Shane Oliver, Head of Investment Strategy
& Chief Economist

AMP CAPITAL

The search for decent yield as interest rates fall

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Key points

> Assets with a decent and sustainable yield are attractive because they provide a greater certainty of return in an environment of volatile and constrained capital growth.

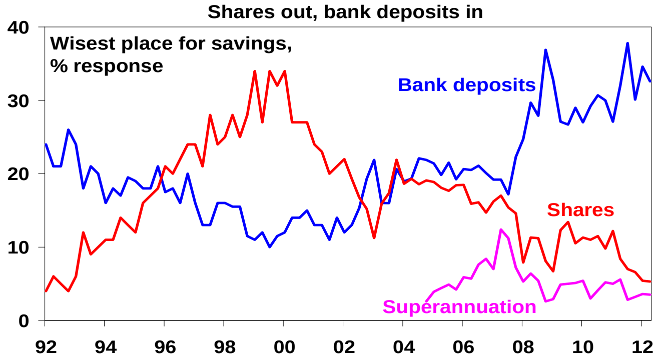
> However, bank term deposit rates have fallen and are likely to fall further, possibly to around 4%, as the RBA continues to reduce the cash rate to help the economy. So it makes sense to look elsewhere.

> Attractive alternatives to term deposits include shares offering decent and sustainable dividends, real estate investment trusts, unlisted non-residential property, infrastructure and corporate debt.

Introduction

The uncertain investment environment and poor returns from shares since the GFC has seen the popularity of bank deposits surge while that of shares has collapsed. When asked by the Westpac/Melbourne Institute consumer sentiment survey what is the wisest place for savings, bank deposits are the most popular response being nominated by over 32% of those surveyed in June, whereas only 5% nominate shares. See the next chart. Consistent with this, investment dollars have been coming out of funds exposed to shares and piling into term deposits.

Shares out, bank deposits in



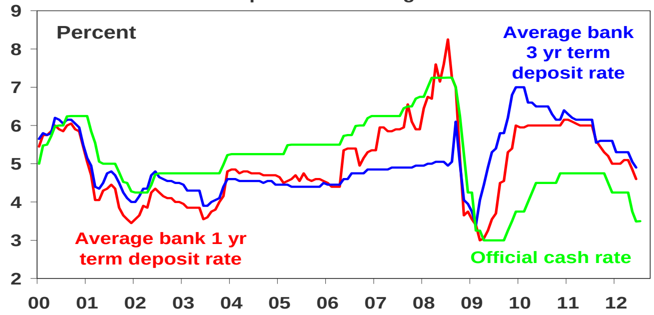
Source: Westpac/Melb Inst, AMP Capital

However, there are two problems with this. The first is that where the crowd is going is usually not the best place to be for the medium term. For example, in 1999-2000 shares were seen as the wisest place for savings on the back of the tech boom only to then see global share markets collapse with the tech wreck. Second, the rates of interest on bank deposits are getting lower and lower, suggesting it might be wise to look around for more attractive sources of income.

Falling interest rates, falling deposit rates

Through 2010 and going into 2011 there were very attractive rates of interest being offered on bank term deposits. At one stage average bank 3 year term deposit rates were around 7%. This reflected a combination of rising official interest rates and a "war for deposits" amongst the banks as they sought to boost their reliance on deposits as opposed to wholesale sources of funding which proved unreliable though the GFC. The war for deposits saw deposit rates rise well above the official cash rate, whereas the norm pre GFC was for them to run below the cash rate. This of course is the flipside of the rise in mortgage rates relative to the cash rate.

