BAIOCCHI GRIFFIN
PRIVATE WEALTH

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POINTS OF **INTEREST**

Welcome to the latest edition of our quarterly look at Australian and global economic and market developments. In this issue we discuss the prospect of rising global interest rates, a development which is likely to have a significant impact on stock market performance.

EXECUTIVE SUMMARY

- With inflation accelerating rapidly, interest rates look set to increase in coming months
- Rising interest rates can be expected to have a negative impact on asset prices, including property and the stock market
- Investment returns were disappointing over the first three months of the year, with losses on both shares and bond investments

The rising cost of money

One of the defining economic features of the past few decades has been the consistent trend of declining interest rates. Mortgage rates experienced by borrowers in the 1970's and 80's are now little more than a distant memory. Finally, however, after reaching rock bottom in the wake of the pandemic, interest rates look set to increase once again. In this section we consider the implications for the economy and financial markets.

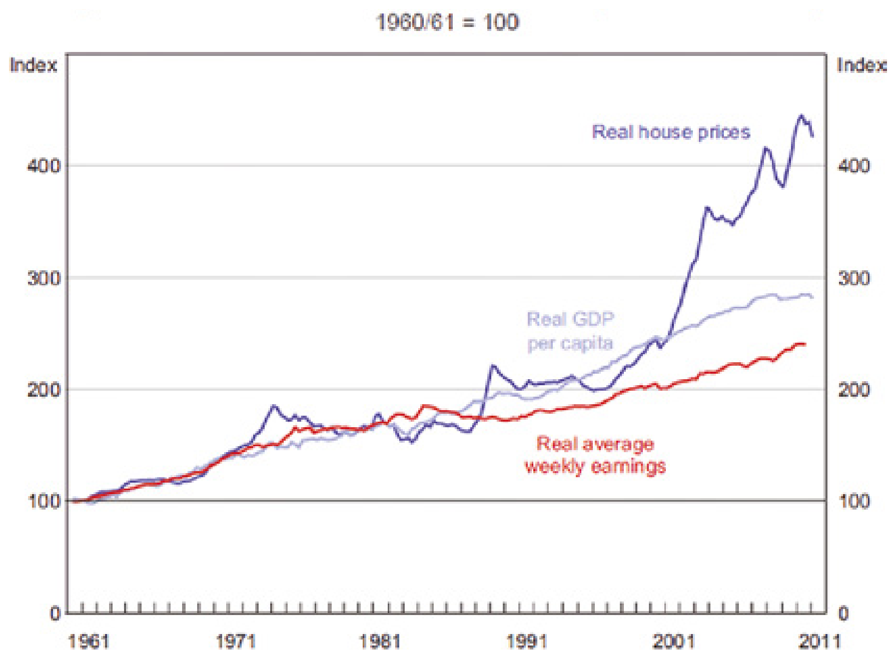
As an illustration of the old saying 'A picture is worth a thousand words', the image below is almost a textbook example. It shows the RBA cash rate target from 1990 to 2022, falling from a peak of just below 18%, until it reached the effective bottom boundary of 0.00% (though to be technically correct, the current target is 0.10%, where it has been since November 2020).

Graph of the Cash Rate Target

Source: RBA

This thirty-year period represents an unprecedented reduction in what is effectively the cost of money. The financial impact of such a significant reduction in interest rates should not be underestimated – the cost of borrowing impacts nearly every economic activity, none less so than the housing market. The sustained increase in Australian house prices since the 1990's can be directly linked to the reduction in interest rates over that period, as evidenced by the chart below, showing the accelerated growth in house prices since the mid-1990's.

Figure 1: Real House Prices, GDP per Capita and Earnings



Sources: Abelson and Chung (2005); ABS; Australian Treasury; REIA

Falling interest rates do not benefit just the housing market of course: valuations for nearly every investable asset are linked to interest rates, be they shares, bonds, farmland or commercial property.

