Investment Perspectives

GRANT SAMUEL FUNDS MANAGEMENT

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The boy who cried wolf was right in the end

Australia hasn't had a recession for some 27 years. But through that time, there has been a hardcore cabal of Aussie economy bears who have insisted that disaster was just around the corner. There was a rich lode of material to draw upon in terms of potential shocks from overseas dragging the Australian economy down. These ranged from the 'tech wreck' to the Financial Crisis, the European debt crisis and occasional Chinese 'wobbles', and the prospect of the domestic house price 'bubble' bursting.

China and housing in particular have been the source of many a bearish prognostication going back more than a decade to a period prior to the Financial Crisis. That none of those dire prognostications have yet eventuated has led to notions of 'crying wolf'. However, as I've often been reminded, the boy who cried "wolf" was right in the end.

So, what about Australian housing? Do housing developments have the capacity to derail the Australian economy? And what of the prospects of a chill wind from China?

Aussie housing

That there are headwinds to growth in Australia that stem from imbalances wrought by excessive household debt (mostly mortgage debt) is, to my way of thinking, incontestable. According to Bank for International Settlements data released in June, Australia had the second highest level of household debt to GDP ratio (122%) of the 43 countries surveyed.

It seems a reasonable conjecture that the flip-side of that accumulation of debt is the extraordinary run-up in house prices. Certainly, the level of house prices in Australia on a relative-to-income basis is quite high, but perhaps not egregiously so as might be widely assumed (indeed, the 'gold medal' goes to our trans-Tasman cousins). Nevertheless, the key element is that the interplay of high household debt and high house prices renders the domestic economy vulnerable to potential shocks, particularly those focused on housing.

Chart one: Household debt

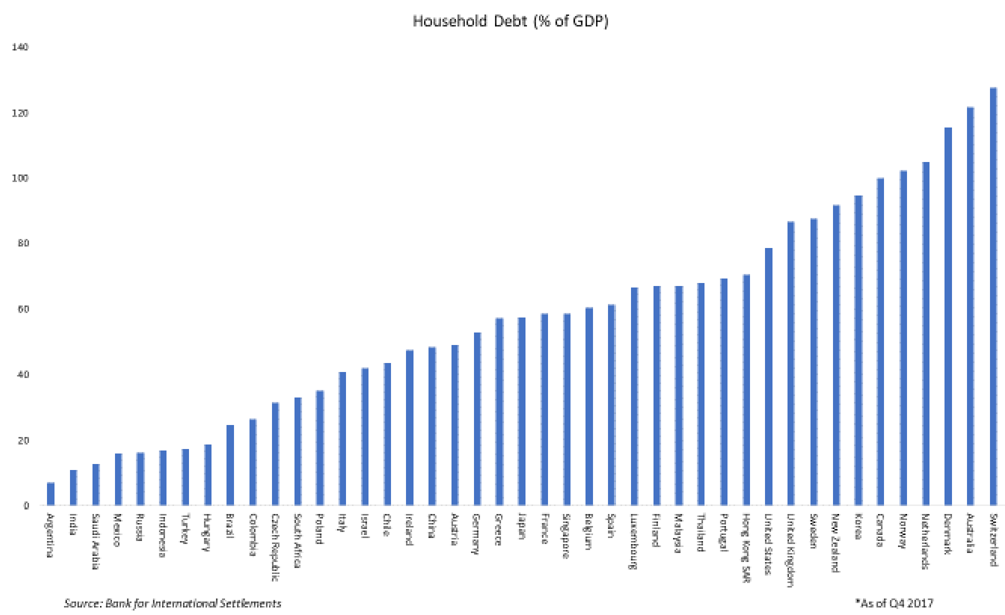
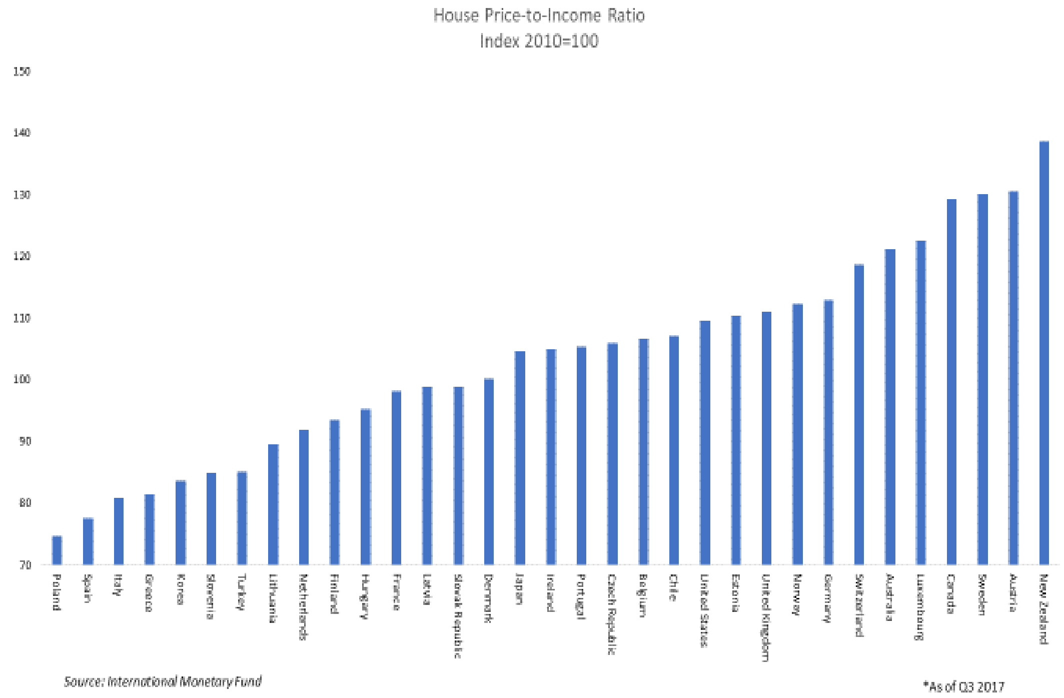


