pushed the multiples of these growth companies to historic levels and caused indexes to become concentrated in just a few names – not that much different from the late 1990s.

However, the recent economic challenges with inflation mean central banks will need to lift interest rates to substantially higher levels than seen in decades. This puts meaningful pressure on growth stocks. Further, there will come a point at which economies will begin to recover, recognising they may experience more pain, and value stocks will do well going into that recovery. The set-up for value stocks appears good and we expect this value cycle will be longer in duration than what we have seen over the last several years, although we recognise that there will be pauses along the way.

*Brad Kinkelaar is Senior Managing Director and Lead Portfolio Manager for the Barrow Hanley Global Share Fund. Barrow Hanley Global Investors was founded in 1979 in Dallas, USA, and is now part of Perpetual Asset Management International.*

*Perpetual Asset Management Australia is a sponsor of Firstlinks. This article contains general information only and is not intended to provide you with financial advice or take into account your objectives, financial situation or needs. Stock charts are provided by Morningstar. The product disclosure statement (PDS) for the Barrow*

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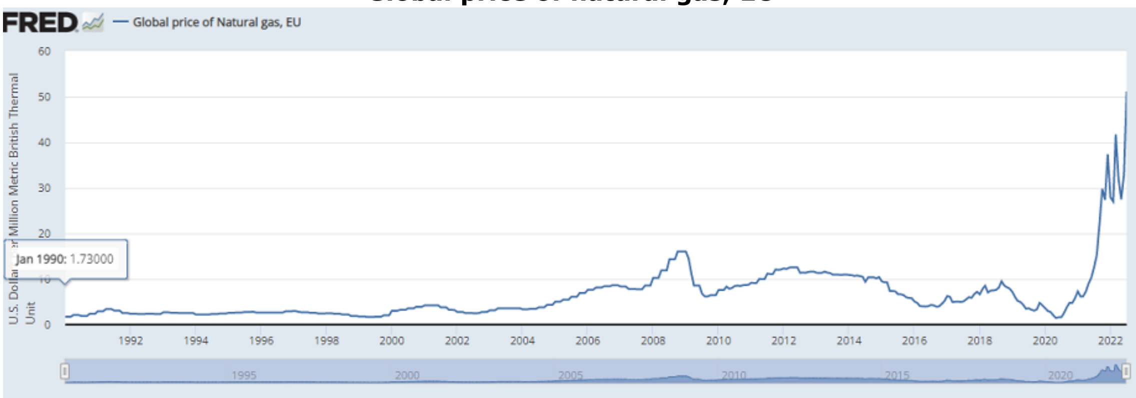
## The energy crisis is likely to last years

### Michael Collins

Europe is restarting mothballed coal-based power plants because the benchmark electricity price has exceeded 1,000% above its average of the past decade (where prices are set by the marginal cost of the last unit – essentially, the most expensive unit – of energy purchased to balance demand). Electricity prices are spiralling because the cost of natural gas, the marginal fuel in most European electricity markets, has soared 1,300% above its decade average. The shock would be like oil nearing US$550 a barrel.

**Global price of natural gas, EU**




*Sources: IMF and Federal Reserve of St Louis. Found at: fred.stlouisfed.org/series/PNGASEUUSDM*

**Widespread controls**

The EU, in response, is imposing wartime-like price controls, rationing and a windfall tax on energy companies. In the UK, the prospect of household energy bills jumping by 9% of GDP has prompted London to announce emergency measures worth double the cost of the pandemic furlough scheme, and to reallow shale-gas fracking.

Norway, where hydropower generates 90% of local needs, may curb the export of electricity, raising concerns cross-border flows could collapse across Europe. French nuclear power output is diving due to maintenance and repairs, with Électricité de France only operating 26 of the country's 57 reactors. President Emmanuel Macron warns of the "end of abundance". Germany is worried that rage over energy prices driving inflation to near-50-year highs could turn violent. Kosovo is facing two-hour blackouts every six hours, the first European country to display this feature of a failed state.

In China, daily hydro generation from the Three Gorges dam on the Yangtze River has dived 51%. Factories have suspended operations and cities are dimming lights. Japan is overcoming its Fukushima fears and returning to nuclear power. Southeast Asia is using coal to replace the liquified natural gas diverted to Europe. South Asia is suffering blackouts because energy is unaffordable. US natural gas prices in August breached US$10 per million BTU, a 400% increase on the recent years, due to demand from Europe.

The world faces its biggest energy crisis since the 1970s when soaring oil prices helped create the stagflation for which the decade is renowned. Today's energy blow could be crueller because the energy industry, having overcome the pandemic disruptions that boosted prices for hydrocarbons, is beset by three challenges that are set to persist, if not worsen.

