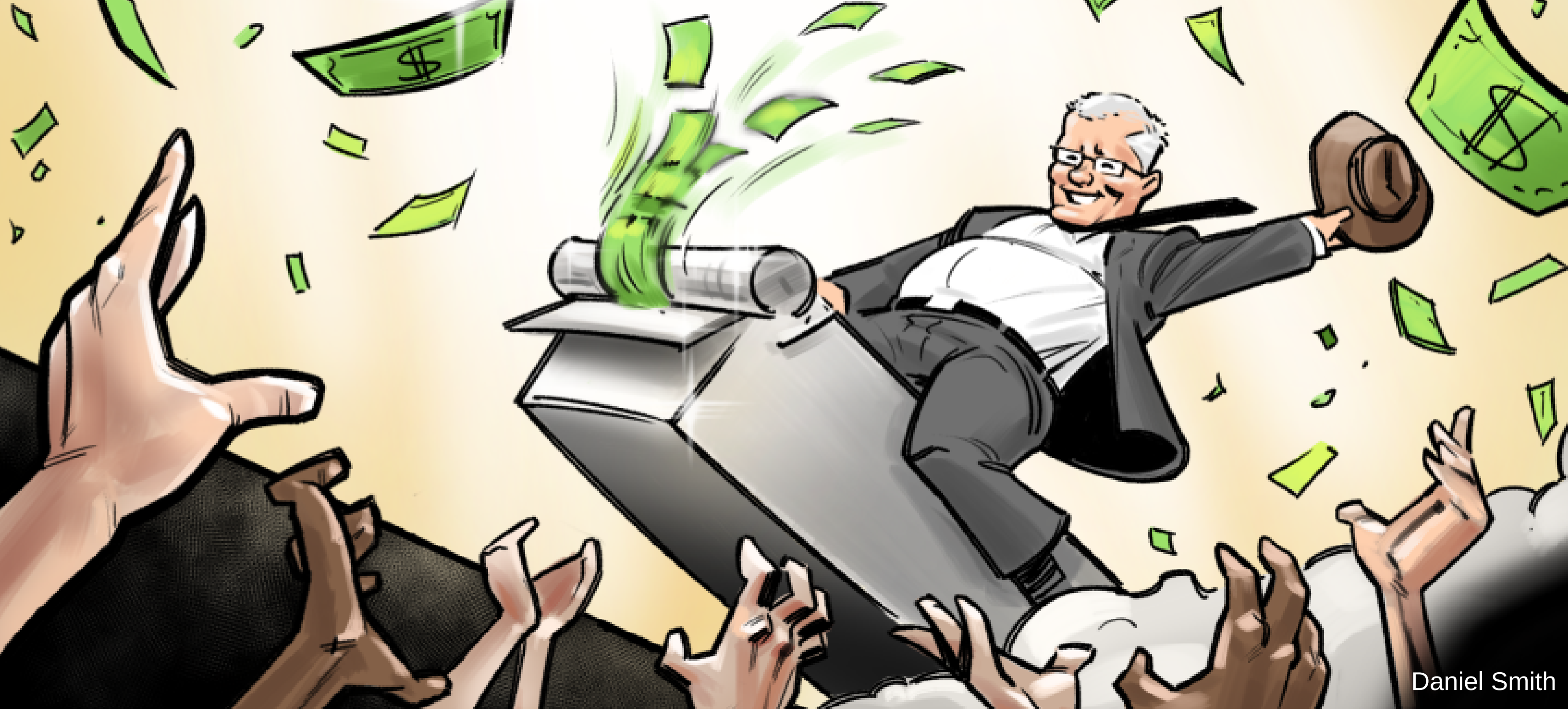

Inflation Can be Your Friend

10 May 2021
By Paul Miron
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The Government and particularly Josh Frydenberg are certainly breathing a sigh of relief this week as the most recent positive economic data demonstrates a strong Australian economy. Phew! Just in time for the upcoming 11 May budget!

Inflation is now both locally and internationally the hottest and most controversial economic topic for the year. That is because the entire global economic recovery hinges on the ability of Central Banks to keep interest rates low for an extended period in order to give the global economy the push it needs towards a full recovery.

The most recent Australian inflation figures have come in lower than anticipated at 1.1% per annum.

This re-affirms the RBA's carefully articulated argument about maintaining low interest rates until the economy reaches a level of full employment. Unemployment is now down to 5.6%, consumer spending is racing back to pre-Covid-19 levels, and trade figures are strong due to high iron ore prices, all of which contributed to a $30b windfall in the current budget figures.

It seems the "Achilles' heel" to all this good news is the inflation uncertainty. The topic of inflation has not been part of our vocabulary since the era when Paul Keating was the treasurer in the 1980s and we experienced "the recession we had to have".

An analogy that best describes the importance of inflation is that like watering a plant, both too little or too much water may kill a plant. The right balance of low constant inflation increases business profits over the long term, therefore increasing business productivity. Such strategy helps to reduce unemployment, increases tax revenue and naturally erodes the real value of debt.

Too much inflation (hyperinflation) can have the complete opposite impact and lead to both undesirable economic and social effects. The most powerful tool left to control high levels of inflation is the RBA's use of contractionary monetary policy (increasing interest rates). If done prematurely, it will have a negative price impact on assets such as shares and property, further stunting economic growth and possibly spiralling the economy into a recession.

