PETER RAE

Are Low Interest Rates a Risk to the Property Market and Economy?

26 March 2021
By Paul Miron
Managing Director of Msquared Capital

It is to the astonishment of most economists, politicians and property experts that we are experiencing an extraordinary V shape recovery.

This week's fundamental economic good news is that the unemployment rate has fallen to 5.8%, smashing everyone's expectations. The property market seems to be booming, job adverts are increasing and consumers are now freely going back to pre-Covid-19 spending levels. Millennials are once again ordering smashed avocados whilst leisurely completing their online home loan applications in order to begin the hunt for their first property purchase. Their first purchase, mind you, is now mostly sponsored by the government's extraordinarily generous schemes, like the home builder ($2billion worth) and other various grants as well (up to $50,000 per person).

This is a far cry from our expectations a year ago, when Prime Minister Scott Morrison sternly prepared Australians for a 6-month hibernation, followed by high unemployment rate and a long hard economic recovery. Well, that is one political promise that I am glad he has broken!

Is it possible that we are all disillusioned?

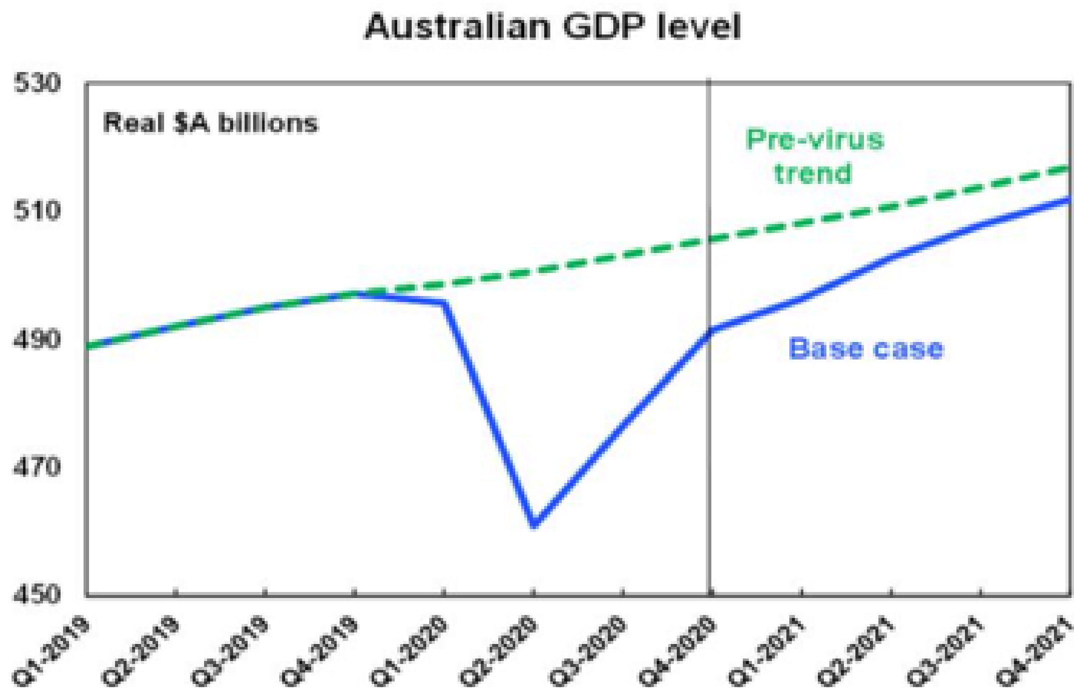
Despite current positive economic euphoria, there are some very respected seasoned investors, politicians and economists who are extremely worried and are of the view that the economic recovery, locally and internationally, is founded on fragile thin ice. There is a high risk that both our local economy and international economies may generate inflation past the prescribed target of the 2%-3% tolerance of central bankers around the world. This would place the RBA Governor, Philip Lowe, under significant pressure to increase interest rates, despite his assertions that rates will stay put for at least 3 years. His motivations would be to avoid the undesirable economic and social impacts of hyperinflation akin to past historical experiences that lead to the 1930's "Great Depression", late 70's oil crisis, and the 80's where many people can remember living through official interests of 18.5%.

During the past few weeks we have seen a number of central bankers worldwide increasing their official interest rates such as bankers from Russia, Brazil, Turkey and from others countries as their economies do not have the financial capacity to continue printing money as freely as our economy.

