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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 review a number of the key issues which impacted 2022 and those we see likely to play a similar role in 2023.

EXECUTIVE SUMMARY

- The collapse of Silicon Valley Bank and a number of other banks has raised the prospect of another Global Financial Crisis
- While there are valid concerns, the US housing market does not appear to be in the same situation as prior to the GFC
- From a domestic perspective, the impending 'mortgage cliff' will present problems, however not to the extent of those experienced during 2007/08
- The share market recorded a small positive return for the quarter, although volatility and uncertainty remains high

Another Global Financial Crisis?

The first three months of 2023 have seen a continuation of the volatility and uncertainty which was a hallmark of 2022. Investors who may have been hoping that the new year would bring about an easing in the volatility ruling financial markets would have been disappointed.

As interest rates have continued to climb both in Australia and abroad, there has been an accompanying growth in the concerns of economists and financial market commentators. These concerns principally stem from worries over the stability of the financial system, given that rapidly rising interest rates have come at a time when global indebtedness has never been higher.

As we have mentioned in previous editions of this newsletter, one of the downsides of pushing interest rates to emergency lows (as happened during the pandemic), is that it encourages reckless borrowing (and lending). That this occurs is not surprising. An individual's (or business') borrowing capacity is simply a function of their ability to make repayments and the interest rate charged on the borrowing. When interest rates fall, assuming that an individual or household's income remains the same, their borrowing capacity increases. The same principle applies to business borrowing, although there are typically additional factors which are taken into account in assessing the applicant's borrowing capacity. Regardless, the outcome is the same: when interest rates are cut in a hurry, as happened at the start of the pandemic, everyone's borrowing capacity is increased. This leads to outcomes such as we have seen over the past three years, particularly in the property market.

Following is an example, selected at random. This shows the change in house prices in Pymble, a suburb in North Sydney. It's not hard to notice the significant increase in prices shortly after the start of the pandemic in 2020.

While the slowdown in prices in the past 12 months or so is evident, average prices are still around $1.2m higher now than pre-pandemic.

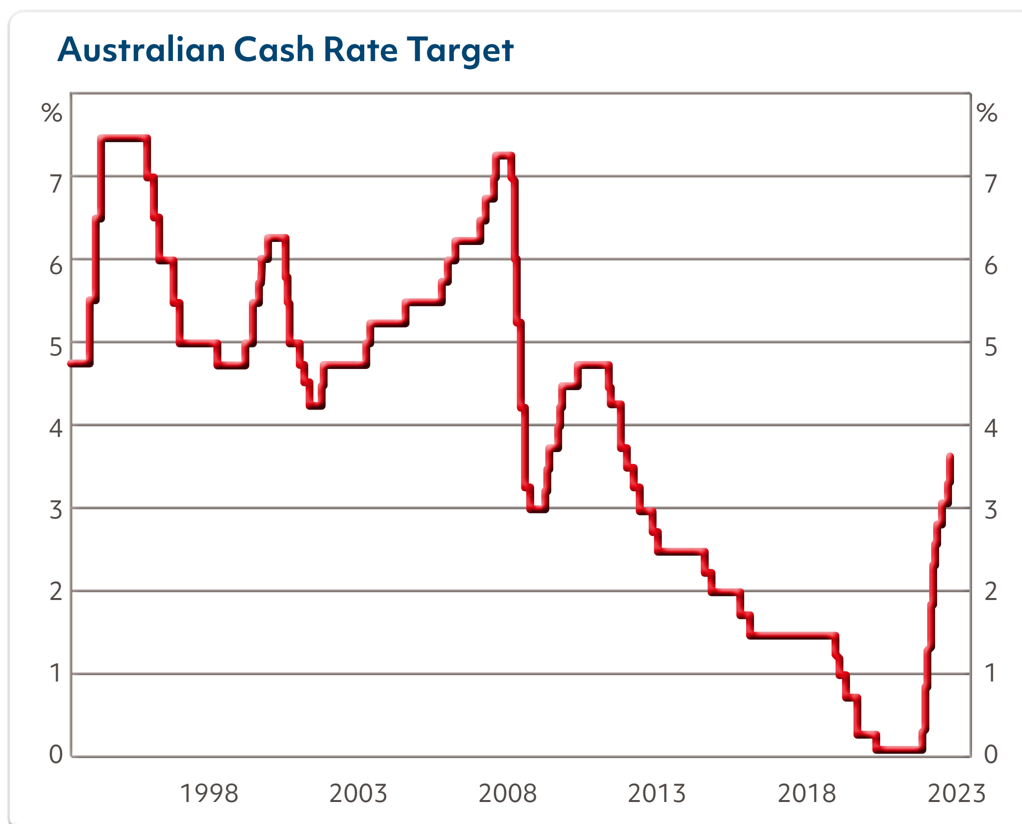
In other suburbs and towns, the picture is even worse. Here, for example, is the average sale price of homes in Tweed Heads, just south of the NSW QLD border.

