PERENNIAL VALUE MANAGEMENT

Perennial Perspective

Reflating the Nation, A tent over our children's head ….

There has been a lot of discussion domestically and abroad about "reflation", with GDP growth slowly accelerating and inflation rising back to more normal levels.

When growth and inflation rises, Governments tend to raise official rates usually forcing longer term bond yields to also rise.

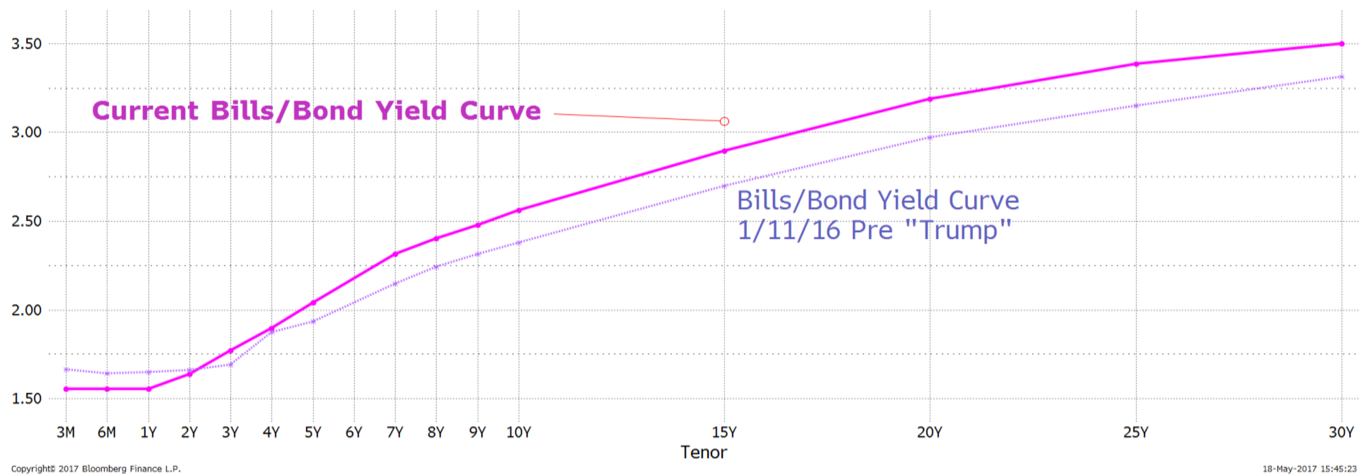
This played out in the last quarter of 2016 with many seeing this a bit like one way traffic – In fact over the last year our 10 Year Bond rate has risen from lows of around 1.8% to almost touch 3% in mid-March, however with faltering commodity prices (ex-Gold), and a more realistic view on the nature of the reflation outcomes, bond yields and expectations around the reflation trade have definitely eased.

The important questions for market valuations is just how fast and how far will rates rise. Importantly, for many reasons, most economists expect rates will not rise to previous levels, at least anytime soon. Some points to consider:

- In the high inflation 1980's 10 year bond rates topped 16% p.a.
- As equity markets were peaking in 2007, rates were over 6% p.a.
- There were no rate rises in the last Federal Reserve and Reserve Bank of Australia (RBA) meetings in early May.
- The markets are currently not pricing a greater than 50% chance in the official cash rate rising by 25 basis points until July 2018.

- Current expectations about the future are very different. I can now buy a 20 year government backed security with a yield of just around 3.3% p.a. implying that rates will rise from here but not to the same extent as in the past.

The following chart illustrates current yield curve for Australian Bills and Bonds compared to the Pre Trump levels. The takeaway here is that expectations about future interest rates are continuing to look subdued compared to historical levels. Naturally future expectations do change as you can see from the lilac 'pre "Trump"' yield curve in the graph below, however the point here is that the markets are expecting yields to remain historically low for quite some time.



Source: *Perennial, Bloomberg*

So what does all this mean for the investor? The rise in interest rates is likely to be more gradual than many of the scaremongers are predicting. In this case growth asset earnings may have time to grow to meet current valuations. Credit markets would also be positive in this environment as compared to Government bonds.

