IT'S ALL ABOUT

INTEREST RATES

The interest rate rise lever.

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BY PAUL MIRON

From an economic standpoint, it certainly seems we are headed in the right direction. We are getting the upper hand in living with the virus, international borders are reopening, and Australia is once again welcoming tourists, students, and migrants. The RBA has modelled that unemployment is at 4.25% and heading to sub-4%, the lowest we have experienced for decades – with GDP growth forecasts recently revised upwards to 4.25%.

Despite the economy recovering strongly enough to support the tapering of fiscal and monetary policies, the prospect of this happening has sent the market into a tailspin due to fears of immediate interest rate increases and inflation getting out of control.

The size and extent of government stimulus combined with “free money” (0.1% p.a. official cash rate) have never been applied in our economy’s history. As a comparison, during the GFC the amount spent to stimulate the economy was 2% of the GDP whilst Covid-19 support equated to 7% of the GDP. Some forget these extraordinary measures are always intended to be temporary. The economy needs to stand independently without monetary and fiscal support from the government. Official interest rates need to be normalised, arguably between a range of 3.5% to 5% p.a., with a move to balanced budgets for the primary purpose of cushioning our economy against future Black Swan events. Smoothening the troughs and peaks of economic cycles to limit the pain of future recessions and crises should always be the primary mission of the Reserve Bank and Governments. Reserve banks predominately use the lever of interest rates against persistent inflation to enable full employment and financial stability.

The inconvenient truth is that there is increased uncertainty in the economic future.

Has the magnitude of the stimuli injected globally by reserve bankers been too excessive? Or will the economic scars caused by Covid subside, with chain supply, transitionary inflation and loss of productivity returning to normal?

Thus, the question is - have we unleashed persistent inflation, which will require a more aggressive stance in increasing interest rates? If the answer is "Yes", this would result in decreased asset prices across most asset classes, reduced real wealth for businesses and personal balance sheets, lower consumption and investing, hence lower economic growth, and the possibility of an economic recession (Keynesian Wealth effect).

An entire generation has never had to deal with the consequences of inflation, and I believe they are not financially, nor psychologically, prepared. Some economic historians reference the past 40 years as the "Goldilocks" period, primarily due to inflation having remained consistently low, allowing for a continual decrease in interest rates. Perhaps this period coincides with the productivity gains made due to globalisation and the subsequent fall in the prices of consumer goods via the movement of manufacturing to countries with much lower labour costs. As Nobel Prize winning economist, Arthur Lewis, concludes in his body of work, we may have indeed reached the "Lewis Turning Point" - the point where there are no further productivity gains made by using cheap overseas labour and manufacturing. Global trends such as "De-globalisation" further support Lewis' theory and the notion of inflation being a more prevalent issue in the near future.

With the trend of cheaper consumer goods ending, will the pace of technological advances be enough to make up for slower productivity gains?

How do investors invest confidently in such an uncertain world?

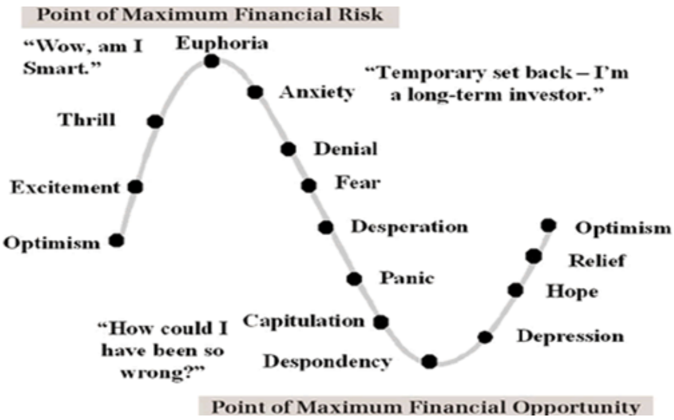
Many investors lean on forecasts; however, there are infinite correlated variables in the world of economics: people's psychology (Animal Spirits), political influences, geopolitical tensions and unforeseen global events, all of which change our future economic outcomes. You need only look at the monthly forecast updates by the RBA to see how this varies month to month.

Investing is the positioning of your capital so that you benefit from, but are not harmed by future events. Rather than being consumed by possible future events and forecasts, one should focus on the present. Looking at your portfolio and understanding where we sit currently in the market cycle, whilst making the necessary risk assessment and adjustments such as reviewing your asset allocation, is one of the most practical, effective, and straightforward strategies.

Accepting uncertainty and embracing it is an essential attribute in becoming a superior investor; it allows one to ask the right questions and evaluate investments objectively.

Market cycles are predominantly caused by human emotion, ranging from excessive optimism to undue pessimism, resulting in booms and busts. These cycles are evident, observed and studied throughout economic history; this inevitability offers the greatest certainty, just as we move from Spring to Summer and from day to night.

"Investors should be worried when there is too much money in the market, not enough opportunity, and complete disregard to risk". The psychological signs investors should look out for in determining risk is the prevailing emotion of the market, as investors should contemplate moving their portfolio to a more defensive position and pivot their portfolio as we move through the cycle presented below.



Source: The Most Important Thing - Howard Marks

The biggest misconception made by investors learning about the market is attempting to consistently sell high and buy low, which is as effective as chasing rainbows.

Despite being confident in the eventual trajectory of the market cycle, no one has been successful in consistently finding the exact timing of a market correction/crash, or finding the absolute bottoms.

Radical decisions, such as selling everything you own and moving all your life savings from one asset class to another in anticipation of a crash or boom, often lead to horrible outcomes over the long term. Money should constantly be working and earning income. The aim is to achieve consistent income over a long time. Albert Einstein once said compound interest should be the world's eighth wonder of the world.

Understanding the risk of your investment, being diversified, always being invested and repositioning your portfolio ahead of the market cycle will hold investors in good stead in both good, and difficult, times. Australia may indeed emerge as the "Lucky Country", being able to manage the tightrope of taming inflation, achieving sustainable economic growth, and having the time to slowly increase rates without the cost to asset prices and the economy. We may not be able to say the same of our global peers.

Knowledge, Insights and Opportunities

I am fortunate to have access to the knowledge, insights and opportunities on the ground, being privileged in running a mortgage fund. Investors commonly enjoy mortgage funds as defensive assets and useful for asset-allocation and further concentration during volatile times, specifically in an environment with increasing market volatility, inflation, and rising interest rates. Investors are seeking regular, reliable, and resilient income as the market cycle changes and investors seek to rotate their portfolios into a more defensive position to withstand volatile times. Asset preservation is the foundation of mortgage investing. Those who have invested in 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 importance of security offered and give our investors the platform, tools, and opportunity to create the direct mortgages portfolio that meets their risk profile.

Mortgage funds can also take advantage of the dislocation in the market at various times within the market cycle. Msquared will be launching a high-income opportunity fund backed by property to add to the current offering.

If you would like to know more, please contact us on 02 9157 8608 or email us at investor@msqcapital.com.au.

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