Increase in interest rates would put downward pressure on asset classes such as property and shares, whilst undermining consumer confidence which would result in lower spending and impede a full economic recovery. The current unemployment trend would also change from positive to negative very quickly. The most alarming comment is that both monetary and fiscal policies have pretty much been exhausted during the pandemic. Worse still, if the Government was unable to support the market, it could lead to a market collapse like in the share market crash in 1987 and 2004 and other property market corrections that we have experienced in the past.

The rationale for such divergence of economic opinion is fundamentally based on the fact that we're living through an economic experiment. The combination of monetary and fiscal policy employed by the Government and RBA has never been tested before e.g., zero interest rates, Quantitative Easing, Job Keeper, Job Seeker and mortgage payments deferrals to name a few.

Another way to appreciate this is by the graph depicted below that has been prepared by AMP. It demonstrates the hypothetical green line if Covid-19 has not happened. The blue line depicts actual GDP figures.



Despite Australia's GDP being in excess of 3% for the past 2 quarters (for the first time ever) we are still 2.4% below than what we would have been if Covid-19 was avoided. Our unemployment was mid 4% before Covid-19, with our wage growth peaking at a mere 1.4%p.a., whereas today we have unemployment of 5.8%.

It is the RBA's fundamental economic assumption that in order for inflation to shoot past 3% maximum traditional target, interest rates must be kept low and we really require the unemployment rate to fall to 3%. This is because in the current economic situation, wage inflation is the key element to push overall inflation. According to many economists this could take years for unemployment to reach a rate below 4% which supports the RBA's expectation.

The estimated financial cost to future tax payers to ensure that we have this V shape recovery is estimated to be circa $350b, roughly 17% of our GDP. This is 5 times larger than any stimulus that was provided during the GFC.

In our opinion, despite the surging asset values, it is unlikely for the economy to overshoot the green line suddenly while a number of industries such as tourism and overseas students are still being subdued and let's not forget the industries being targeted in our ongoing trade war.

The true economic recovery picture will be seen in the next two quarters of GDP figure, where either the fear of inflation will abate or crystallise into reality.

Property Commentary

Msquared is not surprised that we are experiencing a sharp increase in houses prices, much more than the official monthly core logic of 2.5%. In previous articles and media interviews over the past 24 months, our view was consistent that there was upside capacity for property prices to increase. The major driving factors can be mathematically demonstrated using the RBA modelling, which directly correlates a decrease in the cash rate directly increasing property prices.

The other main driver is that there is a greater demand and a lack of supply of housing – be it physically or listed on the market. We do not have an oversupply of houses in any of our major capital cities presently[1]. However, the unit market is a different story highly dependent on the geography and style of a unit.

The non-mathematical elements to property

Since 2017 the confidence of property purchasers has been subdued due to many significant events, starting with government intervention to ease the money supply (2014-2017), the lead up to the Federal Election in 2019 and Covid-19 hitting just as property prices began to increase. Therefore, the pent-up demand is substantial and is in combination with the tsunami of the first owner grants and the $2B home builder scheme adding fuel to demand.

Our belief is that the overnight price growth we are currently experiencing will plateau out as a result of vendors wishing to take an advantage of the market and this will increase supply options and the demand will flow through to the rest of the property market.

It is clear that if the RBA believes that the property market begins to overheat (exceed their expectation of property prices increasing more than 30% over 3 years), rather than increasing interest rates they will opt to dampen demand via non-traditional tools such as making it harder for people to borrow money from the banks as they have done previously between 2014 to 2017. This is by far the better option to continue to give the economy the full benefit of the low interest rates whilst dampening our currency to keep our exporters busy.

From a personal perspective the factor I love most about being a Mortgage fund manager is that irrespective of whether the economy or property market is going up or down we are able to deliver a consistent regular income for our investors. Even in the worst-case scenario where a borrower defaults and we need to recover; we always have a quality asset as a security in order to maximise preservation of investors capital and interest. Through our chairman's 45 years career as a mortgage fund manager and never losing a dollar of investors capital, the most critical lesson learnt is sticking to the discipline in credit assessment (5 C's). Msquared was founded for us to share with our investors the platform, tools and structure to make intelligent investments and help manage your portfolio into direct mortgages.

Should you wish to subscribe to our database to receive upcoming opportunities, please feel free to call or book in a meeting here:
https://www.msqcapital.com.au/contact.php

[1] https://www.planning.nsw.gov.au/Research-and-Demography/Sydney-Housing-Supply-Forecast

Contact for more information:

PAUL MYLIOTIS
Managing Director
e. p.myliotis@msqcapital.com.au
p. 02 9157 8608
http://msqcapital.com.au/

PAUL MIRON
Managing Director
e. p.miron@msqcapital.com.au
p. 02 9157 8608
http://msqcapital.com.au/