Consumer headwinds to weigh on retailers

Low wage growth and higher costs will dampen spending

ROGER MONTGOMERY

With the 2018 financial year under way, it's worth examining the forces that could determine whether the Australian stockmarket repeats its circa 13 per cent return of 2017.

For those with less patience, the executive summary goes something like this: valuations remain relatively stretched across the broader universe of high-quality companies (typically this limits future returns), and this is occurring at a time when the prospects for many domestically focused businesses give cause to be less sanguine. Rising non-discretionary household costs, combined with weak wages growth, leaves less discretionary spending capacity. As such, discretionary retailers and product manufacturers are vulnerable to weakening demand.

Fuelled by the speculative bubble in residential property, rising household debt levels, combined with a falling savings ratio, have provided households with the flexibility to maintain their consumption levels until now. Debt must reach a ceiling and the process of deleveraging includes reduced consumption and regulatory or prudential responses. Should the pendulum swing towards parsimony, it will do so at the same time that the real economy has to deal with the imbalances associated with rapid house price inflation, including residential construction overactivity.

Another source of structural weakness stems from very low wage growth — much lower than inflation. And given that weak business confidence is producing excess labour supply and a high level of underemployment, wage growth is unlikely to come to the rescue of highly indebted households.

The latest mortgage cycle saw a significant increase in the proportion of new mortgages written on an interest-only basis. In fact, data produced by APRA reveals new interest-only mortgages increased steadily from a low 21 per cent of total new mortgages in 2011 to a peak of 42 per cent of total new mortgages in June 2015.

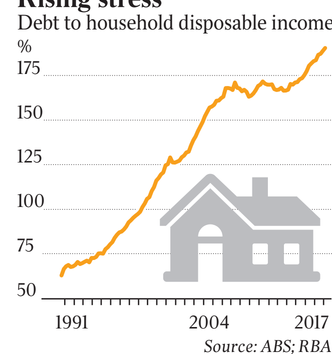
Many, if not most, interest-only mortgages revert to principal and interest after five years. Customers who reach the end of their first term will then need to refinance their mortgage for another five years and many will only be able to afford interest-only mortgage repayments.

But the introduction of a 30 per cent cap on the proportion of new mortgages that can be written by banks as interest-only from July 1, 2017, will force some households to begin to repay principal on top of their interest payments. This could represent an increase in repayments of as much as 40 per cent. And that will occur even without an increase in interest rates. Additionally, the households that are less likely to be able to refinance their mortgages to gain the benefit of another interest-only period are more likely to be those that are already financially stressed.

For those that are able to refinance a new five-year interest-only mortgage, we believe they will have to do so at a rising cost relative to the RBA's official overnight interest rate. This is because the banks use pricing to allocate the limited amount of new interest-only mortgage product capacity, and to offset likely increases to risk weights on more vulnerable mortgages such as investment property mortgages that are dependent on rental revenue to meet serviceability requirements.

Record debt combined with rising rate charges will have a material impact on discretionary spending by households. According to the recent National Census, 34.5 per cent of households have a mortgage, while 11 per cent have one or more investment property mortgages.

Rising stress
Debt to household disposable income



Source: ABS; RBA

The RBA's 2014 breakdown of household debt by income and age provides some clues on which demographics will be more exposed to rising rates, and growth in debt has been the most significant in the 35-44 year old, 45-54 year old and more recently, the 55-64 year old demographics.

Significant increases in household utility prices will add to household stress. The closure of the Hazelwood power station has started the process of progressive closures of baseload coal power plants. When combined with rising spot gas prices on the east coast, energy costs have risen substantially in the past six months. As of June, higher wholesale electricity prices were being reflected in higher retail prices, with rises of 20-30 per cent common.

In addition to its impact on consumers' wallets, rising power prices will affect domestic business profitability. This will be more significant for energy-intensive business — for example, large-scale manufacturers and miners — squeezing margins and/or forcing price increases.

It is in these periods of cost pressure that a focus on investing in high-quality companies with pricing power is paramount.