Would-be home buyers in Tweed Heads are now paying double for a house, as compared to prior to the pandemic. Somewhat understandably, the pandemic convinced a significant number of people living in the capital cities, that perhaps a better lifestyle could be had somewhere else (the advent of Work from Home also likely facilitated this change).

While these two charts cover just two suburbs in Australia, a similar experience occurred in nearly every developed country in the world. After all, the reaction by authorities worldwide to the pandemic was almost identical – cut interest rates as low as they could go and hand out hundreds of billions of dollars in economic support.

The rise and rise of interest rates

Unfortunately, as we all know (and notwithstanding rash promises made by the Governor of the RBA), interest rates can go up just as quickly as they can come down. In response to the rapid increase in inflation in 2021, the official cash rate in Australia increased from 0.10% to 3.60%. While it is true that a cash rate of 3.60% is not very high on a historical basis, problems have arisen as a result of both the magnitude of the change (from 0.10% to 3.60% is an increase in interest rates of 3,500%!) and the rate of the change (never before have interest rates increased so rapidly). This sudden reversal in interest rates is clearly shown in the chart below:



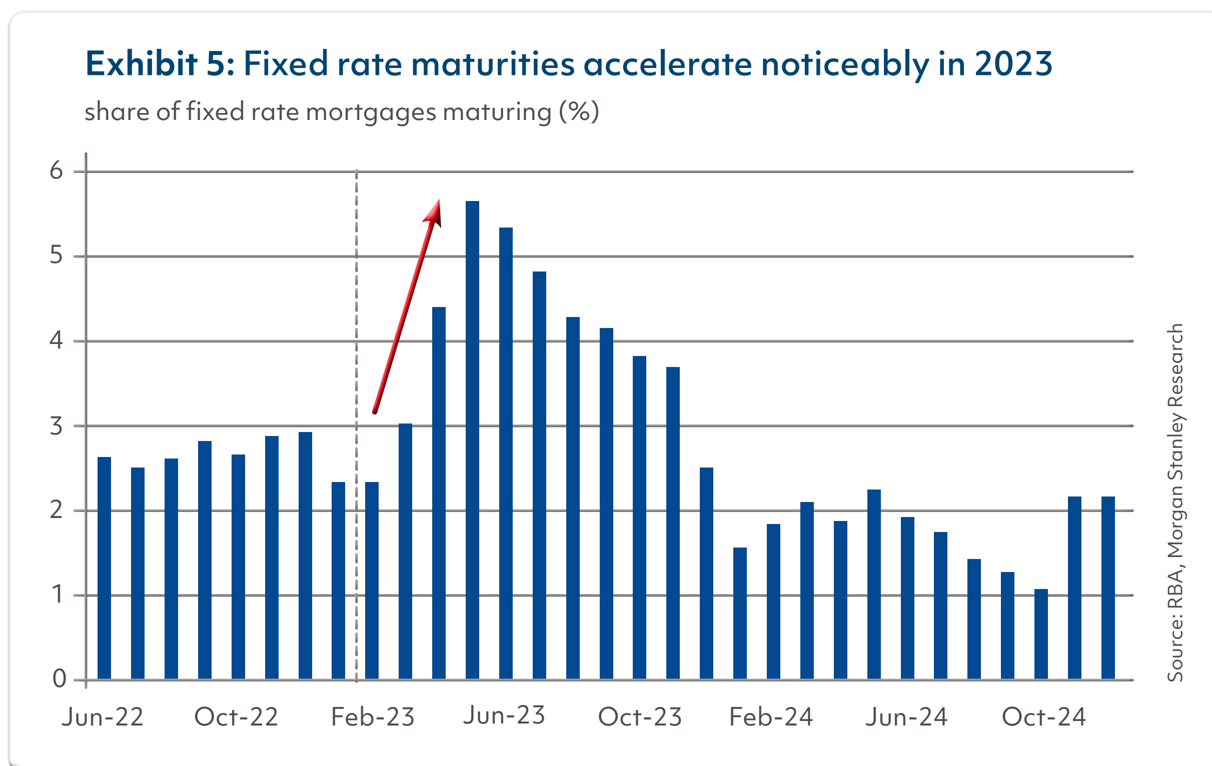
The juxtaposition of rapidly increasing interest rates and over-leveraged borrowers has naturally raised comparisons with the Global Financial Crisis (GFC), which ran from 2007 to 2008. As is by now well known, the GFC was triggered by the collapse of the US housing market, where ultra-low interest rates (following the dot-com bubble and 9/11) resulted in homeowners borrowing far more than was prudent (particularly by low quality borrowers, or 'subprime' borrowers as they became known), as house prices were chased upwards. When interest rates increased rapidly in 2005/06, this caused the housing market to collapse, as borrowers defaulted en masse (the household delinquency rate eventually peaked at 11.50% in 2010). Losses on mortgages in the US were spread worldwide through the widespread adoption of collateralised debt obligations, prompting bank collapses in countries as diverse as the US, the UK, Germany, Belgium, Ireland, Iceland, Latvia, Venezuela and the Philippines.

Thus the question – given the similarities in financial conditions between the period pre-GFC and today, is the world on the verge of another GFC? These concerns have been heightened by the recent high-profile collapse of a number of banks: Silicon Valley Bank and a number of smaller US banks, as well as the forced merger of Switzerland's UBS and Credit Suisse.

