The Coming Hyperinflation of Australian Property

May 2022

Analyst Martin North (MN) and Economist John Adams (JA) discuss the most important set of economic questions facing the Australian people is inflation, interest rates and mortgage/financial stress. The recent release of the Consumer Price Index by the Australian Bureau of Statistics at officially 5.1% and the subsequent raising of interest rates by the RBA (Reserve Bank of Australia) is now the main conversation which many Australian families are having. With only one interest rate there is already a sea change in the sentiment in both the property market, shares and cryptocurrencies. Many Australians with significant debts are now quite nervous about what does the future hold.

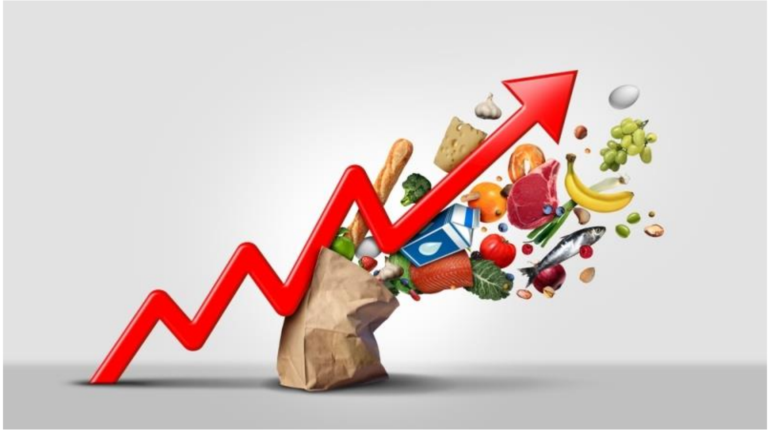
(This is a transcript of some of the most important points raised. The link to the full show is provided at the bottom)

KEY TAKEAWAYS

- Inflation will increase through 2022
- Interest rates will go up to try to reign in the inflation
- Then they will reverse and start to come back down
- By 2024 interest rates are likely to be reach record lows
- Strong monetary easing will commence by 2024
- Inflation combined with new low interest rates and substantial monetary easing could create a situation where property prices rapidly escalate by another 30% on where they are today.

John Adams: People are talking about interest rate repayments in terms of mortgages, and so people are saying do we fix? What are we doing?. How do we manage if the Reserve Bank continues to increase interest rates? And obviously there's a concern about property prices as well and **a lot of speculation is to where property prices may or may not go.**

So basically, we have had a couple of episodes before when we talked about stagflation and how this sharp rise in official inflation by released by the Australian Bureau of Statistics is hurting a lot of Australians at the moment.



Now obviously we are in May and **everyone's talking about interest rates and inflation** etc.

Obviously we have sharp inflation, part it is due to the stimulus package of the last two years, part of it's due to Ukraine and oil prices. We're starting to see interest rates go up. Now we've had a whole host of financial institutions like ANZ and Goldman Sachs that are now saying we're going to have **eight consecutive rates rises** between May and December of this year and we're going to some sort of neutral rate of two and a half percent which is what the RBA Governor has suggested.

My view is that **there's a mathematical limit to how high interest rates can go**. That is because of how indebted the Australian economy is – households, business and Government but particularly households. interest rates.

Here's my general process of what I think will happen is**, interest rates will go up.**

We will see a sharp decline in asset prices which we are now. We see a sharp decline in consumption because people are less able to purchase because of interest rate costs going up.

We'll see a decline in consumer and business confidence. All of that will translate over the next few months into lower economic growth and potentially rising unemployment given that we have very low unemployment at the moment.

And when that happens, obviously that process will play out for a while. Then we start to get questions about what the ability of households will be to make their debt repayments to the banks.

So I think we'll see elevated mortgage stress levels beyond the 42 percent that we're at at the moment. Then we'll see a sharp rise in problems paying back the banks, delinquencies etc.

The banks will obviously start to get nervous about critical mass if there are too many borrowers who are now in some sort of financial peril.