Chart two: House price to income ratio

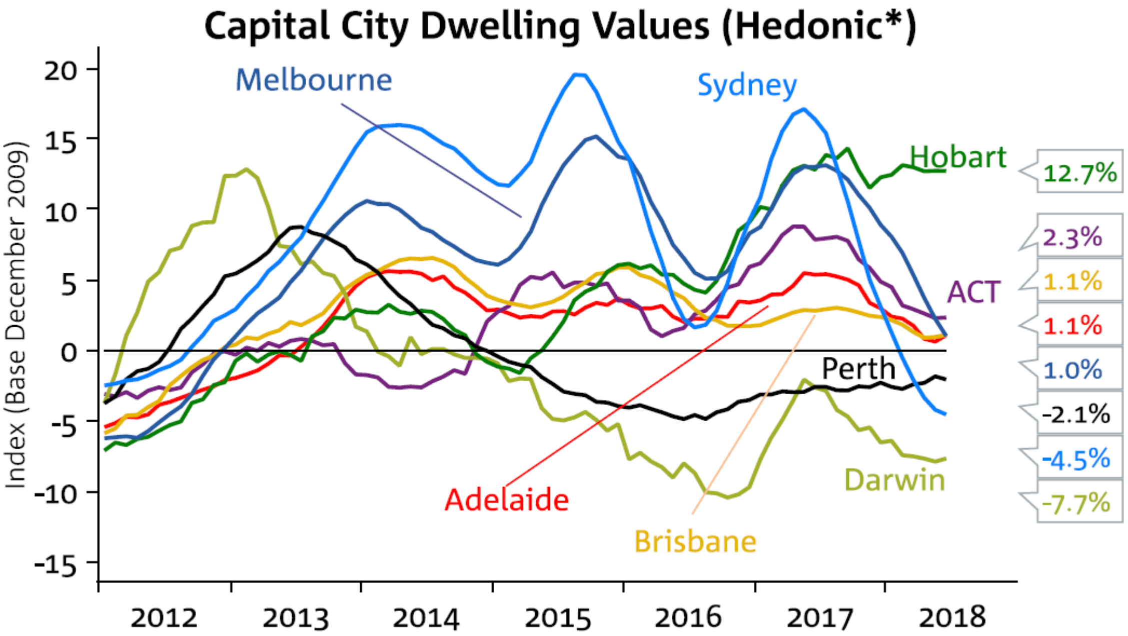


The question seems to be…what are the likely sources of shock that might send house prices into significant decline and reverberate on the domestic economy? Certainly, regulatory curbs on lending appear to have been increased over the last 18 months or so and it seems likely that the Banking Royal Commission will only add to those regulatory curbs.

