ZANACORP

Investment Insight

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Change is constant, relentless and unforgiving. Think back to mid 2020 for just a moment, it wasn't that long ago. Amidst a world wide panic, global interest rates were slashed to 0%, money printing was rampant, consumers bought stuff, investors chased share prices higher and borrowers lost their minds, sending house prices through the roof. Price meant nothing in a world of free money, even though we all knew it could never last. The landscape is less sanguine today, as we pay for countless policy errors and poor investment decisions. 2022 has seen global bond markets suffer once in a generation losses. The cost of everything has risen from a perverse fusion of supply chain disruption, an explosion in demand and workers MIA. Inflation is real. Central bankers have slammed on the brakes recalibrating interest rates from zero to 4%, within 12 months. Investors uncertain of the interest rate peak or whether inflation can be contained, are now reassessing debt, risk and asset prices - finally! No one really knows whether the FED (or RBA) will stay the course in their inflation busting crusade, or blink to avert a panic. Paradoxically, as bankers try to suppress consumer spending, governments seem intent to use fiscal deficits and subsidies to provide consumers with cost of living relief. Do these guys talk to each other? To bedevil matters, decades of international co-operation and trust have been eviscerated. China, Russia, the US, Europe, OPEC and even Australia are at odds over national security, energy supply and trade alliances, erasing many of the deflationary economic benefits of China's rise and 21st century globalisation. Progress moves one funeral at a time. The 2022 list of potential economic fatalities is long. 2023 looks challenging with many unsettled systemic problems. Winter is coming.

Tightening Interest Rates, Until Something Breaks

The Cobra Effect - The Law of Unintended Consequences

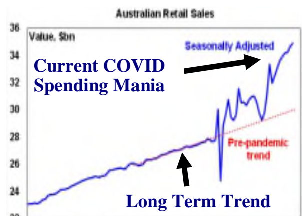
Often, well intentioned regulators seeking to resolve problems introduce poor regulations that unintentionally make them worse.

An instance of this phenomenon can be found in the early 1900's when the British colonial government in Delhi, India attempted to eradicate a growing number of venomous wild cobras appearing on the streets. They decided to offer a bounty for every dead cobra. After initial success, in time, enterprising locals saw an opportunity to make easy money from the government and began **breeding cobras** for income.

Once the government became aware of this they removed the bounty and the then worthless snakes were let loose on the streets, **in greater numbers than before**. This became known as the **"cobra effect"** recognised as a common outcome of many government initiated and funded programs.

In the 1990's, **President Bill Clinton** responded to widespread concern with the explosion of corporate salaries introducing a controversial **CEO salary cap of $1m.** Fair enough. Unfortunately this gave rise to the era of share based remuneration packages, exempt from the cap. Executives became incentivised to grow the company share price and NOT grow the business. Use of **unproductive corporate leverage** to fund share buybacks to elevate share prices, one of many abused tools that led to the GFC and the destruction of corporate capital. Today of course, share price incentives are used extensively around the world, including Australia. They are naively seen to align the interests of management with those of shareholders and have contributed greatly to the offshoring of many local jobs, to maximise profit.

Moving closer to home, our 2020 government stimulus response to COVID left a significant number of Australians with more income, savings and time available to them than when they were working. Hastily crafted JobKeeper rules saw many part time workers and school children earn the same $750 per week as full time workers. This contributed to post lockdown **revenge spending** firstly on imported goods ("stuff") and now on domestic experiences like travel, recreation, hospitality and meals, largely taxpayer funded.



This chart plots monthly Australian Retail Sales. September and October 2022 **broke all time retail spending records.** We are apparently unconcerned about rising interest rates, food, energy and fuel costs. So, until this **exuberant behaviour** moderates the RBA has no option but to lift interest rates higher and higher. In fact it must.

To be fair, many corporates also exploited our COVID-19 stimulus measures including Harvey Norman, Premier Investments and Grill'd proving government benefits can and will be abused for profit even by those least in need.

Leaving the greatest cobra effect until last, let us now address the outcome of the COVID fighting 2020 **RBA** decision to relax lending criteria and reduce Australian interest rates to the lowest level in Australian history. Oh no.

RBA Emergency Cash Rate Of 0.1% Until 2024. Yeah Right!

Emergency measures were taken out world wide to manage the COVID-19 pandemic. This was an absolutely necessary and appropriate response to an emergency situation. However, as the financial emergency passed, both monetary and fiscal regulators over-reached. In the consumption driven US, Federal and State fiscal **stimulus measures went way too far, for way too long.** Sound policy measures became the victim of their ideological divide as both conservatives and progressives spent like drunken sailors.

In Australia's far more debt driven economy, the RBA assuaged borrowers by stating plainly and often (**but not promising**) that the new **"emergency"** interest rates would remain until 2024. The **RBA Term Funding Facility (TFF) lent $188bn to our banks at 0.1%** who on-lent those funds at irresistibly low rates to unsuspecting borrowers to buy or refinance their 1st home, a larger home or sea change/ tree change property at record rates and at record prices. The RBA saved the economy by boosting all asset prices, especially **houses, now representing 70% of all bank lending**. Job done.

