NEWSLETTER

October 2022

Edgeworth Partners

Introduction

September was a big month and not just for football fans. September also saw (another) interest rate rise, (another) fall in residential property prices and (another) conniption on global share markets. Read on to find out more.

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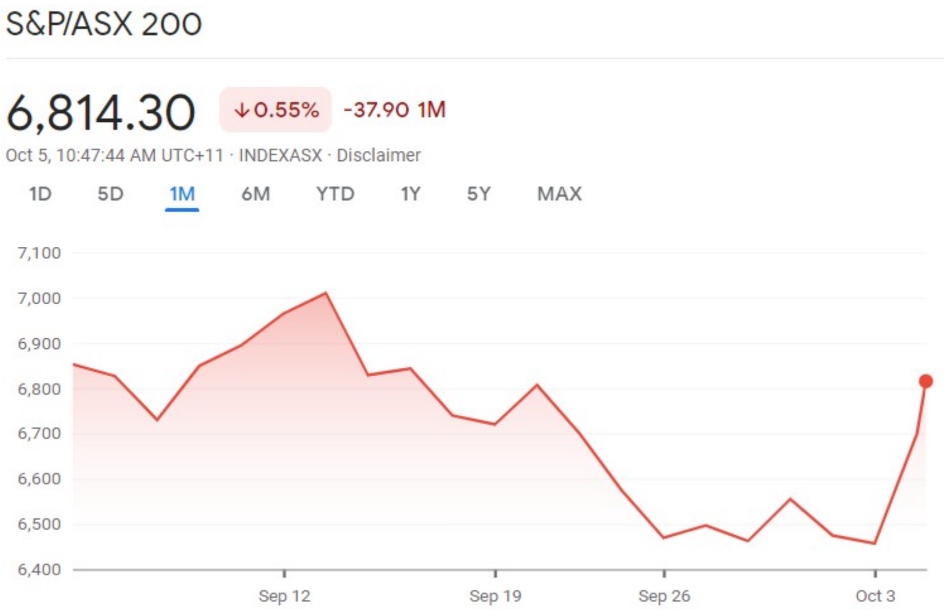
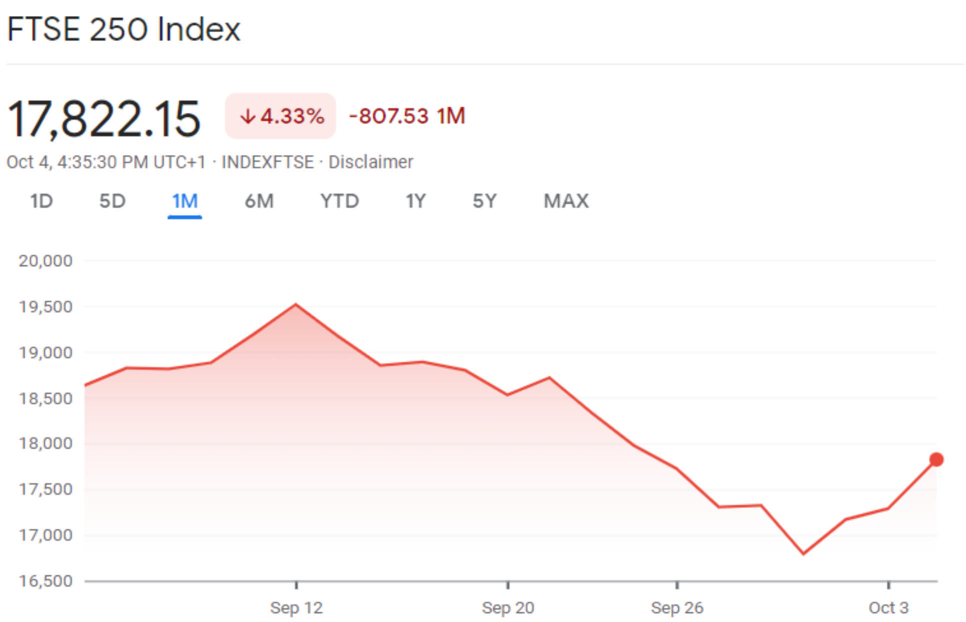
The Share Market

