SUPERVISED INVESTMENTS
AUSTRALIA LIMITED

June Quarter, 2019

The Supervised Fund: Macroeconomic Outlook

Investing in a low interest rate environment

Overview

On 2 July 2019, the Reserve Bank of Australia (RBA) reduced the cash rate by 25 basis points, to 1%. It was the first time since 2012 that the RBA had cut in two consecutive months, and represents the lowest central bank cash rate in Australia's history. Image 1 below shows the cash rate reaching new lows of 1%, having dropped from a high of over 17% 30 years ago.

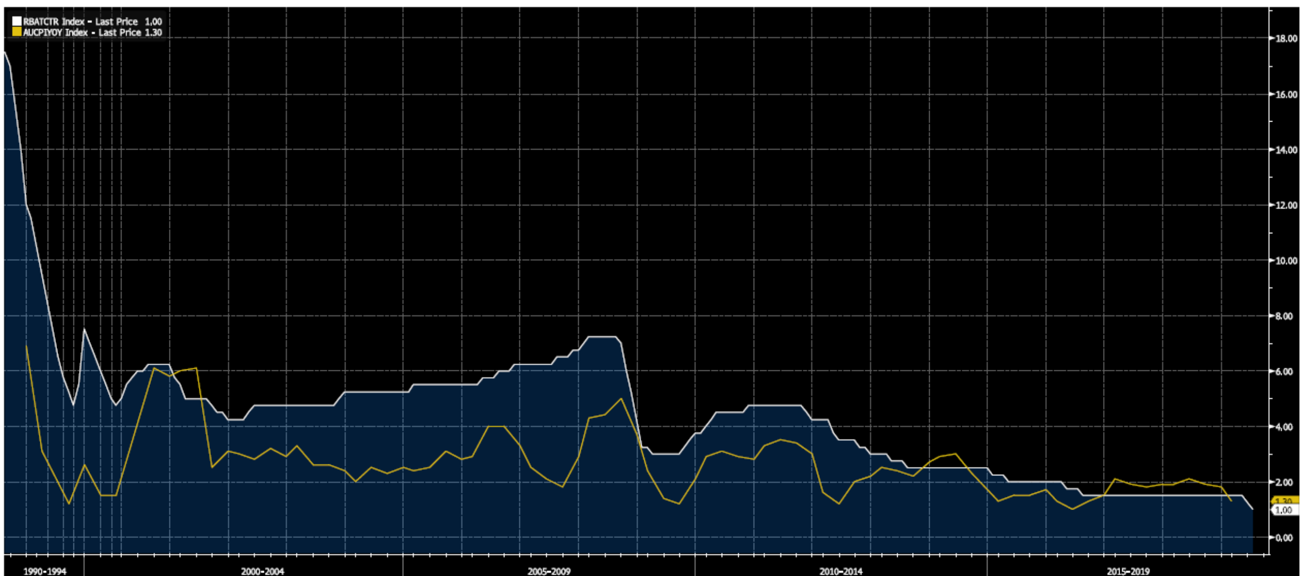

Image 1: RBA target cash rate (white) vs inflation (yellow), past 30 years (source: Bloomberg)

This report will analyse the reasons for the RBA's decision, in addition to the expected effects of these rate cuts on individuals and markets in Australia.

Reasons for the RBA decision

In its various public releases, the RBA cited such factors as subdued inflationary pressures, a weak housing market and spare capacity in the labour market as reasons for reducing the cash rate in both June and July 2019.

Inflation over the year to 31 March 2019 was 1.3%, below the RBA's target of 2-3%. As the table below shows, the main pressures on inflation have been increases in the price of food and drink, as well as in health and education, but offset by weak or negative price changes in housing, recreation and culture, transport and household equipment / services.

CPI group	2018 % weighting	Year to Mar 2019 % change
Housing	23.19	0.8
Food and non-alcoholic beverages	15.76	2.3
Recreation and culture	12.6	0.9
Transport	10.48	0
Furnishings, household equipment and services	8.89	-0.8
Alcohol and tobacco	7.36	6.4
Insurance and financial services	5.86	1.1
Health	5.69	3.1
Education	4.27	2.9
Clothing and footwear	3.32	-0.1
Communication	2.57	-4.6

Table 1: CPI weighting and % change over year to March 2019 (source: ABS)

Although overall housing costs[1] increased 0.8% in the year to March 2019, residential house prices decreased by 7.4% over the same period. The RBA considers these house price decreases to have played a role in holding back household consumption spending in the economy, as declining property values prompted home-owning Australians to feel less wealthy and therefore reduce expenditure. Nonetheless, inflation and house prices figures are backward-looking, and the RBA has suggested it expects both these measures to increase in the next 1-2 years. Its central forecast is for inflation to run at around 2% in 2020, and it noted there are tentative signs of price and credit growth stabilisation in the housing market.