A simple example illustrates this effect: imagine you invested in a bond paying $5 per year and it cost you $100, at a time when interest rates were also 5%. If interest rates were to drop to 2% for example, your bond would become more valuable relative to other interest-bearing investments which are likely to be issued at the new prevailing rate of 2%. You might be able to sell the bond to someone else for $120 for example, who would be happy to pay $120 for an investment which would pay them $5 per year (in this case their income return on the investment would be $5 ÷ $120 = 4.17%, which is much more attractive than other alternatives which offer only 2%).

This is of course a very simple example, however the same relationship applies to nearly all assets – commercial property, for example, can be valued based on a capitalisation rate. The capitalisation rate can be viewed as an investor's expected income return over a year and as in the example with the bond, if interest rates are falling, investors will be willing to pay more for an asset that generates a relatively higher income stream.

One further (and final) example of the impact of falling interest rates, is evidence from the RBA which shows that house prices, expressed as a ratio against household disposable income, have risen from 2.5 in the 1990's to around 5 today. That means that thirty years ago the average Australian bought a house for 2.5 times their income, whereas today the average Australian buys a house that costs 5 times their income. The only way that this makes sense of course, is that the interest bill associated with taking out a mortgage and buying a house today is that much lower, allowing buyers to purchase far more expensive homes, relative to their incomes.

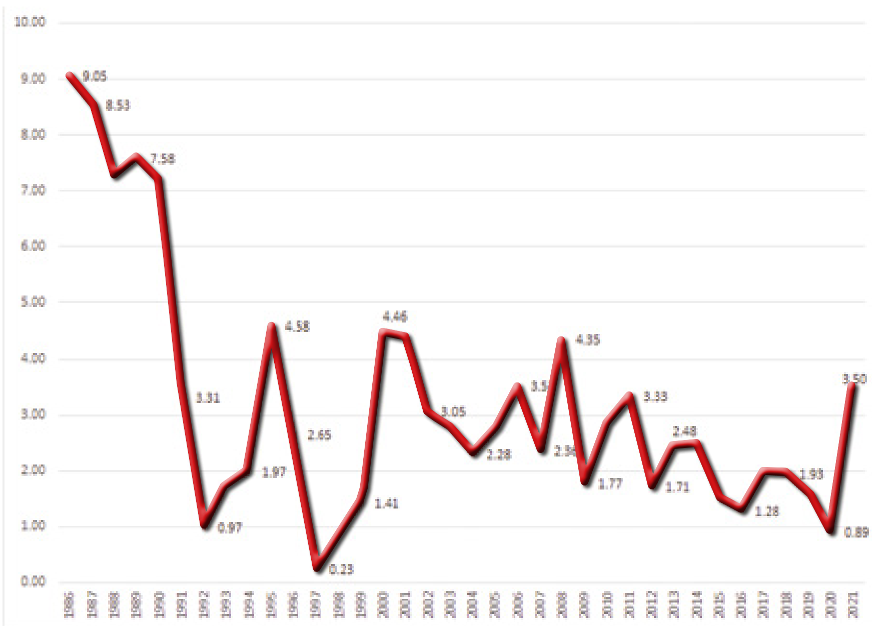
Overall, it is clear that falling interest rates over the past few decades have pushed up prices for nearly all asset classes. The question now however, is what happens in the absence of this tailwind?

Inflation is back

Before we consider the potential impact of rising interest rates, it is worth reviewing why interest rates will increase in the coming months. The short answer of course, as everyone would well be aware by now, is the acceleration in inflation in recent months.

Unsurprisingly, low interest rates over the past few decades are closely correlated with low rates of inflation over the same period. Of course, correlation does not necessarily imply causation – interest rates were able to be kept low due to low inflation, but the reasons for the existence of low inflation are not linked to the RBA cash rate.

