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Investment Newsletter – August 2022

Interest rates are rising but it is affordability that matters

In this month's cover article, we will address the question of ***what impact will rising interest rates have on households with home loans?*** The answer to this question has implications for whether or not there will be a recession and how investment portfolios will perform into the horizon.

But first know this - Before we launch into addressing this question, let us firstly just cast a broad brush on home ownership in Australia. As much as our media is fascinated by interest rates and mortgages, let us remind ourselves that there are in total 9.8 million households in Australia, according to ABS' 2022 data. Of this there are 3.3 million households, or 33.6%, with mortgages. A 30% of households have no mortgage, 24% are renters, and remainder fall in social and other housing types. So, the observation to be made here is that while higher interest rates raise the cost of living for a third of our households, there are a greater majority who remain unaffected, though renters will be affected indirectly through mortgaged landlords raise rents to fund higher interest bill.

Turning now to our topic - If you are scratching your head trying to keep up with all the news on interest rate hikes since April this year, let us state here in simple terms. The official interest rate in April was 0.1%, it is now 2.35% in September. However, what matters is what an average home loan borrower is paying right now compared to April. Average variable interest rate is now 4.6% p.a. (2.2% in April) while to fix your interest rate over next four years you will be paying close to 6% p.a.- these are ball park numbers.

This means that, nationally, a median home loan borrower with $600,000 loan is now paying roughly $3,100 in monthly repayments. This monthly repayment is after increases of $600 since April. We have seen a range of forecasts on how high this monthly repayment will go – monthly loan repayments on the median loan may peak around $3,500 before the RBA takes a pause in raising rates in December 2022.

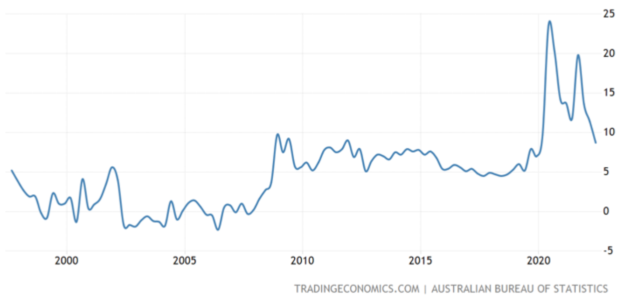
Concerns of affordability - Let us now turn to elevated concerns amongst some commentators about borrowers falling into financial stress and not being able to meet their higher monthly repayments. In our view, home loan borrowers have at least three lines of defence which should collectively increase their affordability in facing rising interest rates and be able fund higher monthly repayments.

Let's go through some evidence on affordability.

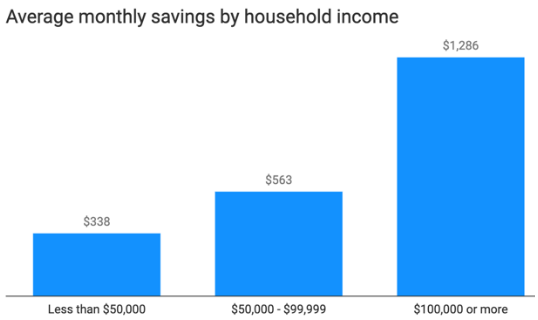
The first line of defence against higher interest rates is *'Monthly savings rate'*

The sudden onset of Covid-19 pandemic in 2020 and resulting fear of massive job losses as most economic activity went into lockdown worked as a big reminder to households for the need to build up a rainy-day fund and regularly put aside a good chunk of income into savings.

Just take a look at the chart below, you can see that Aussie households' saving ratio went from 7% of total income prior to Covid-19 to almost 25% in the pandemic year of 2020 and households continued saving in the range of 15-20% of their income into early 2022. Even now it remains just a touch under 10%.



The next chart to show you is that of household incomes. But before you consider the chart below, know that the average household in Australia earns close to $100,000 in most states but certainly major cities. Thus, the following chart tells us that average working household in Australia is saving around $1,000 per month, this figure was published in August 2022. So, it should already account for savings after consumers have adjusted for higher cost of living to date, including home loan borrowers paying higher repayments on increasing variable interest rates between May to July.

