

Australian equity markets this month finally reclaimed the 6,000 point level, for the first time since March 2007, before peaking at 6,854 in November 2007. Meanwhile, most global markets have soared substantially higher than their 2007 peaks. Many are 60% - 80% higher than their 2007 levels. So it is that Australian shares, once the darling of investors, languish relative to their more dynamic IT, industrial and diversified international peers. Despite sailing through the GFC relatively unscathed, our markets and our economy rely heavily on businesses that dig or lend and consumers that spend, is becoming fatigued. However, the jobless rate remains low, iron ore prices are high and our construction, gas, tourism and education sectors are booming. All is not well but neither is it bad.

Populate Or Perish

The unending debate continues over Australian house prices, affordability and debt levels. This edition of Investment Insight seeks to add colour to one of many of the critical variables that make up what appears to be an unsolvable equation, immigration.

Since being founded in 1788, Australia has always been a land of migrants. Our title "Populate or Perish" was a call to arms phrase spoken by Arthur Calwell in 1945, Australia's first Minister for Immigration. At that time, we had a population of **7 million people**.

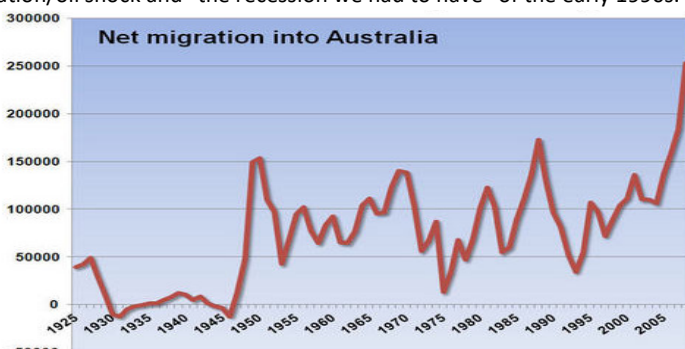


Shaken by the bombing of Darwin in 1942 by the Japanese, a sleepy Australia found itself undersized and vulnerable to external attack. Then PM Ben Chifley, quickly engaged Calwell to embark on an ambitious post war population reconstruction program, made up initially (as in the past) of British migrants, commonly known as Ten Pound Poms.

Soon after, the narrow "White Australia policy" was redefined to include WWII displaced persons, mainly Europeans. In 1950, we had accepted over 153,000 migrants, mostly Christian artisans & labourers who inhabited all parts of our country building roads, houses and schools and working in factories. Under the direction of government, a common condition of entry for non-British migrants was that they undertake many "unwanted" low paid jobs building critical infrastructure across regional Australia. The Snowy Mountains Hydro scheme is an example. In a post WWII world, **opportunity came at a price, it was not a right.**

At the time, the citizens of our small, insular and substantially British nation, were understandably fearful and distrusting of migrants arriving from Europe, many of whom were not Allies. **Concerns were high, that foreigners would "take our jobs". In fact, they created many new ones.** This economic outcome is not lost to current politicians. (Ironically, it may have been the origin of the current Federal politicians' citizenship fiasco diverting their attention from the jobs they were elected to do).

Over the ensuing decades the relatively smooth assimilation of overseas people and cultures expanded to include people from all continents, enriching our nation with true diversity. Migration levels varied between 50,000 and 150,000 pa interrupted only by cyclical economic booms and busts. We now have **24.7m people**. The diagram below clearly demonstrates the impact of the Korean war of the early 1950s, the 1970s stagflation/oil shock and "the recession we had to have" of the early 1990s.



Source: Australian Historical Population Statistics

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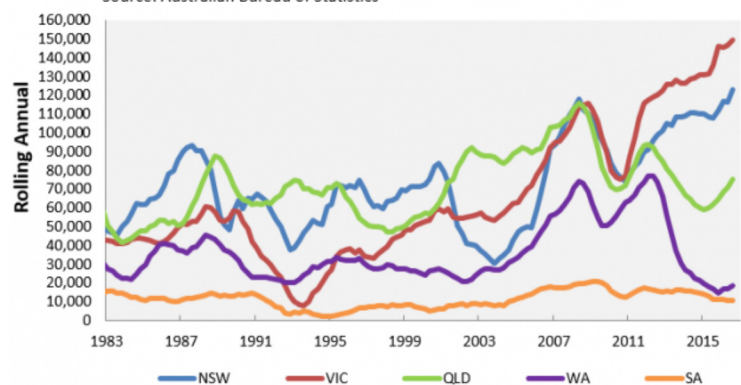
It is insightful to observe that immigration peaked before each of these events and then plummeted. Although there is no provable causal relationship between the two, one could conclude however, that rising immigration contributes to rising demand/growth and favourable business conditions until the point that it leads to an unsustainable boom.