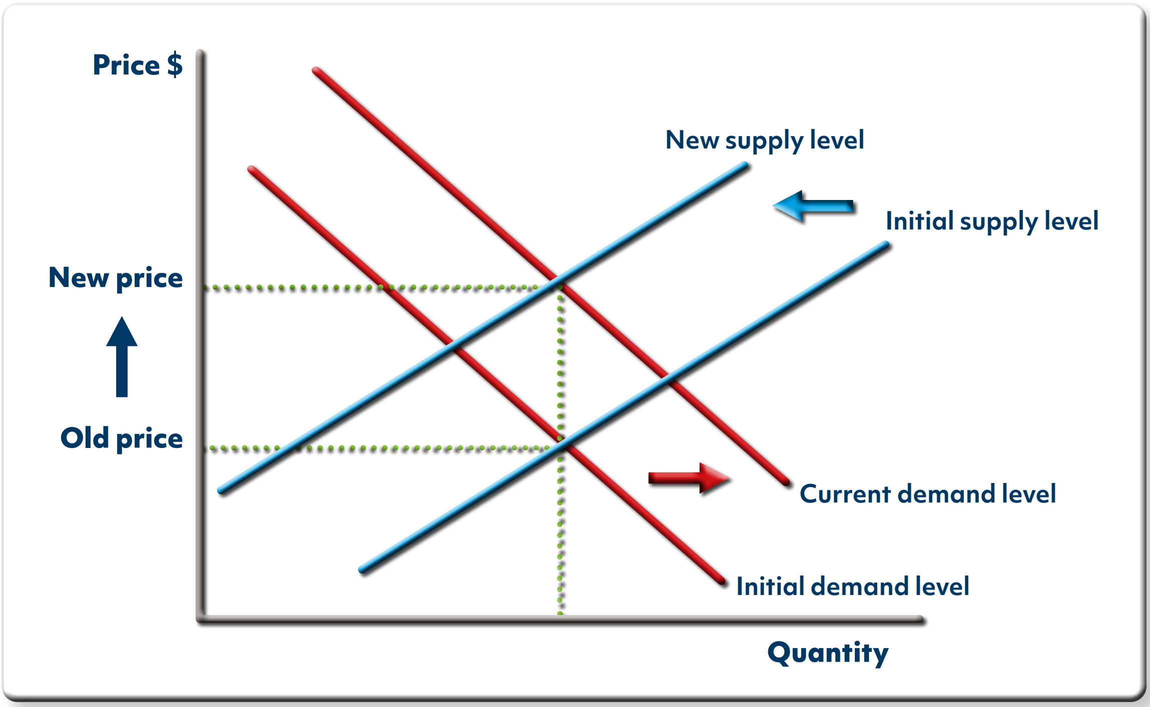
Inflation Rate in Australia 1986 to 2021