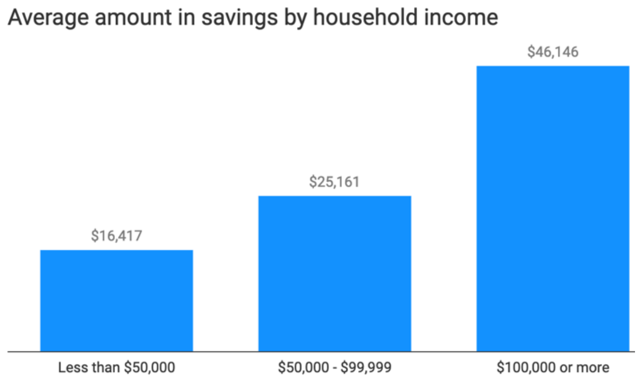


Source: https://www.finder.com.au/savings-account-statistics

Our argument is that if rates do increase by a net $1,000 - $1,500 per month on a median home loan as indicated by most forecasts, then borrowers have their current savings rate of $1,000 per month as the first line of defence.

The second line of defence against higher interest rates is *'Money saved in the bank'*

Those households with mortgages in the big cities are likely to have average cash levels in their bank accounts somewhere in the range of $25,000-$45,000 (see chart next page). In a pessimistic scenario of monthly repayments rising by $1,500; if average cash held in the bank is combined with the monthly savings rate of $1,000 as above then there is at least 4 years of headroom on servicing the median loan before falling into trouble i.e. running out of savings. Moreover, most people also adjust their spending habits when the monthly budget is tight so that should reduce the drain on savings.



Source: https://www.finder.com.au/savings-account-statistics

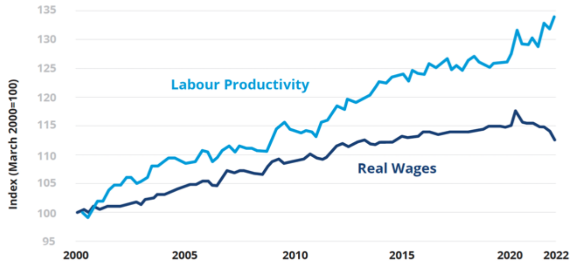
The third line of defence against higher interest rates is *'Accelerating wages growth'*

This is the big one! There is increasing evidence that wages are set to grow at close to inflation and for some workers even above inflation as they change their jobs in the tight labour market. There are two key reasons supporting accelerating wages growth. One is shortage of labour, which is a global phenomenon, and second is the rising role of unionism here in Australia. Let us discuss the unions.

Lately, you may have made a passing observation on the ongoing kerfuffle of union actions across a range of industries claiming wage increases. Not just that, unions have used the recently held national jobs' summit at the federal parliament to mount a convincing argument for wages growth to be set in-line with current rate of inflation of 6.1% or whatever the future inflation happens to be. Their rationale is that companies have been enjoying record profits, in fact profits having grown 3x faster than wages since 2016 while labour compensation as a share of economy (GDP) has declined to a record low of 45% from the peak of 60% in the 1970s. To make matters worse for workers, their real wages have fallen back to 2010 level due to the currently high inflation, this calls for an immediate remedy through giving wage increases in line with inflation, claim the unions.

The business community in response have said that worker productivity is not keeping at pace to justify higher than 2-3% wages growth. In response, the unions have released a paper explaining that Australian labour productivity has never been this high as it is currently. In fact, real labour productivity grew 13% over the last ten years. But real wages grew less than 1% in the same period.

Unions are claiming that with current inflation accelerating well ahead of wages, real wages will fall in the months ahead. In other words, a 13% improvement in real labour productivity in the last decade has translated into precisely zero gain in living standards for the workers whose skill and effort explains that productivity. So Australian workers are sceptical that the key to improving real wages is for them to boost their productivity. The chart top-right shows that labour productivity & real wages gap has continued to widen in the last 10 years and when you combine this with current cost of living crisis with an empathetic ear of the labour government it is quite likely that wages growth in the order of 4-6% is forthcoming, in fact it is already in train for a lot of workers and industries.



Source: Calculations from ABS National Accounts, Table 1, Wage Price Index, Table 1, and Consumer Price Index, Table 1.