The other primary reason provided by the RBA is the 'spare capacity' available within the Australian economy. Spare capacity refers to the gap between the actual unemployment rate and the unemployment rate associated with full employment. An economy which exhibits an unemployment rate above its theoretical rate of full employment is said to be underutilising its resources, whilst negative side effects such as excessive wage and inflationary pressures are said to occur when the reverse is true. The RBA reducing the cash rate by 50 basis points in recent months is reflective of its view that the unemployment rate of 5.2% is well above its estimated rate of 4.5% associated with full employment, and that it is both 'possible and desirable' to reduce this spare capacity. It judged in its June Minutes that reducing interest rates was 'likely to support growth in employment and incomes, and promote stronger overall conditions'.

Outside of domestic economic considerations, it appears as though Australia may have been caught up in global market forces, which helped guide the RBA's decision. The US-China trade war continued to cause concern amongst market participants, with Mr Trump threatening during June to increase tariffs on another $300bn worth of Chinese imports. This, combined with low levels of inflation across many developed nations resulted in an increased likelihood of US rate cuts, and thus attractiveness of fixed-income assets (as demand for previously-issued bonds offering higher returns increases). The chart below shows how government bond yields have been falling, which occurs by definition when the price of bonds increases.

[1] Housing costs include rent, new dwelling purchases, utilities and other housing-related expenses in the ABS inflation data.

Image 2: Falling 10-year government bonds across major economies (source: Bloomberg)

As alluded, falling yields indicate investor concern for economic growth, and consequent expectations that monetary policy easing will occur across major economies, including in the US, Europe and Japan. In fact, the RBA admitted in its Minutes that the positive outlook for inflation and unemployment were grounded in the assumption that the cash rate would follow the path implied by market pricing; i.e., that interest rates would decrease. The RBA therefore concluded that the improved outcomes forecast for the Australian economy would only occur if expected rate cuts were to eventuate. Additionally, with interest rates falling internationally, it is possible the RBA assessed that Australia would need to lower its interest rates in line with trading partners to keep its currency competitive.

Analysing the RBA's decision

The RBA's decision to reduce the cash rate has been criticised from several angles. Many wonder why a strong economy with a relatively low unemployment rate necessitated a reduction in rates to their lowest level on record. The latest annual GDP growth rate is 1.8%, but the RBA stated in its May Minutes that its forecast is 2.75% over 2019 and 2020. This forecast was supported by strong export growth on the back of a low AUD exchange rate, and some newly announced mining investment projects.