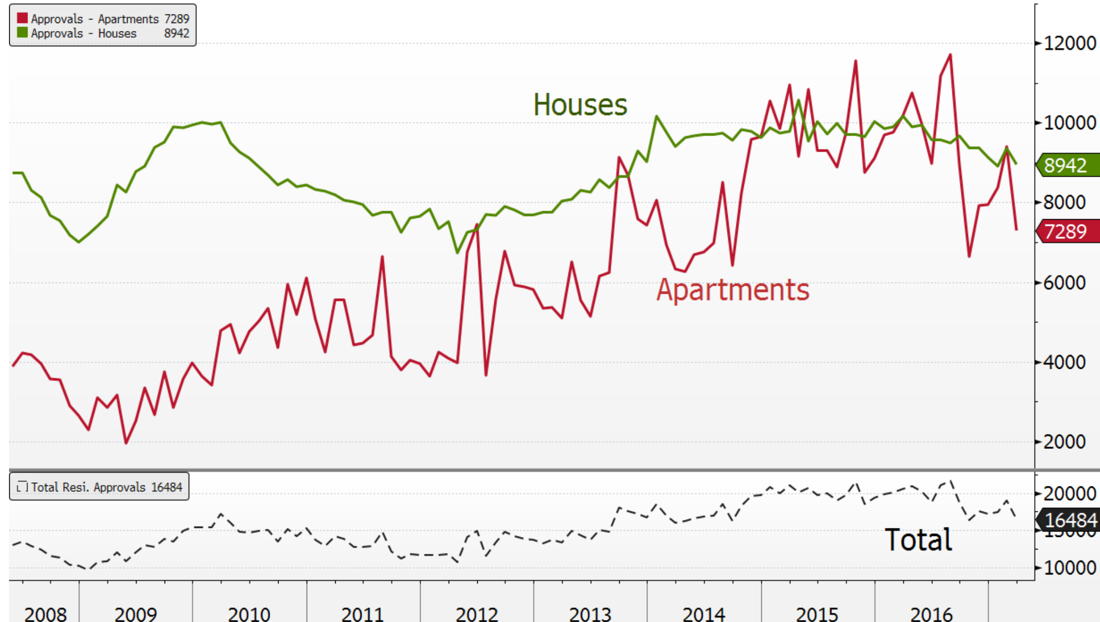
Budget

It was almost a "Labor" budget with Gonski, Infrastructure, higher taxes and a hit to the Banks. It's probably too easy to be cynical, however the government does have its' hands tied to a major extent given the difficulties of getting previous more traditional "Liberal" measures through the Senate, although more tinkering with superannuation house savings accounts as well as Medicare and Bank taxes etc. is a long way from genuine well thought out, long term tax reform which the country is crying out for to ease the current perceived and 'real' housing dilemma faced by the next generation of house buyers.

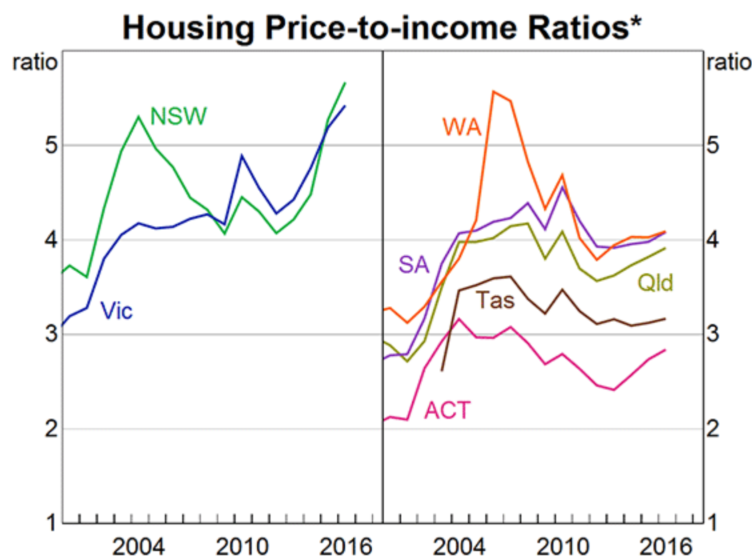
A tent over our children's head ....

Unfortunately the announced 'housing measures' may see the frothy housing market continue to rise as interest rates don't look likely to rise for several months and the supply issues in preferred locations looks like remaining tight (the decision to downsize is a tax-free outcome for most in any case, so being able to re-invest a bit more into superannuation will help some down-sizers reduce their tax bill but not enough, I would suggest, to see a large supply increase). The superannuation savings measures for housing are very complex – given that savings for housing is more in the domain of the banks, a simpler, targeted tax-free or advantaged savings account with a penalty if the proceeds are not used for a first home could have been more targeted and more successful.

Interestingly the latest (admittedly volatile particularly for apartments) numbers on building approvals does indicate a slowing down in the growth rate of potential supply with building approvals to March (the latest number released in early May) down 13.4% in the quarter to end up nearly 20% lower than a year ago albeit this is off historically high base.



On the other hand the latest CoreLogic house price index for April showed some moderation in housing prices with capital city overall prices only 0.1% higher in April (but still up 11.2% over the year!). In his most recent speech on housing debt, prices and resilience the RBA governor, Dr Phillip Lowe discussed the risks of ballooning house prices reflected in the dramatic increase in the Price to Income ratios particularly in the Sydney and Melbourne markets as illustrated in the following chart. Another issue evident in the below chart is the role played by NSW and Victoria in the rising price to income ratio momentum.



Governor Lowe also made the following interesting points:

- Housing prices and the nature of the related debt are important in terms of potential future shocks and intergenerational wealth distribution.
- The positive side is that strong financial markets and house price performance has now seen overall Net Wealth to Income ratio rise to record levels, surpassing the pre-GFC highs.
- Restricted supply where people want to live, population growth and low mortgage rates has fuelled housing prices.
- Unlike the US's GFC housing crisis our housing debt is skewed towards the wealthiest households and most mortgagees are ahead in their payments with the banks having sufficient buffers to withstand larger price falls. However we are definitely less resilient to shocks with such high debt levels.
- Households are not withdrawing equity to finance consumption like they have done in previous booms.
- Tight financial conditions due to mortgage debt can also affect consumption.

Overall the RBA's view seems to be that the increase in the price to income ratio is now an area of concern and that they would prefer to see a moderation in this ratio over the next few years.

Whether the Budget has done enough to affect the demand and supply equation in Australia's much loved residential ownership culture remains to be seen, however its outcomes it will be closely watched for the sake of both our economy and our children.

Brian Thomas

General Manager – Investment Services

Disclaimer: Please note that these are the views of the writer and not necessarily the views of Perennial Value.