Investors are now becoming acutely aware of these issues with leading economists, governments, companies, and click bate media all weighing in on the topic, each with their own very diverse opinions, fuelling volatility and uncertainty which may start to impact markets over the next 12 months.

Governments and Central Banks will need to put on a brave face and maintain confidence in their ability to steer the global economies through these tricky times. A loss of confidence from both consumers and businesses ironically is enough of a catalyst for a self-fulfilling prophecy for inflation issues to emerge unfavourably.

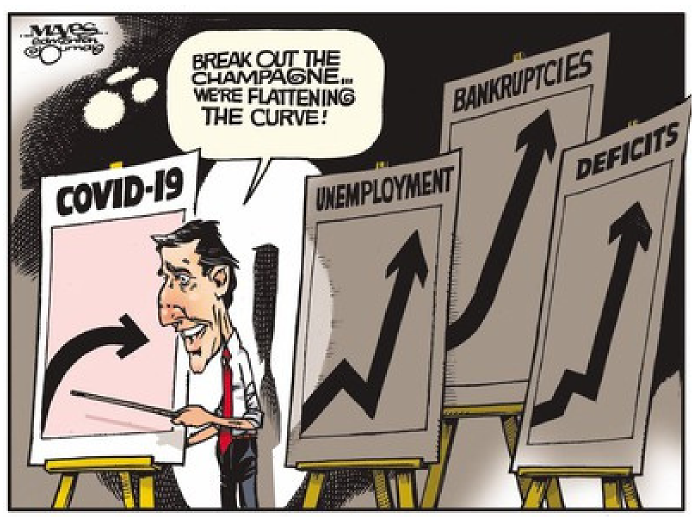
This is in itself a very thought-provoking concept as inflation is not purely driven by economic data and activity. It is also driven by the future expectation of businesses and workers, which drive businesses to make decisions such as increasing prices on goods and services and employees hitting up their bosses for a pay rise.

For investors to keep calm in what I anticipate to be a year of alarmist clickbait driven articles relating to the economy and inflation, I suggest keeping in mind some of the following points:

COVID-19 Has Completely Skewed/Screwed Economic Data

A mathematical concept worth explaining when attempting to interpret economic data is the "base effect". Covid-19 forced the economy to a complete standstill, with all the major economic indicators falling off a cliff. Once the economy has been rebooted from a virtual standstill, the economic indicators are all being overly exacerbated during the economic recovery. As an example, we have had two quarters of GDP growth at 3%, however, our economy is still nowhere near the same levels as it was pre-Covid-19 despite the data implying otherwise.

Be prepared that the next inflation figure will be an absolute whopper, as it will reflect the effects of people returning to work and spending money on normal items such as childcare, entertainment and transport.



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Classical Demand And Supply Mechanism "Say's Law"

Once again, Covid-19 has seen disruptions to supply chains worldwide. There is a real concern that inputs from raw materials will cause a flow-on effect resulting in higher prices across many goods and services. A prominent story in the US at the moment is the possible impact of the sharp 30% cost increase of timber on the construction industry. However, these supply shocks are temporary as higher demand will increase supply by businesses adapting production with prices stabilizing over the longer term. Companies are currently playing the biggest catch up due to Covid-19 that they have ever experienced.

Central Banks Intervention

Central Banks are all committed to intervene in the money market by buying up 3-year bonds to maintain the low current cost of funds which is passed down to the banks and then onto both business and personal borrowers.

As fund managers, we often are asked:

- Where do you think property prices are going?
- Why has the property market had phenomenal growth in recent months?
- Where do we see the market going in the next 12 months and finally what are the major risks?

A novel way to describe the property market is through a ripple effect. Sure, we all appreciate how low interest rates with years of pent-up demand have resulted in the fastest recorded property growth since property data was first recorded.

However, the property market consists of many different segments spanning many types of property, geographical areas and price points. The two most active property market segments which are the driving force behind the current property boom are as follows:

1) The prized Owner-Occupied properties in affluent suburbs:

We have experienced virtual overnight price growth of anywhere north of 30%. An additional driver has been the white-collar wealthy expats running from Covid-19 stricken Europe and Asia to domicile into their newly

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purchased waterfront mansions. The net effect is pushing locals to consider neighbouring suburbs, pushing them out of reach of their 1st choice suburbs.

2) First owner purchasers:

Thanks to the generous government schemes of home builder being circa $2billion and other grants for first-time buyers, land and house packages and houses under $750k have never experienced stronger demand.

These two segments are showing signs of normalisation due to an increase in people listing their properties to take advantage of prices (an increase in supply). The ripple effect is now impacting property in other segments, in supporting modest price growth e.g., property investors are becoming more confident and going into the market.

As a result, price increases are becoming more evenly distributed across other property segments.

Importantly, the risks to the property market are still prevalent and are tied to inflation and interest rates. Additionally, the property market in Australia and the construction industry have been solid off the back of historic immigration. The government has to delicately navigate a path in the next 6 months in managing inoculations and transitioning from a zero Covid-19 tolerance philosophy to an acceptance to living with the virus so that our borders can be open.

Msquared offers investors the opportunity to create a diversified portfolio of mortgage investments using appropriate tools and a proven platform to invest intelligently. Investors are paid consistently and on a monthly basis, whilst their investments are secured by registered 1st mortgages over quality real estate assets on the eastern seaboard of Australia. It has never been more important for investors to have the peace of mind that comes with 1st mortgages than during turbulent times as they have proven to withstand an unexpected economic shock.

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