The other element may well be that the banks tighten lending standards at their own accord in the wake of some of the revelations around banking malfeasance revealed by the Royal Commission. In addition, restrictions on foreign purchases are now having an impact. And all this may occur at a time when a significant number of 'interest only' loans roll into principal and interest (P&I) loans, occasioning more pressure on a significant cohort of mortgagees. (The RBA makes the case that the cash flow effect on household disposable income from this latter source is relatively minor – see Christopher Kent, Assistant Governor (Financial Markets), *The Limits of Interest-only Lending*, Speech to the Housing Industry Association, 24 April 2018. Having said that, coming on top of other curbs to private lending, it cannot be helpful.)

Indeed, there are already signs that some correction in house prices is underway. As chart three from the National Australia Bank Economics team shows, there has been pronounced house price disinflation (and in some instances, deflation) evident in Australia's capital cities dating from around the middle of 2017. This comes at a time when leading indicators of housing activity have rolled over and household consumption growth is slowing.

Chart three: Capital city dwelling values



Source: CoreLogic, National Australia Bank, Macrobond

* The Hedonic Index takes into account property attributes for a more accurate estimate of price movements. Examples include: the number of bedrooms, bathrooms, land area, and geography.

The worry is that continuing curbs on private lending (regulatorily induced or self-imposed by the banks) may intensify disinflation or deflation in house prices; in turn this will reduce household wealth and thus household consumption and send GDP growth lower.

There are further negative feed-back loops; the big four banks comprise approximately 20% of the ASX200. Greater regulatory constraints, less lending activity, and further (potentially significant) declines in house prices might further constrain bank profitability and create uncertainty around the sustainability of current bank dividends, leading to diminished holdings of bank stocks by the banks' large retail investor base.

We could also add to the mix the prospect of a change of government and further curbs on tax-free dividend distributions, restrictions on 'negative gearing' and a diminution of the capital gains tax advantages currently attaching to housing investment. (I am not here to comment on the overall desirability of certain of these measures, but to note their effect on housing prices and activity and the negative feedback loop on bank stocks).

Again, there are mitigants. For one thing, a large part of the mandated growth in the superannuation investment pool finds its way into bank stocks. Also, markets have already moved to discount some of the bad news given the rather dramatic underperformance of bank stocks last financial year in what was otherwise not a bad year for the ASX200 (banks were down some 15% while the broader market was up circa 8%). Nevertheless, the point remains that the housing market is potentially a source of significant drag on the economy and on the stockmarket going forward.

I am doubtful as to whether these developments alone might cause a recession, but that is where the other key risk – a sharp slowdown in China – comes into play.

China

As was reported in a number of financial media outlets in the last week of June, the National Institute of Finance and Development, a Chinese government-affiliated think-tank, published a report warning of “financial panic” sparked by a cocktail of a falling stockmarket, bond defaults, renminbi depreciation, tight liquidity, US Federal Reserve interest-rate rises and trade tension with Washington. In some circles this was taken as an explicit sign of high-level concern and followed a further relaxation by the Peoples Bank of China in the reserve requirement ratio, freeing up some RMB700bn ($US100bn) for new lending and investment – an action that also implies a degree of concern among policymakers about the sustainability of economic growth going forward.