Australia's 26 Year Miracle

Despite at least 3 major global economic downturns, the 1990s Asian crisis, the dot-com bust and the GFC, Australia side-stepped each recording a now OECD record of 26 years of continuous economic growth. That our island is distant, resource rich and has a unique financial oligopoly does not explain this record. A better explanation is that labour reforms in the 1980s, trade reforms of the 1990s and tax reforms in the 2000s each contributed to a more robust and durable economy. Significantly we must add to these, the decision at the turn of this century to encourage population growth by Howard/Costello via both renewed immigration and the domestic "baby bonus". The Federal Government raised Australia's permanent migrant intake from an historical average of around 80,000 pa to over 200,000 pa currently. This policy remains intact today.

Australian Population Change

Source: Australian Bureau of Statistics



Part of the 21st century "big Australia" rationale was to grapple with our ageing population. No less important was the knowledge that migrating job ready workers aged between 25 and 45 with either skills or money will **ABSOLUTELY INCREASE GDP**. Fearful of recession, politicians became acutely aware that a rapidly growing population increases demand for everything, food, housing, goods and services and even more children. The economic success of this 17 year strategy is demonstrably undeniable. Yet it has come at a cost. Paradoxically, **many of the early new wave of migrants introduced to deal with our ageing workforce problem have now themselves become part of the problem.** So too has the humanitarian family reunion (non-skilled) intake associated with those migrants.

Take a moment to study the above Australian Population Change graph by State over the course of 34 years. What is very noticeable is that since 2003 the overwhelming increase is concentrated in Victoria and NSW. In particular, we know that the population increase is disproportionately borne in the capital cities, Melbourne and Sydney. This new population trend statistically contrasts all previous population patterns.

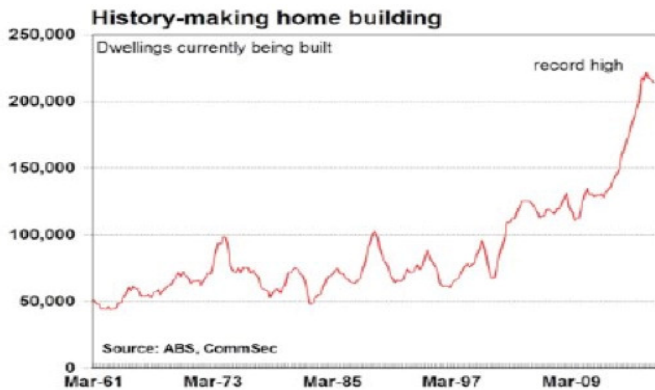
In the absence of any prior Federal planning, it appears obvious that the infrastructure capacity of our 2 largest cities to absorb a sudden population explosion has been found wanting. Simply replicating 20th century policy in a 21st century economy exposes the expediency of the strategy.

Unlike the past, infrastructure today is largely privatised, driven by profit and slow to invest. Public transport is stretched, energy costs are high, hospitals are full, child care is expensive and roads/freeways are infuriatingly congested. Housing construction costs and prices are exorbitant extracting gains from the demand/supply mismatch, reminiscent of the mining boom and fuelled by low interest rates and overseas buyers. **GDP growth it seems, does not mean improved standard of living. BANG!** Whilst cities with the high population growth suffer housing supply and affordability problems, housing in regional Australia, withers on the vine.

The Construction Boom

To remedy the rising demand for houses, dwelling construction is currently at all time highs. This has led to shortages in all building trades and after tax labour rates that most lawyers would be envious of.

Building activity has become one of our biggest GDP growth drivers and employers. This is good. However, remember what has happened after every immigration boom? It better not happen this time.



Therein lies part of our county's dilemma. **We are economically reliant on high levels of migration, high levels of construction, high home prices, low unemployment, high levels of debt and low interest rates and solid investment returns.**

Each of these is dependant on the other and each contributing to a discretely different problem for different sectors of the economy. The concern if anyone should have one, is the sustainability of the status quo. The lessons of history suggest we should expect something will change, as they always do.

