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QUOTE OF THE MONTH

“Success is the sum of small efforts, repeated day in and day out.” - Robert Collier Author

Financial Quote

“Financial markets remain under considerable stress and credit has tightened further for some businesses and households.” - FOMC (Federal Open Market Committee)

Market Statistics

Official Cash Rate: 7.00%
U.S. Fed. Funds: 3.00%
90-Day Bill Rate: 7.40%
5 Year Bond Rate: 6.40%
\$AUD (US cents): 90.54
All Ordinaries (Aus): 5,921.7

As at 5 February 2008



INTEREST RATES, EQUITY MARKETS AND THE ECONOMY

The Reserve Bank of Australia (RBA) raised the Official Cash Rate to 7.00% per annum as expected following the recent release of inflationary, employment and credit lending data.

The increase was deemed to be warranted to curb excessive inflation. In the December quarter, the Consumer Price Index (CPI) rose by approximately 0.9%, which brings the adjusted annual inflation figure the RBA’s threshold of 3% per annum. Compounding the inflation rate is the very real prospect of an increase in the price of water and oil, which flows through to the consumer almost immediately.

Another influence on the Reserve’s decision was the heightened levels of credit growth seen throughout the Australian economy. It was estimated that Australian households borrowed a further \$116b last financial year, with businesses adding another \$142b to bring the total amount to \$260b. While household credit grew

at a relatively placid 11.5% last year (compared to previous years), it still provides cause for the RBA to be concerned enough to peg back borrowing and increase personal savings further.

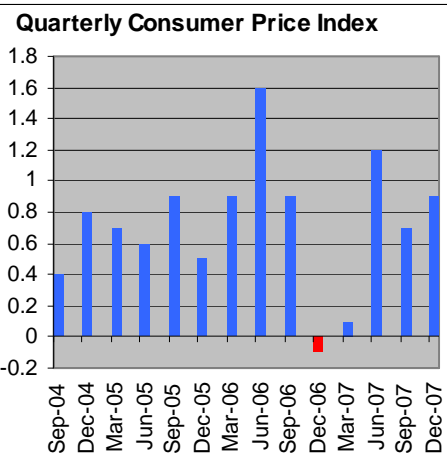
The RBA is also mindful of the government’s plans for widespread tax cuts, which will be inflationary in nature as disposable income increases.

While the banks recently increased their mortgage rates independently of any changes in monetary policy (i.e. without increase in the Official Cash Rate), the RBA still felt that it was necessary to raise rates to avoid the possibility of high inflation regardless.

Globally, Australia appears to be fairing sufficiently barring a collapse in the US due to the sub-prime market (see finance article). While employment is strong, spending is robust and profits are high there are still very real risks in the global economic setting. Rates may stay as is for the remainder of the year, decrease or increase, nobody can be sure at this time.

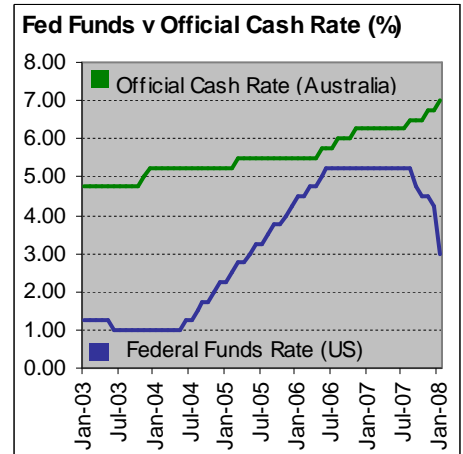
The situation in Australia may be contrasted with the United States where the United States has continually cut interest rates. The sub-prime crisis (refer article) has cut very deep in the US.

Quarterly CPI (%)



Consumer Price Index: Domestic inflation reached 0.9% for the quarter ending in December 2007 which has concerned the RBA.

Federal Funds v Official Cash Rate



Federal Funds v Official Cash Rate: Widening spreads between the US and Australian Cash Rate may strengthen the Australian Dollar.