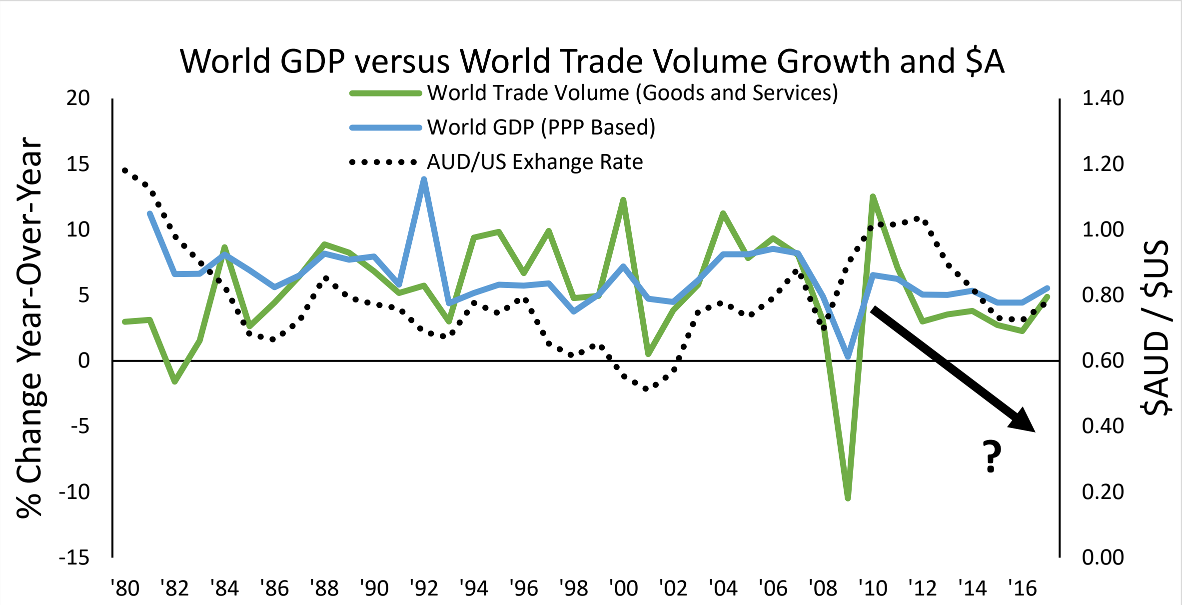
The most recent Purchasing Manager Index series indicated some diminution in the pace of expansion (particularly in exports) but did suggest that overall the expansion nevertheless rolls on. To be sure, there have been other occasions in recent years when the Chinese authorities have faced similar (and arguably greater) challenges and have exhibited a degree of policy dexterity that has successfully navigated the economy through times of potential turbulence. (Although there is the question whether that “policy dexterity” was simply ‘kicking the can down the road’.)

But for Australia, the point is that the Australian economy is by far and away one of the most highly leveraged to China. That, in large part, accounts for the extraordinary 27 years since a technical recession as Australia rode on the coat-tails of China’s emergence as an economic powerhouse. (As an aside, I’ve always maintained that Australia’s greatest Treasurer was Deng Xiaoping!).

That leverage has come about from China’s extraordinary demand for Australia’s commodity exports, which has sustained Australia’s GDP and income growth through challenging periods. The downside is that were China to “sneeze” then Australia may well catch “pneumonia”. Were this to occur when the consequences of housing excess were working their way through the system, then the 27-year dream run may well come to an end. In this context too, the recent emergence of diplomatic tensions between Australia and China may have adverse economic consequences.

The intensification of trade tensions sparked by US President Trump’s tariff crusade has the potential to tip the balance. Markets, in my view, are underplaying the risks that emanate from a trade war. Econometrically, the direct impact on global growth might at this time seem small, but the indirect effects through the impact of disruption of global supply chains on financial conditions, business sentiment and internecine ‘policy retaliation’ are potentially quite large. Indeed, JP Morgan economists note it could reverse the positive feedback loop linking growth, business confidence and financial conditions that have played a central role lifting the global economy over the past two years.

Chart four: World GDP, trade and the AUD



Source: International Monetary Fund, Reserve Bank of Australia

Investment implications

The remarkable run of 27 years without a recession is arguably faced with some potentially severe challenges, largely emanating from high household debt and housing excess. The real 'fox in the henhouse' scenario is the potential for a China slowdown to afflict the domestic economy at the same time that household debt / housing excess was working its way through the system. The consequences would be a dramatically lower $A, an underperforming stockmarket and an extended period of low interest rates and bond yields.

In other words, now may be the time for investors to think about a particularly challenging return environment from domestic financial assets!

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