The Key

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What's driving the volatility in the Australian dollar?

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If you are new to reading The Key newsletter, welcome. If you are an avid reader of this publication you would be familiar with this forum, delivering relevant and interesting content from the financial planning industry, to help you better manage your financial life. A core value of our business is that every Australian should have access to, and benefit from, good financial advice. In reading this publication, we hope that you find the articles interesting, and perhaps they will provide some talking points for your next review meeting with your financial adviser.

Enjoy reading this edition of The Key.

Chinese demand for commodities like copper, steel and iron ore, and speculation over what the Reserve Bank and other central banks will do with interest rates, are key drivers behind recent Aussie dollar volatility.

A strong currency is usually a sign of a healthy, growing economy. That's why the AUD generally rallies when the Reserve Bank of Australia (RBA) raises interest rates and conversely dips when there's a rate cut.

A rate hike signals a vibrant growing economy, and typically coincides with good news like strong manufacturing data, positive inflation, falling unemployment and improved retail spending while a rate cut is a tool used by central banks to spur economic growth.

Over the last five years, interest rates in Australia have fallen to a record low of 1.75 per cent, as the RBA strives to make borrowing even cheaper to encourage spending and investment.

There's speculation that rates may fall further as the Australian economy struggles to transition from mining-led growth to broader-based growth.

The RBA's May decision to cut rates to 1.75 per cent and keep them on hold in June has seen the value of the AUD slide back against the US dollar (USD), aided by falling commodity prices.

This was markedly different to April when the RBA's decision to keep rates on hold for the eleventh consecutive month amidst rising steel and iron ore prices saw the dollar rally. In order to understand the drivers of recent AUD volatility, it's important to first understand the key drivers of the Australian economy.

The performance of the Australian economy is closely linked to the growth of the mining sectors, which are big exporters to China and the rest of the world. The Australian government depends heavily on taxes from the resources sector.

The Australian dollar is therefore tied to global growth and demand for commodities, which is why it's commonly described as a "commodity currency".

financial services partners

China is Australia's largest export partner but the pace of growth in the Chinese economy is slowing, pushing the country's central bank, the People's Bank of China (PBoC), to introduce a range of stimulus measures.

Commodity prices and interest rates are two of the major forces that drive the AUD.

The tug of war over the AUD in the last few months is linked to the price of China-related commodities like steel and iron ore, which have rallied off the back of PBoC stimulus and then fallen, in part due to higher prices resulting in extra supply.

The other important factor is the interest rate differential between Australia and the rest of the world. While Aussie bonds may not be giving investors a real return, at a time when other countries have zero or negative rates, Australian 10-year bond yields look fairly attractive, which is supporting the AUD at the moment. Despite historically low interest rates, the AUD seems overvalued due mainly to economic instability in other parts of the world. In June, German bond yields dipped below zero for the first time, joining Switzerland and Japan.

The US Federal Reserve's recent change in tone from hawkish to dovish also provided impetus for a higher AUD. Weak US employment dimmed the prospect of the Fed raising rates again, which saw the AUD edge higher over the potential for the interest rate differential between the US and Australia to narrow.

The differential between Australia and the rest of the world is a factor that may be buoying the AUD, and many investors believe it's currently trading above fair value.

The Australian economy has been relatively resilient until now, with moderate inflation, but there's a real risk it could also be impacted by the low inflation affecting many other countries.

In terms of volatility, the interaction of commodity prices and interest rates is driving volatility in the AUD, and also the ebbs and flow of risk appetite as the world economy adjusts to a slower pace of growth.

A long term financial plan is designed to withstand volatility across currencies and markets. However, if you wish to find out more information about how currency volatility can impact your investments, please make an appointment to discuss this further with your financial adviser.

Please note, all information in this article was compiled in July 2016 and accurate as of the dates stated throughout.

How the ATO's new LRBA rules affect SMSF trustees

SMSF trustees must comply with new rules around Limited Recourse Borrowing Arrangements by 31 January 2017 to avoid a hefty tax bill.

The introduction of changes to the rules around Limited Recourse Borrowing Arrangements (LRBAs) for self-managed super funds (SMSFs) has been pushed back by the Australian Taxation Office (ATO), giving trustees an additional six months to comply.

The new rules, which require any related party loan to a SMSF to be considered an arms' length deal, will now come into effect on 31 January 2017 to allow SMSF investors extra time to review their borrowing arrangements and make any necessary changes.

In April, the ATO has also released a Practice Compliance Guideline providing guidance on the factors it believes signify an arm's length arrangement. For a real property loan that includes a formal written agreement; an interest rate of 5.75 per cent for the 2015/16 financial year; monthly principal and interest repayments; a loan term of 15 years or less; and a maximum loan to value ratio (LVR) of 70 per cent for both commercial and residential property all apply.

If the investment being purchased is a parcel of identical stock exchange listed shares, the loan should have an interest rate of 7.75 per cent for the 2015/16 financial year; a loan term of seven years or less and a maximum LVR of 50 per cent to finance the LRBA.

The ATO has also committed to providing further guidance, including case studies, by the end of September.

What will happen if trustees miss the extended deadline?

An SMSF can only borrow money to invest in very limited circumstances. A trustee can use an LRBA to fund the purchase of a single asset or parcel of identical stock exchange listed shares, to be held in a separate trust.

Basically, under an LRBA, if the loan defaults the lender's rights are limited to the assets held in the separate trust.