The 'mortgage cliff'

An additional cause for concern, at least from a local perspective, is the looming 'mortgage cliff' in Australia. The 'mortgage cliff' refers to the fact that many borrowers took advantage of the low fixed rate mortgages on offer through 2020 and 2021, and fixed their mortgage interest rates for periods of up to five years. Many of those borrowers are facing the expiry of their fixed rate mortgages in coming months and will then shift over to a much higher variable rate. As many as 880,000 households will be forced on to a variable rate mortgage this year, with the new interest rate on their mortgage being more than three times higher than before.

These households must deal with two problems – not only will the interest rate on their borrowings increase significantly (most borrowers will move from an average of 2% to over 6%), but their borrowing capacity will have fallen as a result of the interest rate increases. That is, should they wish to refinance their mortgage, higher rates will result in a reduction in the amount they can borrow, which will prevent them from attempting to refinance at a lower rate. This 'mortgage cliff' is shown in the chart below, with the majority of mortgages set to mature over the rest of 2023.



While the 'mortgage cliff' may be an issue in Australia, a repeat of the GFC is unlikely unless the problem is replicated worldwide and most particularly, in the United States. In this regard, there is some good news. While borrowers in certain countries (the UK and Spain most closely resemble Australia's situation) face a similar dilemma, the United States appears to be relatively immune. This is largely a function of the fact that most US homeowners choose to fix their mortgage for the life of the loan (an option not available to borrowers in Australia). In fact, it was not fixed rate mortgages which were the source of the housing collapse in the US pre-GFC, but Adjustable Rate Mortgages (known as ARMs, which is the US version of an Australian variable rate mortgage). While borrowers in the US did take advantage of lower interest rates during the pandemic, only 5% of mortgages were adjustable rate mortgages, compared to around 34% of all mortgages in 2005. In short, the ability to fix a mortgage for terms as long as 35 years, appears to have allowed the American housing market to avoid the Australian-style problem with very short-term fixed rate mortgages.