Furthermore, the federal government will most likely make the relevant changes to the industrial law in the near term to ensure the unions are armed with an effective industrial law that enshrines their role in wage bargaining and right to strike, These changes will allow unions to play a wider and more significant role in wage bargaining across industries and employers.

Here are some headlines that suggest wages growth is on the move:

Unions to fight 'unrelentingly' for pay rises despite RBA inflation warning

Business a boiled frog on industrial relations

4.1 per cent salary boost tipped to spread across the labour market: SEEK

Childcare centre strike to hit 70,000 families

More than 1000 childcare centres will shut on Wednesday as workers go on strike for higher wages.

Australian minimum wage increased by 5.2 per cent in Fair… Commission decision

NAB offers workers 5% pay rise, extra holidays

Sydney train strikes: NSW government and rail unions to seek conciliation next week

The union is seeking a 3.5% annual wage rise, with an additional cost-of-living supplement

Robert Half, which is a major recruitment agency, published a 2022 Salary Guide in August. It found that 96% of business leaders are increasing their salary budget this financial year by an average of 20%. The tight employment market is showing no signs of easing, a vast majority of employers believe it is challenging to hold onto a candidate during the recruitment process and not lose them to a competing business.

Thus, as closing remarks, when you combine the average monthly savings rate of $1,000 with average cash in the bank ranging $25k-$45k, and then add to that wage increases approximating inflation then it is not far-fetched an idea that consumers may just be able to absorb the one-off re-set to higher interest rates.

GLOBAL MARKETS OVERVIEW

		Month End	Price Performance (% Chg)			
	Units	Value	1-day	1-mth	6-mths	1-year
Developed Markets Equities						
ASX 200	AUD	6,987	-0.17%	0.60%	-0.88%	-7.27%
ASX 200 Futures	AUD	6,908	-0.14%	0.70%	-0.17%	-5.55%
Dow Jones	USD	31,510	-0.88%	-4.06%	-7.03%	-10.89%
S&P 500	USD	3,955	-0.78%	-4.24%	-9.58%	-12.55%
Stoxx Europe 600	EUR	415	-1.12%	-5.29%	-8.38%	-11.84%
FTSE 100 (UK)	GBP	7,284	-1.05%	-1.88%	-2.33%	2.31%
DAX (Germany)	EUR	12,835	-0.97%	-4.81%	-11.24%	-18.95%
CAC (France)	EUR	6,125	-1.37%	-5.02%	-8.02%	-8.31%
Nikkei 225	JPY	28,092	-0.37%	1.04%	5.90%	0.01%
Emerging Markets Equities						
MSCI Emerging Markets	USD	993	0.00%	-0.10%	-15.24%	-24.14%
Shanghai Composite	CNY	3,202	-0.78%	-1.57%	-7.51%	-9.64%
South Korea	KRW	2,472	0.86%	0.84%	-8.41%	-22.73%
Taiwan	TWD	15,095	0.95%	0.64%	-14.48%	-13.69%
Brazil	BRL	109,523	-0.82%	6.16%	-3.20%	-7.79%
South Africa	ZAR	60,736	-0.96%	-2.78%	-12.77%	-0.50%
Foreign Exchange						
AUDUSD	Currency	0.6840	-0.20%	-2.08%	-5.82%	-6.51%
AUDGBP	Currency	0.5887	0.12%	2.58%	8.78%	10.69%
AUDEUR	Currency	0.6804	-0.57%	-0.44%	5.11%	9.83%
AUDCNY	Currency	4.73	-0.59%	0.51%	3.47%	0.18%
Commodities						
LME ALUMINUM 3MO ($)	USD/mt	2,391	0.00%	-3.92%	-29.02%	-12.03%
LME COPPER 3MO ($)	USD/mt	7,864	0.00%	-0.68%	-20.43%	-17.39%
LME NICKEL 3MO ($)	USD/mt	21,369	0.00%	-9.53%	-12.00%	9.32%
SILVER FUTURE Dec22	USD/oz	17.86	-2.36%	-12.23%	-27.47%	-26.33%
ICE Newc Coal Fut Oct22	USD/mt	415.50	1.96%	7.99%	106.31%	258.04%
62% Import Fine Ore in USD	USD/t	95.23	0.00%	-8.71%	-24.57%	-37.82%
Gold Spot $/Oz	USD/oz	1,710	-0.78%	-3.14%	-10.40%	-5.69%
WTI Oil	USD/bbl	88.81	-3.09%	-8.21%	5.63%	38.98%
Henry Hub	USD/mmBtu	8.93	-1.87%	7.20%	108.16%	110.61%
Corn	USD/Bu	673.25	-0.96%	9.25%	-3.48%	26.08%
Wheat	USD/Bu	809.00	1.35%	0.15%	-12.82%	14.47%
Fixed Interest						
10-Yr Bond Yield						
Australia	AUD	3.60%	-0.01%	+0.54%	+1.46%	+2.44%
US	USD	3.18%	+0.07%	+0.53%	+1.35%	+1.87%
Germany	EUR	1.54%	+0.03%	+0.72%	+1.41%	+1.92%
Japan	JPY	0.23%	-0.00%	+0.04%	+0.03%	+0.20%
Italy	EUR	3.89%	+0.06%	+0.87%	+2.19%	+3.18%
Australian Rates						
Cash Rate	AUD	1.85%	+0.00%	+0.50%	+1.75%	+1.75%
90-Day BBSW	AUD	2.47%	+0.01%	+0.32%	+2.40%	+2.46%
180-Day BBSW	AUD	3.02%	+0.01%	+0.25%	+2.77%	+2.99%
CBOE Options						
CBOE VIX (Volatility Index)	Index	25.84	-1.41%	21.14%	-14.30%	56.80%