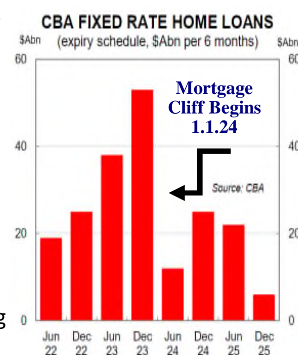
(As for savers or retirees, at that time, they were rewarded with effectively 0.05% pa deposit rates, condemning them to second class citizenship).

In a variation of the cobra effect, **to protect existing borrowers from possible default, the RBA TFF incentivised a greater number of often new (younger) borrowers, with inadequate capital and/or income to take on big home loans at very high prices.** This is reminiscent of the 1980s Pyramid Building Society policy debacle. For Victorian readers, enough said.

To compound this mess, although all the banks got RBA TFF funding for 3 years at a fixed 0.1% rate, many borrowers took out variable **"honeymoon loans"** at sub 2%. This means as our banks currently enjoy **"super profits"** first home buyers many of whom are now in **negative equity,** have effectively become their indentured servants (slaves). A lesson to be remembered.

The RBA failed to read or accept the obvious monthly signs of GDP growth and rising inflationary pressures throughout 2021. It did nothing. To catch up, they have ratcheted up rates at a rapid clip. Aussie borrowers on variable rates, relying on consistent RBA guidance, have had the **cash rate increase from 0.1% in April 2022 to 3.1% in December 2022.** Home loan rates have increased from 2% to over 5%. In retribution for its duplicity, **RBA bond losses were $37bn in 2021/22 wiping out its entire capital base.**

The brutal change in lending rates has hit variable rate borrowers first. The CBA Fixed Rate Loan chart shows that 67% of remaining fixed rate borrowers, currently sheltered from the 2022 rate rises will unfortunately face the mortgage cliff by 2024 **when an affordable 2.5% home loan becomes a 5% nightmare**.



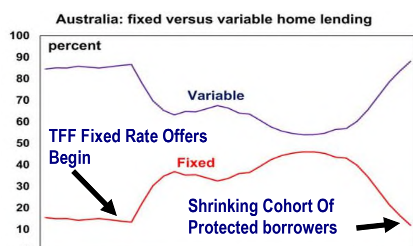
This predicament is a somewhat home grown problem as **Australia's debt profile is mostly variable,** unlike many other countries. The RBA followed world rates down possibly failing to properly map our unique pathway back up.

Household Debt Hazard - The Future Is Not The Past

Australia has accepted massive profits selling fossil fuels to the world and is destined to prosper in the decades ahead from our abundance of both old and new green energy resources. Booming exports and ever declining interest rates helped us side-step 3 world recessions over the last 25 years and enjoy an unstoppable rise in asset prices and passive wealth. **As people earned more from rising asset prices than working**, borrowing has became a learned behaviour. Leverage created wealth and thus both a household's strength and its Achilles Heel—**no fear of debt.**

In Australia (and the world) that elegant formula worked, as falling interest rates and rising growth came without inflation. With inflation, interest rates tend to rise, asset prices fall and debt hurts. That is today's reality.

There is something special about Australians, our householders borrow more than any other comparable country and most of it at variable interest rates. With ever falling rates, it never paid to lock in loans. Until 2021.



Source: ABS, AMP

The RBA Conundrum

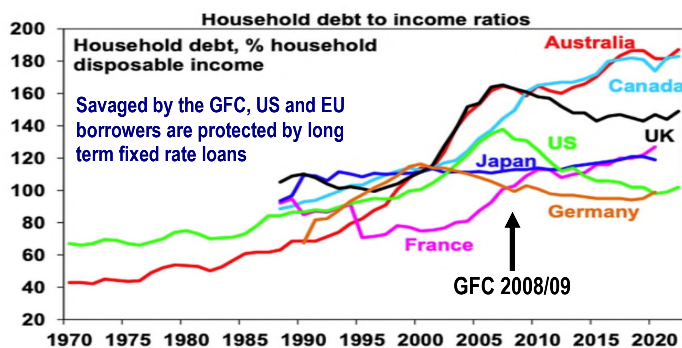
Many ultra low fixed rates set in 2020 for 2 or 3 years mature in 2022 or 2023 reverting to variable interest rates at precisely the wrong time. Borrowers are now trapped.

House price warning lights should be flashing for us all.

In contrast, **US borrowers** learned valuable lessons from the GFC including the risks of short term fixed rate debt (ARMs). **85% have 30 year fixed rate loans**, **mostly below 3.5%.** Although now 7%, most existing homeowners are sheltered from the storm. Rate rises still impact new borrowers and new home sales which are falling, but for the US, this is not GFC 2.0.

Peruse below, the **Household Debt** chart. It somewhat speaks for itself.

