Are you interested?

Over the last few months the Reserve Bank of Australia has made history, by raising the official cash rate to its highest point in a decade. And while media focussed attention on stories of how the rise would effect struggling home owners and credit card holders, this is only half the story. For pensioners and retirees, a rate increase can be heaven sent.

For many years now interest rates have remained at 30-year lows, which has been great news for accumulators, homeowners but not so great for self-funded retirees. While low interest rates mean buyers can continue to borrow, and home owners can easily meet their interest payments, they also mean low rates of interest on savings and term deposits. This is bad news for retirees, many of whom have paid off their mortgage and rely on fixed interest investments to provide them with income.
Now that interest rates are steadily rising, many homeowners and accumulators are feeling the pinch while many retirees should be breathing a sigh of relief.

How do interest rates affect people on pensions?

We mentioned that the recent rise in interest rates is good news for self-funded retirees, but it is also good news for people who rely on investment income to supplement their aged pension.

In 1996 the Government created deeming to discourage pensioners from putting money into low-earning everyday bank accounts to avoid losing part of their Centrelink payments. The deeming rules are a central part of the social security income test. Deeming assumes that financial investments are earning a certain rate of income, regardless of the amount of income they are actually earning. If pensioners earn more than these rates, the extra income is not assessed.

This means ideally pensioners should be looking for investments that return the deeming rate, if not more.
The current deeming rates for a single person are 3.5% for the first $39,400 and $65,400 for a couple, jumping to 5.5% for financial investments above these amounts.
The thresholds at which the higher deeming rate begins to apply are indexed in line with the Consumer Price Index in July each year. While the lower deeming rate is expected to cover at-call savings, the higher rate assumes a more diverse portfolio of investments. Many safe and readily available financial products will actually meet or exceed deeming rates. But as everyone's circumstances are different, it's best to seek help from a financial adviser.

The great thing for retirees is that changes to the deeming rates are usually made in March or September to limit disruption to pension payments. So although interest from term deposits, cash management accounts or savings accounts have gone up, the deeming

rates have not yet followed suit. So if you're a retiree, anything more you are earning because of higher interest rates, is extra money in your pocket and will not affect your Centrelink pension.
Of course, with account based pensions, the underlying investments will determine how it will perform. If you are purely in cash, an increase in interest rates will certainly boost returns in that fund. However, if you have a mix, then the movement will have an impact, but it is not going to be as significant.

What about my shares?

In theory, an official rate rise should be a good sign for shares as it means the economy is growing too rapidly, which means corporate earnings should also be growing rapidly and so should shares prices. But in the short-term rising interest rates also have negative impact on share prices for several reasons.

• When rates go up, rising interest rates and bond yields attract many investors away from shares.

• The market looks ahead. Shares rise when investors think the economy and corporate earnings will grow.
When the Reserve Bank increases rates, it is seeking to restrain the economy.

• Companies that borrow money pay more when interest rates go up. This reduces their earnings.

• Consumers also pay more to borrow money, which discourages them from buying things, which hurts companies dependent on the consumer.

But although at a company level it is clear rising interest rates are a negative to earnings, overall there is no direct relationship between interest rates and the share market. This is because a range of factors such as investor sentiment, the broader economic environment and what is happening in overseas markets also come into play.

Rising rates are best described as a short-term constraint on share market returns, while shares are generally considered a long-term investment. Of course, some products like ones that use gearing are less attractive in a high interest rate environment as you will have to pay more interest on your borrowings.

But as always everyone's situation is different, so it's best to speak with your financial adviser before making any decisions based on changes in interest rates. They can help you determine the right mix of assets to suit your personal needs. End.

Source: InTouch Magazine 308