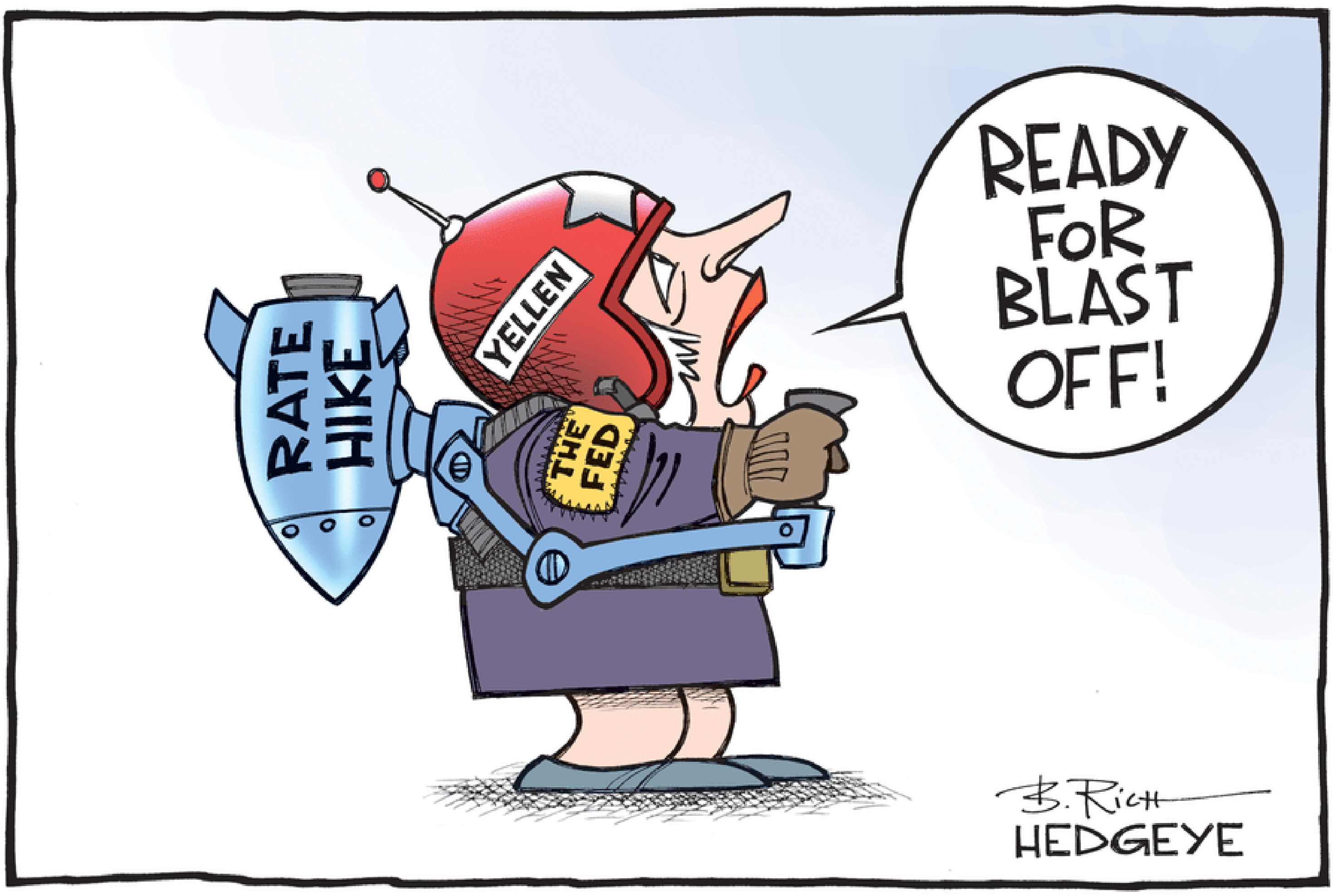
Time to End Rate Hikes!



[1]

TIME TO END RATE HIKES!

BY PAUL MIRON

It is time to say it – Enough is Enough! We do not need any more rate increases!