A further catalyst for a Global Financial Crisis which is missing this time around, is the absence of the Collateralised Debt Obligations (CDOs) which were responsible for transmitting the pain of mortgage defaults in the US to banks and investors all over the world. Mass mortgage defaults and a housing collapse in Australia would have severe implications for Australia of course, however the impact on the rest of the world would be slight.

Other risks still exist

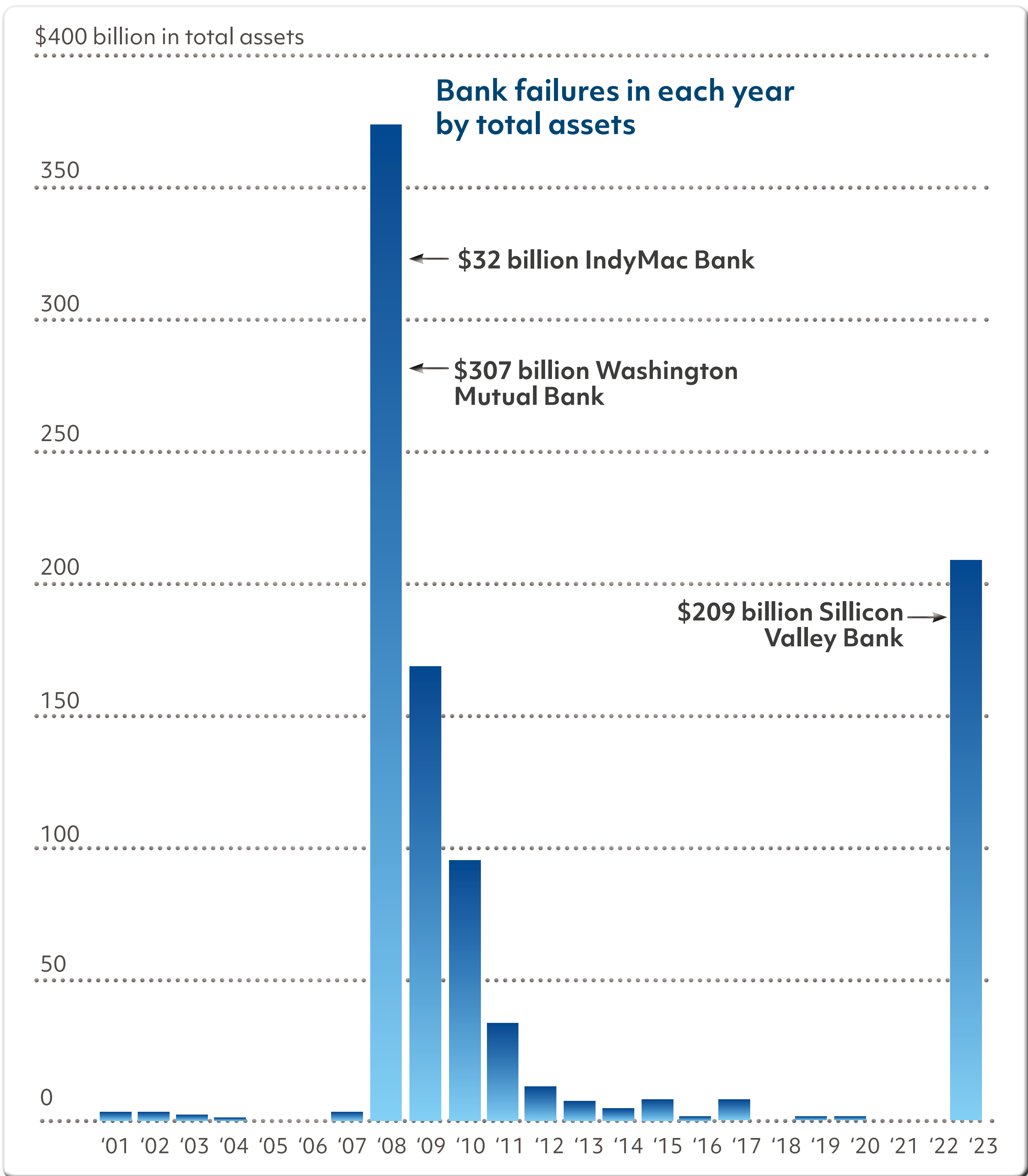
While it appears that the housing market is unlikely to be the source of any future crisis, at least on a global scale, that's not to say that there are no other risks to the global economy. These generally also stem from the complications caused by the rapid increase in interest rates.