Then the RBA and the other Central Banks will pause, waiting to assess what sort of financial stability we have in the country and then once they realise that the economy is too weak to sustain higher amounts of interest rates **that's when they're going to start cutting again.**

Stimulus

And then we got into the new monetary easing cycle. I think the amount of additional stimulus that's coming which is likely to be next year- going into 2024 -will be a **magnitude bigger than what we saw in 2020 and 2021.** And the reason why I think the stimulus will be larger is because anytime you have a growing debt bubble, to keep it going, you have to pump in with ever more amounts of stimulus to keep it intact and to keep the show on the road.

We will get to the issue of negative interest rates because I think a lot of our viewers have missed the boat about what really the Government was doing while everyone was focused about Covid there was things happening in the background on negative interest rates but before we go to here, I just want to bring this concept of the neutral rate which is something that both the RBA and the US Federal reserve has been talking about.

The “neutral’ rate

So in the economic literature the neutral rate is the rate in which you set the official interest rate where the economy is neither contracting nor is it growing. The Governor of the RBA has said for Australia that’s about two and a half percent and for the US Federal Reserve they said it’s just above three percent maybe three and a quarter.

The key thing to my mind and mathematically trained is that the debt over 2020 and 2021 has grown substantially compared to where we were in 2019.

In 2019 the official cash rate in Australia was one and a half percent and, in the US, it was two and a quarter percent and so the question that becomes is if the debt is so much larger in 2022 compared to 2019 is it reasonable to assume could we go back to where we were in 2019, or go beyond where we were in 2019 and would those higher levels of interest rates be sustainable?

Stability

I mean only the last few weeks did the US Federal reserve chairman say that we will tighten monetary policy, raise interest rates **subject to economic and financial conditions** and so they always have a caveat. So the caveat is always data dependency and also financial stability and obviously as you raise rates with the biggest debt bubble in the history of the world If things become unstable or they’ve already told people, if you understand how they talk and read between the lines that instability is the mechanism in which **they’ll stop raising rates and they’ll reverse course.**

Now the really interesting point about stability in the Australian context is to what extent are our banks -particularly the big four - exposed to property but also exposed to the household sector. A rough International benchmark that our International Bank or foreign banks, usually, lend at about 38% of their total debt portfolio into mortgages.

So at Nov 2021, at that point it was a record high in terms of the percentage of bank lending to persons which was about 58 - 59%.