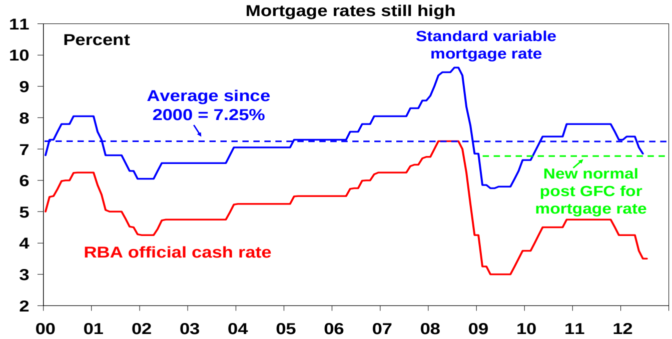
Australian term deposit rates falling with RBA cash rate



Source: RBA, AMP Capital

The trouble now is that the cash rate is falling as the RBA has cut rates to deal with softer than expected economic conditions and lower inflation and the war for deposits has faded a bit. So term deposit rates have fallen sharply. Our view is that further falls are likely as the RBA is likely to cut official interest rates to 2.75% to 3% over the next six months on the back of sub-par confidence, disappointing growth and benign inflation. At present the standard variable mortgage rate at around 6.82% is only just below its longer term average of 7.25%, but at the past two cycle lows it had to fall to around 6% to ensure a decent recovery in economic activity. What's more, the neutral level for rates has likely fallen since the GFC reflecting business & consumer caution.

Mortgage rates still high



Source: RBA, AMP Capital

The ensure that the mortgage rate falls to around 6% and other borrowing rates fall by a similar amount, the official cash rate will need to fall to around 3% or just below which is what we expect to see over the next six months. This would suggest that term deposit rates will fall to around 4%.

Alternatives to term deposits for yield

As term deposit yields fall, it is logical for investors to look around for more attractive alternatives. Allocating more to shares makes sense for those who can take a long term perspective, but it may not be so good for those near to retirement, in retirement (like my Mum), or with modest investment balances that they can't afford to see fall in value or for those who just don't like any volatility.

One approach for such investors is to focus on assets that provide a better investment yield than term deposits. Assets with a decent and sustainable yield are also attractive because they provide a greater certainty of return in an environment of heightened volatility and constrained returns.

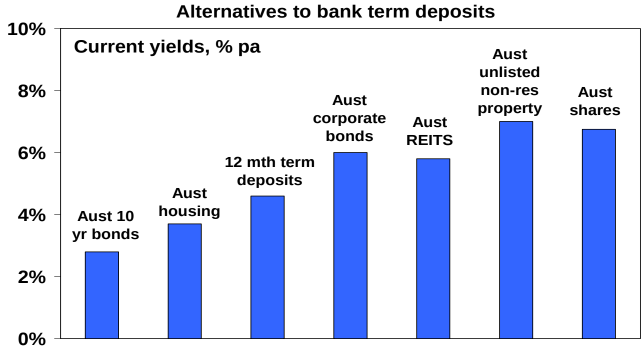
Traditional alternatives to bank deposits include government bonds and housing. However, just as term deposit yields have fallen so too have government bond yields. This has been good for bond investors so far because as yields fall, bond prices rise resulting in capital gains. However, Australian ten year bond yields have now fallen to a record low of 2.8% and five year bond yields are 2.3%. This will be the return an investor will get if they hold these bonds to maturity. Global bond yields are lower, averaging around 1%.

After the house price boom of the past twenty years the rental yield on houses is just 3.7% and that on apartments is around 4.7%. After costs net yields are around 1% for houses and 2.3% for apartments. And after a long bull market Australian house prices are vulnerable to an extended period of poor capital growth.

However, there are a number of attractive yield bearing alternatives to Bank deposits. See the next chart.

- Corporate debt is an option for those who want higher yields than term deposits but don't want the volatility of shares. For Australian corporates, investment grade yields are around 6% and lower quality corporate yields are higher. Sub investment grade corporate bond yields in the US are actually yielding around 7.5%, which is quite attractive given low levels of corporate debt.