Data as of 31 August 2022

ECONOMIC NEWS

• **In Australia** the Reserve Bank of Australia (RBA) raised interest rates by another +1% (0.5% in August and +0.5% in early September) to 2.35% for the fourth consecutive month. This is the highest level in more than six years and signalled further interest-rate increases would come in the period ahead, forecasting cash rate to rise to 3% by December and then "decline a little" by end-2024. The RBA upgraded inflation forecast with headline inflation seen hitting 7.75% by December 2022 (vs prior forecast of 6%) and 4.25% by December 2023 (vs 3.25% previously) before declining to 3% by December 2024. The RBA downgraded the economic growth (GDP) forecast for both 2022 and 2023 to 4% and 2.25%, respectively.

Private sector activity contracted for the first time in seven months in August as the RBA's rapid policy tightening weighed on demand. Consumer sentiment tumbled in August to levels reached during the Covid-19 pandemic and 2008-09 Global Financial Crisis, as surging inflation and interest-rate increases, combined with falling home prices, weighed on the outlook for households.

• **In the US - U.S.** Business activity contracted for a second straight month in August, reflecting softer demand at both manufacturers and service providers and companies increased headcount at a relatively sluggish pace in the month with Businesses' payrolls rising 132,000, the smallest gain since the start of 2021. However, consumer sentiment rose more than expected in the month rising to the highest since May, with inflation expectations remaining mixed, with consumers boosting their longer-term views for prices slightly, while reducing their year-ahead outlook for costs.

• **In the UK -** U.K.'s Bank of England (BOE) unleashed its biggest interest-rate hike in 27 years, raising interest rate by +50bps to 1.75%, as it warned the UK is heading for more than a year of recession under the weight of soaring inflation. BOE raised its forecast for the peak of inflation to 13.3% in October amid a surge in gas prices with price gains remaining elevated throughout 2023 with inflation expected at 9.5% in September 2023. Worsening cost- of-living crisis will see real disposable incomes fall more than at any time in around 60 years leading to families being around 5% worse off by the end of 2023. BOE is forecasting the economy to contract -1.25% in 2023 and a further 0.25% in 2024 with unemployment climbing to 6.3% by 2025. The economy shrank in June quarter 2022 for the first time since the pandemic with GDP falling -0.1% over the quarter while up +2.9% over the year, driven by a decline in spending by households.