Foremost of these is the vulnerability of certain banks to higher interest rates. This was exemplified by Silicon Valley Bank, which collapsed in March this year. While this understandably created worldwide headlines, it appears that the bank's collapse was more due to poor risk management on its part. The bank was unusual in that it did not take in deposits and then lend these funds to borrowers, as is usually the case. Rather, it took the deposits and invested the funds into US government bonds. As interest rates increased last year, this caused the value of these bonds to fall sharply.

When depositors began to withdraw their funds from the bank, the bank was forced to sell the bonds at a loss, which meant that the capital the bank had set aside to cover this eventuality began falling quickly. As word of the losses spread, customers of the bank recognised that those who got their money out early would get it back in full, while those who waited would not, which led to an outright run on the bank. Eventually the US government was forced to step in and wind up the bank in an orderly manner, ensuring that all customers of the bank were repaid their deposits in full. Interestingly, in something of a sign of the times, panic over the stability of the bank predominantly spread through social media, leading commentators to label it '…the first Twitter-fuelled bank run…'.

It's easy, however, to discern the difference between Silicon Valley Bank and Commonwealth Bank, for example. Two very different business models and a failure in risk management, as it was apparent that Silicon Valley Bank executives took no steps to hedge their potential losses to their bond investments, a reckless oversight. Possibly the most negative consequence of the Silicon Valley Bank collapse was that it rightly or wrongly raised concerns over the stability of all banks. It all coincided with the collapse of a number of other US banks, who were typically involved in some form of cryptocurrency borrowing or lending, which did not help sentiment (although again, these were not typical banks as one might view CBA or Westpac, for example).

It is also important to put the recent bank collapses into perspective. There are just under 5,000 banks in the United States, an incredible number when one considers that in Australia, we have just the big 4 banks and a handful of other smaller banks and lenders (in fact, there are only around 140 registered banks, credit unions and building societies in Australia). As recently as the mid-1980s there were over 14,000 banks in the United States and as one would expect, the more banks there are, the greater the likelihood of problems. Since 2000, for example, 565 banks have collapsed in the US, an average of almost 25 per year (albeit that most of these were linked to the GFC). Silicon Valley Bank may have been notable for its size (being the largest bank to collapse since 2008), but certainly the collapse of a mis-managed bank in the US need not be a harbinger of a worldwide banking crisis.