The large disparity in interest rates between the US and Australia may mean that the RBA will not increase rates too much further this year. A large interest rate differential will lead to a surging Australian dollar and therefore problems for our exporters. The recent stock market correction (refer Financial Planning article) will also reduce inflationary pressures.

QUESTIONS AND ANSWERS

The MCP Group team will answer a selection of our readers' queries in each edition of our monthly newsletter. To submit your query contact our Group by phone on (03) 9620 2001 or by email: enquiries@mcpgroup.com.au.

MCP Financial Seminar

MCP Financial is holding a seminar on Thursday the 28th February where we will discuss the global investment market in more detail.

Please contact **Tegan Fisher** on (03) 9620 2001 for more information on our upcoming seminar.

FINANCE

What is a Reverse Mortgage or a Home Equity Release Loan?

A Reverse Mortgage is a loan that enables you to turn the equity in your house into an income stream or bulk payment. The interest charged on the loan or the funds you receive does not, in many cases, have to be physically repaid.

However, the financier takes their loan share of the property upon the sale of the underlying collateral property, taking into consideration any applicable interest charges. Mortgagees are allowed to lend anywhere from 15-50% from most providers, depending on their age.

Reverse loans or home equity mortgages may influence pension payments and the amount of funds available for distribution under your Will. As such, it is highly recommended that you seek legal and financial advice before committing to a Reverse Mortgage/Home Equity Loan.



SELF MANAGED SUPER FUNDS AND THEIR ABILITY TO BORROW

Much has been recently written about amendments to the Superannuation Legislation in September 2007, effectively enabling Self Managed Super Funds to now borrow to invest in certain situations.

This change is generally labeled "Instalment Warrants" because it came about by reason of the Government's investigation of super investment in listed securities via Instalment Warrants. However the changes appear to have gone further to include, among other assets, real property.

The purpose of this article is to try and put very simply the current situation in this area, without going into the significant technical detail involved. Should you be interested in such detail please contact Mike Poynter at MCP.

Basically, changes to the legislation now mean that a Self Managed Super Fund (SMSF) may borrow funds from a lender to assist in purchasing a "complying asset" (being one that an SMSF would ordinarily be able to purchase in its own right under current legislation), to be held in an external Trust in which the SMSF has a beneficial interest, and a right but not an obligation to take a transfer of that asset once the loan against it is fully paid out. At that point, the asset may be transferred into the SMSF, unencumbered.

One important feature of this new mechanism, is that the lender has only limited rights of recourse to its loan, principally being that it is largely restricted to rights against the asset only, and not any assets of the SMSF. This does not prevent the lender from obtaining other security in support outside of the SMSF.

The basic rules in relation to it being a complying asset still apply, including the sole purpose test, in-house asset rules, arm's length test and related

party acquisition rule (please inquire if you wish further information here).

The major benefits of the new laws appear to be:-

- They apply to real estate.
- Any assets in this arrangement are generally outside the operation of the Bankruptcy Act, and therefore it is a good asset protection strategy.
- Members of SMSFs have the opportunity to grow the value of their funds through gearing.
- If structured properly, there are income and tax efficiencies.
- Pensioners in particular can benefit in relation to tax-free and CGT free rules. For business owners, this may now enable them to more easily acquire business premises from where they operate.

You of course need to have or establish an SMSF.

What we know is:

- There is significant interest in this new possibility to gear SMSF funds to purchase assets including real property.
- To ensure compliance with the new changes, detailed technical advice from planners, accountants and lawyers will be required, to ensure the SMSF documentation allows such borrowing and investment, the external instalment trust is properly set up, the asset is appropriately purchased, and in the case of real estate a legitimate lease is put in place with a tenant and the full benefits of CGT, stamp duty exemptions and land tax issues are properly dealt with. (Please speak with your accountant in relation to matters of taxation in this area).
- The changes are at this stage untested, but will not be for long.

What we do not know at this point is:

- What criteria lenders will place on any loans it may provide (MCP is currently exploring such criteria with its bank panel).
- Whether the legislative changes fully reflect the wishes of the Government, ATO and APRA, and whether they will remain in their

current form for the foreseeable future.