Observe the change in the debt % trajectory of the US, UK and German households to that of Australia and Canada, both beneficiaries of China. Canada has lifted interest rates to 4% and is facing recession with property price falls of 10% - 15% (as is NZ with rates of 4.25%). Are we next?



Source: OECD. ABS. RBA. AMP

Why Have Interest Rates Risen So Quickly?

Our November 2019 Insight introduced you to MMT (money printing). You may wish to refer to it on our website **www.zanacorp.com.au** under the Newsletters tab. Our piece specifically articulated what many economists then believed - **increasing money supply will lead to inflation**. Unfortunately the 2020 onset of COVID and the frenetic explosion in debt/money supply that followed, concealed this pernicious threat. By late 2021 global inflation was apparent but incorrectly dismissed as transitory. Come 2022, **inflation has become every nation's millstone and obsession**. Businesses, workers and consumers are now factoring in inflationary expectations in their every day behaviours, entrenching the problem.

The Ukraine War, ongoing Chinese lockdowns, food/commodity shortages and European energy crisis merely compounded an existing dilemma.

The only tool available to bankers to combat inflation is **INCREASE INTEREST RATES** until it is eradicated, 1980's style. NZ and Canada moved early and hard on interest rates and are in trouble with rising unemployment.

Our previous view that the FED and RBA will stop tightening has altered. To fight inflation, we believe each intend to be diligent, especially the FED. **We now expect interest rates to go somewhat higher and STAY HIGHER FOR LONGER, especially in the US.** Expectations of a FED "pivot" to save markets and investors appear misplaced as even **4% inflation** is now just a hope.

For the next year or two, all investors need to unlearn the lessons of the last 15 years of post GFC painless market dips anaesthetised by unlimited monetary support, QE and falling interest rates. In those years, **bankers feared deflation pursuing growth - at any cost. There's that cobra effect, again.**

So What Could Break?

To restore its credibility with markets, FED Chair, Jerome Powell wants markets to strain as part of an excess purging process. Barring bonds, none have shaken out so far. If they remain elevated, it is likely he will continue to raise US rates (a perilously lagging instrument) until any one or more of either the **corporate credit market, share market**, **property market, employment levels or even a sovereign nation BREAK.** The FED sees its only inflation busting tool as an induced economic recession, taking the heat out of labour markets, demand from supply chains and money out of consumers' wallets.

This could shatter confidence around the planet. In financial matters the US leads the world, **their pain is our pain.** It is likely to be a 2023 event, as such, we have not made significant changes to client portfolios in 2022. Although markets are generally lower than at the beginning of the year, **we have felt it necessary to participate in the anticipated short term rallies typically early in a bear cycle**. These rallies have kept 2022 portfolio losses very low.

We expect to take pro-active action in early 2023, **the cyclical year of fear.** 2022 repriced risk, the "P" in market "PE". 2023 is likely to impact reported earnings, the "E". This lagging indicator is usually the most damaging to asset prices and the inevitable result of rising costs and slowing growth.

We remind paying clients that **interest rate hikes take time to bite and their impact is delayed. Although lower 2023 prices may be painful, they present opportunities for long term investors** to make outsized gains**.** Doing so demands an individually tailored game plan and process that manages risk in an uncertain future. We have a range of strategies ready to deploy.

As current interest rates have risen, some savers are now mistakenly looking at cash/term deposits as long term solutions. This "certain outcome" mindset is destined to lead to another cycle of missed opportunity. Deposit rates are high because the banks need to repay the TFF over the course of 2023. They need depositor's cash, just for now and are paying for it. **Do not confuse 3% - 4% short term deposit rates with 6%+ long term rates of return.** Investing capital as asset prices decline has always been a superior strategy.

Where To For Australian Interest Rates?

There are simply too many unknowable variables both domestic and overseas for anyone to predict interest rates with any degree of confidence. All anyone can do is apply well reasoned arguments to support their position.

Hot employment and retail spending conditions and a construction industry/property market remaining significantly above pre COVID levels, should lead the RBA to continue tightening rates. Expect a **terminal interest rate of 3.35% - 3.95%** (still below inflation levels) and home loan rates at 6%. Prudent borrowers should prepare for rates at the higher end of this range.

Importantly should unemployment rise or house prices fall say 10% during 2023, as we expect both will, we would NOT expect the RBA to drop interest rates quickly. **They will attempt to hold them at 3% or higher** to wring out excess debt in the system, cool down markets, re-educate all borrowers and still leave themselves room to lower rates later in the cycle, as necessary.

During 2023 it is likely we will all know someone in **negative equity** or suffering **mortgage stress**. These terms will become part of our everyday vernacular, as they once were. Dealing with such concerns, we expect new "tools" to be made available to assist stretched borrowers and keep them in their current homes. Perhaps **30 year mortgages are extended to 35 or 40 years** or limited access to existing **preserved super,** even means tested **tax credits.**

As the crisis period of the Fourth Turning unfolds, new approaches and new solutions will be adopted to meet the new challenges of future generations. Boomers are no longer in control of government, so they should expect less from it. **Many sacred cows may soon need to be sacrificed.** Such is life.

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