• **In Europe.** The Economy grew slightly less than initially estimated in the June quarter 2022 with GDP growing +0.6% over the quarter and +3.9% over the year with signs emerging that momentum is unravelling. Inflation accelerated to another all-time high in August with CPI increasing +9.1% p.a. with core CPI up +4.3% p.a., leading to economic confidence dropping to its lowest level in 1.5 years with sentiment declining in industry and services as energy shortages jeopardize output and soaring prices curb demand.

• **In India.** The Economy expanded at the fastest clip in a year in June quarter 2022 with economy (GDP) increasing +13.5%p.a., fuelled by strong domestic demand. Central bank (RBI) returned borrowing costs to pre-pandemic levels by raising policy rate by +0.50% to 5.4%, while still maintaining its 2022 forecasts for economic growth at 7.2% and inflation at 6.7%.

• **In Japan.** Economy recovered to its pre-pandemic size in June quarter 2022 with GDP growing at 2.2% p.a., however, inflation continued to increase leading to Prime Minister Fumio Kishida ordering another set of measures to contain inflation by early September, with a boost in funding for regional governments and a continued cap on imported wheat prices.

GLOBAL MARKETS UPDATE

• The ASX200 gained +0.6% and US markets were lower in the month, with the Dow Jones up -4.1% and S&P500 -4.2%.

• Long-dated US treasury yields were higher, with the 2-Yr yield at 3.48% and 10-Yr yield at 3.18%.

• WTI oil price declined -8.2% to US$88.81/bbl, as concerns over a recession induced decline in demand for oil were partially offset by IEA boosting its forecast for global oil demand growth in 2022 by 380k barrels a day, saying soaring natural gas prices and heat waves are prompting industry and power generators to switch their fuel to oil.

THE LONG READ

CHINA'S PLANS FOR TAIWAN IS A KNOWN UNKNOWN: HOW SHOULD INVESTORS POSITION FOR THIS RISK?

In markets, as indeed in life, there are risks we know and can price and plan for, then there are risks we know that we don't know (known unknowns) and you can still plan for these but not necessarily price them accurately. And, finally there are black swan risks that we don't know we don't know (unknown unknowns), you can neither price them nor plan for them.

Russia's invasion of Ukraine was an unknown unknown risk - at least up to the point Putin started mobilising his army at Ukraine's border in 2021 when it became a known unknown - and we are seeing the consequences of that risk now manifest through war in Ukraine and inflation across the world.

Covid-19 pandemic was another unknown unknown risk that quickly transitioned to known unknown for few weeks in early 2020 when we started hearing stories of an unknown virus spreading overseas but couldn't quite work out its economic impact, and then it inflicted itself with full force on the markets. So, by that definition of unknown unknown risks, we can't enlighten you on what could next be around the corner for markets as a black swan event.

However, there is currently a significant known unknown systemic risk of China walking into Taiwan. This will not be without a war and the magnitude and economic consequences of which are anyone's guess. If we were to hazard a guess, you will most certainly be looking at military & economic consequences at multiples of what we have experienced from the Russia & Ukraine war.

We see China & Taiwan dispute being a major known unknown risk for the markets going forward until it is resolved or neutralised politically. It is difficult to price this risk as such but investors with a 'set & forget' approach to portfolio investing should approach their portfolio construction with a 'reasonable' probability (we don't have a number) that this risk manifests at some stage over the near to medium term. For investors with more dynamic approach to asset allocation, there is margin for flexibility in portfolio allocations and being tactical around this risk. Let us explain below.

Firstly, let's get some sense of the magnitude of the potential consequences for the world economy and global markets should China indeed goes to war with Taiwan. Such a war would likely involve some level of involvement by the U.S. The U.S. President Biden gave an off the cuff statement to journalists in May that U.S. would get involved militarily to defend Taiwan against China, however, that was quickly followed up by an official statement by the White House which maintained its policy of strategic ambiguity. The U.S. policy of strategic ambiguity on Taiwan, in a nutshell, acknowledges Taiwan as a province of China under 'One China Policy'. But on the other hand, U.S. also endorses 'Taiwan Relations Act' under which the U.S. is committed to providing military means to Taiwan for it to defend itself. We read the second part as similar to the way U.S. is currently providing military support to Ukraine through military equipment and funding without committing its own troops on the ground.