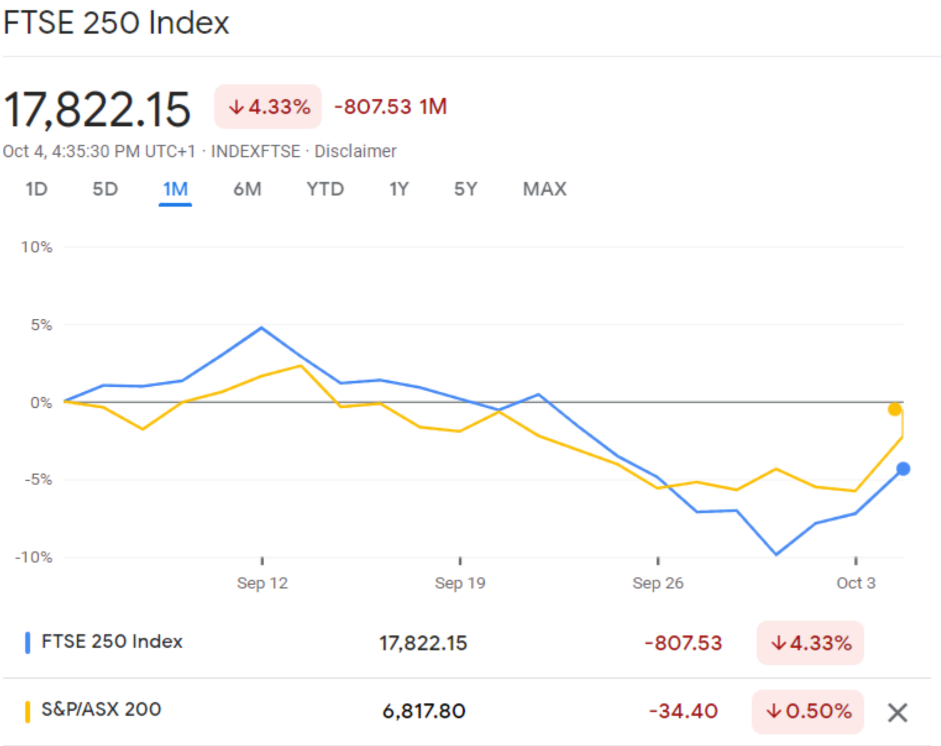
We are writing this article on the morning of October 5, which is a little after the end of September. Perhaps this is just as well, because the market has bounced since September ended. Over the month to October 5, the market has basically moved sideways, as measured by the ASX 200 and as shown in this graph from Google and the ASX:



As you can see, the market was well down in the last week of September. This may have been because the market supports Sydney in the AFL and particularly Parramatta in the NRL. More likely, it was responding to news of inflation and turbulence in international markets, especially this time in the UK. The UK is going through a period of change, and a change of Prime Minster meant a change in tax policy. In particular, the incoming PM and Treasurer (called the Chancellor of the Exchequer in the UK) announced large tax cuts for high income earners. These cuts were pretty much universally condemned as silly in a situation of deficit budgets and high inflation, and they were in turn cancelled earlier this week. However, in terms of the UK share market, the damage was largely done by then, as Google again demonstrates using the FTSE 250 index:



Once again, the market went south at the end of September before bouncing once the tax cuts were cancelled. Putting the Aussie market side by side with the UK market, we see how they moved in line with each other, although the Australian market didn't go down as far and thus was able to recover back to its previous month's levels more quickly:



Australia has its own version of 'top-end' tax cuts waiting in the wings. There are widely known as the 'Stage 3 Tax Cuts.' As that name suggests, there have been two previous stages of tax cuts. The three stages together were announced by then Treasurer Scott Morrison back in May 2018. This was, of course, back in what dystopian novelists call 'the Before Times.' The pandemic was not yet here, and Australia's economy looked very different. As a simple example, inflation for the 12 months to June 2018 was 2%. For the 12 months to June 2022, it was 6.1% with most people expecting that the next official numbers, to be announced at the end of this month, to be a little higher than that. The target cash rate was 1.5%. It has now risen to 2.6%, with further rises likely (see below).