Take a look at the above Home Building graph covering the last 56 years of construction activity. Please excuse this now dated expression but that really looks like the "mother of all booms". NEVER in history, have such extraordinary conditions prevailed, unless you believe **this time it's different?**

There Is No Panacea

Despite the efforts of our greatest economists, that there remains no answer to Australia's great housing debate, is testament to its complexity and its uncertainty. This is compounded by vested interest groups who have profited from inept policy making, exploiting opportunity.

We have not touched on the leakage of over \$1 trillion of capital fleeing China and disrupting traditional valuation models in other property markets such as Hong Kong, Canada, UK, US and of course Australia.

We have not discussed negative gearing or CGT exemptions on the family home. We have not discussed mortgage stress, SMSF's, "liar loans" or interest only rate hikes.

We have not discussed demographics, downsizing, retirement living, reverse mortgages or even Aged Care accommodation. All of these play a part in the housing market and warrant due attention and analysis.

Be aware that our simplified and brief discussion of the impact of current migration into Australia and some of the associated consequences merely scratches the surface of some challenges to our current domestic economy. In a way, all it does is introduce **known unknowns**. These are factors economists are most aware could change, so they are monitored diligently by the RBA, ABS, ATO, FIRB etc. We shall leave discussion on the more debilitating "unknown unknowns" for another day.

Want Lower House Prices? Anyone?

To conclude our article, a simple question must be asked and answered. Aside from first home owners, who really wants lower house prices?

We have seen the carnage that happened overseas from falling house prices, surely no one would seek that here? Recently released ABS figures show that **housing now makes up about 55% of the gross assets** of Australians. Our property wealth is worth 3 times as much as our superannuation, demonstrating why **80% of Australians retire reliant on at least some or all of the Age Pension**. There's that "asset rich cash flow poor" mentality we keep referring to. You can't pay bills with capital growth. Many retirees choose to have no money, rather than sell their home.

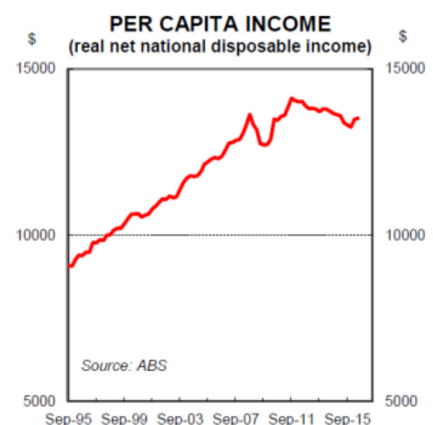
The Australian Housing of Research Institute, the RBA and a string of anecdotal statistics suggests that **non-housing consumption increases by between \$1,000 and \$3,000 for every \$100,000 home values increase**. This "wealth effect" feeds directly into our economy and must surely be considered a good thing. Put simply, we spend more when house prices rise. This phenomenon has **underpinned both the "lend" and "spend"** parts of our economy for years. Naturally this mechanism also works in reverse. **Should house prices fall, we spend less**. Now that is a situation no politician wants to contemplate, much less be responsible for. Aside from ending our miracle GDP run, it would most likely result in an election loss and some form of economic recession.

If immigration stays high, and interest rates stay low, do not count on a property price collapse, it just will not happen. That does not preclude however, a 5 year property price coma. Welcome Jerome "Jay" Powell, soon to be Chair of the FED. The world awaits your every word expecting more US interest rate rises. And for a final word on interest rates:-

We continue to be mindful that many Australians dig a deeper hole for themselves by continuing to go deeper into debt and spending equity.

With broadly flat incomes, at a time of prosperity and interest rates set at **BELOW the 2008 emergency levels**, rising debt means less disposable income and rising mortgage stress.

Stretched borrowers, rest assured, the RBA knows this, which is why it **CANNOT** raise home loan rates to "normal" any time soon. However, they should ponder their ability to adapt to changed conditions.



POST SCRIPT

Following our July feature on Melbourne apartments, a recent announcement was made that Tower Melbourne, a 71 storey project at 150 Queen Street has been scrapped, with all deposits soon to be refunded. Could this be the canary in the coal mine?

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