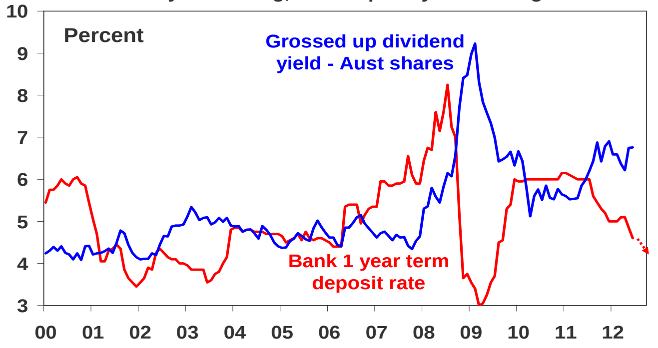
Alternatives to bank term deposits



Source: Bloomberg, AMP Capital

- Before the GFC Australian real estate investment trusts (A-REITs) were a popular alternative to bank deposits. They had high yields and their capital values were relatively stable. This fell apart during the GFC as their yields proved unsustainable due to high debt. As a result while the Australian share market fell 54% through the GFC the A-REIT sector fell 78%. However, A-REITs have now refocussed on their core business of managing buildings, collecting rents and passing it on to their investors, with lower gearing. A-REIT yields at around 6% are currently the second highest in the world amongst REITS and the sector seems to be more stable – while the Australian share market is down 7% from this year's high in May, the A-REIT sector has moved higher.
- Unlisted commercial property also offers attractive yields, around 7% for a high quality well diversified mix of buildings, but into the low double digits for smaller lower quality property. And it doesn't suffer from the overvaluation of residential property.
- Listed and unlisted infrastructure offers yields of around 6%, underpinned by investments such as toll roads and utilities where demand is relatively stable.
- Australian shares also fare well in the yield stakes. The grossed up dividend yield on Australian shares at around 6.75% is well above term deposit rates meaning shares are actually provide a higher income than bank deposits.

Share yields rising, term deposit yields falling

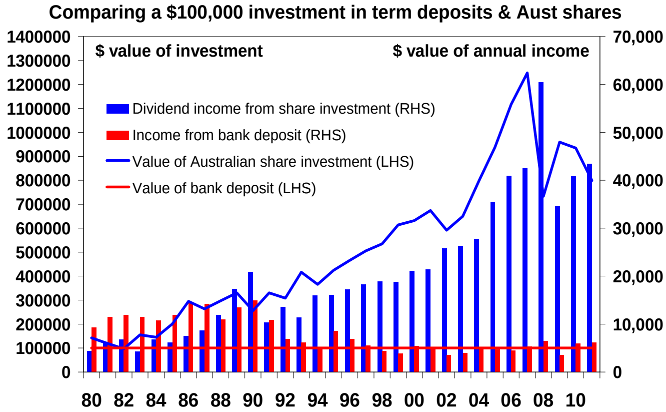


Source: Bloomberg, RBA, AMP Capital

A way to minimise the risk of capital loss is to focus on stocks that provide sustainable above average dividend yields as the higher yield provides greater certainty of return during tough times. Excluding resources the grossed up dividend yield on Australian shares rises to over 7%, for telcos it is around 8% and for banks it is around 10%. What's more there is evidence that stocks paying high dividends are associated with higher returns over time. Of course there is no such thing as a free lunch – so the key is to focus on companies that have a track record of delivering reliable earnings and distribution growth over time, but where dividends are not reliant on significant leverage or the yield is only high because there is something wrong with the company.

The next chart compares initial $100,000 investments in Australian shares and one year term deposits in December 1979. The term deposit would still be worth $100,000 (red line) and last year would have paid $6,150 in interest (red bars). By contrast the $100,000 invested in shares would have grown to $800,000 (blue line) and would have paid $43,000 in dividends before franking credits (blue bars). The reason for the difference is over time an investment in shares tends to rise in value, whereas an investment in term deposits is fixed.

Comparing a $100,000 investment in term deposits & Aust shares



Source: RBA, Bloomberg, AMP Capital

Concluding comments

With term deposit rates falling it makes sense for investors to consider alternatives offering higher yields in corporate bonds, non-residential property, infrastructure and shares.

Dr Shane Oliver
Head of Investment Strategy and Chief Economist
AMP Capital Investors