NEWSLETTER
August 2020

Introduction

The share market, interest rates and the residential property market. Not simple concepts, but in this our August newsletter we look at each of them in turn, paying particular attention to the impact that Melbourne's resurgence in Coronavirus numbers might mean for them. This newsletter is probably a bit more 'heavy' than we normally like our newsletters to be. But we think this is important to ensure we cover the issues with sufficient depth. Enjoy, and stay safe!

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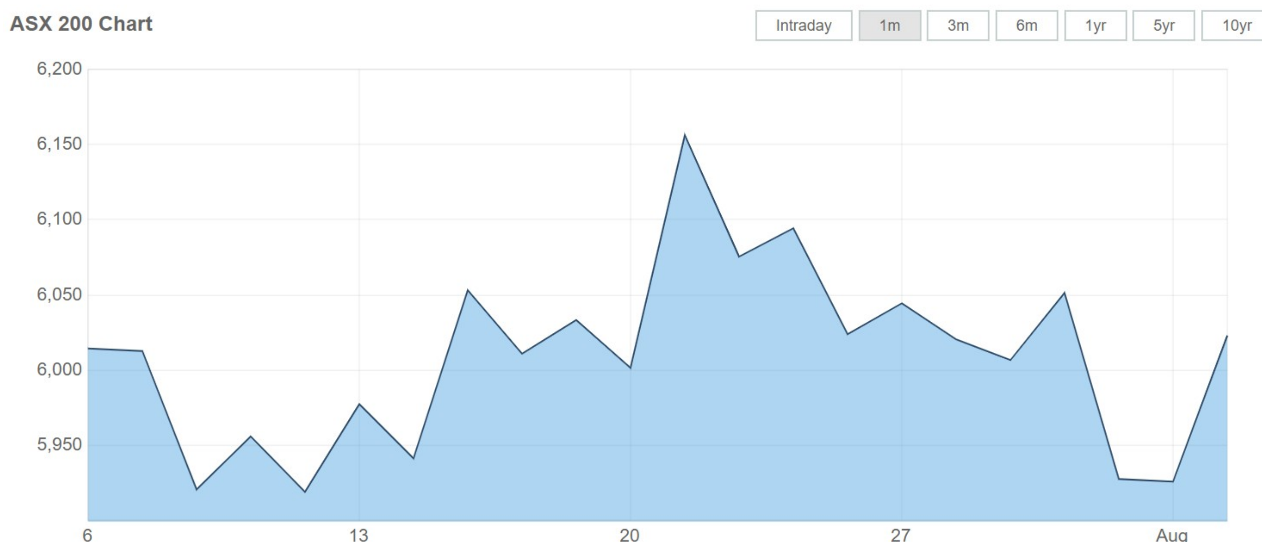
The Share Market

The Australian share market continues to defy the expectations of many. Between the 6th of July and the 4th of August, here is how the market performed as measured by the ASX 200, this time with thanks to www.marketindex.com.au:



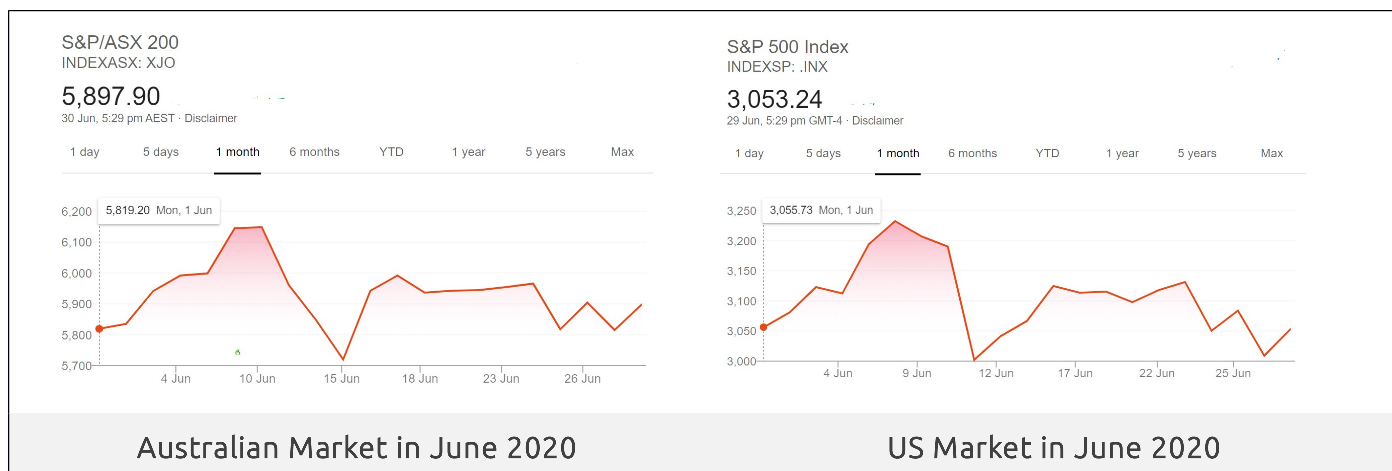
That's right: the market basically finished that one month period back where it had started (albeit with a rise and then fall of about 2% in between). Given events within the Australian economy in the past month, this is in many ways a puzzling result. Consider the following snapshot of what happened in the last month:

- July 8: Melbourne reverts to stage 3 restrictions due to the pandemic;
- July 19: face masks become compulsory in Melbourne;
- July 23: The Commonwealth Government release figures showing that they recorded a record high deficit during the 2019/2020 year, of $86 billion;
- July 26: NSW records 74 new cases of Coronavirus over the previous seven days;
- August 2: Melbourne enters stage 4 restrictions, including the closure of all non-essential businesses;
- August 3: NSW records 86 new cases of Coronavirus over the previous seven days.

While this list of events is Melbourne (and to a lesser extent, Sydney) centric, that is deliberate. According to the Australian Bureau of Statistics, Victoria accounted for 23.67% of Australia's GDP in 2018/19. NSW accounts for 32.6%. Between them, these two states account for more than 56% of the entire national economy. What happens in those states is incredibly important to the national economy. We can't really write an investment newsletter that is not focussed on these states at the moment.

So far, the NSW Government has not needed to reintroduce formal restrictions – while there have been outbreaks during July, the rate of growth in transmission is not high. That's not to say that the NSW economy is going swimmingly. But it is not in quite the same state of lockdown as the Victorian economy.

At first glance, it is perhaps surprising that a share price index that is made up of the share prices of Australian companies would remain unaltered during a month when significant risks to such a large part of the national economy emerged. To understand this, once again perhaps we should look at the US market and its influence on the Australian market. Last month, we pointed out how eerily similar the share market performances of the Australian and US markets had been during June. Here are the graphs of that performance, thanks to Alphabet, the ASX and S&P:



Australian Market in June 2020 US Market in June 2020

This similarity in performance was not the experience in July, however. For the first time in a long while, the Australian share market did not simply perform in lock-step with the US market. As measured by the S&P500 index, the US market rose by 3.6% between July 6 and August 3, while the Australian market went sideways. There are various conclusions that can be drawn from this, but one of those is that the local negative impact of the Coronavirus resurgence was 'buffered' by the continued optimism in the US market. Bad news in Australia was neutralised by optimism in the US.

This seems particularly likely given the performance of Australian share prices at the end of July. The likelihood of stage four restrictions in Victoria was looking increasingly certain on Friday July 31. The index fell by 2% during that day. The restrictions were duly announced on Sunday August 2. The next day the index barely moved, suggesting that the impact of the restrictions had been priced in on the Friday.

Prices then commenced rising on August 4, finishing the day up 1.8%. It seems our market could not resist the positive influence of the US market. As we also reported last month, the US market is largely driven by stocks in just five companies – all of them tech companies who are doing quite well out of the increased reliance on technology that the pandemic has necessitated.

Whether our companies here in Australia can mimic that success remains to be seen. But, as of the end of June, the average PE ratio for the ASX 200 was 19.59 (www.marketindex.com.au). This is almost a third higher than the long-term average of 15. The figure was also based on historic earnings, not expected future earnings. To put the figure in perspective, in January 2009, following the GFC, the average price-earnings ratio fell to below 9.

This week, several economists are saying that the current national recession is likely to continue beyond the June quarter and extend potentially to the end of the year. This would suggest that earnings expectations as of the end of June were almost certainly too high, furthering the sense that the Australian market is at historically very high prices. As with all things pandemic, we will have to wait to see the full impact of its most recent consequences.

Interest Rates

Earlier this week, the Board of the Reserve Bank of Australia ('RBA') met and decided to maintain the target interest rate at its current level. As we have discussed before, the RBA aims to influence all interest rates in the Australian economy by setting a target rate for two interest rates in particular: the overnight cash rate and the 'yield' on 3 year Australian Government bonds. The target for both is 0.25%.

To achieve these targets, the RBA buys (or sells) securities in the market. In the case of the three year bonds, the RBA announced that it will buy already-issued bonds in the secondary market until it reaches its target yield for the primary and secondary market of 0.25%.

The term 'yield' in this case is worth thinking about, so bear with us if you would like to know more about Government bonds and, in particular, their interaction with deficit spending. (If not, then perhaps skip ahead to the section marked 'Implications').