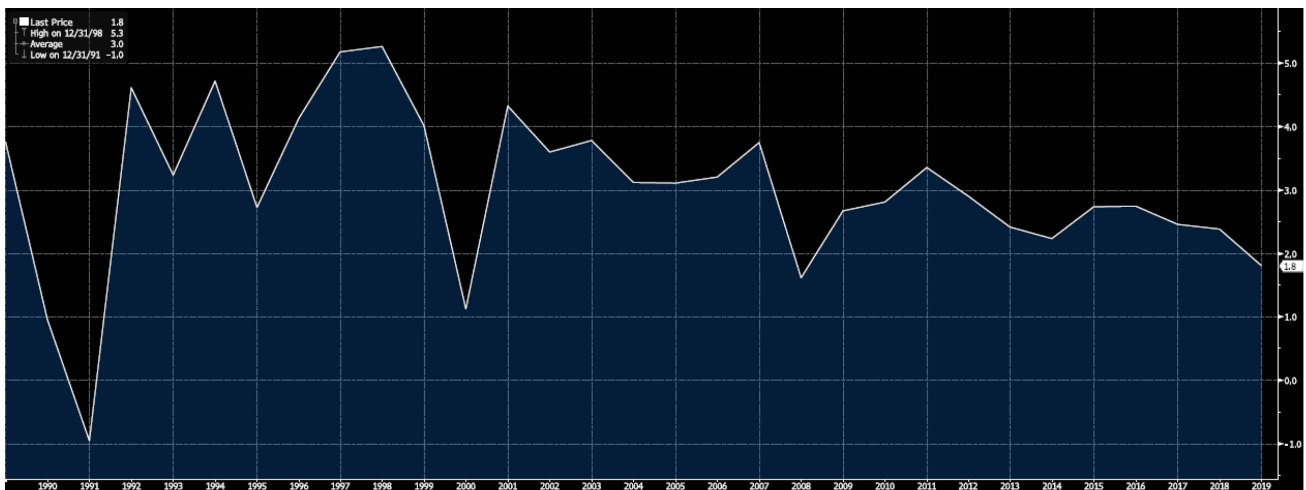

Image 3: Australian economic growth over the last 30 years (source: Bloomberg)

Meanwhile, Australia's unemployment rate of 5.2% is low in the context of the last 30 years (Image 4), and the RBA expects this to reduce to 4.75% by 2021. Although it ticked up slightly in the latest monthly figures, this was driven by an increase in the participation rate, rather than through people losing their jobs. In the month of May, 34,200 people who weren't previously looking for jobs began doing so, of which 28,400 became employed – an 83% success rate within the first month. This would seem a positive outcome, and reflective of a healthy economy in which people are not discouraged from looking for work.

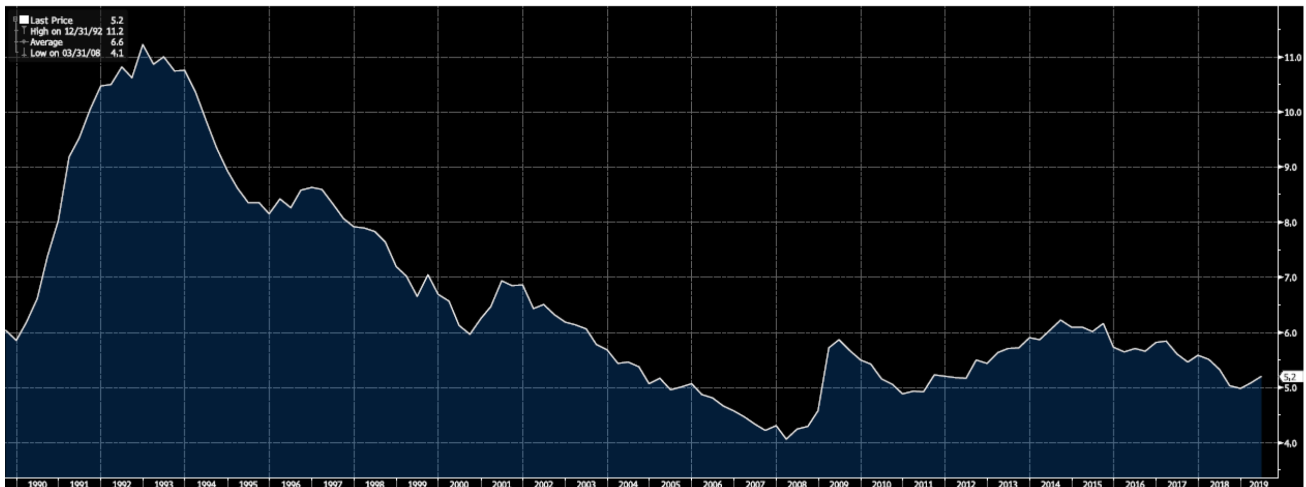

Image 4: Australia unemployment rate over the last 30 years (source: Bloomberg)

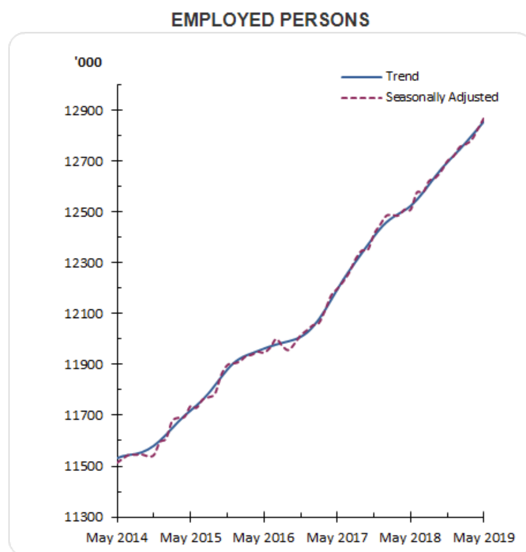

Image 5: Employed persons in Australia over the last 5 years (source: ABS)

In addition to more jobs being created, wages in Australia are actually rising faster than the rate of inflation. The wage price index increased by 0.5% in the March quarter to be 2.3% higher over the year, which the RBA states is evidence of spare capacity in the economy despite falling squarely within the desired inflation target band.

