Quay Real Estate Advisors
Preserve + Create

Investment Perspectives

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Key Points

The mechanics of easy monetary policy is to encourage private sector credit growth via interest rate policy

The policy result is higher private sector debt burdens

Each cycle interest rates move to encourage more credit until the cash rate approaches 0%

This theme has played out globally – Australia and New Zealand have been an exception – but for how long?

A case for Australian interest rates to approach 0%

Taking a longer term view

Since the Reserve Bank of Australia ('RBA') moved the official cash rate to 2.5% in August 2013, market and RBA commentators have often speculated when and how the next move will occur.

For much of 2014, the consensus was interest rates would rise into 2015. More recently, this view changed to more cuts. Last week, a stronger reported CPI divided the commentary. In the end, the RBA decreased rates by 25bps – and so the speculation will begin again.

Quay has no strong opinion on the near term outlook for Australian interest rates. However, by taking the long-view, we believe that there is a compelling argument to suggest Australian interest rates are more likely to approach zero than revert to the long-term average.

Here's why.

How Monetary Policy Works

The common view is low interest rates stimulate the economy by:

- Reducing mortgage and business costs, thereby "freeing up" indebted households and companies to spend, and
- Reducing funding costs to encourage more private sector investment

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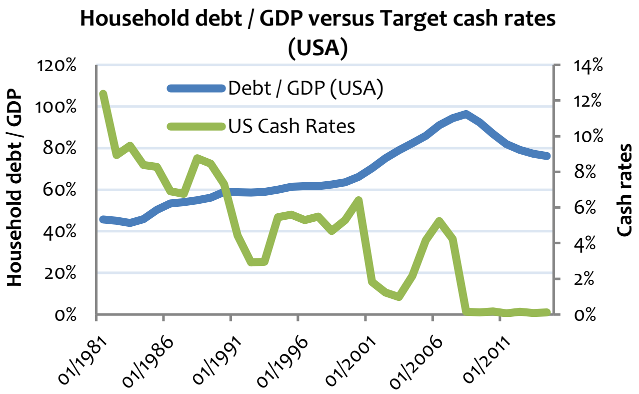
Central Banks have done an excellent job encouraging private credit growth – but what happens when the private sector has no further appetite for credit?

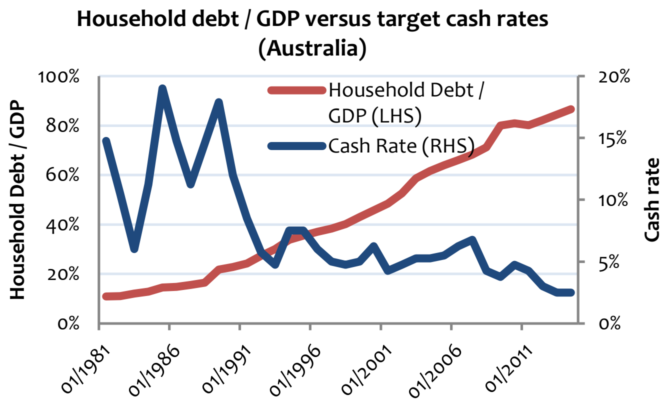
While indebted households and companies benefit from lower interest payments, savers are disadvantaged with lower interest income. From a private sector income perspective, the result of an interest rate movement is a (near) zero sum game.

However, lower interest rates can encourage investment particularly from the household sector prepared to swap rental obligations for mortgages. The real benefit of lower interest rates is that it encourages credit growth.

The success of interest rate policy will be its failure

Since the 1980's central banks have used successively lower interest rates to stimulate the economy after each downturn. The result has been ongoing private credit growth and a sustained increase in private debt measured against GDP. The figures below highlight the ratio of household debt / GDP for the USA and Australia, illustrating the success of this approach.





As households (and generally the private sector) take on additional leverage, central banks resist increasing interest rates too much for fear of strangling the (over) leveraged household. Moreover, to encourage new lending, interest rates generally have to be lower than the previous cycle since central banks are forever trying to increase the total stock of debt (i.e. credit growth).

As experienced in the US and Japan, eventually interest rates reach near zero and a long period of private sector deleveraging occurs (with the assistance of sustained near zero interest rates and fiscal deficits). At this point, the appetite for additional private debt diminishes and lower interest rates are akin to central banks "pushing on a piece of string".

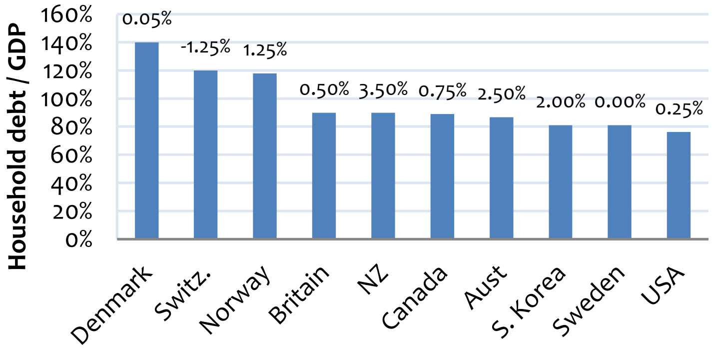
The inverse relationship between household debt and official interest rates is common for many western economies. In fact, Australia and New Zealand appear to be the outliers with relatively high cash rates relative to its stock of debt, as the chart on the next page demonstrates.

The only country where there is clear consensus interest rates will rise happens to be the country with the lowest ratio of household debt, the USA.

Implications for Australia

There is much hand wringing about Australia's economic prospects as the mining

Household debt / GDP versus Cash Interest Rates



Source: IMF, RBNZ, EuroStat, St Louis Fed, RBA, Quay Real Estate

boom comes to an end. And since both sides of politics have the goal of trying to balance the federal budget, all of the heavy lifting is being left to the RBA.

In the near term, there will be changing expectations on future rate cuts and rises, but the longer-term trend is clear. Interest rates work by encouraging credit growth – and the success of more private credit ultimately pushes the central bank to ever lower cash rates.

There is now enough empirical evidence to support the case that interest rates are not mean reverting. Instead, private sector indebtedness gives a clearer picture of long-term central bank intentions.

Australia's stock of household debt is already high and growing and we have seen how this has played out in other economies. It is difficult to see that Australia will be any different.

Concluding thoughts - impact on asset prices

Ever decreasing interest rates, in our opinion, are likely to push asset prices higher as investors become willing to accept lower returns. In the context of real estate we are focused on the risk that this can create - supply.

In a world of little inflation there is little pressure on replacement cost and as capital values are pushed past replacement cost, developments become feasible through cap rate compression rather than necessarily from rental growth. The Sydney office market is a classic example of this.

In the current environment we think the best way to protect investor capital and generate acceptable returns is to identify assets that are difficult to replicate/replace and/or identify opportunities where purchase price is at a discount to replacement cost.

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