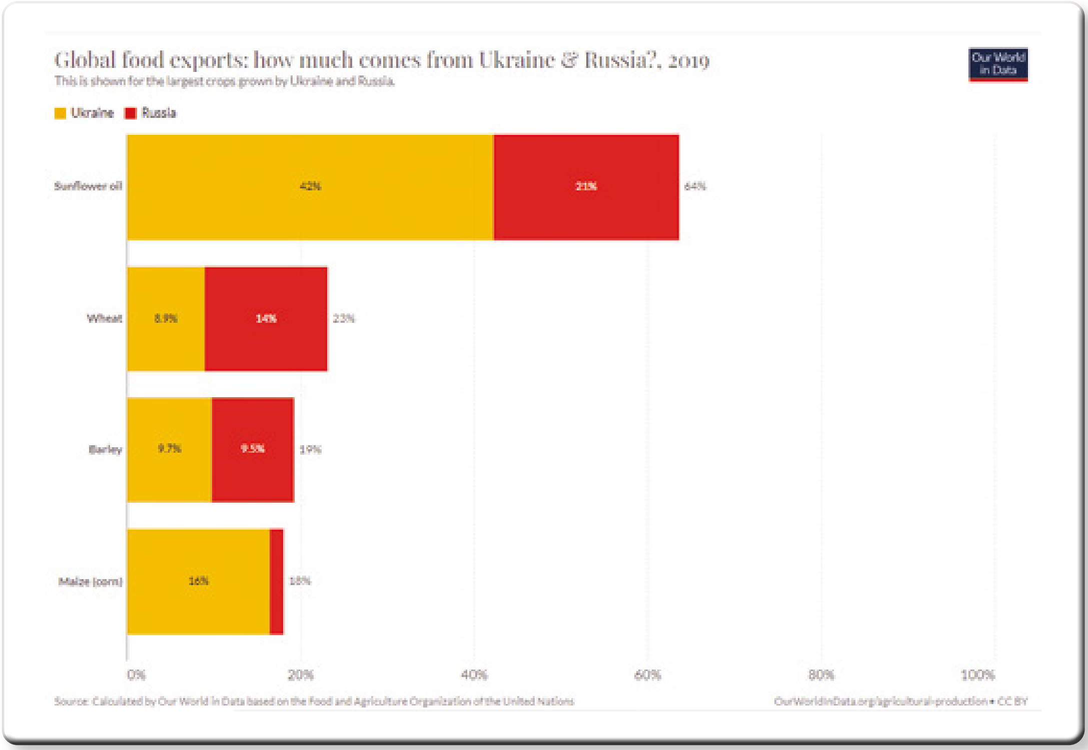
Rather, several domestic and international factors conspired to keep inflation low over much of the previous past few decades. Pinning down the exact reasons is an argument for economists to have in their lunch hour, however it is certain that globalisation and the integration of China into the global economy specifically, helped foster the pre-conditions for a period of sustained low inflation. This makes sense when one considers the significant shift of manufacturing capacity from high-wage countries such as the US, UK and Australia to low-cost countries such as China. The addition of a labour force of nearly a billion people to the global economy, willing to work for far lower relative wages, was a key factor behind globalisation and the era of low inflation. Economists may like to argue that the actions of former Federal Reserve Chair, Paul Volcker, ended the inflation bogeyman which had dogged the US in the 1960's and 70's, however it seems more than likely that he benefited from good timing, more than good policy.

Given that nearly everything we buy is still made in China, it's fair to question why inflation is now a problem. Despite some political 'challenges', China is still a contributing member of the global economy and as yet not too many factories have made the long trip back to the US or Australia from China. Certainly, the pandemic has played a role in fostering inflation. Firstly, governments around the world tackled the problem by showering their citizens and economies with money, nearly all of it borrowed. Coupled with interest rates falling to 0%, it has meant that the world is literally awash with money looking for a purpose. Secondly, as the world slowly returns to normal, people are also looking to make up for lost time over the past two years: they want to travel again, eat out, go shopping… all the types of activities that involve spending some of the money they saved sitting at home during lockdowns.

At the same time, the global supply chain is under pressure. All the way from the factory floor, to the truck driver, to the crews on cargo ships, the pandemic has interfered with the usual supply and flow of goods. In effect, just at the same time as there is rising demand for goods and services, the supply of such goods is restricted. The net outcome of this situation can be illustrated in a simple chart studied by every first-year economics student. As shown below, if demand increases at the same time as supply decreases, the expected price for a particular good or service will increase.



The are other factors in the mix – sanctions on Russia in relation to the invasion of Ukraine has pushed up the price of oil, for example. Between them, Russia and Ukraine also produce a significant proportion of global agricultural products (as shown below), with food inflation now becoming an issue in many countries.



Taken together, there is sufficient evidence to suggest that inflation is becoming a global problem. From a policy perspective, the only tool available to central banks in combating inflation is the interest rate lever, with the only question needing to be answered being how fast and how high will rates go?