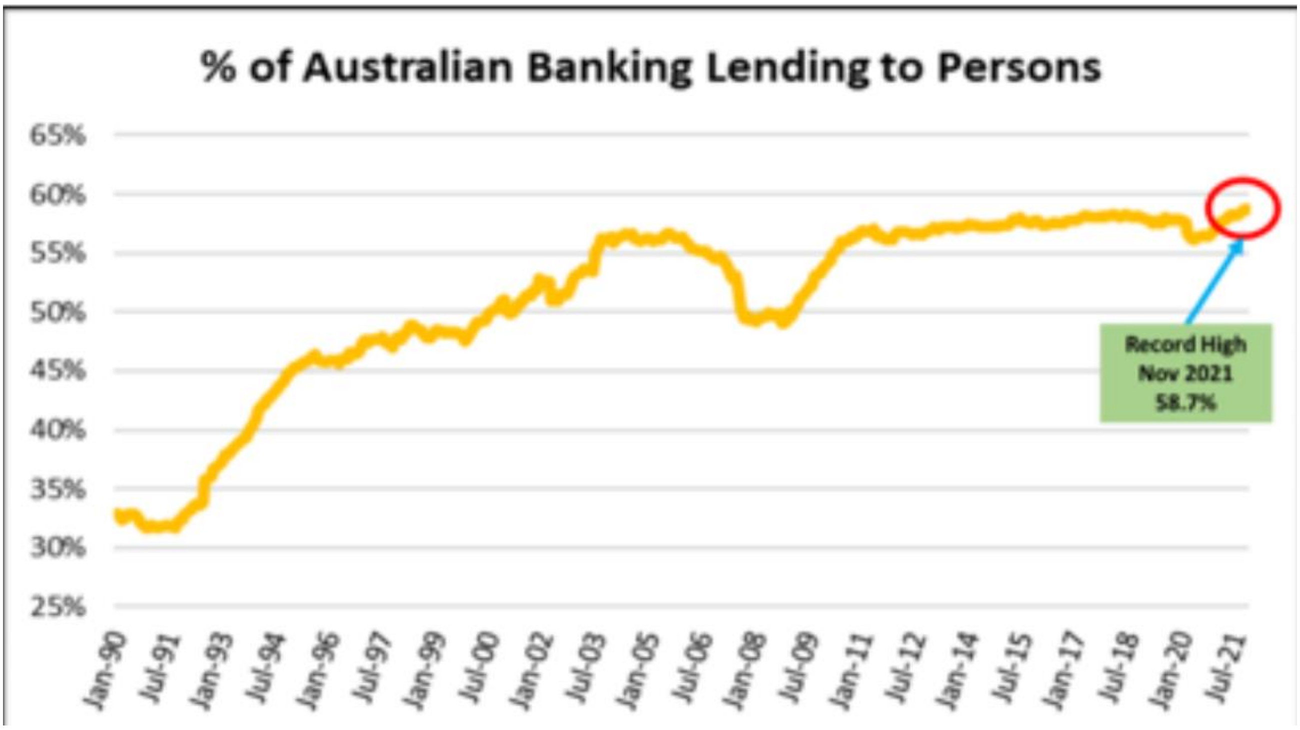


Chart from John Adams

So my key thesis as to why the RBA is even more limited than other Central Banks is because the banks in this country have basically put all the chips on the table and made one big bet which is households and so if household consumption was to collapse - if incomes were to fall dramatically- if the property sector was to tank - what that would mean ultimately is that the banks would go, because they were so concentrated in terms of their position.

So this relationship between household debt in banks, the commercial banks **- is so interlinked that you cannot separate them**. You can't say we're going to allow the property market to fall. In some cases some people said 25, 30% over the next short period of time. If so, it's going to have a huge impact on the banks so that's why I think this particular phenomenon is **a bigger issue in Australia** compared to other economies.

Buffers

MN: There's a couple of way around to look at the first is some people have already paid ahead on their mortgage.

So they've paid more than they need to. **So that they're actually ahead at the bank and on average those with buffers are probably a year**

to 18 months ahead on their repayments. So they could actually afford to go through quite a long period when they were actually paying a lot lower and still actually being okay with their mortgage payments the reason, they were paying ahead head was because they wanted to get the debt down right?

Some of them also are on these facilities where you can pull the money out again if you need to. It's an offset account and that's another thing that people talk about quite a lot.

They are in offset accounts which means of course that the value of debts has gone down but that means they can pull it out again and what I'm seeing already is some people who've got those offset facilities now starting to pull money out to cover the other costs of ongoing living.

So it depends, you know, there are people who can do really well but there are other people who've probably got 2 to 3 to 4 month of buffer before they've got difficulty and then there are other people again who are sitting on really big pools of saving they maybe pulled money out of superannuation, they maybe have sold the property or something so they're sitting on a lot too.

Interest rates movements

JA: Now one of the people that I will sort of just quote is that the Financial Review only last week quoted Macquarie Banks Global strategist who also said exactly what I'm saying is that **interest rates will go up and then next year the rates will come back down** and quantitative easing will start:

"Central banks will be forced into a dramatic "back pedal" and will be considering cutting rates within 12 months just as markets expect policy rates to peak".

(Australian Financial Review May 4, 2022)

Macquarie Group strategist Viktor Shvets says rates are going up and then back down again.

"*My view for some time was that as we go through 2023 and 2024, there is a much higher probability of loosening of both fiscal and monetary policies than tightening," he told the Macquarie Australia Conference on Wednesday.*

"What is going to happen is when Federal Reserve starts tightening – via quantitative tightening and lifting rates – and rates are getting closer and closer to neutral rates, volatility of asset prices will increase substantially."

***"When that happens, the financial conditions index will go through the roof and at that point in time, inflation and growth rates will start disappearing and Federal Reserve will have no choice but to backpedal*."**

JA: **They'll have to recommence stimulus quite soon**. And the obvious reason why is the financial system with this level of debt just cannot sustain.The financial system can't go through withdrawal by having no stimulus because as we've seen throughout human history that the debt bubble will collapse.