MCP believes it is ideally placed to assist clients with these new changes, given its expertise across the legal, finance broking and planning functions. We have developed a flexible package to assist as required. Please contact Mike Poynter in the first instance for any queries or assistance desired.



THE EQUITY MARKET CORRECTION AND INVESTOR SENTIMENT

2008 has started as a difficult year for share market investors with the Australian market down by as much as 20% from the market highs in October. The sell off has at its root cause the sub prime credit crisis in the United States. Previous newsletters have focused extensively on the sub prime crisis.

Markets were anticipating that 2008 would be a much more volatile period for investors. However the scale of this sell-off was not anticipated. In a market such as this a lot of good companies are being marked down considerably. As a result we certainly do not recommend that investors sell at what may well turn out to be reduced prices and then miss the inevitable upturn in investment markets.

As a result of the sub prime crisis MCP Financial has been maintaining a conservative asset allocation with clients' investments throughout 2007. We have also invested clients' funds in accordance with our investment philosophy, which has as its principal aim the protection of your capital through the compounding of investment returns over the long term.

We believe that long term investors will have good buying opportunities however with the current level of volatility we recommend a dollar cost average strategy whereby you enter the market on a phased basis rather than all at once.

Declining Markets - New Trends?

It was once thought that the share market fell three times faster than it rose. Admittedly true several years ago, this multiple may be many times higher due to several factors, including the expanding Contracts for Difference (CFD) market, other levered financial instruments, online trading accounts and the availability to sell quickly without consulting a stockbroker, margin lending calls and media reporting.



WHY THE FIXED RATE LOAN YOU SIGN FOR MAY NOT BE THE RATE YOU RECEIVE

While this has been a topic of discussion in the Questions & Answers' section of our newsletter, we have had several inquiries and thought that we explain why the rate you sign for is not necessarily the rate that you receive.

Basically, the applicable fixed rate is that which applies when your loan settles, irrespective of the rate outlined in your mortgage documentation when your loan is unconditionally approved.

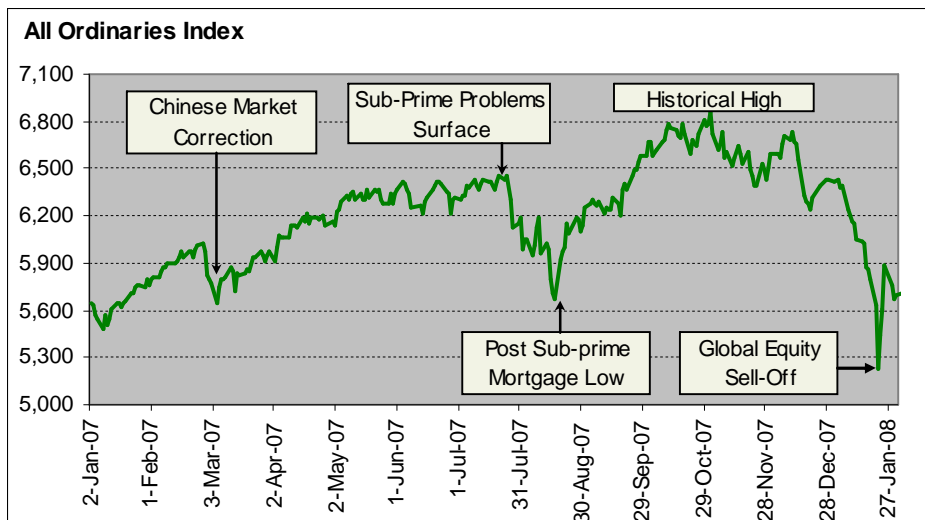
For example, let's assume that a hypothetical couple, John and Mary, sign mortgage documents for a \$300,000 fixed rate loan at an interest rate of 7.00% on 1 July. As the proceeds will be used to purchase a house the loan will be drawn in approximately two months' time on 1 September.

If the bank's fixed rates were to increase to 8% by 1 September, John and Mary would have to repay the loan's interest at 8% for the fixed period. This would equate to an additional \$1,000 in interest costs for each year of the fixed rate term, or a total of \$3,000 in additional interest charges over the three years of the loan.