When a Government issues a bond, the purchaser has the right to two payments. One of these payments is equal to the 'face value' of the bond when the bond 'expires.' The second is a stream of interest payments while they hold the bond. If, for example, a Government issues a three year bond for $100 million and an interest rate of 0.25%, then the purchaser will receive $250,000 per year for three years and $100 million in three years' time. ($100 million is the 'face value').

So, the bondholder gets two types of payment: one while it holds the bond and one at the end of the period. Purchasers then decide how much those two payments are worth to them, and 'bid' for a bond at auction. The 'winner' of the auction buys the bond off the Government (who can then use the cash they receive to pay for deficit spending).

The purchaser can pay more or less than $100 million, depending on market conditions. Because the payments that are received by the bond holder are fixed, the purchaser can change the yield they receive for the bond by changing the price they are prepared to pay for it. The more they pay, the lower the yield. And vice versa.

Whoever is holding the bond at the time it expires gets the face value amount ($100 million in our example). Between the time when the bond is issued and the time when the bond expires, the bondholder can sell it to someone else. Any sales after the bond has first been issued take place in what is known as the 'secondary market.' On Tuesday of this week, the RBA announced that it will buy bonds in that secondary market. By doing so, the RBA will reduce the number of bonds available in the market. Everything else being equal, this will raise the selling price of any bonds that remain for sale (remember, reducing supply has the effect of raising prices if demand does not change).

Because the payments flowing from the bond are fixed, raising the price of a bond has the effect of reducing the yield that the bondholder receives. In this way and in this case, interest rates in general will be driven slightly lower. This is what the RBA wants, because as of Tuesday this week the yield was slightly higher than 0.25%.

In summary, the RBA is going to buy some bonds in the secondary market, to increase the price of the bonds that remain and thereby reduce the yield for bondholders.

Implications

If our description above does not all make sense, do not worry. We offer the description because we want to make two further points. The first is that when the RBA buys bonds, it acquires the right to receive the payment at the end of the bond period. This means that, when the RBA buys a bond, the Commonwealth Government then owes the RBA the face value of the bond (say, $100 million in the example above). In summary, when the RBA buys a bond, the money has effectively flowed as follows:

- the Government sells a bond for (say) $100 million. The purchaser gives up $100 million cash and the Government gets $100 million cash;
- The Government spends that $100 million on things like the Jobkeeper payment;
- The RBA then buys the bond from the initial purchaser. Let's say the sale happens for $100 million to keep the logic simple. This means that, now, the RBA gives up $100 million and the purchaser receives $100 million.

After this purchase, in this example, the Government has an extra $100 million, the purchaser is back where they started, and the RBA has spent $100 million.

The Government now owes $100 million to the RBA and will need to repay it when the bond expires. The thing is, the Commonwealth Government effectively owns the RBA. So, the net result is that the Government has 'borrowed' $100 million from its own bank.

If you are worried about the size of the deficit being run up at the moment, perhaps this can reassure you. Being a Commonwealth Government that owes money to a bank which the Commonwealth also owns is much less dangerous than the debt with which you and we are more familiar – when we owe money to a commercial bank.

The RBA's moves this week mean that it is effectively lending money to the Commonwealth. It is just doing it in a roundabout way, basically so that it does not directly fund the Government.

Our second point is that the RBA wants to keep interest rates low for the foreseeable future. This impacts on people like you and us. If we are investors, with money to invest, we have a range of things that we can invest in. This includes things that pay interest, such as term deposits or cash management accounts. These are known as 'cash or cash-like' investments. They are typically referred to as 'lower-risk' investments, because you are usually assured of getting your original money back when the investment 'ends.'

An alternative is to invest in things like shares. Shares do not pay interest while the investment is held. But they do typically pay dividends. Right now, even though (as we saw in the preceding section), share prices are high, the dividends on offer usually still exceed interest that can be received on a cash-like investment of the same value.

Low interest rates are a worldwide phenomenon at the moment. As a result, low rates might at least partly explain why demand is so strong for shares right now, even though, in terms of earnings (and especially in terms of future earnings), those shares seem very expensive. It may well be that at least some people are buying shares because, even at high prices, the dividend return is greater than they can achieve with a cash investment.

The problem is, shares are much more risky than cash investments. Unlike cash investments, with shares there is always a chance that you might not get all the original money back when the investment 'ends.' That is, the extra income a share investor may receive (from dividends versus interest) might be negated by a fall in the capital value of their investment.

If this all sounds confusing, the main point is this: people who are investing in shares because the dividend return is higher than they can get if they invest their money in cash are taking a substantial risk, because the value of shares can fall. We sincerely hope that this is not about to become people's experience. But with share prices rising even in the face of such seriously bad news in Australia, it is a risk that must be considered.

