

NEWSLETTER

June 2023



M & M FINANCIAL GROUP
WEALTH CREATION | INSURANCE | RETIREMENT

Introduction

Welcome to the newsletter for June 2023. Neither the US nor the Australian share markets were spooked by talk of the US reaching it's debt ceiling. And house prices continue to slowly rise. But whether this is sustainable is very much up for question.

Read on to find out more.



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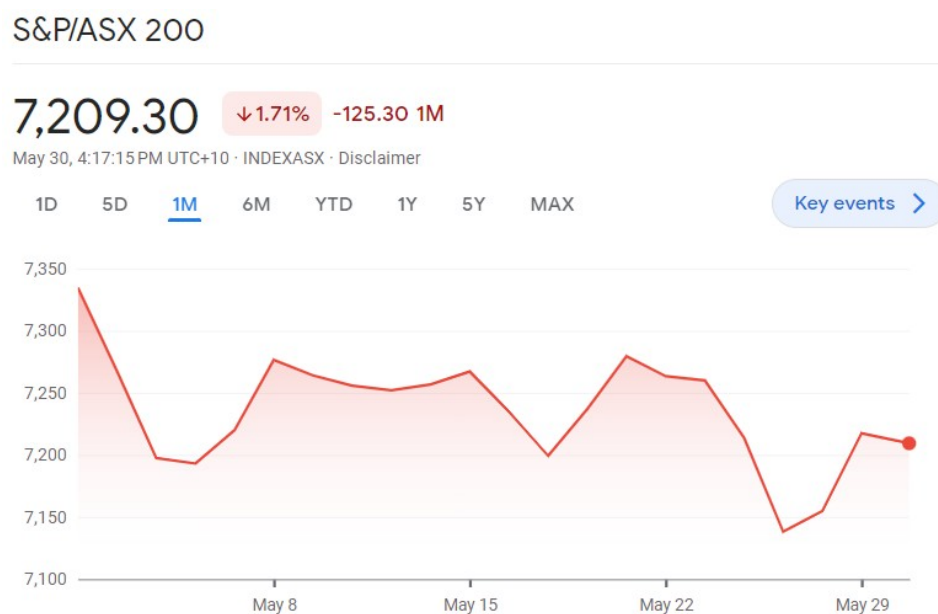
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The Share Market

May was a slightly 'down' month for the ASX. We went to press on Tuesday night (May 30), with one trading day remaining before the end of the month. But at that stage, the market had fallen by about 1.7% for the month, as measured by the ASX 200 (source: ASX and Google):



Not much happened in our share market in May. One issue having some small effect on world markets in May was the 'debt ceiling' issue in the US. The US debt ceiling is a self-imposed limit on the value of US Treasury securities that can be issued. The conventional wisdom is that these securities finance the activities of the US Government, although there is a counter-position that, for countries like the US, securities exist more to provide a no-risk rate of return to domestic savers.

Regardless of whether bonds are really needed or not, the US debt ceiling is a legislated limit. The US Treasury cannot issue securities over and above that limit. Once the limit is reached, the US Treasury needs either to use an alternative source of funds (back in 1953, they sold a store of gold that they found lying around) or it needs to stop spending. This lack of spending would include not being able to pay interest on the existing securities on issue, which would be known as a 'default.'

The US has had a debt ceiling since 1917. It has never defaulted on its debts, because the ceiling has been lifted more than 100 times since it first came into existence. The usual pattern is that the ceiling is approached, some argument takes place about the need for discipline, and then the ceiling is lifted.

Earlier this week, it happened again. There was no real chance that the ceiling would be left where it was and the US Government would be unable to pay for things that had already been committed to. As proof, have a look at whether US investors were 'spooked' as the ceiling was approached during May, in the story told by the S&P 500 index:

S&P 500

4,205.45 ↑ 0.90% +37.58 1M

May 29, 5:39:30 PM UTC-4 · INDEXSP · Disclaimer

1D 5D 1M 6M YTD 1Y 5Y MAX

Key events >

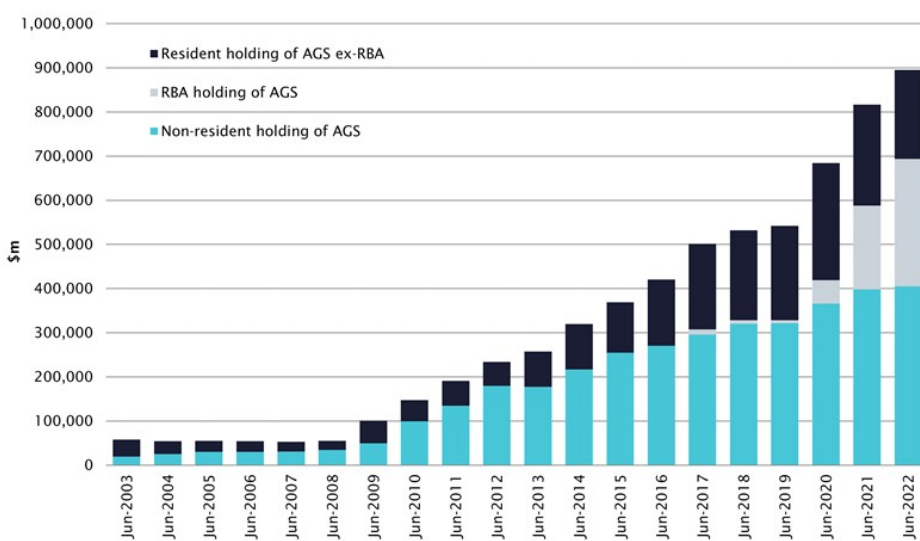


The US market finished the month slightly up, having not fallen by more than 2% or so during the month. This is not a pattern of a stock market worried that the Government was about to default.

So, despite the noise around the US debt ceiling, the US market (and ours as well) took a steady as it goes approach during May.

In case you were wondering, Australia also had a debt ceiling for a while there. It was introduced in 2007 by the Rudd Government and lasted for six years. Our ceiling limited the extent to which our Commonwealth Treasury could issue bonds. The initial limit was \$75 billion and it was increased three times before it was removed altogether by the new Abbott Government in 2013. This relative absence of a ceiling, as well as the fact that the US *always* raises the ceiling anyway, suggests that there is no real need for a debt ceiling. One saving grace for us is that, by not having a ceiling, we are saved from the bad theatre of politicians posturing about the pros and cons of Government securities while threatening to not let new bonds be issued.

As measured by the value of bonds on issue, Australia's 'debt' is growing. This graph from Parliament House shows the total value of Australian Government Securities on issue and the residential status of who holds them:



As the graph shows, of the \$900 billion or so of securities on issue in June 2022, more than half were held by Australian residents. Even more interestingly, around a third were actually held by the Reserve Bank of Australia. The RBA is of course also an arm of the Commonwealth Government, meaning that our Treasury 'owes' \$300 billion to our RBA. This of course means that, from the perspective of the Government as a whole, these bonds cannot be a debt. Treasury's liability is the RBA's asset, and they cancel each other out.

Perhaps you can remember this next time you hear someone refer to Australia's "trillion-dollar debt." A third of the bonds on issue are actually held by the Government itself. This means that any actual debt is a long way south of \$1 trillion.

As an aside, the RBA bought those bonds by simply creating new money to finance a series of purchases throughout 2020, 2021 and into 2022. If you look closely you will see that the amount of bonds purchased by the RBA is pretty much exactly the same as the value of all of the new bonds issued by the Commonwealth during the Covid years. The RBA basically created new money to pay for the pandemic spending.

This is one of the reasons that some people argue that Commonwealth bonds are not really a debt in the way you and I think about our personal debts (which will require us to use future income to pay them off). If the RBA can simply create money to buy back the bonds, in what sense can the bonds really be seen as a debt in the first place?

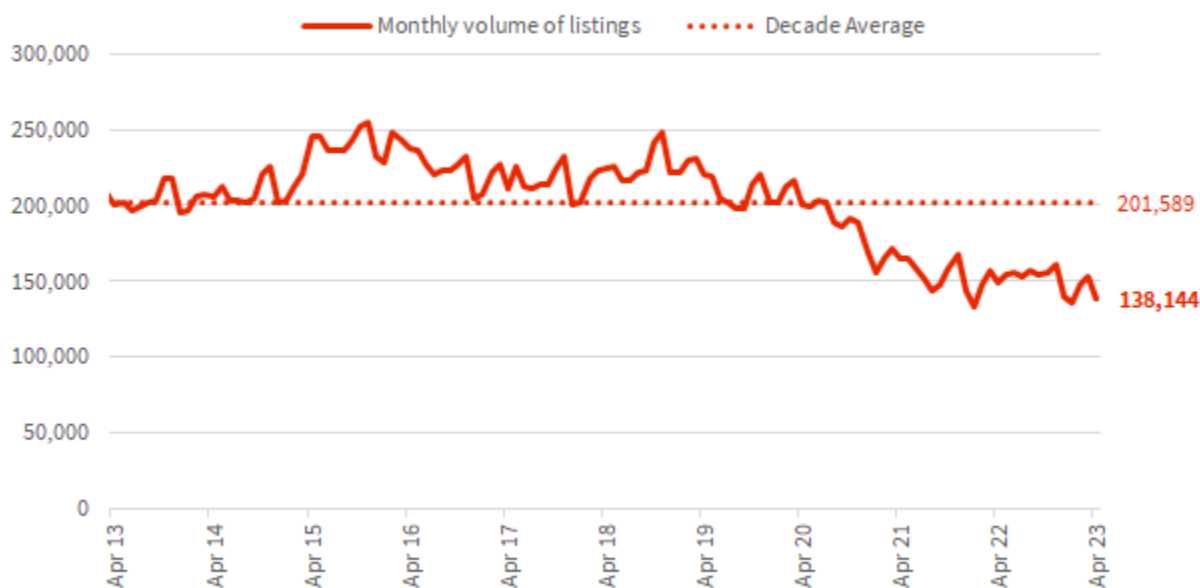
For now, we do not really need to worry about whether Government bonds do or don't constitute debt. We can simply take a lead from the investment markets, who are not showing much anxiety about such issues. After all, the US market actually rose during May, while the US debt ceiling was being approached. Ours was not far behind. It was a boring month.

