PROPERTY & ECONOMY IN 2022...

IT'S ABOUT RISK MANAGEMENT

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BY PAUL MIRON

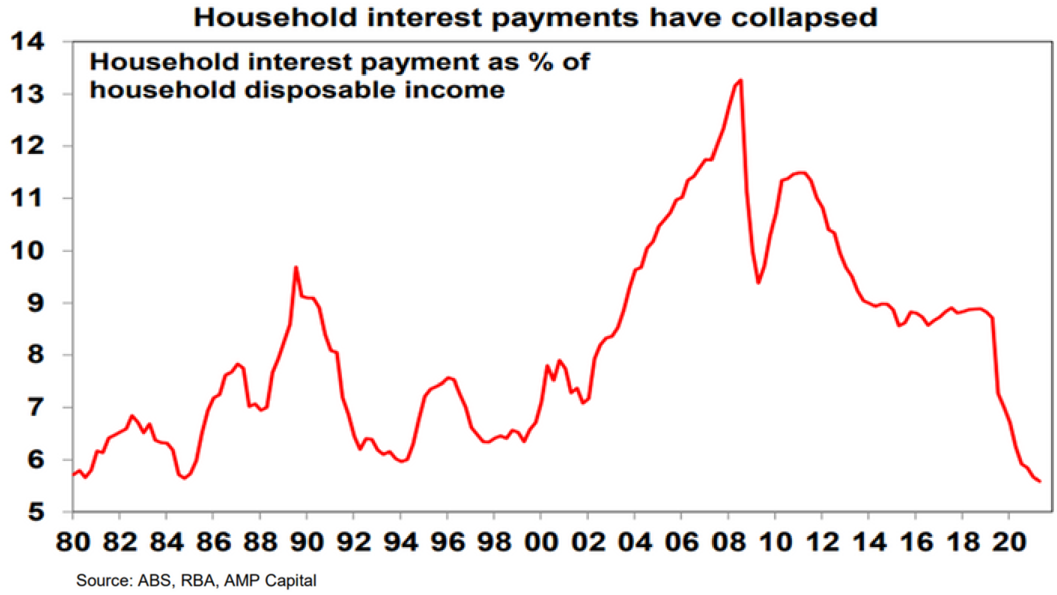
The end of 2021 brings an appreciation that we are in the middle of a bull market across most asset classes whilst still dealing with the pandemic. It is a general consensus amongst the economists that we could have experienced a recession as significant as the Great Depression if the governments and reserve banks did not act accordingly.

To illuminate, the scale of financial support provided by the Australian government to the economy was roughly seven times greater than what was provided during the GFC.

The question to ask now is what does the future hold and what can we expect in 2022 once this extraordinary sugar hit, the tapering of bond-buying programs and special Covid-19 disaster payments begin to fade.

With lower interest rates and easy access to cheap money, households spent money on property and otherwise saved, due to pent-up demand due to lockdowns. With the added benefit of hindsight, it is no surprise that property, the share market, and other asset classes have done exceptionally well.

With US latest inflation figures hitting 6.2%, inflation fears are realised. With global recovery occurring quicker than anticipated, global supply chain issues still holding up



deliveries of goods, tight labor market, and the world teetering on energy shortages, the argument whether inflation is transitionary seems less likely. Interest rate rhetoric is quickly changing, and it seems interest rate hikes are inevitable. Economists argue long-term official interest rates should be closer to 3%, not 0.1% and that we are at the beginning of a new market cycle.

What is anticipated within the property sector?

The cohort of banks' property forecasters such as Westpac, CBA, and ANZ predicts the property market has another 5% to 7% in appreciation until interest rate hikes kick in, resulting in a sharp 20% decline in property prices.
Despite interest rates being the most significant contributors to property prices, other elements such as demand and supply, migration, vacancy rates, and employment need to be considered collectively.

1) Supply and Demand of property:

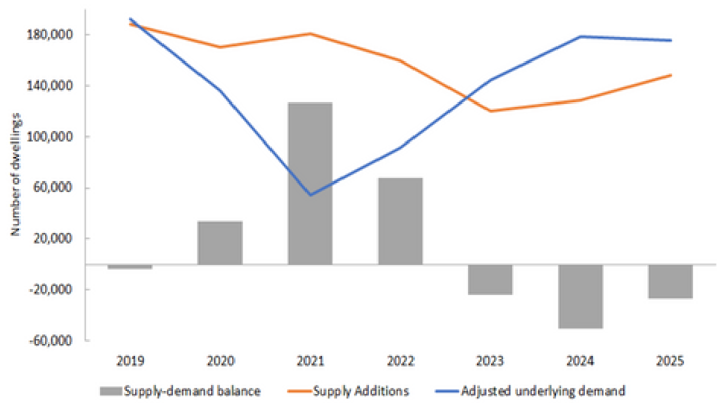
a) The available supply of property for resale. Due to the uncertainty of Covid-19, people held off either selling or buying during the lockdowns. That said there were thinly traded volumes, placing upward pressure on prices. Some buyers have resorted to trading money for patience, resulting in many anecdotal prices going far beyond reserves and smashing records.

Since lockdowns eased, we have witnessed an explosion of listings anywhere between 30% to 50% above the five-year average depending on geography. Clearance rates in Sydney have fallen to 64% and 65% in Melbourne, lowest since 2017, marking the normalisation of property price growth as a reality.

b) The second subsection is the structural demand and supply of property.