All of which is to say, the Stage 3 tax cuts were designed for a very different economic situation. That said, the cuts are not actually due to take effect until July of next year, so there is plenty of time for them to be adjusted, delayed or even done away with. As it happens, the Federal Government will deliver two Budgets between now and then. One will be later this month, before we revert to the normal cycle of the Federal Budget being delivered in early May each year. This means that, even if the tax cuts are not altered in the October Budget, they can still be considered next year before they come into effect.

One thing the Federal Government is assuredly measuring is public sentiment towards the Stage 3 tax cuts. And the experience of the UK market may be quite influential in this regard. Share prices fall when investors think the economic outlook is worsening and rise when they think the future looks brighter (in terms of companies making profits). Clearly, the UK investment markets felt that tax cuts for higher-earning Britons would actually worsen the financial performance of UK companies. That is, the tax cuts would reduce profits. This might encourage our Federal Government to adjust the proposed cuts here in Australia.

This is perhaps more likely given that interest rates keep rising. We discuss those in the next section.

Interest Rates

One of the reasons we held off writing this newsletter until Wednesday of this week was so that we could see what happened to interest rates on Tuesday when the RBA had its monthly meeting. Rates were increased again, for the sixth month in a row. However, the rise was by only 0.25%, which is less than the five previous rises. The official target cash rate is now 2.6%.

In all, this means that interest rates have risen 2.5% since April 6. They are still low by historical levels, but they are now at their highest level since mid-2013. Here is how the last 30 years of the target cash rate looks, thanks to the RBA:

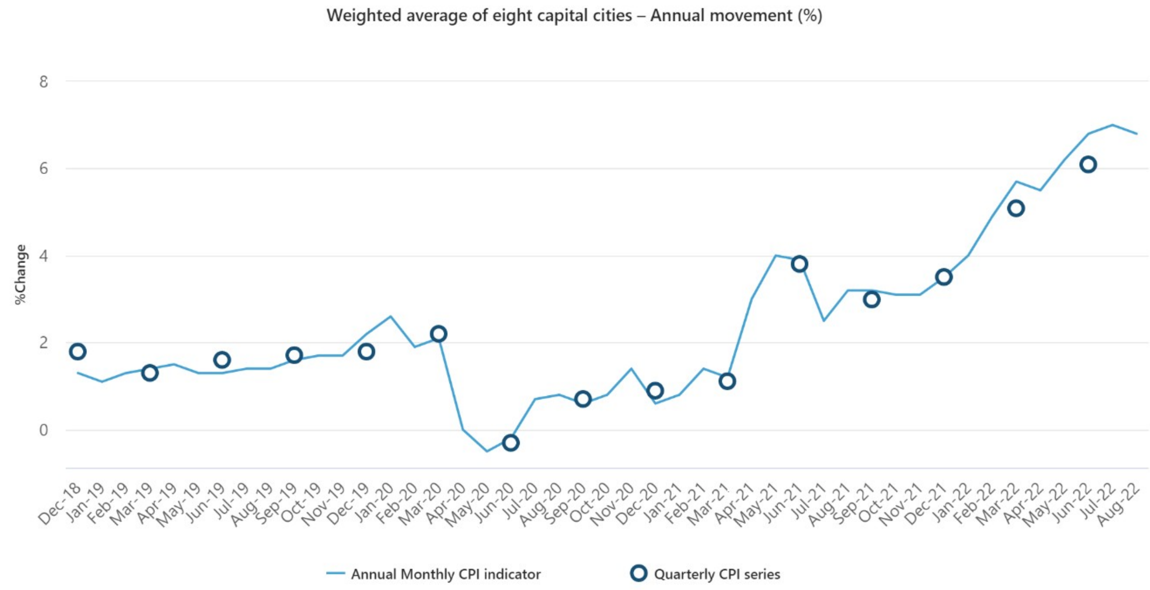
If you get out your protractor, you will see that the rate of increase over the last six months is the sharpest since the early 1990s. Interestingly, although 1994 is a long time ago now, that sharp rise in 1994 actually took the target cash rate up to a level that it has not returned to since. The rate rose (to 7.5%!) in 1994, stayed there for two years, and then fell back. Plenty of recent borrowers will be hoping for a similar experience this time.

