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# STUART + CARLYON

Financial advisers for your lifetime goals

## Glimmers ahead

In these economically dark days, it takes a brave soul to make forecasts. Well we're not here to toss coins and make promises, but we can report a number of glimmers that are starting to appear on the horizon.

First let's acknowledge that we're going to be in the tunnel for a while yet. Let's face it, the crisis which started in the overheated mortgage market of the USA has rippled out to just about everywhere. Business confidence is so low in Europe at present that big lorry manufacturers such as Volvo - always a barometer of business optimism - are lumbered with vast fleets of unsold trucks and only a trickle of forward orders. This will impact on tens of thousands of jobs. In the USA (and now here) unemployment is creeping upwards and workforces are shifting to nine-day fortnights – which are hardly a stimulus for the economy, but at least a defensive means of reducing unemployment.

On every level the shakeout is seeing people return (after a decade of living on the inflated promise of property prices and the promise of booming business growth) to the idea of living within their means.

So where's the light? Amidst the gloom there are positive things happening. Right now some old fashioned business values are returning to the investment world. So while many investors are paralysed by doubt, and have been shedding not only the high-risk structured credit products but also their sound investments, others are saying: "hang on – humankind is not grinding to an utter standstill." And so they're looking for logical, transparent and slightly old fashioned companies to invest in: companies that make things. Thanks to the recent sell! sell! sentiment, there are some good buys out there.

And right now there is more upside than downside. According to *farrelly's* (asset allocation specialist) global shares should return 13% per annum over the next ten years. The worst case "Armageddon" scenario is for global shares to return only 1% per annum. In this what-if scenario the cash rate would be even less than 1% so "investors will be better off long term in equities – it just may not feel like it." The key is finding companies delivering sustainable dividends. The message: even if things get worse, it is still time to buy equities.

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In fact as the analysts at *farrelly's* note: "selling out in response to appalling economic news is often a very expensive strategy... shares are pretty safe right now as cash rates are coming down." In NZ the Official Cash Rate is 3% and likely to come down again. At this point, the dividend yield from NZ shares is 8.3% gross and listed property 13%. Over in the USA where economic problems appear deeper than they are here, the cash rate is 0.25% and the S&P 500 representing the top 500 US companies is delivering a yield of around 3.5%

At Stuart + Carlyon our philosophy has been to focus on matching cash flow with clients' spending. Over time one's net capital value may bump up and down somewhat, but in good years, we lock in gains to cushion the bad years. Looking right across our client portfolios we've seen a dip in value over the last 12 months – for sure – but none of our client portfolios have been decimated by the failure of finance companies or CDOs (eg ING Diversified Yield Fund). That, we might add, was not a matter of luck.

### Signposts for recovery

What should we look out for as indications the worst is over?

1. **Increasing stability in the financial system.** Signs include easing lending criteria and narrowing credit margins (an indicator that people are more comfortable lending to sound companies). Lower cost of borrowing for companies will improve profitability.

2. **World governments (not just the USA & UK) climb into rescue mode.** Watch for Europe to use similar tools to rescue banks to stimulate lending to businesses. China, Japan and Germany have excess savings so can spend more to reignite global growth.

3. **US house prices stabilise.** Oversupply diminishes, housing affordability returns, number of sales increases.

4. **Very high cash levels and low interest rates.** Not since 1933, has there been more money in cash rather than in share funds. The arithmetic is simple and will see investors return to the market.

5. **Shares start climbing.** Expect confidence and unemployment to continue to worsen but shares usually turn the corner first.


## More money in our pockets

The new personal tax rates, effective from 1 April 2009, put more money in our hands. If you earn $48,000, you'll pay $1,820 less in tax than you would have for the 2008 tax year. If you earn $70,000, you'll save $2,420 a year.

| New Personal Tax Rates | |
|---|---|
| $0 - $14,000 | 12.5% |
| $14,001 - $48,000 | 21% |
| $48,001 - $70,000 | 33% |
| $70,001+ | 38% |

The reduced tax results from the adjustment of the various thresholds as well as the lowering of the tax rates. Effectively everyone will be paying tax at around 18.5% on $48,000 which is a big improvement on the long standing 19.5% up to $38,000 then 33%. And the 33% rate is extended from the old threshold of $60,000 up to $70,000. Unfortunately banks won't be changing RWT rates to 18.5% until 2010 so check you haven't overpaid tax on bank deposits next year. Not all employees will see the full benefit due to ACC levy increases and for those receiving family tax credits, tax savings were already in place.

For our retired clients this change will make a big difference. A couple can earn investment income up to $68,500 jointly on top of their NZ Super and pay tax at 18.5%. For single superannuitants the amount is $30,000 on top of NZ Super. The message here is review your tax planning - for those with family trusts, more income can be paid out to you instead of paying tax at the trustee rate of 33%.

Here are three more tax savings:

1. **Generous donors rewarded.** If you make qualifying donations to approved charitable organisations you can now give as much as you want up to the amount of taxable income you earn. Receipts are still required and the donations must be $5.00 or over.

2. **Are you self employed** and operating as a company? The company tax rate was lowered from 33% to 30% on 1 April 2008.

3. **Softening the redundancy blow.** Not a new rule but if you have received a redundancy payment you can claim a tax credit of 6 cents in the dollar up to a maximum of $3,600. You'll need to complete an IRD claim form (IR524).

## Fixed interest paradox

It's bad enough for income oriented investors to see money on-call earning 2.9% and term deposits rates half what they were a year ago. But falling interest rates have also negatively impacted a number of tradeable re-set fixed interest investments namely ASB Capital, CBA Capital and Rabobank.

> "The swap rate is an internationally recognized benchmark used for setting interest rates and has been at a historical low of 3%."

There do not appear to be any credit concerns about these banks. So why have the values of their investments fallen? Because the interest rates are re-set annually, the investment is now marked down on the expectation that the new rates will be significantly lower. The reset rate is linked to the prevailing one year swap rate, plus a margin above this swap rate. The swap rate is an internationally recognized benchmark used for setting interest rates and has been at a historical low of 3%. Furthermore, investors are demanding a higher margin above this swap rate than these securities were originally issued at. This recipe has resulted in price declines should you want to sell on the secondary market.

| | Credit Rating | Current Rate | Reset Date | Margin | New rate if set today |
|---|---|---|---|---|---|
| ASB No 1. | A | 6.73% | 15/11/09 | 1.30% | 4.30% |
| ASB No 2. | A | 9.03% | 15/05/09 | 1.00% | 4.00% |
| CBA | AA- | 9.32% | 15/04/09 | 0.75% | 3.75% |
| Rabobank | AA | 7.449% | 08/10/09 | 0.76% | 3.76% |

Clients have benefitted from the high annual rates up to now and when interest rates eventually increase, we expect to see the values go up. In the meantime, income will continue based on the number of units (face value) times the annual rate set. These investments are part of the portfolio weighting to short term interest rates. Fortunately we locked in some five year rates last year at 8% to 9% and those bonds have had double digit returns in the same environment of falling interest rates. The key is to maintain a spread of maturities to minimise the effect of adverse interest rate movements.