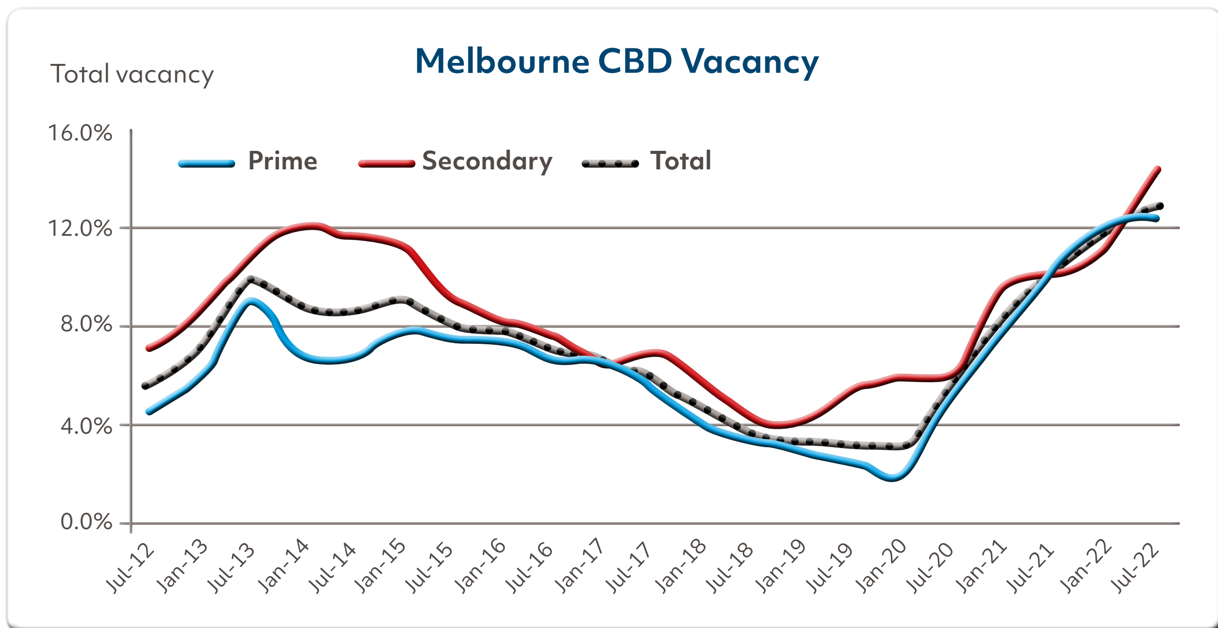


Commercial property concerns

A related note are concerns over the fate of the commercial property sector. This principally stems from the fact that commercial property values are typically inversely related to interest rates (i.e., when interest rates increase, commercial property vales fall) and the high level of leverage that is often associated with commercial property lending.

In the United States, there is around $2.2 trillion of real estate debt which falls due between now and 2025 and there are concerns whether all of the debt will be able to be refinanced. Complicating the issue is the ongoing switch to Work from Home (WFH), which has remained more resilient than expected, which has added to elevated vacancy levels in key office buildings.

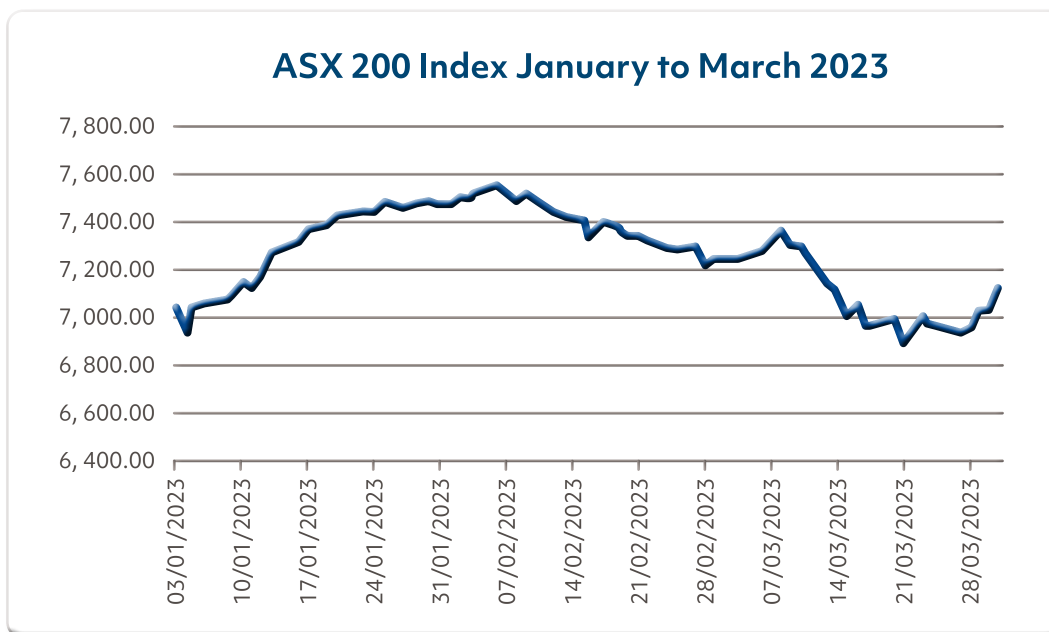
Australia has not been immune from the fallout from WFH, as shown in the graphic below. This details vacancy rates in the Melbourne CBD, which are now well over 12%, as compared to below 4% prior to the pandemic.



