NEWSLETTER

November 2022

Introduction

Interest rates are dominating the markets at the moment – pushing banking stocks up and house prices down. It really is that simple.

Read on to find out more.

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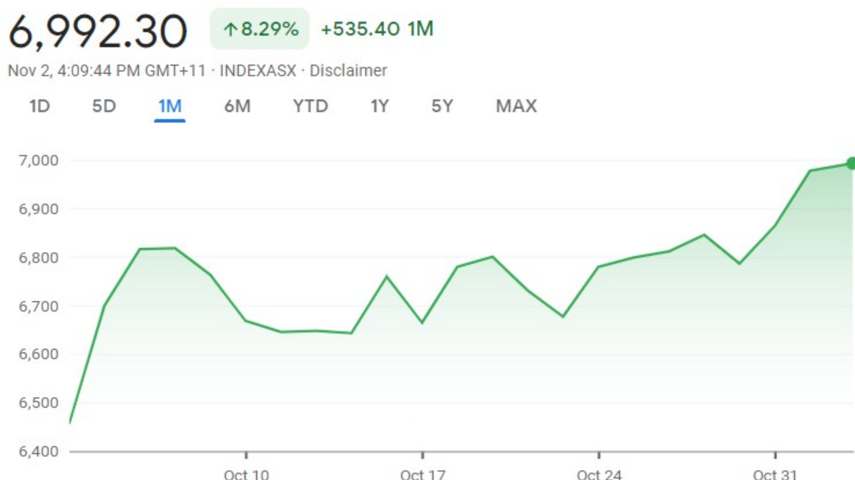
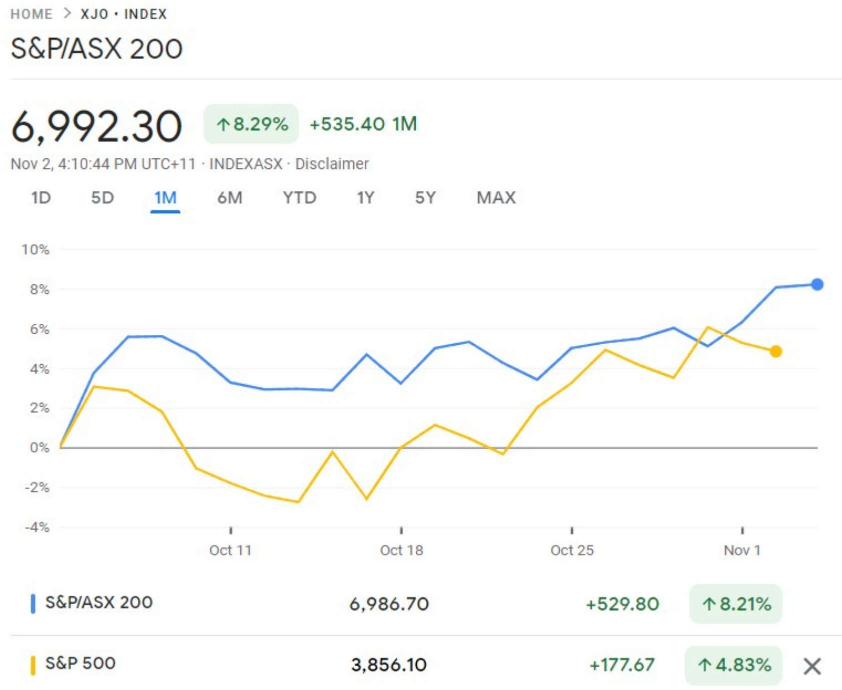
The Share Market

October was a gangbuster month for the Australian share market. Here is how the ASX 200 performed for the month, thanks to Google:



A rise of more than 8% in a single month is extraordinary. What's more, the Aussie market outperformed other world markets, and in particular the US market, whose benchmark S&P500 index only rose by less than 5% for the same period:



One of the drivers of this strong performance of the market on average is the effect of interest rates on the profits of companies within the index. In the section below, we discuss (yet another) interest rate rise and why rate rises are good news for companies such as banks, for whom interest rate rises are the same as profit rises.

The ASX 200 is heavily dominated by banks and other lenders. Five of Australia's seven largest companies (by market capitalisation) are banks. Together, these five banks (Commonwealth Bank, NAB, Westpac, ANZ and Macquarie Bank) constitute approximately 21.6% of the entire ASX 200.

This means, quite simply, that good days for banking companies are generally good days for the ASX as a whole.