And, while predicting these things can be a mug's game, there may be some indications that a scenario like this might turn out to be the case. In announcing this week's rise, the RBA stated that it expects annual inflation to be around 7.75% for the remainder of this year, before falling back to 4% in 2023 and 3% in 2024. 3% is in line with the RBA's ambition for inflation, so if the current settings are working as the RBA hopes, it may be that the need for further interest rate rises is lessened.

That said, the RBA's statement also includes the following line: 'The Board expects to increase interest rates further over the period ahead." That makes it pretty unequivocal that rates have not yet peaked. Very important to the decision about future rates will be what the next official inflation figure turns out to be. This will be the figure for the 12 months to September 30 2022. The relative size of that figure, especially when compared to the 6.1% recorded for the 12 months to June 30, will go a long way to determining whether and by how much the target cash rate keeps rising.

Interestingly, there is some evidence that the rate of price rises is easing. The ABS has actually started announcing 12-month inflation rates on a monthly basis. (That is, at the end of each month they announce the rate of change in prices for the 12 months prior to that date. This is distinct from previous practice to do these things quarterly). These monthly figures are still lagging a month behind the actual date, but the most recent data for August suggests that inflation may be easing. In the 12 months to the end of July 2022, the CPI rose by 7%. In the 12 months to the end of August, the rise was only 6.8%. The difference is small, but it is important as it suggests that general prices did not continue to rise much in August 2022.

The change in the growth in inflation is perhaps best shown using a graph, so here is the one that the ABS itself has made available:



Source: Australian Bureau of Statistics, Monthly CPI indicator rose 6.8% in the year to August 29/09/2022

The circles on the graph show the quarterly figures that the RBA Board uses when it decides on interest rates. As you can see, these have not started to come down. But the blue line, which shows the monthly figures, has turned south.

This measure of inflation is still high, and easily higher than at any time on this graph other than last month. If the blue line starts tracking sideways, interest rates will keep rising. If the blue line goes up, interest rate rises will accelerate. For the recent series of interest rate rises to end, the blue line will need to turn down and keep moving in that direction, until it falls below the 4% line.

As the RBA has said, it does not expect this to happen until next year, so more rises in rates between now and then seem likely.

The Residential Property Market

Residential property prices do not like rising interest rates!

Since interest rates started rising, so residential property prices have started to fall. During September, none of Australia's capital cities reported increased property prices. Darwin performed 'the best,' with prices there not changing at all. Sydney was 'the worst,' with falls of 1.8% for the month, followed by Brisbane with a fall of 1.7%. All this data comes from respected market analyst Corelogic, who show the results for each of Australia's capital cities in this graph:

Index results as at 30 September, 2022	Change in dwelling values				
	Month	Quarter	Annual	Total return	Median value
Sydney	-1.8%	-6.1%	-6.0%	-4.2%	$1,053,131
Melbourne	-1.1%	-3.7%	-3.9%	-1.0%	$774,531
Brisbane	-1.7%	-4.3%	13.4%	17.6%	$746,017
Adelaide	-0.2%	0.1%	19.2%	23.0%	$649,983
Perth	-0.4%	-0.4%	4.1%	8.7%	$558,879
Hobart	-1.4%	-4.5%	2.0%	5.9%	$705,079
Darwin	0.0%	1.4%	6.2%	12.8%	$509,440
Canberra	-1.6%	-4.4%	4.0%	7.9%	$886,990
Combined capitals	**-1.4%**	**-4.3%**	**-0.7%**	**2.0%**	**$798,101**
Combined regional	**-1.3%**	**-3.6%**	**10.1%**	**14.0%**	**$589,364**
National	-1.4%	-4.1%	1.7%	4.5%	$730,163

(To give you a 'wowee' statistic you can use to impress your friends, a fall of 1.8% for the month of September equates to a fall in the median value of a Sydney property of $640 *per day*!)