### Three major challenges

The **first** challenge is the unfavourable state of global politics. Europe's torment is due to the significant cuts to the supply of Russian oil and natural gas that accounted for 40% of its energy needs. Oil and gas prices are likely to stay elevated in the near term because the world's energy system cannot quickly replace Russia's lost hydrocarbons, which equate to about 10% of global energy production.

The Middle East is another concern. The return of Iranian oil to replace Russia's missing barrels depends on restoring the agreement on Iran's nuclear capabilities between Iran and the EU, Germany and the five permanent members of the UN Security Council, one of which is Iran's ally, Russia. Moscow could easily delay any new agreement or ensure that any restored pact is short-lived.

The **second** energy challenge relates to climate change. Droughts and heatwaves in China, Europe and North America are hampering hydropower electricity generation while boosting demand beyond capacity. France's nuclear industry has cut production because receding rivers make it harder to cool reactors. The other angle to climate change is that renewable energy generation has not reached a level where it can compensate for lost fossil fuels.

The **third** challenge for energy markets is overcoming policymaker mistakes:

- The biggest error is that Europe, notably Germany, became dependent on Russian energy, especially natural gas that is not as easy as coal or oil to replace.
- A second mistake is France has failed to keep operational the country's nuclear reactors.
- A third error, many would argue, is the world's turn away from nuclear energy after the Fukushima disaster in 2011.
- A fourth blunder was not investing enough in renewables. Much blame will flow if the rising prices that are creating huge paper losses for utilities on Europe's energy derivatives markets spark financial instability.

### Reduction on living standards

Today's energy crisis is still unfolding. In time, the promise of profit will calm the crisis with clean solutions that snap Western dependence on despots. In the meantime, however, the energy crisis is likely to cut global living standards, boost inflation, trigger a recession or worse in Europe, hound those in power, widen inequality within and between countries, trigger social unrest, spark industrial conflict and impede the fight against climate change. The damage inflicted just in Europe will likely make the 2020s energy crisis worse than that of the 1970s.

To be sure, favourable developments in relation to the Ukraine war could calm things and droughts will break and heatwaves pass. Maybe a sunny, warm and windy winter in Europe and energy substitution and conservation will ease power costs. Countries with gas and other energy reserves stand to gain. The recent fall in oil prices relieves inflationary pressures. But spot oil prices have declined on China's pandemic lockdowns and concerns about a European recession.

The energy crisis largely created by Russia's missing fossil fuels might best be viewed as shorthand for a series of crises around climate change, government finances, inequality, inflation, politics and social cohesion. Policymakers have much to solve before they can close for good those coal plants being refired to overcome today's energy emergency.

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## How powerful are Xi Jinping and the Chinese Communist Party?

### John West

Xi Jinping would be China's "president for life", "chairman of everything", "the most powerful man in the world", and China's most powerful leader since Mao Zedong, according to a common narrative. The Chinese Communist Party (CCP) is widely perceived to completely dominate all aspects of life in China – a country with the world's largest population, and the world's biggest economy by some measures.

On closer examination, however, the situation is not this simple. In order to have the possibility of extending his presidency beyond 10 years, in 2018 Xi had to push the National People's Congress to abolish presidential term limits in the Chinese constitution. These term limits had been put in place by Deng Xiaoping in the 1980s as part of his effort to ensure that China never suffered another crushing dictatorship like that of Chairman Mao.

**The 20th National Congress of the CCP**

It will only be at the 20th National Congress of the CCP, beginning in a few weeks' time on 16 October, that the Party will likely extend Xi's term of office. And while CCP leaders and elders are widely expected to give Xi his desired extension, not everyone is happy with the situation.

In particular, the next generation of leaders rising through the CCP ranks will no longer have a shot at the top job. Xi has also created many enemies through his draconian anti-corruption campaign, which mainly targeted political enemies and rivals. Under Xi's stewardship, the economy has not performed well, and the future prospects are weakening with China's ageing population, enormous public debt, and trade war with the US. What's more, Xi's strict zero-COVID policy has proved very controversial in cities like Shanghai.

So, China watchers will be reading the tea leaves to interpret the strength of Xi's new mandate. Will he receive an extension with implicit conditions? Will the new membership of the Politburo Standing Committee be entirely to his liking? How will the CCP factions be represented in the Standing Committee? Indeed, it's not so long ago that Xi's predecessor as China's paramount leader, Hu Jintao, governed with his wings clipped by CCP elders and rival factions, even though he had been chosen for the position by Deng Xiaoping.

Further, it is unclear how long Xi will remain at the top of the CCP. Whatever the end of his reign, it is quite possible that the ultimate succession to his rule will provoke a power struggle in the CCP and political instability – something that the two-term limit on the Chinese leader, together with anointing an eventual successor, was designed to avoid.

In short, Xi's hunger for power may not be in the best interests of the CCP. And the recent social media rumours of a coup against Xi may indeed be a sign that all is not well inside the CCP.

