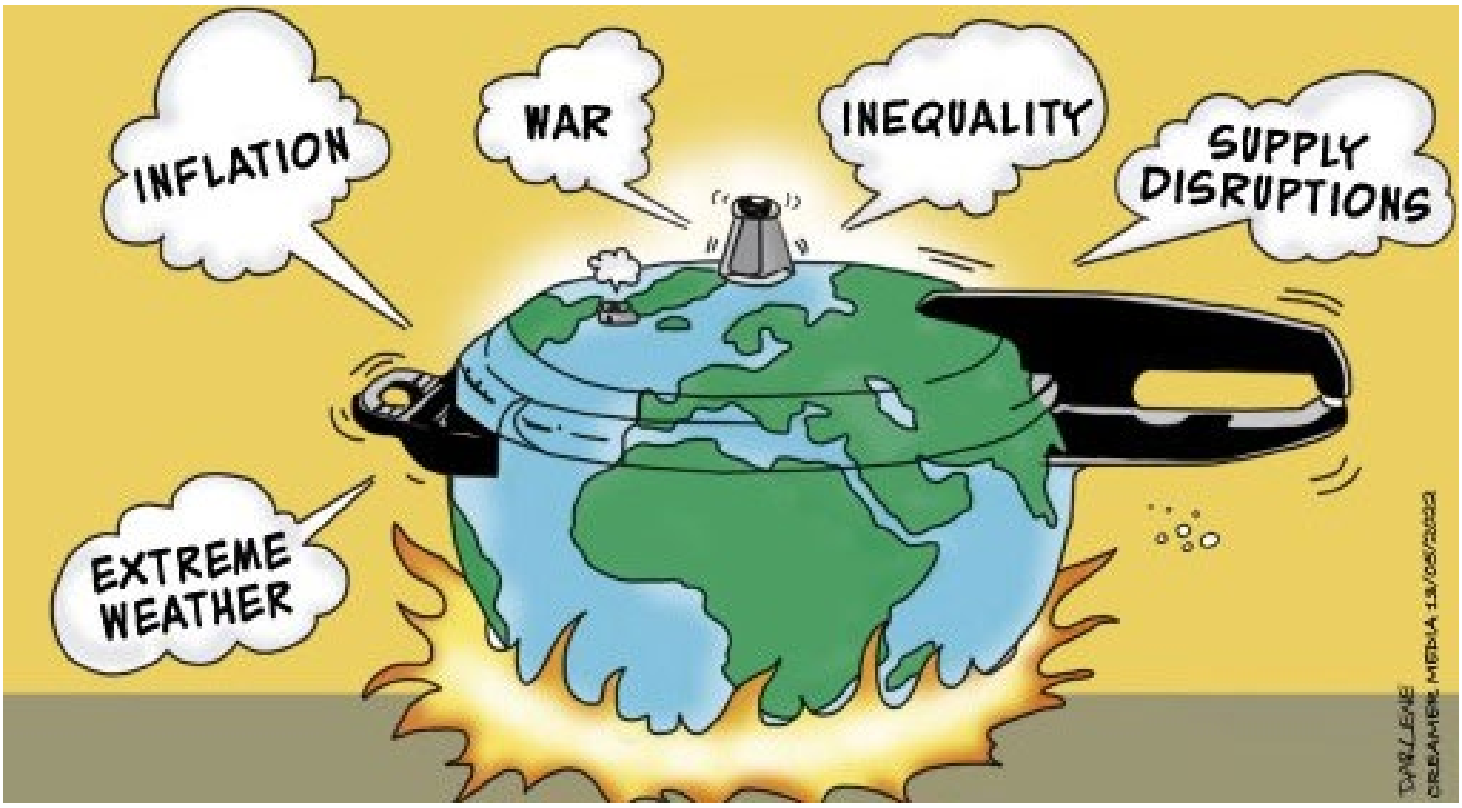
The Economy of Extremes

What is the True Outlook for Property and the Economy?



THE ECONOMY OF EXTREMES

BY PAUL MIRON

Despite the rhetoric from central bankers and global leaders blaming the world's current economic woes on inflation, a war in Europe, an energy crisis and irrational consumer sentiment, there is an obvious alternate root cause to the world's current financial dilemmas.

Higher Interest Rates

Excessive use of monetary loosening during the COVID-19 era has resulted in skyrocketing inflation. Unfortunately, there is not a clear antidote to this other than placing our faith in the blunt economic instrument of interest rates.

It is clear that the economy needs to reset from the past chaos and extraordinary market conditions fuelled by the excess cash being pumped into the economy, with inflation, the labour market, housing and consumer markets needing to return to normal fundamentals.

