Welcome to the "Bumper" March 2019 Edition of the Martin Bros Monitor.

In this edition of the Martin Bros Monitor:

Batten Down the (Economic) Hatches

Not many of you would have heard of a man we called “Billy Bond”. He was a lifelong friend of our father until his passing in March 2011 and our families grew up together. Billy Bond would very regularly send us faxes (he never trusted computers) on his views and missives of the current market, right up until his passing. These notes were always humorous but with an underlying tone of his insights. He worked in markets his entire life with major financial institutions and as adviser to some of Australia’s wealthiest in the 1980’s and 90’s. In fact, he came to prominence in this industry after the 1987 stock market crash. Billy Bond had foreseen trouble ensuing and protected some very wealthy Australians from the fallout.

Billy Bond's key to foreseeing trouble in the lead up to the 1987 stock market crash, apart from skyrocketing equity prices (which alone is not an indicator), was movements in the Bond market – hence the name. Billy was a firm believer in watching key developments in the Bond market. Why? Because the bond market often is ahead of the equity market in predicting future trends. Of course, this is not a fool proof method and can at times throw out false starts, especially with the amount of central Bank intervention we have seen around the globe since the GFC (Quantitative Easing). However, all major changes in economic activity, either recovery or slowing, have been preceded by Bond market movements.

It is important for us to point out that in this article we are talking about economic activity, which is very different to equity market movements. One of the factors which cause equity markets to move up and down is company earnings. If an economy slows then corporate earnings will generally slow to and vice versa. But this is just one ingredient that contributes to equity market movements. Some are factual such as earnings and others are psychological, all mixed together driving the short term direction of markets. Longer term it is earnings growth over 5, 10, 20 years that will drive a stock price.

In Australia we have had 27 years without a recession. During this time we have had periods of good growth (greater than say 2.5%) and periods of sub-par growth (below 2%). Right now, our economy is slowing. Contributing to the slowing economy is low to non-existent wages growth which has resulted in weak retail spending which is a major contributor to GDP. Construction, particularly residential, has slowed significantly with the outlook over the next 6-12 months deteriorating. Building approvals which are normally an indicator of future activity in 6- 12 month's time have halved in the last year. Falling housing prices are hurting consumer confidence and the home been used as a bank for people borrowing against it for spending or investment into a small business is all but over.

On the positive side however is the revenue Australia is receiving from record volumes and value from our major resource exports of gas, iron ore and coal. These revenues are offsetting some of the decline in contribution from construction activity. The risk is commodity prices falling and hence our national revenue declining. The other issue with the contribution to growth from our resource exports is that very little flows through to you and I on the street. It doesn't make us feel richer or increase our pay packets.

The next six to twelve months will be very interesting here in Australia (global growth is another topic altogether and one we don't have time for here in this article). The "best case" scenario as we see it is we have a soft landing. That is described as slowing growth while unemployment stays stable. The "worst case" scenario is we have a hard landing and growth slows and unemployment starts to rise again. In this scenario, the possibility exists for Australia's record breaking recession free period to come to an end. We will sit on the fence and sit somewhere in the middle of these two possibilities.

In addition to the above factors impacting our economic outlook, a notable development in the Bond markets today is our 3 year Government Bond yield falling to 1.47% which is below the cash rate of 1.5%. In an ordinary environment you would expect to be paid more interest lending money to the Government for 3 years versus overnight. The 5 year Government Bond rate is also teetering at 1.547%. Below is a chart showing you the 3 year Government Bond rate over the past six months. The Bond market is clearly concerned about what lies ahead for the Australian economy. Time will tell if this is a false start or a “Billy Bond” indicator.

[Australian Property Market Outlook]

In over 16 years of writing the Martin Bros Monitor, we don’t believe we have ever dedicated an article solely to the property market. Now is the time to pen our thoughts on this emotionally charged sector in this inaugural piece.

Like equity markets we also do not have a crystal ball into the short-term direction of the property market. However, we do have a view on the macro, fiscal and regulatory factors affecting our property market and how these have impacted prices and will continue to do so until a change occurs.

From our conversations with you over the last few years, and as regular readers of the MBM, you will recall our view that the property market would at some stage have to have a period of negative growth. Simple demand dynamics dictated that the pace of growth would eventually be squeezed by affordability and people’s ability to borrow would become maxed out.

Wages growth in Australia has been very low for the past ten years since the

GFC and in real terms (after accounting for inflation) has been almost non-existent. Official inflation figures also seem to understate how the real cost of many items for you and I have risen significantly above the quoted inflation rate of circa 2%. I’m sure all of us can recognize the cost of power, gas, water, health insurance, car insurance etc. has risen more than 2% per annum!