The official RBA Cash Rate has increased for the 10th consecutive time – unprecedented in our modern economic history. We have now reached a stage where it is becoming unnerving as to when our path of rate increases will halt. More disturbingly, this is happening worldwide – not just in Australia. Central bankers are becoming unhinged and seem to disregard the inevitable financial consequences of a recession as long they win the short-term battle against the unfriendly foe of inflation.

As former US President Ronald Reagan, famously said, "Inflation is as violent as a mugger, as frightening as an armed robber, and as deadly as a hitman."[2] That being said, despite the evils of inflation, caution still needs to be taken when raising rates so as to not break the economy.

The most recent data shows that the worst fears of the wage-price inflationary spiral have not materialised and that inflation on goods is moderating. Inflation on services and rent is now forming the battleground's main front line in the fight against inflation, and the weapon of choice should not be higher interest rates. It only further adds fuel to the inflation fire.

All of this is to reiterate – we do NOT need an 11th consecutive interest rate increase.

[1] https://app.hedgeye.com/insights/48113-must-see-8-cartoons-highlighting-the-rate-hike-absurdity?type=macro

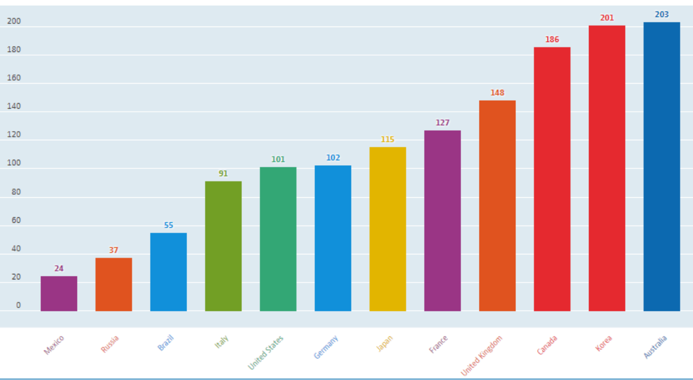
[2] https://www.ssctech.com/blog/inflation-101-what-it-is-and-what-it-means-for-your-portfolio

Want to continue raising rates? How about driving a car blindfolded?

The full effect of the current interest increase will impact thousands of mortgage holders, generally young working families and small businesses, who will be hit the hardest.

To crystallise this point, let us look at some figures. The average mortgage rate was just under 2% p.a. a year ago, with an average mortgage in NSW being $750,000 on a 25-year term.[8] With this week's increase and the average mortgage rate now being 5.5% p.a, the result is a 45% increase in monthly repayments. Looking at the core data, it is safe to assume we have not witnessed the ramifications of this increase, such as a reduction in discretionary spending and the undesirable structural changes to come. This is especially so as many households are burning through the excess savings hoarded during the government's generous financial assistance schemes during the COVID-19 pandemic.

It is no secret that Australian households are some of the most indebted in the world. Therefore, they are more sensitive to these rate rises than their global peers. Thus, great caution needs to be exercised at this critical juncture.



As much as increasing interest rates is unpopular, it is not easy to execute and needs to be more dynamic to make an impact in the short term. We are witnessing month-to- month critical key data, missing targets and expectations, such as retail spending, inflation, unemployment, GDP growth and wage inflation. The key question is whether we should rely solely on blunt monetary policy, and whether or not more must be done on the side of fiscal policy to help curb inflation.

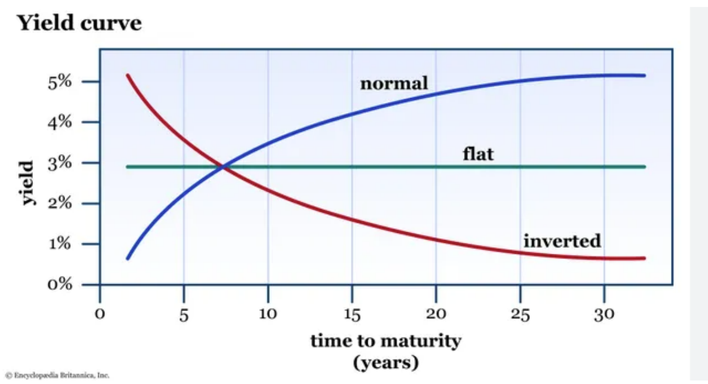
There needs to be a plan B in place too. We must look past Robin Hood tax policies and focus on the fundamentals – increasing productivity and tackling more significant issues that may hinder future growth, such as our tax system as per the Henry Tax Review, removing the red tape and bureaucracy, and generating real incentives for businesses to grow and invest.