Negative normal interest rates

The Reserve Bank of Australia has stated that a negative cash rate is highly unlikely in Australia. This, however, does not preclude the possibility of a negative cash rate in the future or of other interest rates determined in the financial markets falling to, or below, zero.

Operational preparedness for zero and negative interest rates

Thursday 28 October 2021
(Australian Prudential Regulation Authority (APRA)

While everyone was deeply focused on Covid last year, what was APRA doing?

APRA was getting the banks ready for negative interest rates.

That's what is actually has been happening since maybe about 10 months ago and will continue on for the next six months. You think to yourself when the middle of a pandemic, everyone's focused on public health, we're seeing stagflation in 2021 in the United States and now inflation's here. Why would in that whole environment, why is Apra saying to the banks get ready for negative interest rates?

I think Apra is preparing Australia's Financial Institutions for the next round of stimulus which will be bigger, and which will involve negative, normal interest rates.

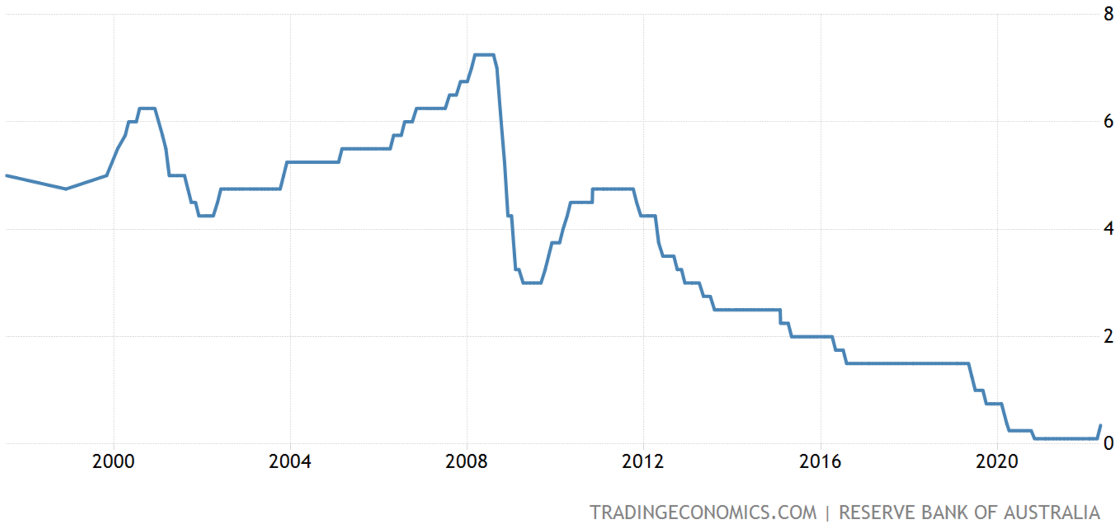
MN: In some areas of Europe we have negative normal interest rates. APRA is preparing the ground for lower interest rates. If rates were really going to go up, why are they getting ready for this, is because some people are aware things can change quickly.

What are Negative Normal Interest Rates?

JA: We saw this announcement about interest rates being charged on balances at the RBA. So, basically, each commercial bank has a bank account effectively with the RBA, they put reserves in there for the last couple of years that interest rate has been zero on those balances. Last week they announced that the RBA is going to actually start paying interest to the commercial banks so that actually provides an incentive for the commercial banks to park some money at the RBA because they actually can generate some return from that.

What happens with negative interest rates is that basically the RBA effectively is charging commercial banks an interest rate or a fee or whatever you want to classify it, as for leaving money at the RBA in these reserves, and what the RBA is trying to do is say to the banks take these reserves out, put them on your balance sheet and go lend them out.

By lending more and more money out, basically that gives banks with more liquidity to drive interest rates down in terms of commercial interest rates.