Surprisingly, interest rates are lower now than they were during the 1991 recession, the dotcom bust of 2001, and the Global Financial Crisis (GFC) of 2008. In fact, they are a full 200 basis points lower than they were in CY2009 (Image 1), right after the GFC, even though the unemployment rate was higher, and inflation and GDP growth rates lower. At this point in time, interest rates had been reduced by over 4% in response to

the GFC. If a similar crisis were to occur today, the central bank would not have the same 'firepower' as it did then. The RBA has a different take on this issue, however, suggesting that the targeted 'lower level of interest rates would stimulate activity and thereby improve the resilience of the Australian economy to any future adverse shocks'.

Another concern is the amount of debt taken out by Australians over the last 30 years (Image 6). Australia's household debt to income percentage is around 190%, one of the highest in the developed world. In its June Minutes, the RBA stated that reducing interest rates was unlikely to result in a material pick-up in household borrowing because, amongst other factors, debt was already high. Contradicting this RBA statement, the data appears to show that interest rates are inversely related to debt – which makes sense given people pay less to service borrowings when interest rates are lower.

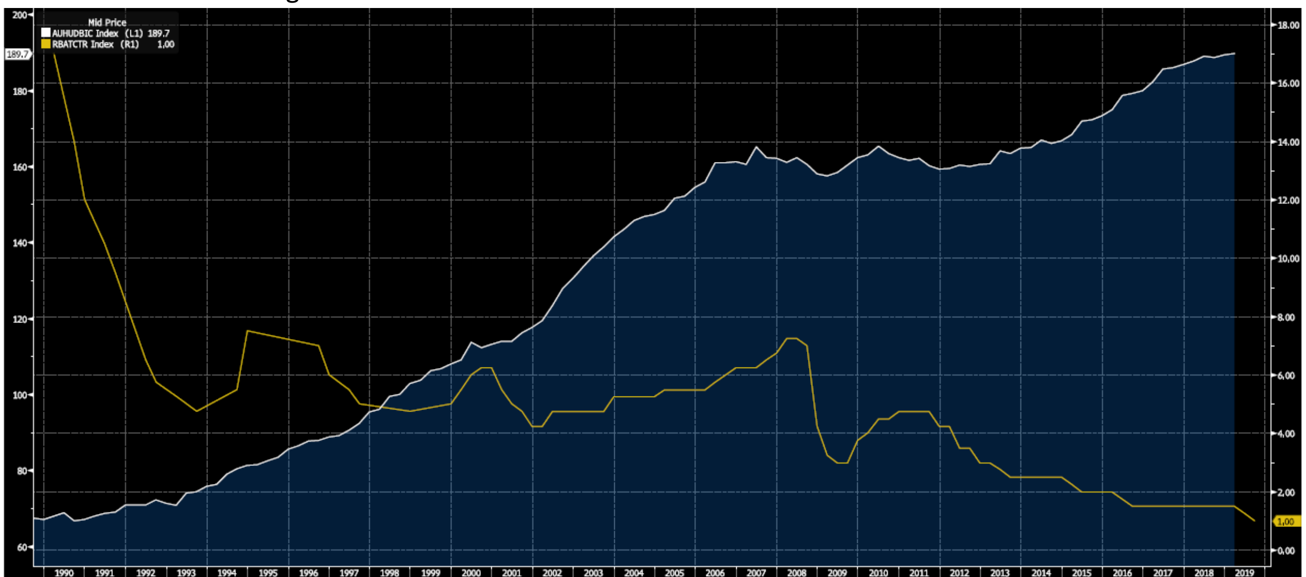

Image 6: Australia household debt to income % (white), vs RBA cash rate (yellow), last 30 years (source: Bloomberg / RBA)

Despite the recent dip in property values, prices have still almost doubled over the last 15 years (Image 7), fuelled in part by household access to cheap credit[2].