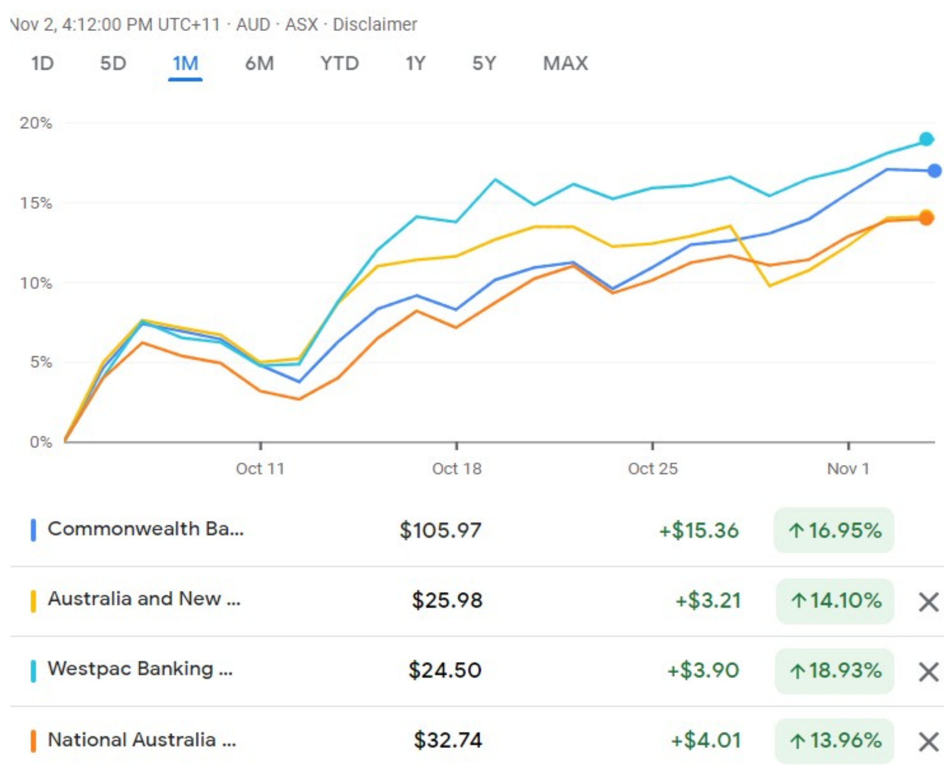
Over the years, you will have heard us repeatedly say that a diversified exposure to the ASX 200 is one of the best ways to invest in the Australian market. One of the reasons for this is that any properly diversified exposure to the ASX 200 will mean a substantial holding of shares in banks. If you invest $100 into an index fund that follows the ASX 200, for example, then you will be buying $21.60 worth of shares in the five largest banks.

And Australian banks have a business model that can make money in virtually any environment. At times like these, where interest rates are rising, banks make profits from the increased interest payments. If interest rates fall, then the amount of interest banks receive on each loan will fall. But that can be offset by there being more loans in general – and the loans potentially being for larger amounts.

What's more, these days most financial transactions involve moving money between bank accounts (rather than paying cash). Banks often charge transaction fees on these transfers. Once again, this means that an increase in economic activity will mean increased revenue for banks.

There is one major risk for banks: if borrowers start defaulting on their loans, then the bank loses its revenue stream (and there are other consequences in terms of other loans that the bank can make).

Clearly, though, for now, the market does not think that there is much risk of that. Here, for example, is the October performance of each of Australia's 'Big 4' banks (again thanks to Google, and as of close of business on November 2):



The graph is quite remarkable. The smallest gain between October 2 and November 2 was 13.96%, by the NAB. Australia's largest bank (and largest company of any type), the Commonwealth Bank, rose by nearly 17%.

If you do the maths you realise that the overall market performance of 8% must have meant that the parts of the economy other than banks lost money – after all, if 21% of the market rose by 14% or more, but the overall market rose by just 8%, the market must have been dragged down by companies that aren't banks.

Those companies that aren't banks will include a lot of companies who have borrowed money from banks. Their interest rates have risen, reducing their profits. Many of those companies that aren't banks will also have customers whose ability to buy things has been reduced because they are paying more in interest to banks.

So, the way in which interest rates are rising so inexorably is increasing the profits (and the share prices) of banks at the expense of companies that aren't banks.

Which is why owning banks within a diversified portfolio is usually a good idea.