Australian interest rates

That's why, if we think about what people were borrowing last year in terms of mortgages. So, having spoken to a number of mortgage brokers, a lot of people were able to sign up mortgages, new mortgages or refinancing at about 1.8% or 1.9%. Obviously, some were lower, there was some higher around the 2.1%, 2.2% but a lot of people are about 1.8% or 1.9%.

In a negative nominal negative interest rate environment, what I'm anticipating is that we're going to see **mortgage rates potentially go down to about 1%** or potentially lower.

What does that mean if mortgage rates are going to go to 1%?

That would mean that on a cash flow basis, households can borrow a substantially larger amount of money compared to what they were borrowing in 2021. If that were to happen, where would a lot of that additional new borrowing go**? It would go into property and that would drive property prices substantially higher compared to where we are today**. Even though a lot of people have said that property prices was completely unsustainable in bonkers in 2021. In this scenario property prices would even go you know to a much more elevated level. **And so that's what I think the direction of house prices will go.**

There will be obviously some people concerned about house prices crashing.

There probably have already been people who have sold out expecting house prices to fall quite sharply and they can buy a cheaper property.

In theory there's a chance I could get this forecast wrong. But this is not economics at the end of the day this is politics.

The one thing that I will say is that the elite power structure in this country - but also globally - do not want to lose their power and so, if they raise the interest rates too high, if we had financial instability, if we had a financial crisis in an economic depression. What would that mean? It would mean that the banks would go bust. And all of that commercial financial power that a number of people hold would be dissipated.

The bureaucrats would lose all the credibility, the politicians would be voted out because they've triggered the depression and all the current crop of elites would basically be swept away in that depression and obviously it would create a new environment for a whole bunch of new people to emerge as the new leadership for the country both in corporate world, bureaucracy in terms of politics as well.

There is a conscious effort to keep the bubble going and **so that's why I'm confident in this forecast** because our elites are not suicidal, they're not kamikaze. They're not going to do something stupid and only in late March 2022 did the - I think- the assistant Governor Chris Kent tell Senator Renick we have no conscious plan to crash the economy. That's why I think as people make their decisions and set their expectations between now and the end of the year particularly as people are concerned about rising interest rates, think about what the powers that be, what do they want?

But no one is willing to address the elephant in the room because they know the consequences of that is too extreme - politically - to handle.

That's why I think we're going to see a new cycle of easing, probably staring in 2023.

We're gonna see negative interest rates probably by 2024. Mortgage rates will be lower than that when they were in 2021 and **property prices are going to go sky high** and that has a whole host of implication for millions of people both in property but also people who want to get into property over the next couple of years and people need to I guess you know listen to us or listen or make their own assessment and then obviously find out who is more accurate and then make your financial decisions accordingly.

MN: Just a couple of add-ons. Firstly of course that stimulus program will also have a significant upside impact on the stock market too. Just like it did the last cycle, so what we'd be doing is playing the last two or three years again, again. Which means more asset inflation you know the devaluation of real money and all that sort of stuff it's all part of that program.

The second is that sometimes it's worth just inflecting on, at the RBA they have the model and this model that they've got shows that **for every 100 basis point movement (1%) in interest rates property prices go up 30% or down 30%.**

If you were right if rates drop back down again and stay down**, property prices might go another 30% up from where they currently are.**

And that's a pretty scary thought for many people because many people would say, hang on they're already really sky high, but people need to understand that **property prices are absolutely connected to the free flow of credit and the price of credit and when credit is expanded and the price of credit drops, property prices go up.**

JA: The other key point to notice is **property prices in my assessment is critical to financial stability** because obviously if banks are lending out at a particular valuation, if those property prices were to fall it has a material impact on the bank's balance sheet and that has serious concern, so it's also so it is about the movement of credit. Property prices are a big thing in terms of the bank's balance sheet and so as we move forward, you're **going to start to see more banks squealing about rates being too high** and we need to stop and reverse.

MN: Absolutely and expect more lending standards to be released and all of those things we're just going around the cycle once again, aren't we? Thanks John, for this very important conversation.

(The above is an abbreviated transcript of the original show and shown in its entirety on You Tube here: https://youtu.be/Fbf9b7Y9vTo)