In terms of comparability, the middle column in this graph is the most useful one. It shows the percentage change in prices for the 12 months to the end of September. As we discussed in the previous section, inflation in Australia is around 7% for the 12 months to the end of September. What this means is that, if house prices have not risen by this much, they have actually fallen in 'real terms.' That is, if the price of everything else went up, but housing stayed up the same, then housing became *relatively* cheaper.

As you can see, this means that for the 12 months to the end of September, only Brisbane and Adelaide showed 'real' rises in house prices. Other than Melbourne and Sydney, the other capitals all rose by less than the inflation rate. And the two biggest markets (Melbourne and Sydney) actually fell - Sydney by 6% for the year.

If we look back now to the monthly figures, we see that the markets other than Melbourne and Sydney are also starting to turn down. It may be that the two big markets simply lead the other capital city markets.

That's what has happened so far. A big question is, of course, what will happen next? Again, predictions are hard to make, but further falls seem likely. One of the reasons for this is that the effect of rising interest rates can have a lag. This happens because increases take time to filter through to the market.

The effect of a series of interest rate rises also has a cumulative effect. Each single rise has an effect. Not each single rise becomes magnified if there are subsequent rises as well. And here is where there is a very interesting observation to be made, as the cumulative total of the increases reaches 2.5%.

In Australia, financial lenders are regulated by the Australian Prudential Regulation Authority (APRA). Among many other things, APRA requires lenders to use a 'buffer' when assessing a potential borrower's ability to repay a loan. The buffer is an additional amount added to the actual interest rate that is likely to be charged on the prospective loan when it is first made. If the loan is likely to be 4%, for example, APRA require the lender to do their sums on 4% plus a buffer amount. The idea is to make sure borrowers are not wiped out by a rate rise.

Up until this time last year, APRA's required buffer was 2.5%. That meant that, for loans issued before October 2021, lenders had to add 2.5% to the actual interest rate that would be charged and ensure that their borrowers could afford to repay that higher amount.

Over the last six months official interest rates in Australia have now increased by a total of 2.5%. This means that the interest rate being paid on variable loans written before October 2021 is now equal to the buffer amount used by lenders to assess a borrower's capacity to repay their loan. In turn, this means that lenders cannot be sure that their borrowers will be able to repay loans if interest rates rise again from this point forward.

It is likely that some people could only just afford to repay their loans with the 2.5% buffer if they took their loan out before October last year. We sincerely hope that these people have had a wage or salary increase in the meantime that means they will be able to continue to afford their loans if interest rates rise again. If they haven't, and interest rates do rise again in the coming months, it may be that some people will no longer be able to afford their loan. This can lead people to be forced to sell their home.

If this happens to enough people, it will increase the number of properties available for sale. Unless demand also rises, this would usually push prices down even further. Unfortunately, demand is not rising. For obvious reasons, the fact that interest rates have already increased, as well as the fact that APRA's buffer rate is now 3%, has reduced people's borrowing capacity. In turn, this means they can pay less for property, which dampens demand.

To illustrate what we mean, we can use some rough and ready figures from finder.com.au. These figures show that we can usually add about 3.5% to the cash rate target to get the standard variable home rate paid to most of Australia's big banks. This means that, in September 2021, when the cash rate target was 0.1%, the standard variable home loan rate was around 3.6%. Lenders added their 2.5% buffer, which meant that they were calculating a potential borrower's ability to repay their loan using a rate of 6.1%. If a borrower could not repay a loan at 6.1%, they would not get a loan.

That was September 2021. Move forward to today. Australia's largest bank is the Commonwealth Bank. CBA's standard variable home loan rate is currently 6.1%. The APRA buffer is now 3%, meaning that the CBA is now assessing a potential borrower's loan limit based on a rate of 9.1%. If the borrower cannot repay a loan at 9.1%, they will not get the loan.

Obviously, more people can repay a loan at 6.1% than at 9.1%. Put another way, people can afford to repay larger loans at 6.1% but only smaller loans at 9.1%. So, we now have a combination of fewer people qualifying for new loans plus smaller new loans for those people who can qualify.

Both of these things reduce demand and, together, they add up to a likelihood that property prices will keep falling.

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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