Retailers targeting cost-conscious consumers are likely to see a more significant impact from rising non-discretionary household costs. Stuart Jackson, the Montgomery (Private) Fund's portfolio manager, reckons discount department stores such as Kmart, Target and Big W, The Reject Shop, Specialty Fashion Group, Super Cheap Auto, Noni B, Dominos, and Coca-Cola Amatil are all in the firing line. Retailers focused on more mature customers — those with increased debt — include department stores like Myer.

The final headwind that is likely to materialise in the 2017-18 financial year is a downturn in residential construction. Growth in this sector has supported economic growth, taking the mantle from mining investment following the end of the resources boom. The recent downturn in residential building approvals data, however, indicates that in six to nine months, residential construction is likely to begin to slow and turn negative toward the end of calendar 2017, turning an economic tailwind into a headwind.

We continue to believe that asset prices remain elevated. Elevated share prices imply strong earnings growth. For several key economic sectors, growth is becoming much more difficult.

Roger Montgomery is founder and chief investment officer of the Montgomery Fund.

www.montinvest.com

THE COACH

I have read that I should always hold my life insurance inside superannuation. Why is this and what is the difference between owning insurance inside and outside super? I have death and total permanent disability insurance provided by my employer via a super fund. I am 38, single, with no kids. On my death I plan to leave my estate to my parents and charity. I have sufficient disability cover to pay off my mortgage if I can't work again.

When considering whether to hold life insurance inside or outside super, you need to factor in your personal circumstances, your insurable need and the tax consequences applicable to the premiums, and more importantly the death proceeds.

A major advantage to you of structuring your insurances under super is that the premiums are paid from your accumulated super fund balance, or from pre-tax super contributions. If you were paying for life insurance outside of super you would have to fund the cost from your after-tax dollars.

Often the premium costs of life insurance held in an employer super fund are at group rates, and so should be priced at a lower rate than what you can secure via individual retail cover outside super.

Before making any changes, check the level of cover you have, compare the features and benefits of the cover and the terms and conditions of the insurance contract.

While funding insurance costs from super as opposed to post-tax cash flow is attractive, it does come with some negatives that need to be considered.

The purpose of super is to fund retirement. Insurance costs will eat into your retirement savings and impact on your long-term rate of saving for retirement.

If your employer pays your insurance premiums as an employee benefit under super, the cost of the cover will count as a contribution towards your super concessional contribution cap of $25,000.

This may limit your ability to salary-sacrifice super contributions.

Generally speaking, in the event of death, insurance proceeds on policies self-owned outside super are tax-free to beneficiaries. However with super, you need to be very careful as tax treatment will vary depending on who you nominate as beneficiaries. If proceeds are payable to a tax dependent — a spouse, child under 18 or someone financially dependent upon the member — the proceeds are tax-free. Assuming your parents do not rely on you for ongoing financial support, if proceeds are payable to a non-tax dependent such as your parents or a charity, the death benefit proceeds are taxed at 15 per cent. Or, where the super fund has claimed a tax deduction for the insurance premiums, the proceeds are taxed at 30 per cent.

These tax consequences are quite substantial. You may argue that you're dead, so what? But ultimately this becomes a question of who you want to benefit: your beneficiaries or the ATO. By careful planning you can manage this risk and provide as much benefit as possible for those you wish to provide for.

It is important to understand the tax consequences on your death for beneficiaries and also the options you have with insurance to minimise the tax impact. If you are in the position of knowing you will die in the foreseeable future, it is particularly advisable to learn more about the options available to you on payout of the insurance benefit. You may be able to manage how and to whom the proceeds are paid via your death benefit nominations. Better to give to charity or loved ones than Canberra.

Visit the Wealth section at theaustralian.com.au to send your questions to Andrew Heaven, an AMP financial planner at WealthPartners Financial Solutions.

Fintechs target tech-savvy millennials with growing online financial services

ROSEMARY STEINFORT

Millennials, a demographic group born between 1980 and 2000, make up one of the largest living generations and have now overtaken the baby boomers.