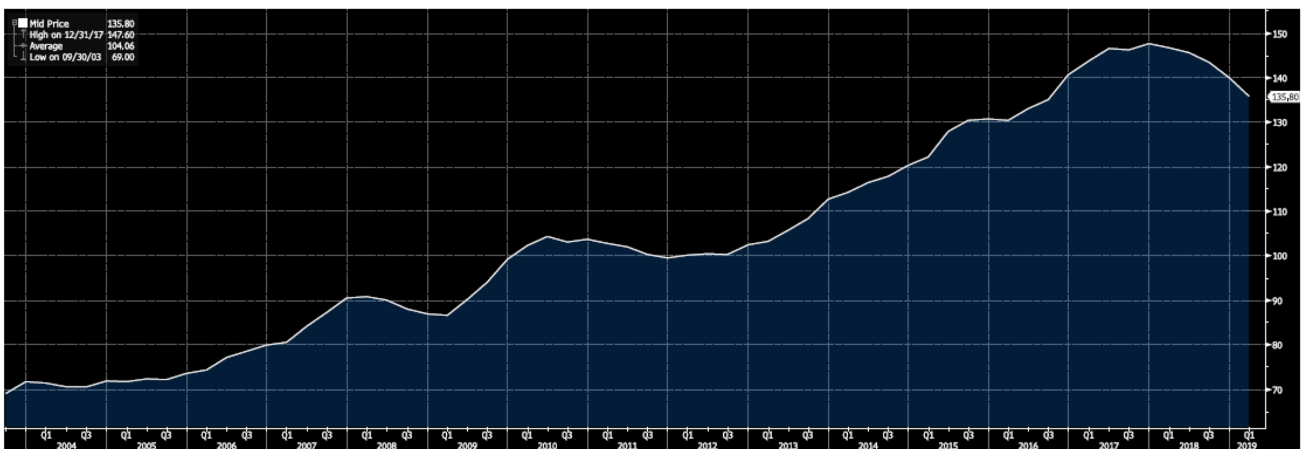

Image 7: Australian residential property prices since Q3 2003 (source: Bloomberg / ABS)

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[2] Over the same period, the All Ordinaries Accumulation Index has increased by ~3.6x.

And now, with the Royal Commission concluded and changes to negative gearing and capital gains tax no longer a threat, the property market has been showing signs of recovery. Auction clearance rates have reached their highest in 15 months, and housing credit has stabilised, having slowed substantially over the preceding year. Further, regulatory standards have recently changed to benefit borrowers. Banks were previously required to assess borrowers' ability to service mortgages at a 7% interest rate, but now require a 2.5% margin above borrowing rates. The Financial Times reports that this measure alone could increase borrowing capacity by 14%.

In short, with the property market showing signs of recovery, alongside increasing inflation and economic growth and a strong labour market, the requirement for record low interest rates appear questionable. Today's debt will require tomorrow's savings to pay off, which will ultimately reduce consumption spending and capital flows into the housing market.

Impact of the RBA decision

Quickly decreasing interest rates will significantly impact the well-being of savers and borrowers, and their resource-allocation decisions. With the average interest rate paid on retail deposits about 1%, i.e. lower than the rate of inflation, there is little incentive for individuals to leave their money in the bank. Instead, they can earn a higher return by investing in other asset classes, such as ASX-listed companies, property, or gold. Similarly, borrowing is made more attractive (assuming banks pass on the rate cuts) to both individuals and organisations, which is reflected in Australia's high and increasing household debt-to-income ratio.

Investing in the stock market offers an attractive alternative to saving, given the average dividend yield on ASX200 companies is about 4.5% (according to JP Morgan estimates). Part of this is because the availability of franking credits encourages Australian companies to pay out more in dividends as a percentage of their profits (Image 8).

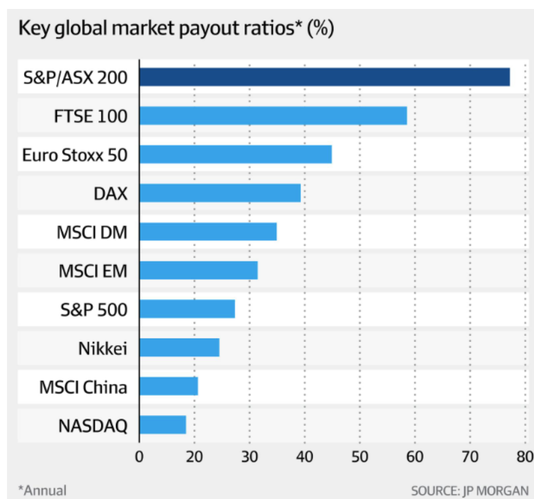

Image 8: Company payout ratios across different geographies (source: ARF / JP Morgan)

Every time interest rates are reduced, the gap between the amount an investor can earn by keeping money in the bank compared to investing it in shares increases. Compounding this, lower interest rates generally help to improve companies' profitability, especially those that are indebted or require debt to grow, as their interest payments decrease. Both these factors help to justify enlarged company valuations. On the other hand, economic risks abound; barely profitable ("zombie") companies may stay in business longer because

they can access cheap credit, and capital may be allocated to unproductive causes. Expect a rise in M&A activity.