Interest Rates

The RBA raised the official interest rate again this week. The rise was the seventh in seven months, but at 0.25% was smaller than many of the other recent rises. The official target cash rate is now 2.85%, and the total increase since rates started rising in April 2022 is now 2.75%.

One of the truisms of economics is that one person's spending is another person's income. So, the higher interest expense that borrowers are facing is also income for someone else.

As a general rule, the higher interest payments are going to the banking sector. So, banks have more income. But what else is happening?

It would be really great for savers if banks in general were not just receiving higher interest rate payments on loans, but were also paying higher interest payments on deposits. Unfortunately, that is not generally the case. For example, almost all home loans have increased by at least 2.75% since the RBA started raising rates. However, as of November 2, none of the term deposits for a period of up to 12 months offered by the NAB had incorporated the increase to date of 2.75%.

Banks are increasing interest on their loans by the full 2.75%. But they are not generally increasing the interest on their deposits by that much. This means that very little of the increased interest payments by borrowers is ending up in the hands of savers at the same bank.

Contrary to what many people think, customer savings constitute very little in terms of the source of money that banks lend out. So, if it is not from customers, where do banks get the money they use to make loans?

Lenders like the NAB and all the other banks borrow some of the money they lend from elsewhere within the banking sector. The interest paid on this money will be increasing in line with the increase in rates that the RBA is implementing. So, some of the increased interest paid by borrowers to banks is passed on by that bank to another lender somewhere. But this money remains within the overall banking system as income for whichever company is the ultimate source of the money.

So, if lenders like the NAB source a little bit of their money from depositors, and a little bit more of their money from other banks, where do they get the rest of the money?

Well, you might be surprised to learn, much of the money that banks lend out as loans is actually new money created for precisely that purpose. This is actually the major way that new money is created in the Australian system, as explained here by the Assistant Governor of the Reserve Bank of Australia.

That's right – the loans that you or someone you know took out to buy a home or run a business usually represent new money created for that purpose. The lender did not source the money from someone else, such as a depositor. They simply created it. Clicks on a keyboard and blips on a silicon chip.

This means that the interest you pay to the lender usually represents 'pure' income for that lender – they do not use much of it to pay higher interest on money they in turn owe to someone else. Your expense is the bank's income. And because the bank's costs have not increased, your increased interest expense is a bank's increased profit.

The Residential Property Market

As we wrote last month, residential property prices do not like rising interest rates! This means it was much better to own a bank than a home in October.

Last month we wrote about how house prices had fallen by a national average of 1.4% during September. Well, in October, the falls were not quite that large, coming in at national average of 1.2% lower for the month. In October, though, the falls were more widespread, with every capital city reporting lower prices for the month.

Here is how the data looks, thanks to Corelogic:

Index results as at 31 October, 2022	Change in dwelling values				
	Month	Quarter	Annual	Total return	Median value
Sydney	-1.3%	-5.3%	-8.6%	-6.9%	$1,036,727
Melbourne	-0.8%	-3.1%	-5.6%	-2.8%	$767,117
Brisbane	-2.0%	-5.4%	8.4%	12.5%	$728,615
Adelaide	-0.3%	-0.6%	16.5%	20.3%	$654,079
Perth	-0.2%	-0.7%	4.0%	8.6%	$559,043
Hobart	-1.1%	-4.1%	-1.0%	2.7%	$696,334
Darwin	-0.8%	0.0%	4.9%	11.2%	$507,081
Canberra	-1.0%	-4.3%	1.0%	4.7%	$876,567
Combined capitals	**-1.1%**	**-4.0%**	**-3.1%**	**-0.5%**	**$787,485**
Combined regional	**-1.4%**	**-4.1%**	**6.6%**	**10.5%**	**$581,412**
National	**-1.2%**	**-4.1%**	**-0.9%**	**1.8%**	**$721,018**

Brisbane was the largest fall, with prices falling 2% for the month. This also meant that Brisbane's market had fallen by slightly more than the Sydney market for the three months ended 31 October.

The Sydney market is, of course, the largest in the country, though, and it's annual fall is now more than 8.5%. The second largest market is Melbourne and with an annual fall of 5.6% it is not faring much better than Sydney.

Of course, whether lower house prices is a good thing depends on whether you are a buyer or a seller. The unluckiest Australians at the moment are those people who bought a year or two ago and have seen a simultaneous drop in the value of their home, to below the price they paid, while paying extra interest on their loans. A double whammy that people could do without.

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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