The Property Market

Data is slowly coming in about the impact of the Coronavirus on residential property prices. It is, of course, much more difficult to value property than it is to value, say, shares in public companies. In the share market, for at least the larger companies, shares are bought and sold every day. Because one share in a company is exactly the same as every other share in that company, a shareholder can be pretty sure that the shares they hold would be valued at the same price as other shares that have recently been traded.

Not so the property market. Very few residential properties are exactly the same as another residential property, and no residential properties are the same as several other residential properties. That means we can only really be sure of the value of any particular property when that particular property is sold. On average, though, that happens roughly every 20 years (source: Reserve Bank of Australia). In between time, we cannot precisely value a piece of residential property.

So, instead of precise valuations, we use estimates that we obtain by recording changes to the median selling price of other properties over time. Accordingly, it takes time for us to see trends in property prices. Because the Coronavirus only really started to make itself felt in March, we are only now starting to see trends in the way the market is responding.

That trend is generally, but reasonably gently, down. For the month of July, prices in every capital city except Adelaide and Canberra fell. In Adelaide, prices rose by just 0.05%; in Canberra, the rise was 0.59%. In Sydney, the largest property market, residential property prices fell by 0.87%. In Melbourne, the second largest market, prices fell by 1.19%. The falls were greater in houses (as opposed to apartments or units), with house prices falling by 0.96% and 1.44% respectively. It should be noted that these figures relate to the period before stage four restrictions were announced in Melbourne.

There is a danger in reading too much into these monthly figures, especially if you are a buyer with an eye for an investment. The danger comes from the fact that the number of houses being sold is much lower than would normally be expected. In the last week of July, for example, there were only 176 residential property auctions in Victoria. This compares to 454 for the last week of July 2019 (source: Real Estate Institute of Victoria). That is a fall of more than 60%. While there may have been an increase in the number of properties sold privately (that is, not at auction), it is clear that many fewer people are selling their homes right now.

The supply of housing for sale is, of course, expected now to fall even further, as Melbourne's real estate agents have to close their office doors as of this week. This will basically bring the number of sales of property down to zero for the next six weeks – making the market especially hard to predict.

Melbourne is not on its own in this regard, either. According to the Real Estate Institute of Western Australia, to take an example as far away from Melbourne as is geographically possible, the total number of properties listed for sale in the last week of July 2020 was 25% lower than for the same week in 2019. Similar numbers are being seen in all capital cities and in the regions as well. Put simply, fewer people are selling properties right now.

In residential property, each city really is its own market. So, here is the price-change data for all the capital cities for the month of July 2020 (source, Corelogic):

	Houses	Units	All Residential Property
Sydney	-0.96%	-0.68%	-0.87%
Melbourne	-1.44%	-0.66%	-1.19%
Brisbane	-0.28%	-0.09%	-0.24%
Perth	-0.57%	-0.85%	-0.60%
Adelaide	+0.08%	-0.09%	+0.05%
Hobart	-0.40%	+0.63%	-0.20%
Canberra	+0.59%	+0.13%	+0.59%
Darwin	-0.16%	-0.65%	-0.33%

As we state above, in all markets there are fewer people offering their properties for sale. The effect of this is that, in most places, prices are not falling to the extent that they might normally be expected to, given what is happening in the broader economy. This is a case of sellers responding to market signals. Almost certainly demand has fallen. However, as long as supply falls by as much as demand has fallen, prices ought not be affected. Price changes really start to take effect when supply and demand become unaligned.

At the moment, throughout Australia there are concessions being made by lenders with regard to loan repayments. In many cases, almost certainly this will be allowing people to 'hang on' to their property when they might otherwise find themselves in repayment difficulty. Ordinarily, repayment difficulties lead to a property being sold, which represents an increase in the supply of housing to the market. Unless that increase is met by buyer demand, prices would therefore fall.

If there are very many property owners around Australia who find themselves in repayment difficulty when the concessions start to be lifted, we would expect housing prices to fall. However, if any increase in supply is matched by demand from other people, then this will not happen. In an economy that is performing poorly there will not be a large amount of 'pent-up' demand available to soak up the supply. So, for prices to 'hold up' we really need for the supply of properties for sale to not increase too quickly.

This will be quite a balancing act for the Commonwealth and Australia's major lenders: a way needs to be found to allow lenders to once again gather profits by having loan repayments re-continue, while ensuring that requiring repayments to re-commence does not cause too much distress for borrowers and thereby force too many properties to be sold.

We really do live in interesting times.

The Legal Stuff

General Advice Warning

The above suggestions may not be suitable to you. They contain general advice which does not take into consideration any of your personal circumstances. All strategies and information provided on this website are general advice only.

We recommend you seek personal financial, legal, credit and/or taxation advice prior to acting on anything you see on this website.

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