As previously discussed, the property market is also be expected to benefit, as individuals' capacity to borrow increases and unlisted property continues to yield strongly. According to RBA analysis conducted in March, a 1% cut in rates would lift house prices by 30%. However, this is only to the extent that banks reduce mortgage rates in line with the RBA, which has not been occurring (Image 9). The ANZ was the only bank amongst the largest four lenders to pass on the latest cut in full, and, according to analysis by The Australian, the additional 2.14% spread between the RBA cash rate and standard mortgage rate has netted the big four banks an extra $2.1 trillion since January 2008.

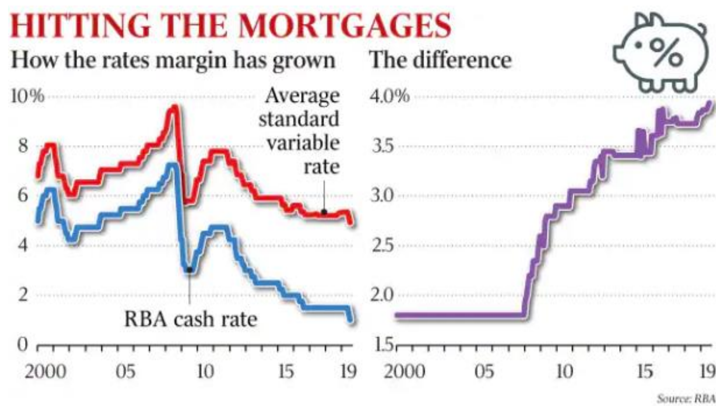

Image 9: Widening gap between RBA cash rate and standard variable loan rate (source: The Australian / RBA)

As the cash rate nears zero, competition for deposits amongst banks will make it more difficult for them to pass on RBA cuts in full. If community pressure does force banks to pass on rate cuts, expect them to concurrently reduce deposit rates, and for total savings to consequently reduce as individuals move their money from the banks to other investments. In other words, while bank profitability may decrease (Macquarie Wealth Management research found the latest cut would reduce banking sector profitability by 3-4%), prices of assets across the board should increase.

Another asset class that has performed strongly in the current low interest rate environment is gold. Negative interest rates in Europe, and expected lower rates in the US, represent a deterrent to hold Euros and US dollars respectively – and an improvement in the relative appeal of holding gold. In fact, with Brexit uncertainty affecting the GBP, and persistently low rates in Japan, none of the major currencies appear to offer an attractive 'safe haven' for investors. This may also explain some of the buying activity of gold by the central banks of Russia and China. Investors' concerns over low interest rates and a weak economic environment are reflected in US government yields, which, for the reasons previously mentioned, appear to be inversely correlated with the gold price (Image 10).

Image 10: USD gold price (black) and US Govt 10 year yields (source: Bloomberg)

Conclusion

The lowering of interest rates presents the Australian economy and investors with both opportunities and threats. In the short-term, a 1% cash rate will spur consumption and investment spending and help to lift GDP. In the longer-term, access to cheap credit will increase debt and distort capital-allocation decisions, potentially leading to asset price bubbles.

Investors with a well-positioned portfolio will be able to take advantage of record-low interest rates. For example, given the already-substantial pipeline of infrastructure work, combined with the ability of the private and public sectors to fund infrastructure very cheaply, maintaining exposure to this sector seems sensible. Similarly, given funding costs for mining capital works has decreased, and the RBA expects a pick-up in mining activity in the coming years, there is a strong case for mining segment exposure. The Supervised Fund is exposed to these sectors and, recognising the global forces pushing the gold price to six-year highs, is invested 7% in physical gold ETF and gold call options. The Fund should also benefit from a weak AUD, especially when Kangaroo Island Plantation Timbers and Po Valley Energy Limited begin producing.

Lachlan Kirwan

The Supervised Fund

30th June 2019