Over the past few years, the popularity of LRBAs has significantly grown, forcing the ATO to issue continuous guidance.

The ATO is trying to further clarify the rules applying to related-party loans, given a number of LRBAs have low or zero-interest loans and other generous terms.

In 2014, the ATO issued a private binding ruling, stating that the income derived from an LRBA that was non-commercial had non-arm's length income rules applied to it.

Therefore any earnings from the relevant asset would be taxed at the highest marginal tax rate, rather than 15 per cent in accumulation phase or nil in pension phase.

Key take-outs

The ATO is committed to ensuring that where an SMSF has taken out a related-party loan, that arrangement was entered into and maintained on terms consistent with an "arm's length dealing".

If it is not, SMSFs must either adhere to the ATO's new guidelines by 31 January 2017 or refinance their loan through a commercial lender or pay out the LRBA.

Failure to do so will result in the ATO deeming that the asset gives rise to non-arm's length income, which should be taxed at the highest marginal tax rate – 47 per cent!

It's important for SMSF trustees to speak to their financial adviser as soon as possible to ensure they understand the impact of the ATO's new rules and will comply by the extended deadline.

In order to meet the requirements, investors may need to make payments of interest and capital for the year ended 30 June 2016 from their SMSF prior to 31 January 2017.

Further guidance on the $500k lifetime cap on non-concessional contributions

With superannuation being a moving feast it can be hard to keep up and know how you are affected. Your financial adviser can help you to understand these changes in relation to your personal circumstances and help you understand what opportunities this may present.

What are the changes?

The lifetime contribution cap has been abolished

In the May 2016 Budget, the Government proposed the introduction of a $500,000 lifetime cap on non-concessional (after-tax) contributions to superannuation.

What has changed?

This lifetime cap of $500,000 has been replaced by these proposed changes, starting 1 July 2017:

- a non-concessional contributions cap of $100,000 per year
- individuals under 65 as at 1 July each year can 'bring forward' three years of non-concessional contributions
- individuals with over $1.6 million in super can no longer make non-concessional contributions.

These proposals won't take effect until 1 July 2017, so the existing non-concessional contributions caps will continue to apply for the current 2016-17 financial year (see table below).

The work test will now continue from age 65

In the May 2016 Budget, the Government announced it was removing the work test for contributions made on or after an individual's 65th birthday. This would have allowed individuals over age 65 to contribute to super without having to be gainfully employed for at least 40 hours over a consecutive 30-day period.

What has changed?

This change has been abandoned and so individuals looking to contribute to super from age 65 will still need to satisfy the work test, so the current rules will continue to apply.

Age at 1 July 2016	Does the work test need to be met?	Annual non-concessional contributions cap	Can the $540,000 cap be used?
Under 64	No	$180,000	Yes
64	Only if the member is 65 at the time of making non-concessional contributions	$180,000	Yes
65 or older	Yes	$180,000	No

The 'catch-up' of concessional contributions will be delayed

In the May 2016 Budget, the Government announced that from 1 July 2017, the Government proposed to reduce the cap on concessional contributions (such as employer and salary sacrifice contributions) to $25,000, and then allow individuals to 'catch-up' on any unused concessional contributions within the next five years, if their superannuation balance was less than $500,000.

What has changed?

While the reduced concessional contributions cap is still proposed to apply from 1 July 2017, the ability to 'catch-up' on any unused concessional contributions has been delayed until 1 July 2018.

Do you have a question?

Despite this new round of changes, superannuation remains a very tax-effective way for you to build up your retirement savings. However, these proposals need to successfully pass through Parliament before becoming law and may be subject to further change during this process.

For more information on how these changes could affect you, contact your financial adviser today.

5 ways to build resilience

Do you crumble in the face of adversity or thrive under pressure? We look at some ways you can build your resilience and manage stress.

The term resilience describes a person's capacity to bounce back from stressful situations. Being able to cope under difficult circumstances can reduce the incidence of mental health or behavioural problems such as depression, anxiety, substance abuse and antisocial behaviour.

There is also emerging evidence* that young people who display resilience are more likely to achieve school success.

Here are five ways you can build your resilience.

1. Look after yourself

In a fast-paced world, we all need to take time out for ourselves occasionally. Engage in activities you enjoy, exercise regularly and ensure you get enough sleep. Taking care of yourself helps to keep your mind and body primed to deal with tough situations.

2. Think positive

Resilient people are optimists. Maintain a positive outlook and find ways to build your self-confidence. Keeping a sense of perspective in stressful times can help you to solve problems and avoid blowing the event out of proportion.

3. Accept change

We live in a world of constant change, so being adaptable when responding to uncertainty is a key life skill. Rather than expecting to have full control over everything in your life, instead expect the unexpected. Be open to different points of view and rather than resisting change, try to engage with it.

4. Make connections

In a TED talk which has achieved over 11 million views, Stanford University health psychologist Kelly McGonigal discusses how the stress hormone, oxytocin, motivates us to seek support from people who care about us.

Building close relationships, whether that is with colleagues, family or friends, can help you to recover more quickly from stressful situations.

5. Learn from your mistakes

Failure is one of life's common traumas, yet our responses to it can vary widely. Seeing failure as a learning opportunity is one of the traits of resilient people. Appreciating your mistakes for what they are can help you to overcome fears, take responsibility and live a life without regrets.

* Building Resilience in Young People – Youth Research Centre, Melbourne Graduate School of Education

Resilience characteristics – a cluster of traits

flexible positive
connected focused
organised proactive
open-minded

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