**CCP's fragmented authoritarianism**

For its part, the CCP is well known for its tough, repressive policies in Xinjiang, Tibet, Inner Mongolia, Hong Kong – and indeed against anyone who is perceived as a threat against the CCP. Further, the CCP refuses to be accountable to the Chinese people through elections. At the same time, the CCP feels a need to be "responsive" to the opinion of the many actors in China's political system and society, according to a recent book by Bruce Dickson of George Washington University.

Indeed, Dickson describes the Chinese political system as being one of "fragmented authoritarianism", with many competing interests and policy preferences which impede simple top-down decision making. For example, "When the CCP's legitimacy and survival is not at stake, it sets the broad policy priorities but leaves the details of laws, regulations, and implementation to other state actors – including government ministries, local governments, and people's congresses at both the local and national levels". Further, the CCP solicits the opinions of experts and regular citizens on most pending legislation and major regulations before final passage.

The CCP has an ambiguous relationship with civil society groups. It seeks to repress those that threaten its grip on power or legitimacy, notably those that promote labour rights, human rights, religious freedom and the like. At the same time, local officials often tolerate and even cooperate with groups that provide disaster relief, poverty alleviation, job training, and other social welfare goods and services. There are some 800,000 registered non-government organisations in China, and twice that number unregistered, but still active.

Religion is resurgent in China, and the CCP is conscious of the role that the Catholic Church played in the fall of the communist regime in Poland. So, the CCP has been repressing religions, especially those with foreign ties like Catholicism, Protestantism, and Islam. Nevertheless, religious groups have been helpful as they often provide social services that the local government can't deliver, such as orphanages, hospitals, and homes for the disabled. For example, in response to the 2008 Sichuan earthquake, which killed about 69,000 people, religious groups stepped up to provide much assistance while the government responded feebly

**What explains the CCP's responsiveness to societal groups?**

The CCP also has mixed reactions to political protests. It won't tolerate protests that are seen as a threat to the CCP. But the vast number of protests since the Tiananmen Square tragedy of 1989 have mainly been ad hoc protests about specific events and grievances, rather than calls for political reform. Once again, the CCP has often been responsive to people's concerns, such as local officials' corrupt land grabs, as well as plans to build dams, chemical plants, and high-speed rail systems. Public concerns about extensive environmental damage has also motivated the CCP to clean up the air in major cities and become a global leader in renewable energy.

The CCP's policy of combining political and social repression with responsiveness is motivated by the existential objective of the Party – namely its survival. Following the CCP's near-death experience of the 1989 Tiananmen Square protests, the Party is keen to be at least somewhat responsive in order to maintain social stability to ensure its own survival. In this regard, maintaining social stability is a key performance indicator for local officials' job performance and prospects for promotion. And the CCP's policy responsiveness is a means to pre-empt demands for democracy.

It is important to stress that the CCP's responsiveness can be rather ad hoc. It is more apparent on some issues, in some regions of the country, and at some points in time than others. Moreover, since Xi Jinping became China's leader in 2012, the pendulum has swung decisively away from responsiveness and toward repression.

**Will China democratise?**

One of the great puzzles for political scientists has been the possibility of democracy coming to China. Modernisation theory suggests that as a country develops and sees the rise of an urbanised, middle class society, there will be an irresistible demand for democracy. That was one reason why the US Clinton administration supported China's entry into the World Trade Organization in 2001.

But modernisation theorists have been disappointed with the case of China, where there is no sign of democratisation, and indeed no organised opposition to the CCP. There are several reasons why China has not democratised. First is the CCP's belief that successful economic development would improve popular support for the CCP, rather than usher in political reform. And economic development has been buttressed by political responsiveness discussed above.

Dickson also reports that the Chinese people actually believe their political system is increasingly democratic because they experience improving standards of living and a somewhat responsive government. They seem to define democracy in terms of good governance, rather than in terms of the election of leaders, civil rights, or the rule of law.

At the same time, a critical factor in the CCP's survival has been the strict Leninist political regime with no organised opposition; tight Party control over the senior appointments in government, state-owned enterprises, banks and universities; a network of party cells throughout the state and society to monitor compliance with the party line; and suppression of ethnic minorities in favour of a uniform national identity.

The regime of Xi Jinping has reoriented Chinese governance towards even more repression (especially through modern surveillance technology), less responsiveness, and a tightening of the Leninist political regime, provoking discontent in some quarters. As China's economy is becoming a weak spot, and relations with the West have deteriorated immeasurably, the future of the CCP regime comes into question.

Dickson warns that if CCP were to succumb to regime change, history suggests that it is unlikely to become a democracy, but rather another authoritarian regime. For example, most of the formerly communist countries in the Soviet Union and Eastern Europe have not become democracies. Further, China does not have an organised opposition, or an opposition figure like South Africa's Nelson Mandela. The most plausible avenues for regime change in China would be an internal CCP coup (change of leader) or a military takeover.

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