Chronic undersupply of property enables property prices to be resilient in Australia. According to the National Finance and Investment Corporation, we are short of 210,000 dwellings nationally. We witnessed how specific property segments reliant on international students, tourism, and short-term stay accommodation, which initially showed price weakness, ultimately recovered and evolved over the past 18 months due to the supply of property.

There is a supply lag inherent in the market as it takes years to adjust to demand due to the time it takes for the planning approval, financing, and construction of a development project.



Depending on which state you live in, the lagging supply of property to demand is exacerbated by the inefficiencies created by the planning process, as detailed in the report by Peter Tulip, RBA's own property economist. The modelling identifies the premium that consumers pay for lack of supply.

As borders are re-opening, politicians wish to resume migration and international travel promptly.

Just 1% of net new migration is responsible for 2% of our national GDP. That, of course, drives economic growth and can cushion our economy for the immediate term while rebalancing trade as we divorce ourselves from our largest trading partner, China, responsible for 60% of our net exports.

The fact that Evergrande, China's largest property developer, is on the verge of collapse is not the main issue of concern for investors; it is the appreciation that China's economic model in creating growth via supplying property artificially has run its course. China provides roughly 30% of the world's GDP growth. The sheer size of the issue is larger than the Chinese government can resolve, with 22% (90 million units) empty with 19 million dwellings being built yearly by over-leveraged developers; this is an economic Ponzi scheme that we have not seen since the spectacular Japanese property collapse in the '80s. We believe that Australian investors and the world are underestimating the contagion of this event to both credit market and investor psychology.

This is enough for politicians to bet on increasing migration to offset China's risk to the global economy and cushion any labour supply constraints, suppressing inflation pressures.

The additional 60,000 required to house migrants provides a significant multiplier effect on the general economy, as for every million dollars contributed to construction it adds three million to our wider economy.

Employment:
We see the labour market bouncing back strongly post lockdown as normal life resumes. The Australian Reserve bank predicts that unemployment will reach 4% by 2023, possibly a more robust labour market than before Covid-19. Once again, this will place upwards pressure on property prices.

Vacancy rates:
The property vacancy rates are currently at a ten-year low.

Animal spirits:
A famous scientist Richard Fynman said, imagine how much harder physics would be if electrons had feelings, then physics would only work sometimes. The same can be said about economic forecasting.

Forecasting is a noble task; often, the market outcome is driven by the general mood of the market, which is referred fondly as 'animal spirits'.

The market comprises people, and actions are not always based on fundamentals; their perspective on the future drives demand and affects prices. As mood can change from positive to negative and vice versa, markets overshoot, and assets are oversold, creating the economic market cycles that have existed for centuries. Older and wiser investors constantly remind us more naive investors of appreciating risk assessment, diversification, and holding your nerve in the market during bad times and taking comfort in holding quality assets.

	Sydney	Melbourne
Additional cost to houses	$489,000	$324,000
% To the total value	73%	69%
Additional cost to units	$355,000	$97,000
% To the total value	68%	20%

Mark twain has been quoted saying "history does not repeat itself, it rhymes."

Issac Newton, known as one of the greatest minds who have lived on our planet, could not tame his own animal spirits when it came to investing. "Sir Isaac Newton in 1720 owned shares in the South Sea Company, the hottest stock in England. Sensing that the market was getting out of hand, the great physicist muttered that he 'could calculate the motions of the heavenly bodies, but not the madness of the people.' Newton dumped his South Sea shares, pocketing a 100% profit totalling £7,000. But just months later, swept up in the wild enthusiasm of the market, as he was quoted, he could not stand his friends and other investors getting rich. Newton jumped back in at a much higher price — and lost £20,000. For the rest of his life, he forbade anyone to speak the words 'South Sea' in his presence."

Understanding the combination of market cycles and the underlying market fundamentals is the key to unlocking the secrets to sustained investing without added stress. The Australian property market still possesses solid underlying fundamentals despite eventually succumbing to the inevitable market cycles due to the onset of animal spirits.

Due to a favourable migration policy, we believe that inflation pressure will not be as acute as in the US and Europe. Interest rates will rise, but not at the same pace as overseas. The property market will remain resilient and eventually succumb to a fall in value.

We believe that property will remain flat until such time, and it will be closer to 10% rather than going up 5%-7% and then falling 20% as predicted.

The price gap between houses and units has never been wider, according to CoreLogic research. It is close to 54% in Sydney, and 52% in Melbourne. We believe that in the coming years the gap will reduce as demand will increase for apartments. We believe high quality luxury apartments that cater for empty nesters and professional families will be one of the best performing asset types across the sector.

Investing in mortgages is increasing in popularity, especially in an environment where most asset classes are unlikely to deliver capital gains due to the prospect of increasing interest rates. Investors are seeking regular, reliable, and resilient income as the market cycle changes and investors will seek to balance their portfolios to a more defensive position to withstand volatile times. Asset preservation is the foundation of mortgage investing. Those who have invested into mortgages over time have seen first-hand the value of compounding interest at work to build wealth over time. For added peace of mind and certainty, we at Msquared typically lend 65% against the value of security offered and give our investors the platform, tools and opportunity to be able to create their own portfolio of direct mortgages that meets their risk profile.

If you would like to know more, please contact us on 9157 8608 or email us at investor@msqcapital.com.au

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