Where should long-term interest rates be set? What is the likely trajectory from here?

Governor Philip Lowe of the RBA has provided insights into what he believes to be Australia's neutral official cash rate, being 2.75% p.a. In contrast, the current official cash rate neither stimulates the economy (by providing excess support to the supply of money) nor contracts it. We are far beyond the neutral cash position of 2.75% p.a, with economic indicators recently showing signs of changes to headline inflation, spending, unemployment, and GDP growth.

The 2.75% p.a. neutral cash rate assumption provides a logical rationale to assume this would be the ideal cash rate set once inflation is controlled. It justifies reducing the official cash rate to allow the economy and property market to return to normality. This forms the basis of the financial market's primary argument that central bankers will certainly overshoot interest with a higher rate in the short term and will be forced to decrease rates once the inflation battle is won.

This logic makes a recession much more probable, with the critical question being at what cost and whether there is a better way to manage rates. The assumption is now reflected in the long-term money market, where the yield curve is inverted for the first time in years, with interest rates to increase during 2023 and fall promptly rather than later once unemployment and GDP growth start scaring both the market and RBA Board.



Alarmingly, there needs to be more conversation regarding a possible ceiling of the official cash rates before the economy unnecessarily enters territory that may cause long-term economic damage.

[8] https://tradingeconomics.com/australia/mortgage-rate

One of the greatest economists (whose life work was the study of inflation), Milton Friedman, conducted research which concluded that there is a 6-9 month lag between the beginning of interest rate hikes and the ultimate impacts on the economy. This provides the best rationale **for an immediate pause to official cash rates for at least six months before any further changes to the official cash rate.**[13]

Ultimately whether it is 6 to 18 months, official cash rate will ultimately be lowered closer to 3% p.a, albeit unforeseen black swan events.

Inflation on Services

Due to higher cost of living, excess demand, higher wages, and, most critically, interest rates, there is a genuine need to adjust prices for services. Traditionally, businesses are apprehensive when prices increase as it may lead to loyal clients shopping around. As per basic economic principles, this reduces demand, which may result in lower sales. However, this may be tolerated if it is systemic across the entire industry (precisely what we are experiencing). If businesses are pushing up prices and there is no subsequent negative change in demand, they will be less fear of continuing the cycle. This is the exact concern stated by Philip Lowe – a spiral in inflation for services.

The antidote to all of this is an increase in competition and productivity. This would ease labour constraints and reduce the red tape. However, the most crucial factor is to give enough time for markets to stabilize and for demand to lower.

Property Market and Rent Inflation

The RBA has undertaken to model the impact of interest rates on the property market, which one may find by reading the research discussion paper by Tulip and Saunders, titled "A model of the Australian Housing Market".[15] The model estimates change to property prices as a consequence of changes in interest rates. It predicts the property market will fall more than 30% with a 1% increase in the official Cash Rate, with other variables remaining constant. Despite interest rate increases of 3.5% p.a., property has only fallen slightly – a little over 10% thus far.

The main objective of the report and the analysis needs to be understood as it is not necessarily aimed at predicting property prices. Instead, it seeks to ensure general economic stability, as price stability impacts 10.7% of Australia's GDP, which is directed from activity within the property sector, according to the ABS. Significantly, 40% of our wealth is stored in property, strongly driving consumer sentiment and investment (Keynesian Wealth Effect).

