Opinion

RBA could blow bubble back up

Christopher Joye

Mar 15, 2019 — 10.31am

If only the RBA had its brilliant new research on the impact of interest rates on house prices back in 2013 when this column warned them that their easy money policy would blow a huge housing bubble, as it subsequently did.

We have long argued that the RBA made a major forecasting error when it slashed its target cash rate from 4.75 per cent to 1.5 per cent and repeatedly assured the public that this would not fuel double-digit house price growth nor a sharp re-leveraging of household debt, which is precisely what happened.

While the RBA does not target house prices with its monetary policy settings, it is obliged not to amplify financial stability risks. And it is this part of its official mandate that it failed miserably between 2013 and 2017.

One of the RBA's silly operating maxims is that it never admits it is wrong for fear of undermining its credibility. So instead of acknowledging the fact that Martin Plowe made an error when it blew the bubble, multiple governors have told the blame to inert housing supply and population growth. One flaw in this thesis is that the supply-side was, in fact, doing its job: Australia has experienced the largest increase in housing construction on record.

Unfortunately for the RBA's bosses, their own boffins have now debunked their junk. In an outstanding new paper two RBA economists conclude that the "reduction in real interest rates [effected by the RBA] accounts for most of the subsequent boom in dwelling prices" since 2011.

The authors, Trent Saunders and Peter Tulip, find that a one percentage point fall in real interest rates boosts Aussie house prices by 17 per cent based on the assessed cost of owning a property between 1987 and 2018. Yet as interest rates approach zero, the sensitivity of house prices to changes in the cost of capital escalates.

Long run

Based on current ownership costs, Saunders and Tulip estimate that a one percentage point drop in expected real mortgage rates would inflate house prices by an enormous 28 per cent over the long run.

Before RBA ignited the recent boom, the 10 year government bond yield was around 4 per cent. Today it has slumped to less than 2 per cent. The RBA's research

If the RBA bequeathed the bubble, it was APRA who saved us by deflating it in an orderly fashion with an unprecedented series of constraints on new credit creation and a unilateral tightening of lending standards that compelled banks to hike rates on investment and interest-only loans by between 25 and 50 basis points.

Acknowledging these insights is important in the context of the feverish speculation that the RBA will get the yips from its long-held position that the next move in rates is up. There is a consensus that the RBA will once again debase the price of money as a result of declining house prices putting downward pressure on consumption and growth even though Australia's jobless rate is at a historically low 5.0 per cent level that the RBA has stated is consistent with full employment.

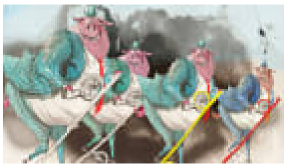
A more sensible central bank might be concerned that its standard minimum move of two 25 basis point cuts would be capitalised right back into house prices, with Saunders and Tulip's analysis implying home values will jump 14 per cent (more than negating the peak-to-trough losses recorded in the current correction).

The sad thing is that the housing downturn is the best thing that has happened to the Aussie economy in years because it is cauterising our biggest financial stability risk. The RBA would be better served by tolerating a period of sub-par growth and allowing the housing market to clear.

process has a long way to run: the major banks' senior bonds were trading on much tighter credit spreads of just 0.72 per cent above BBSW as recently as January 2018.

Two key catalysts for the credit rally have been the US Federal Reserve's decision to back-away from its central case of two interest rate hikes in 2019 and the likelihood that APRA's new "total loss absorbing capacity" policy will disappear about one-fifth of all major bank senior bonds and replace them with bail-in-able debt.

Related



Big banks pass IMF stress test with flying colours
Christopher Joye

A final influence has been the Fed canvassing the possibility of adopting a brand-new monetary policy framework known as "inflation averaging", which has massive implications for asset prices. For many years we have argued that central banks would become politicised and relax their commitments to price stability, and this seems to be playing out.

The Fed currently targets 2 per cent core inflation over its forecast horizon,

2.25 to 2.50 per cent core inflation rate for a prolonged period of time, which is a leave rates lower for longer. (Eventually they will have to normalise to higher levels.)

The bottom line is that the search for yield dynamic is back in a big way, which is positive for any asset that offer returns above bank deposits. The flip-side is that this can translate into mums and dads assuming risks they don't understand.

Capital raisings

This is especially the case with the rush of rapid-fire capital raisings via listed investment companies and trusts (LICs and LITs) that circumvent the Future of Financial Advice (FOFA) laws that prohibit payments of conflicted sales commissions to brokers and advisers pushing product to punters.