To a certain extent it appears that commercial property owners are hoping to avoid extensive asset sales during 2023, hoping that the prospect of interest rate cuts in 2024 will provide support to commercial property valuations.

The stock market over the past quarter

Growing optimism about a possible peak in inflation levels saw 2023 commence with a strong rally in global and domestic share markets throughout January. In fact, January saw the Australian share market post its second-best start to a year in three decades. However, the emergence of evidence suggesting that inflation was not yet under control in February saw a reversal of the new year's rally. This continued into March 2023, albeit at less disappointing levels. Despite two consecutive months of negative performance, the quarter managed to produce a modest gain, with the ASX 200 Index gaining 176 points, equating to a return of 2.54%.



While inflation concerns largely drove market performance throughout February, the March collapse of Silicon Valley Bank and Signature Bank in the US, along with the fall and eventual sale of Credit Suisse – one of Europe's largest financial institutions, created additional concerns for investors. However, despite these additional concerns, global share markets were surprisingly resilient, managing to finish the quarter higher. The US S&P 500 Index had risen 7% by quarter one's end while the Chinese Shanghai Composite Index rose 5.9%. In comparison, the Australian share market underperformed, however, it is worth noting that our market often generates less volatile returns in both positive and negative market environments.

Reporting season throughout February provided an insight as to how companies have performed in the post-COVID and rising inflation environment, with surprisingly, the number of earnings misses being roughly equal to the number of beats. The key finding of reporting season was that defensive businesses that are able to pass on increasing costs to customers, such as Brambles, Woolworths and Telstra, were able to perform strongly. On the other hand, reduced demand for energy saw sharp falls in this sector throughout the quarter (-5.3%).

Looking forward, higher interest rates are likely to slow the economy as we move through 2023. This may in turn negatively affect the share market as reduced spending levels will impact economic growth and corporate earnings. While expectations differ on whether Australia will avoid a recession (an outcome we still believe is likely), defensive sectors like consumer non-discretionary, financials and healthcare are likely to remain resilient and the comparatively stronger performers of the share market.

Bank Transfer Procedures

Due to the unfortunate increase in scams aimed at Australians, we have made a number of changes to the procedures around client requested bank transfers. These are designed to ensure the integrity of a bank transfer request (that it was legitimate, that it is going to the correct destination account and that the funds arrived). In general, if you request a bank transfer from your portfolio account, the following will apply:

- If the request is received via a telephone call or via email, we will telephone you on a number which you have previously provided to us to confirm the transfer
- If the transfer is to a new destination bank account, these details will be reconfirmed in the phone call described above
- The day after the bank transfer was requested, we will telephone you to confirm the funds have arrived in the destination account

We do apologise for the extra time burden these processes will incur, however we believe that they are in our client's best interests. Should you have any questions regarding these processes, please do not hesitate to contact us.

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 wish you all the best for the year ahead.

With kind regards,

Justin, Ray & Michelle

FACTS & FIGURES AT A GLANCE

	Rate / Value	Change from last reading
Australian inflation rate (annual)	7.4% (Jan)	-
Australian unemployment rate	3.5% (Mar)	+0.02%
RBA Cash rate	3.60% (Dec meeting)	+0.50%
ASX 200 Index	7,373	+152 points
Australian $ vs. US $	$0.6712	-1.16c
Australian $ vs. UK £	$0.5415	-2.41c
Australian $ vs. Euro €	$0.6156	-0.0259c

This newsletter provides general information only. Before making any financial or investment decisions, we recommend you consult a financial planner to take into account your particular investment objectives, financial situation and individual needs.

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