EL&C Baillieu
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Australian Strategy Insight

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Investment Strategy

RBA pre-emptive policy and mounting moral hazard

Australia's Reserve Bank continues to deploy a pre-emptive policy strategy, easing policy when expecting below-trend growth and/or below-target inflation. In a speech last week, RBA Governor Philip Lowe indicated that official rates, already cut from a record low 1.5% to 0.75%, could be lowered to a mere 0.25%; though he set a higher bar on adoption of quantitative easing.

The RBA's recent stimulus appears to have reignited the housing bubble and pushed equity valuations to the second highest on record – but so far it has failed to reignite the real economy.

In our view, the RBA's continued pre-emptive policy strategy, continued at emergency rate levels, is intensifying moral hazard, encouraging risk-taking in the belief that the RBA will always bailout weak property markets. This is Australia's version of the Greenspan "put" (now called the Powell "put") where markets expected the US Federal Reserve's chair to always ease policy to rescue a weak equity market. An outcome of this policy strategy in the US was the Technology, Media and Telecoms (TMT) equity bubble of 1999-2000 and the housing bubble of 2007-08.

In Australia's case this policy has driven extremely high household debt levels and very inflated asset prices, with home prices back near record levels and the ASX 200, on a forward PE above 17x, a level only exceeded in 1999-2000. The ASX 200 Industrials ex-Financials is at a record valuation (Figure 1). But rate options are now exhausted, with the cash rate at-or-around the zero bound. Australia is out of monetary policy options should we see a China downturn, a full-blown trade war or domestic downturn – not our forecasts, but real possibilities.

Investment implications: With the RBA out of conventional policy options, investors should be very wary of chasing record Australian asset prices. We see lower risk, less expensive options in international equities.

Fig.1: ASX 200 Industrials ex-Financials forward PE is at a record high

Source: IBES, Reuters, EL&C Baillieu

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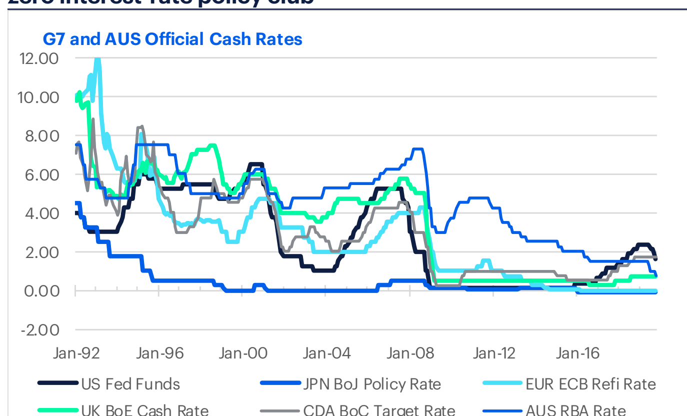
- Australia's Reserve Bank (RBA) has successfully used a pre-emptive policy strategy for decades, easing policy when expecting below-trend growth and/or below-target inflation, and tightening when expecting strong above-trend growth. Recently, the RBA cut rates from a record low 1.50% to just 0.75%, and in a speech last week RBA Governor Lowe indicated a willingness to cut rates to a mere 0.25%; though he set a higher bar on adoption of quantitative easing (QE).
- The RBA's recent stimulus appears to have reignited the housing bubble and pushed equity valuations to the second highest on record, but so far failed to reignite the real economy.
- In our view, the RBA's continued pre-emptive policy strategy, even at emergency rate levels, is intensifying moral hazard, encouraging risk-taking in the belief that the RBA will always bailout a weak property market. This is Australia's version of the Greenspan "put" (now called the Powell "put") where markets expected the US Federal Reserve's chair to ease policy to rescue a weak equity market. An outcome of this policy strategy in the US was the Technology, Media and Telecoms (TMT) equity bubble of 1999-2000 and the housing bubble of 2007-08.
- In Australia's case, the outcome of this policy strategy is extremely high household debt levels, very inflated asset prices and exhausted rate options, with the cash rate at-or-around the zero bound.