The Residential Property Market

It certainly looks like the residential property market has bottomed. According to respected market analysts Corelogic there have now been three consecutive months of price growth, spread reasonably consistently across the various state and territory markets.

In their latest report, Corelogic do suggest that they are not sure that the current upswing in housing prices is sustainable. As we have reported previously, there are some contradictory pressures currently operating on the market. One of these is that there is an historically low number of houses being offered for sale at the moment, as shown in this graph:

Figure 1. Monthly volume of total advertised dwellings



Source: CoreLogic

The current rate of listings is 35% below the average over the last ten years, and approaching 50% below the ‘twin peaks’ of late 2015 and late 2018. Relatively few people are trying to sell property at the moment.

Supply and demand continue to be the main drivers of house prices. In any functioning market, low supply drives prices up. How far prices rise depends on the impact of other market influences on demand. Obviously, the 11 interest rate rises since early 2022 have made servicing a property loan more difficult. This has stymied demand and explains why, given the huge reduction in supply, prices are not soaring. Buyers have fallen in pretty much lockstep with sellers, and so prices are not moving.

Corelogic point out that there is some chicken and egg at work here. Falling prices over 2022 discouraged potential vendors from listing their property. Now that prices are rising (or at least no longer falling), that can be expected to lessen. So, supply would be more likely to rise than fall from now on. This would reduce the supply-side pressure on prices and can therefore be expected to be a ‘slowing influence’ on price growth.

And, of course, even if the rises in interest rates are over, those rates are still much higher than they have been pretty much throughout the ten-year period shown above. Servicing a property loan remains harder now than it has been for quite a while. What’s more, simply getting a loan is more difficult now as well. When an applicant applies for a property loan, the potential lender is

required to assess the ability to repay the loan using a 'buffer rate' 3% higher than the actual rate that would apply if the loan were issued today.

According to Canstar, the average standard variable owner-occupier interest rate is now 6.42%. This means that a potential borrower needs to be able to service a loan on which the interest rate is 9.42% in order to be approved for that loan. Nationwide, in March 2023, the average size of a new home loan was \$577,000 (ranging up to \$710,000 in NSW and down to \$456,000 in Tassie).

The average new borrower, therefore, needs not only to be able to immediately pay an interest expense of \$37,000 per year (\$577,000 times 6.42%). They also need to be able to show that they could pay an interest expense of almost \$54,500.

Bear in mind, of course, that for an owner-occupier their interest expense is after-tax. Someone with a marginal tax rate of 32.5% needs to earn \$54,000 to be able to pay \$37,000 in interest. They need to earn \$80,700 to pay interest of \$54,500.

Put simply, these factors are making loans quite hard to get.

What comes next for property prices is therefore not at all clear. Corelogic are not bullish, though. They suggest that the typically-strong spring selling season might see an increase in properties for sale, as people who have been putting off selling in the hope that prices rise might be encouraged into the market by the fact that prices have risen slightly since February 2023. However, given the sensitivities with interest rates, any increase in supply might actually reduce prices if it is not matched by increased demand.

While we will stop short of forecasting, due to the factors outlined above, it remains likely that property prices will stay mostly at the 'mercy' of interest rate rises. If rates start to fall, then we would expect increased demand to lift prices. But if rates either stay where they are or rise, then continued growth in house prices will be difficult to maintain.

All eyes on the RBA next week, then.

The Legal Stuff

General Advice Warning

The above information is general in nature and does not take into account your personal situation. You should consider whether the information is appropriate to your needs, and where necessary, seek professional advice from a financial adviser.

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