Housing affordability for most of us is based on loan serviceability (unless you’re a cash buyer which very few in the market are). This is a combination of the cost of a loan (interest) and income. Interest rates are historically low and the fall in these rates over the last five years helped to re-fuel the property market. Banks also had very loose lending policies chasing market share. By loose we mean in relation to how they assessed loan serviceability. This includes the interest rate they use to determine the borrower’s capacity to meet loan repayments if interest rates went up and the cost of living expenses they use to “assume” what a borrower spent annually. That is, they would use a standard per annum figure for singles, couples, families etc. These standards were ridiculously low for the average borrower. All of this meant getting a loan, and a big one at that, was easy.

Approximately 18 months ago, out of concern for the over heating property market, APRA placed macro prudential limits on the banks. What this simply means is that they instructed the banks to limit how much lending of interest only loans they allowed, how much capital they had to hold (more capital means less ability to lend) and how they assessed the serviceability of borrowers. All of this resulted in a significant tightening of who and how much could be borrowed to purchase a residential property. This is when the property market peaked. Less available credit meant less demand for properties. People that previously would have been able to borrow to purchase a home or investment property now were not able to. Many people that wanted to buy another property now could not. The days of “upgrading” your principal residence funded by the bank were over (unless someone had a significant increase in their incomes or a very large amount of existing equity).

In addition to these macro prudential measures, other changes also occurred. Lending to foreigners all but dried up as banks almost completely pulled away from this market over concerns on the reliability of information (identity and foreign incomes). China tightened their capital outflow rules so many foreign cash buyers disappeared. Taxes for foreign buyers increased further denting investor demand. Banks have almost completely stopped lending to Self Managed Super Funds for property purchases. Changes to depreciation laws from Budget night 2017 meant the lucrative tax deductions on existing properties disappeared – although we think this has been largely overlooked and the effects are now only starting to be felt by those investors who have purchased since this date unaware of these changes. The likely incoming Labor government is proposing to remove negative gearing for all new buyers and halve the capital gains discount.

All of the above changes have resulted in significantly less demand for residential property. Inner Melbourne and Sydney felt these changes first as the "blue chip" suburbs started to see price adjustments. Now it has caught on in middle and outer areas. When property prices are confirmed to be falling, the next phase is the negative feedback loop. No one likes to lose money or look silly in front of other people. Hence people hold back and if they can afford to buy, will hold off for fear of further falls. Stamp duty on average adds about 5% to the purchase price of a property. This is overlooked in a rising market as people, so confident with future capital gains, expect their investment will be worth more in a year or more. When property prices are falling, and the expectation is that prices could fall another 5 – 10%, then buying a property for say $1 million, paying $50,000 is stamp duty and having an investment worth $900,000 - $950,000 in twelve months is understandably less than attractive. Herein lies the negative feedback loop.

Due to Australia's population growth we do need to keep building tens of thousands of dwellings per annum to house future demand. But this won't stop the market falling in the short term. These imbalances can last many many years (just ask the US about their property experience during the GFC).

The government and Reserve Bank of Australia (RBA) have now realized that their macro prudential measures might have been too effective and are suggesting that some easing may be needed. True and we agree. But these changes would take time to filter through and people would have to be willing to gear up again (questionable). The market now expects the RBA to cut interest rates twice this year. How much, if any, of these rate cuts are passed through to borrowers is what markets are wondering.

Since 1965 there have been 5 downturns in the residential property market. The shortest one lasted 5 quarters (15 months), the longest 23 quarters with the average lasting 14 quarters (3 and half years). The current downturn has lasted 6 quarters so far.

As we mentioned at the start, we do not know when the property market will again go up. Our best guess is there is more chance over the next 12 months that it goes down further than up. Until credit becomes more available again, wages rise significantly or the cost of borrowing (mortgage interest rates) drops significantly, the property market will struggle to rise. The most likely scenario we feel is some more tempered falls followed by a period of (years?) stagnation. One thing is for sure, the cycle will again turn. Which is good news for the estimated 500,000 people with negative equity in their home. Hopefully they can keep their job and meet their mortgage commitments until the next cycle arrives.

Please note the amended ASX trading hours below over the upcoming Easter period.

We wish you a happy and safe Easter and members of the Martin Bros. Team will be available each day the market is open.

- Thursday 18th April - Normal Trading
- Friday 19th April - Market & Office closed (Good Friday)
- Monday 22nd April - Market & Office closed (Easter Monday)
- Tuesday 23rd April - Normal Trading
- Wednesday 24th April - Normal Trading
- Thursday 25th April - Market & Office closed (ANZAC Day)
- Friday 26th April - Market returns to normal trading hours

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