Why is U.S. even bothered about Taiwan defending itself when clearly it acknowledges Taiwan to be a province of China? It's not economics it's security through a strategy of containment. If you locate Taiwan on the global map, you will find this island state to be right outside and midway along the southern coastal border of China at the midpoint of East & South China Sea. From U.S.' perspective it sees Taiwan as an important location from where it can keep China's naval forces backstopped and prevent them from expanding their influence and reach into the western pacific and directly pose a threat to U.S. territories including Guam, Hawaii, and the continental United States. Other than that Taiwan is not a significant trade partner for the U.S. to protect its economic interests in Taiwan so fiercely. Furthermore, U.S. alliance with South Korea, Japan, Taiwan, Philippines forms a forward leaning defence line against China, up and down China's coast line. And U.S. will likely put up a solid resistance against China's attempts to invade Taiwan and thus break the integrity of this line of defence in the East & South China sea.

As China continues to grow along the dimensions of economics, technology, and military it is thus logical to assume that the U.S. is likely to continue hardening its defences in the China seas. This will likely precipitate in a long drawn out cold war (already underway) with risks of a hot war remaining volatile. An all-out hot war which would involve full engagement of U.S. naval, air, and land forces is unlikely given China has built up significant military capability of its own in recent decades but when you add it together with its strong alliance with Russia, it is safe to assume the combined military power of Russia and China would almost guarantee MAD (mutually assured destruction) outcome in case of a hot war between the U.S. & China in the pacific.

But a lesser form of hot war may involve a combination of U.S. providing military equipment support to Taiwan and either no U.S. troops will be involved or in a very limited and strategic capacity. Similar to the play book of the Ukraine Russia war. In that scenario, economic sanctions will be where the mutually assured destruction will likely be played out between China and the U.S. China's current wealth is largely held in $3.2 trillion of international reserves which includes over $USD 1 trillion in U.S. treasuries, another $217 billion in foreign asset backed securities and $273 billion in global equities. Also, Chinese companies have hundreds of billions of dollars in foreign direct investment in the U.S., Europe, Australia. Thus, U.S. led sanctions and seizure of these foreign Chinese assets will wipe out decades of prosperity that China worked hard to accrue. This will hurt China profoundly!

Interestingly, advanced countries led by U.S. and Europe also have much to lose in case of mutually imposed economic sanctions with China during a lesser form of hot war limited to within Taiwanese borders. China could nationalise much of the stock of Foreign Direct Investments in China, worth $1.9 trillion and also freeze $1.2 trillion of Chinese domestic stocks and bonds owned by foreign investors. Furthermore, Chinese entities have incurred $2.7 trillion of external debt mostly in USD and Euro which they may stop servicing in retaliation.

Thus, in overall numbers, China has about $3.4 trillion of identifiable international assets at risk of sanctions and international investors have $5.8 in investment related exposure to China. China therefore has more margin to inflict economic pain.

Moreover, the above calculus doesn't count the economic fall out of the disruption to the significant trade routes to and from China and Taiwan that service the world's markets. Inflation will be out of control in the advanced economies due to shortage of goods everywhere.

These above considerations will set the parameters for geopolitical rivalry based on economic MAD – mutually assured destruction – followed by more catastrophic nuclear MAD. Therefore, it is improbable that a full-fledged hot war scenario will be played out directly between the U.S. and China.

A more plausible scenario is that Taiwan could well be invaded by China and the U.S. responds with Ukraine like indirect support to Taiwan's military without a direct involvement, there will likely be economic sanctions on China but within a framework agreed to by multilateral trading partners of China. China will also respond with own set of sanctions on what assets it will seize in China and what goods it won't import and export. All this will equate to inflation for advanced economies and losses for foreign investors in China and in their home markets due to sell off in markets.

So, what should a 'set and forget' investor do about the above known unknow China / Taiwan risk? The short answer is build your portfolio's resilience to such a shock by having greater tilt to the US and Australian equities and bonds. From a bottom up perspective, invest in companies that are less dependent on China from supply and demand perspective. And, as we mentioned in last month's column, have some allocation to Gold as a hedge against the worst-case scenario of out-of-control inflation due to a potential hot war and supply disruptions.

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