The reason being is because the bank borrows the money for you at the date of settlement at the current fixed market rate, plus their profit margin buffer. In a period of upside risk there is the very real chance that fixed rates can increase above the rate specified in a mortgagor's loan documents.

Protection against rising fixed rates between unconditional approval/signing your mortgage documents and settlement is provided by most banks in the form of a fixed rate lock feature, which can come at a combination of a fixed flat rate charge, a floating rate which is associated with the size of the fixed rate loan or a combination of the two.

All Ordinaries Index



All Ordinaries Index: The All Ordinaries Index has followed the lead of Wall Street and has dipped in recent months, although it has now partially recovered.

Feel free to contact MCP Finance if you would like advice on the cheapest, and most suitable fixed rate loans in the market to suit your circumstances.

SUB-PRIME LENDING UPDATE

Many readers may be aware of the recent increase in the cost of Australian credit as highlighted in various media sources over the past month or so, particularly current affairs programs and print. One of the key concerns amongst financial commentators is the sub-prime mortgage crises in the US and its effect on Australian equity prices and credit practices, as well as its overall drag on other world economies.

Domestic mortgagors have been forced to battle with rate increases due to: 1) A relatively strong domestic economy and increasing inflation; and 2) An increase in the cost of credit for many Australian banks, including the four majors banks.

Australian financiers source their funds from depositors as well as overseas institutions, including those based in the US. As a means to curb the losses experienced in recent quarters and due to the difficulty in obtaining credit due to their diminishing pools of capital, many US credit providers are hesitant to slash the cost of their funds to other borrowers in the near term.

The increase in the cost of overseas credit for our major banks is up to 40 basis points higher than it was pre sub-prime contagion, with many domestic lending institutions unable to absorb this increase for the foreseeable future. As a result, the financiers have been required to raise their mortgage rates independently of any movement in the RBA's monetary policy outputs by up to 12-20 basis points (or 0.12 to 0.20% per annum), which is the first time in ten years that major Australian financiers have acted in such a fashion.

Accessibility of credit has been a driver in lifting housing prices to unaffordable levels, and fattened the real value of many banks' collateral bases. The subsequent decrease in the value of such collateral has decreased both banking profits and domestic growth, as US consumers scramble to repay loans they couldn't ordinarily afford. This, in turn, has led

to a decrease in global share prices, as US demand is scheduled to stall, and as their bourses decline in value due to decreasing share prices.

To allay some of these fears the US government, in conjunction with the Federal Reserve, has:

- Reduced the Federal Funds rate to 3% per annum;
- Injected tens of billions of dollars into the credit system due to liquidity shortages;
- Provided fiscal policy and the temporary tax relief to spur the US economy (President Bush announced plans for temporary tax cuts totaling \$150b+);
- Provided documented financial engineering plans to curb foreclosures; and
- Hinted towards further monetary policy relief if the credit crisis continues.

The US situation at present is falling employment levels, increased jobless claims and increasing stockpiles of housing (especially amongst financiers) and a domestic economy that is teetering on the edge of a recession.

Especially important is bond credit ratings. Most of the \$534b of sub-prime mortgages securities are set to be reviewed and re-rated, and with many of these Mortgage Backed Securities (MBS's) trading well below parity, it is only prudent 'fear the worst but hope for the best'.



The Domino Effect: US Sub-prime issues have also affected the global economy, including Australian, Asian and European equity markets.

Another problem is the differential in the relative interest rates of global economies. The US's low Federal Funds Rate should result in a depleted US dollar value, which would increase US exports and decrease US imports. A reduction in the US dollar could drive up the cost of imports, thereby pushing up inflation and lifting long-term interest rates, but this is only one theory.

Monetary policy may take several quarters to show its full benefits, while injecting liquidity into financial markets and concessional tax breaks are only short term measures to ail a long-term problem. It may take longer for market forces to sort its way through the excess supply of housing to reinstate domestic demand, but that is only the prediction of selected industry experts.

The Australian public is likely to face increased credit costs passed onto them by US financiers and a turbulent and volatile share market in the short to medium term, while the monetary policy takes time to produce its desired outcome and the US economy settles, but this is uncertain.