Interest rates and the economy

At this stage, opinions are varied regarding the trajectory of interest rates. There is an argument that rates will not need to increase greatly before they begin to negatively impact the economy (and hence inflation), due to very high levels of debt. Most economists predict that the RBA's cash rate will top out somewhere between 1.75% and 2.25%, which would still be very low on a historical basis. A major challenge in predicting the likely course of interest rates is that the current bout of inflation is only partially impacted by the act of increasing interest rates. That is, the RBA can influence the level of demand within the economy (putting up interest rates effectively takes money out of the economy and slows economic growth and thus inflation), but as we have discussed, some level of inflation has been caused by a supply shock, which is not subject to influence by the RBA. In essence, changes in interest rates have little or no bearing on the supply constraints which are currently impacting the global economy and contributing to rising inflation.

The issue facing policymakers, is that if the inflation rate is being (partially or largely) driven by the supply side, which is immune to interest rate hikes, then we could end up in a very unwelcome position – that of stagflation. Stagflation describes an economic equilibrium where inflation is high, interest rates are also high (in a vain attempt to lower inflation) and economic growth is weak. In such a situation, the RBA would be unable (or unwilling) to cut interest rates to try and boost the economy due to the presence of high inflation, leaving the economy mired in a state of high unemployment, high interest rates and negative economic growth. The 'stag' in stagflation comes from the word 'stagnant', which well describes such an outcome. Clients with long memories may remember the oil crises of the 1970's, which effectively precipitated a period of global stagflation, ended only by recession in the early 1980's.

Of course, events are rarely so predictable in advance. In early 2020, for example, expectations were that interest rates would increase rapidly over the forthcoming year, when in fact they soon fell to 0% on account of the Covid pandemic. Nonetheless, our basic assumption is that interest rates will increase over the next 12 to 18 months. As the interest rate tailwind morphs into a headwind, all asset prices will be negatively impacted. To a certain extent this is already evident in the stock market, which fell 10% in January alone, and the housing market, where national house prices have already started to ease. As a result, our expectations for the stock market over coming months are low, with capital preservation likely to be more important than capital growth. Even with a subdued outlook however, we believe a diversified investment approach provides the best opportunity of maximising returns in the current uncertain economic environment.

The stock market over the quarter

Unfortunately, investment returns over the three months to March have been disappointing. This was largely due to January, where the Australian stock market fell by 10%, with similar falls on all major global indices. For the quarter as a whole, the ASX 200 Index finished up losing 90 points, or around 1.20%.

The primary reason for this sudden correction appears to have been heightened concerns over rising inflation and the prospect of higher interest rates. While markets recovered somewhat during February and March, the Russian invasion of Ukraine introduced a further element of uncertainty.

The performance of the stock market is only half the story however, with fears of higher interest rates having an even larger negative impact on bond prices, and thus the fixed-interest component of client portfolios.

While clients will be disappointed by negative returns for the quarter, it is important to remember that quarterly returns, while important, present only a snippet of the portfolio's performance. Over a three-month period, investment returns are inherently volatile and can be influenced by any number of short-term factors. Long term returns are more important than returns generated in any one month or quarter and we encourage clients to focus on long term performance over short-term fluctuations.

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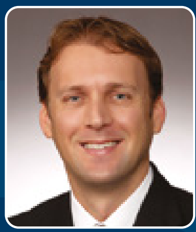

Justin Baiocchi

Ray Griffin

Michelle Higgerson

We hope you have enjoyed this edition of our quarterly newsletter. As always, should you have any queries, questions or feedback, please do not hesitate to contact us. We trust that you and your families remain safe and healthy in these uncertain times.

With kind regards,

Justin, Ray & Michelle

FACTS & FIGURES AT A GLANCE

	Rate / Value	Change from last reading
Australian inflation rate (annual)	3.5% (Dec)	+0.5%
Australian unemployment rate	4.0% (Feb)	-0.6%
RBA Cash rate	0.10% (Dec meeting)	flat
ASX 200 Index	7,499	-190 points
Australian $ vs. US $	$0.7482	+2.26c
Australian $ vs. UK £	$0.5704	+3.28c
Australian $ vs. Euro €	$0.6704	+2.93

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