Even though the Australian property market has been experiencing a slight recovery in the past month, it is too early to say whether this trend will continue. According to CoreLogic's Home Value Index, national property prices fell by 0.14% in February 2023, the smallest monthly decline since May 2022, when interest rates began to rise. Sydney, which had previously led the fall in property prices, has recorded a surprising monthly rebound of 0.3%, contributing to the moderation of the national decline.

The main driver is the soaring housing costs impacting the supply of property, thereby putting pressure on low to middle-income earning renters, particularly in major cities such as Sydney and Melbourne. Sydney unit rents have jumped 16.7 per cent over the past year.[16] Unit rents, most favoured by lower-income earners, are surging, and rents will likely continue to rise for at least the rest of 2023 and 2024.

Even with best modelling available to us has underestimated the impacts of higher net migration, rental growth, and, most significantly, the lack of supply of property.

The supply shortage is due to several factors, including rising interest rates, inefficient planning systems, increasing project costs and diminishing purchaser capacity, hence, buyer demand, leading to slow presales in many projects.

Additionally, the pandemic has disrupted supply chains, causing delays and shortages of building materials. The lack of supply will likely persist over the next few years, with uncertainty and volatility in the housing market expected until a new equilibrium is found.

To exacerbate the difficulties currently involved with construction costs, the newly awaited adopted National Construction Code (NCC), which commenced in March 2023, will pressure an industry already showing significant stress.

A challenging time for constructing, especially new residential dwellings, that will most likely experience the most significant housing shortage in Australia's history. Charter Kreck Cramer's

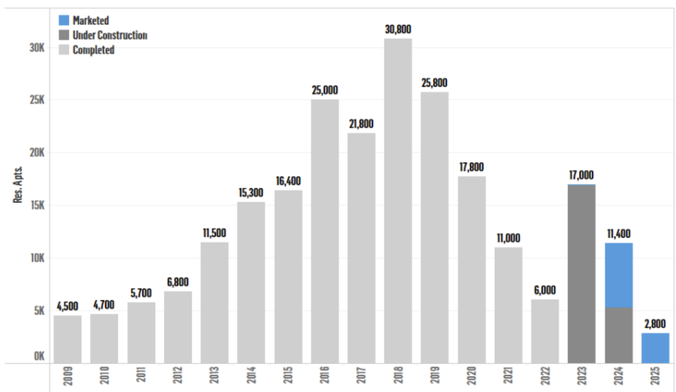
13 https://www.jstor.org/stable/1828534

15 https://www.rba.gov.au/publications/rdp/2019/2019-01.html

16 https://sqmresearch.com.au/weekly-rents.php?region=nsw-Sydney&type=c&t=1

research below shows new residential construction in 2025. Due to excessive rain, COVID-19 disruptions and the Homebuilder scheme, many project completions have been pushed out to 2023, with 2024 and 2025 completions substantially subdued. Only during 2018 had sufficient property been delivered to meet demand; with net migration estimated to be more than 180,000 per year and circa 34% of these people opting to live in Sydney. This means that we will not be able to provide enough property, thereby placing pressure on rents and inflation.

COMPLETIONS OVER TIME - METROPOLITAN SYDNEY



Source: Charter Keck Cramer *Apartments are defined in this report as contemporary own your own (OYO) apartments that are delivered in projects that have 10+ apartments. Student accommodation and serviced apartments are excluded from this analysis.

With apartments being more affordable than houses, the clear alternative is that we need more apartments. A lack of construction places upward pressure on unit prices, and most importantly, inflation on rents will continue to rise due to a lack of supply. Higher interest rates only contribute to a need for more supply in the property market, and developers will need more help to finance their projects.

In our opinion, current interest rate increases have run their course in the fight to combat inflation. Higher interest rates will not assist in the next phase of economic challenges. Focus needs to be shifted to making the economy more efficient, creating a fairer tax system, and enabling the property market to increase supply to lower the demand for property prices, which will moderate inflation pressure from the housing market.

In the end, we ask you, Philip Lowe, to please pause further interest rate increases as these will have little impact on inflation. It is now more about maintaining the RBA's credibility and being in sync with other central bankers.

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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