The difficulties faced by the Australian economy and the reactionary measures taken to address them have resulted in:

- The RBA's longest consecutive and most aggressive interest rate hikes (6 so far and likely to be 7) in our modern economic history
- The most volatile period of consumer and business confidence since records began
- The sharpest monthly decline in Sydney property prices, with a 2.2% decline in the single month of July (if annualised this would be 26.4%)[1]
- The lowest unemployment in 50 years, at 3.5%[2]
- The highest level of inflation since the 1970s, which is expected to peak at 6.8%[3]

[1] Nila Sweeney (AFR) - Sydney House Prices Tipped for Sharpest Fall in 30 Years.
[2] ABS Labour Force Statistics.
[3] Gareth Hutchens (ABC News) - Annual Inflation was 6.8% in August, says Bureau of Statistics.

- Respectful GDP growth of 3.25%, with the RBA downgrading forecasts to 1.75% for 2023.[4]

However, the impacts of these rampant and aggressive rate hikes are yet to be fully felt by consumers and businesses. There is more to come which could further deteriorate the economic metrics outlined above. As CBA economist, Gareth Aird, asks, “Are we sleepwalking into a recession?”[5]

How the Rate Hikes Impact Everyday Australians

Many economic stakeholders and decision-makers are bewildered, including the average mortgage holder, economists, business owners, politicians, and policymakers, as to the full effects of the rate hikes.

What makes this crisis unique from the past is that the RBA and governments globally are forced to make a monetary policy decision by setting interest rates without the comfort and reliance on accurate data in combating the elusive Inflation Genie.

[6]

According to Milton Freidman’s body of work in the 1970s, perhaps the most comprehensive study into inflation, it takes approximately 6-9 months to see the impacts of an interest rate increase.[7] This means that despite the past six months of cumulative interest rate increases, recent data will barely show the results of the 1st interest increase.

It is important to note that interest rates are a blunt instrument which will not impact everybody equally.

According to research conducted by Mortgage Choice,[8] it is not surprising that less than 50% of mortgage holders know what interest rate they are paying on their mortgage and even less ever review the terms of their mortgage.

All of this supports the hypothesis that business investment and consumer decisions are driven purely by immediate cash flow and access to capital and are not fundamentally forward-looking.

With official interest rates rising from their all-time low of 0.1% p.a. to what we eventually expect to be 2.85% p.a., the annual repayments on an average 25-year mortgage of $750,000 will result in additional monthly repayments of $1,129 or $13,560 p.a., which is a 35% increase in repayments.

Accordingly, there will be less cash free cash flow available to mortgage holders to spend. With $750,000 being the average size of a mortgage in Australia, $13,560pa in less average spending capacity across Australia households, is a significant quantum of money.

With this additional market volatility and shock to spending patterns, many world leaders, central bankers and economists have conceded that a worldwide recession is likely a result of simultaneous interest rate increases globally, dealing with an energy crisis, the ongoing developments of a hostile geopolitical environment and persistent inflation challenges.

How Much Further will the Cash Rate Rise?

For clues as to the inner thoughts of the Reserve Bank, one can look at the RBA’s monthly minutes. Governor Philip Lowe introduces the concept of the neutral cash rate target of 2.5% p.a.[9] According to Lowe, this is the official cash rate that is set to have a neutral impact on the money supply. With the higher cost of debt, credit growth will normalise and not add additional cash to the economy via the bank’s credit creation process.

With official interest rates now set at 2.60%, the first stage of Governor Lowe’s plans is in place. Having set the official cash rate above the neutral position, there should theoretically be no further inflationary pressure.

I believe it is conceivable that the subsequent rate increases will be more conservative. It is fair to expect a further 0.25% official Cash Rate increase in November, pushing overall official Cash Rates in 2022 to 2.85%.

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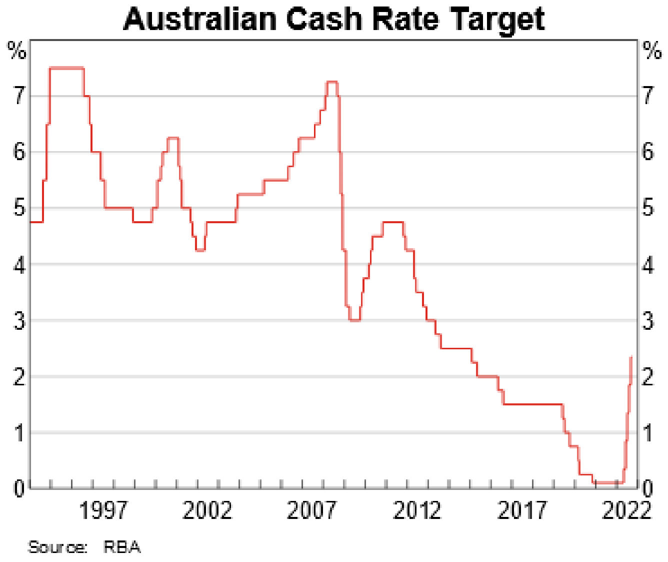
[4] RBA - Statement of Monetary Policy - August 2022.
[5] Are We Sleepwalking Into a Recession Here Comes the Interest Rate
[6] Rachel Turner (Colorado News) - How to Put the Genie of Inflation Back in the Bottle.
[7] Milton Friedman (Journal of Political Economy) - The Lag in Effect of Monetary Policy.
[8] Mortgage Choice - Study Reveals: The Price of Home Loan Interest Rate Apathy
[9] Philip Lowe (RBA) - Inflation, Productivity and the Future of Money.