Given the crazy equity biases in Australian super fund portfolios, which are the highest in the world, and an equally large dependency on cash in self-managed super funds, there is a compelling argument for mums and dads to diversify across a wider spectrum of exposures sitting between cash and shares.

It should be pretty straightforward for an informed retail investor to get their heads around the underlying credit risks associated with buying senior bonds from Telstra, subordinated bonds off IAG, or a hybrid from CBA.

Nowadays there is loads of impressive educational material out there, and none of these assets have anything remotely resembling the pricing uncertainty and volatility of the equities that dominate their portfolios (hybrid volatility is about one-third the risk of lower-ranking shares).

Compared to traditional investment-grade bonds, private loans offer vastly superior interest rates with the trade-offs that they tend to be far less liquid (ie, cannot be easily sold), involve lending to unrated and lesser known companies that would ordinarily get finance from banks, and have a theoretically higher risk of default on a loan-by-loan basis.

Because increasingly tough regulation makes it difficult for banks to lend to some corporates on reasonable terms, there can be attractive opportunities for non-bank private debt players that have the expertise to synthesise and price the complex array of private debt risks.

Private debt

"We can access particularly attractive risk-adjusted returns on sub-investment grade private debt partly because banks have withdrawn from certain market segments as a result of changes to capital adequacy requirements and increased regulatory oversight in sectors like property," says the co-founder of private debt pioneer Metrics, Andrew Lockhart.

Much like a private equity investor (or a bank), active managers like Metrics will be intimately engaged with their borrowers. "We have significant influence over terms and structure, and will maintain a close relationship with the borrower whereas in public debt capital markets, structure and terms are more market driven," Lockhart says.

Another potential benefit is the capital stability that you also see in private equity. The lack of daily liquidity in these assets means they cannot be marked-to-market.

A AAA rated covered bond from ANZ, which ranks above a bank deposit in the capital structure, can ironically have more return volatility than a portfolio of high-yield private loans for which there are no regularly traded prices.

investors confuse the constrained ability of market-makers to inventory bonds on their balance-sheets since the 2008 crisis with poor secondary market liquidity. Yet the latest US Federal Reserve research demonstrates quite the opposite.

Secondary turnover in the investment-grade corporate bond market as a share of all bonds outstanding has consistently increased since 2008 and is now higher than pre-crisis levels. Likewise bid-offer spreads, which exploded in 2008, have trended down for years and are actually now tighter than they were before the crisis. The same is true of market impact costs and new primary issuance liquidity.

And if groups like Metrics continue to liberate the private debt space, you would hope liquidity improves there too. They are certainly well placed to capitalise on the inertia and inefficiency in the Aussie banking system created by heightened regulation and the royal commission.

The trick for investors is to ensure that the investment manager committing to these loans assesses and prices risks as well as the big banks do.

Christopher Joye is a contributing editor to The Australian Financial Review. He is an economist, fund manager and policy adviser. He previously worked for Goldman Sachs and the RBA, and was a director of the Menzies Research Centre. He is currently a portfolio manager with Coolabah Capital Investments, which invests in fixed-income securities including those discussed by this column. *Connect with Christopher on Twitter.*

2 ACTU claims business is 'afraid' of $1.4trn in workers' super

3 Disney's new streaming platform is set to make the company more valuable

4 AustralianSuper declares war on SMSFs

5 APRA may name, shame bad super funds for the first time

LATEST STORIES

Bill Shorten's too boring for comedy, say satirists

11 mins ago

The magic money tree fix for America's fiscal malaise

13 mins ago

How the world rebelled against US on air safety

37 mins ago

RBA could blow bubble back up

45 mins ago

The Australian Financial Review Magazine

How John Kaldor transformed global contemporary art

Why an Australian wine shop sells more Prunier rare cognac than any other shop

Home design: Avoid perfection to create a beautiful interior

'Whiteley', the opera, bets big on attracting a large audience

'Eighth Grade' costume designer deserves an Oscar in the 2019 Academy Awards

BOSS

5 ways female leaders can stop saying sorry

Altus Group's Bob Courteau manages by wandering around

What it takes for elite athletes to get a mortgage

Why you should ignore advice from successful people

Entries open for 2019 BOSS Young Executives

Take your pick: 5 of the most desirable homes for sale right now

Special Reports

How young Chinese women are taking on Xi Jinping

The ultimate travel experience is even better than you think

PwC, Accenture groups submit visa processing bids, await political unbundling

Ian Harper slams Morrison government's power breakups

The more a job changes, the more secure it might be