Millennials are likely to fall into three categories:

- Inheritors: With wealthy parents, they are major consumers while they wait to inherit.
- Strivers: Coming from a more modest background, they are studying, saving and working hard with ambitions for promotion. They will borrow to support their lifestyle, not unlike inheritors.
- Given-ups: They are more likely earning a low salary but continue to consume as much as the other two categories. Buying a house is not on the agenda, so they do not see the point in saving.

Millennials have been called the "smashed avocado" generation, as some would rather spend money on brunch and takeaway coffees than save, for various reasons, depending on the category to which they belong.

While millennials may have wider lifestyle choices compared with their parents, they are the unlucky generation in the housing stakes. Buying a house for many is an unattainable dream. But conversely, growing up in the internet age has opened a treasure chest of opportunities that were not available to previous generations. And the arrival of the smartphone has revolutionised the way people communicate, bank, shop, and more. In particular, the possibilities of online investing, lending and saving are changing the way they and future generations manage their finances.

With the arrival of financial technology, or "fintech", which offers new solutions for financial services using technology and innovation, the opportunities abound for the tech savvy generation. Fintechs are targeting those that have fallen out of love with banks and other traditional financial services. And 71 per cent of millennials, according to Viacom's Millennial Disruption Index, would rather go to the dentist than to the bank.

A close look at local fintechs

Company	Category	What they do
Acorn Australia	Investing	Micro investing by allowing small change to be invested in a diversified portfolio
BetterWealth	Robo-advice	Online adviser personalised to suit the investor, using ETFs
BigFuture	Robo-advice	Free applications that can help you manage your financial future.
FirstStep	Investing	A mobile app that lets you automatically invest the virtual loose change from your everyday electronic transactions
Goodments	Investing	Online investing that matches investors with their values to create a portfolio
Six Park	Investing	Online low-cost investing advice

Source: Australian FinTech

Below is a list of four types of fintechs and some examples:

1. Robo-advice: This provides financial management advice with minimal human intervention, usually for a lower cost. It is especially attractive for those who cannot afford to pay a financial adviser, which can cost up to 1 per cent of savings. Companies such as BigFuture provide a free app that allows easier navigation of a person's finances by keeping all their assets in one location, while BetterWealth offers online financial advice customised to the investor, and InvestSmart is a free automatic investing service that provides a supermarket selection of products.

2. Peer-to-peer lending: Another type of fintech, peer-to-peer or marketplace lending is useful for millennials. Typical marketplace lenders such as DirectMoney or RateSetter provide simple, flexible personal loans for creditworthy borrowers. Some P2P lenders allow borrowers to take out a loan that can be used to fund stamp duty or furnishings, as well as bridge the deposit gap.

3. Digital Wallets: Managing finances electronically is possible, with apps such as Pocketbook providing a free way to budget and manage finances, allowing real-time control of a person's money, along with a "safety" budget feature that allows setting of the amount that can be safely spent on non-essentials. Meanwhile, Stocard allows users to store all loyalty cards in their smartphones, collect points and rewards, and monitor transactions.

4. Investing: Easier ways to invest at lower costs are likely to increase the appeal to millennials, who are unlikely to ever meet a traditional financial adviser.

Acorn is a micro-investing app that links to an investor's bank account and credit card, rounding up daily purchases and automatically investing the small change into a diversified portfolio of exchange traded funds.

All the investor has to do is choose the diversified investment option. FirstStep is another app that offers automatic investing of virtual loose change from electronic transactions into three investment options that invest in ETFs. Atlas Trend allows small amounts to be invested in global trends.

Not just for millennials

By removing the inefficiencies of traditional financial services, dealing directly with the source rather than the intermediary and often a lower cost solution, millennials are getting a better deal from fintechs, especially with a quicker turnaround. Who wants to wait two weeks for a personal loan, earn paltry returns from bank deposits or pay over-the-top fees for financial advice?

Millennials are not the only ones rejecting conventional models of finance, as the proliferation of fintech solutions increases appeal to other generations.

Disclaimer: Fintechs mentioned in the article or in the list above are not recommendations but for reference use only.

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