With the impact of current interest rates changes on the economy being substantial, the RBA will likely elect to wait for data throughout December and January to come through prior to making any further interest rate decision. We believe that the economic data will demonstrate that inflation is indeed contracting, and further action will not be required e.g., any further interest rate increase.

If inflation indeed persists, then reluctantly, interest rates will need to be increased, with the sacrifice of economic growth as we go into a deeper recession.

Why are we Unable to Follow the US and Europe?

When looking at interest rates, you need to examine the household debt-to-income ratio relative to other countries. According to the OECD's latest data comparing other countries' debt versus household disposable income, Australia is one of the most indebted households in the world.[10]

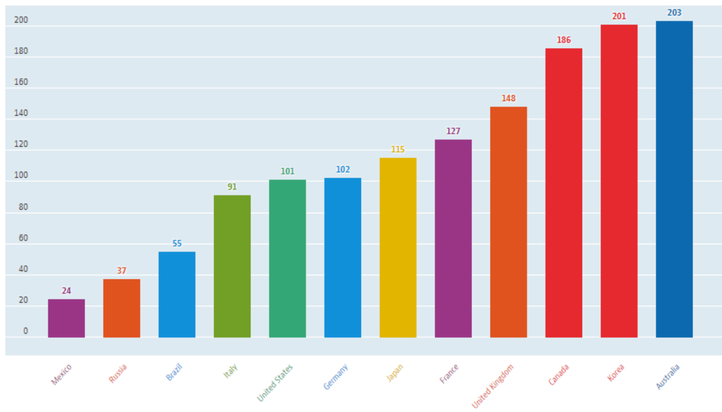
In Australia, households are indebted 203% of their income, whereas in the US, the ratio is sitting at 101%.

It would therefore be unwise for Australia's central bank to match the Fed and ECB in raising interest rates. Australians have two times the indebted household debt of the US, making them much more sensitive to changes in the official cash rate. Furthermore, the RBA will be placed in a difficult position as they will be reluctant to move interest rates too high and risk negative pressure on the Australian currency.

We hope the Australian government has paid attention to the UK fiasco in recent times. The world has witnessed their currency freefalling due to what has been interpreted by many as a fiscally irresponsible budget and the need to intervene in the markets to assist the stabilisation of the British pound.

Indeed, governments need to rise to the occasion in making fiscally responsible decisions and not adding fuel to the inflationary plight with superficial tax cuts for the sake of keeping voters happy. These are definitely times where unpopular, yet necessary, decisions may need to be made by policymakers for the greater good of the wider economy.

Household Debt %



What Does the Future Hold?

Despite the short-term uncertainty in the real estate market, once there is clarity on interest rates (which we are nearing), confidence will enter back into the market stemming any further capital losses with property prices plateauing.

There is considerable pent-up demand for new housing for empty nesters and incoming migrants. This is evident by the significant rental growth and vacancy rates across the country.

We believe the recent increase of 0.25% is a positive signal to the property market and Australian economy. It demonstrates the RBA's appreciation of the unique fundamentals Australia has compared to the rest of the world. Our economy is more sensitive to higher interest rates due to personal debt and a higher concentration of our wealth stored in property. We unable to increase interest to the levels of our counterparts globally and need to follow our own path. This is further reinforced with the recent release of Credit Suisse's Annual Report,[11] where it is made clear that Australia is the wealthiest nation per capita in world.

As such in these volatile times globally, private credit will offer a safe haven for investors amidst the volatility and uncertainty. It offers investors regular returns above inflation whilst offering asset preservation against property. We envisage the increased flow of investment opportunities with the contraction of free capital flowing through the traditional credit offered by banks, which will

[10] OECD Data - Household Debt

[11] Credit Suisse - Annual Report 2021.

be reflected in higher returns for investors whilst not necessarily going any further up the risk curve.

Msquared Capital is a private credit provider with investment opportunities backed by quality property along the Eastern Seaboard; we ensure that all investment opportunities are based on risk-to-reward as our core offering and performance. Mortgage funds perform well during volatile times, and the preservation of capital is regular, with reliable monthly income that gives our investors peace of mind.

If you would like more information, please feel free to contact myself or our dedicated team of professionals at our office with the following details:

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