Australia joins the ZIRP club, without a downturn

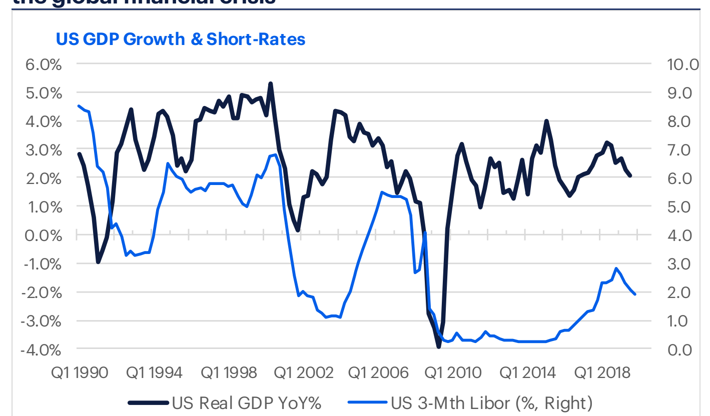
- The RBA has cut Australia's cash rate to just 0.75%, or within 25bps of what we deem to be "effective zero" – the point at which it will be unlikely for a cut in the official cash rate to drive any pass-through into mortgage rates.
- With a sub-1% cash rate, Australia joins Japan, the Eurozone, parts of peripheral Europe and the UK in the emergency zero interest-rate policy (ZIRP) club (Figure 2). Only the US and Canada appear to have escaped from the vortex of zero rates, and even then after a period of more than eight years.
- Australia's path to ZIRP has been very different to the other members of the zero rates club. All other club members resorted to emergency rate levels in *response* to an economic emergency: repeated deflationary downturns in Japan, the global financial crisis in the US, Canada and UK, and the Eurozone sovereign debt crisis in Europe (Figure 3). By contrast, Australia has embraced emergency ZIRP without a downturn, using this extreme policy measure as a part of normal counter-cyclical policy.

Fig.2: Australia's official cash rate has joined the emergency zero interest-rate policy club



Source: Datastream, EL&C Baillieu

Fig.3: The US Fed adopted emergency zero rates in response to the global financial crisis

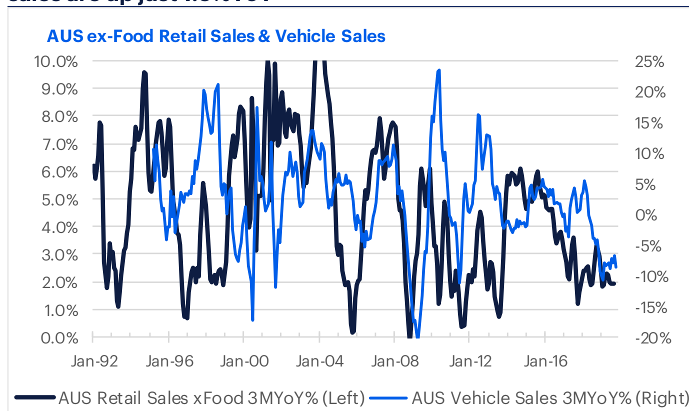


Source: Datastream, EL&C Baillieu

The impact of the recent policy easing

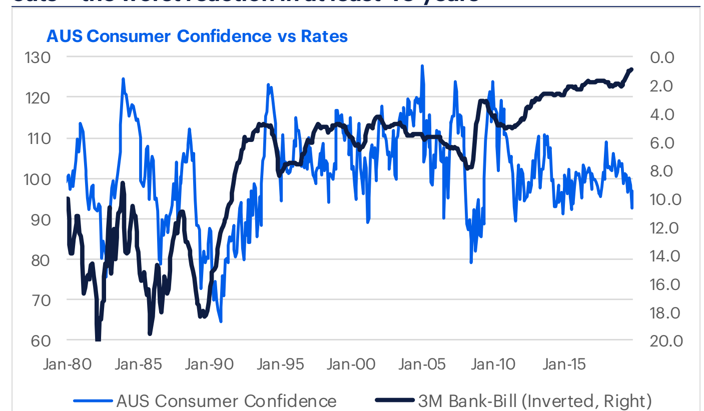
- The RBA's recent 75bps policy stimulus has so far had a muted impact on the real economy, but a strong impact on asset prices. Seven of our nine "canaries in the coalmine" – early warning indicators – remain weak. In particular, we note:
  - Falling vehicle sales, down 8.7% YoY on a three-month moving average (3MMA – Figure 4);
  - Soft ex-food retail sales, up just 1.9% YoY (3MMA – Figure 4);
  - Weak consumer and business sentiment, with the former down 6.0% YoY (3MMA – Figure 5);
  - Soft dwelling approvals, down 19.7% YoY (3MMA);
  - Falling ANZ Job Ads, down 11.4% YoY (3MMA); and
  - Sluggish tourist returns and arrivals, up 1.6% and 3.5% YoY respectively (3MMA) – both eight-year lows.
- The two canary indicators showing strength – home prices (up 5.7% over the 5 months since troughing in June) and owner-occupier (ex-refinancing) housing finance (up 11.4% since a trough in April) – are primarily associated with asset prices rather than the real economy.
- In our view, the underlying Australian economy faces significant headwinds – falling residential investment, the loss of multiple drivers of growth (in particular, the NBN rollout, the LNG ramp-up and RET investment boom), squeezed households and stall-speed risks – that tend to outweigh the tailwinds from easier monetary and fiscal policy, and better-than-expected (but now slipping) commodity prices.

Fig.4: AUS vehicle sales are down 8.7% YoY, and ex-food retail sales are up just 1.9%YoY



Source: Datastream, EL&C Baillieu

Fig.5: AUS consumer confidence has fallen, despite RBA rate cuts – the worst reaction in at least 40 years



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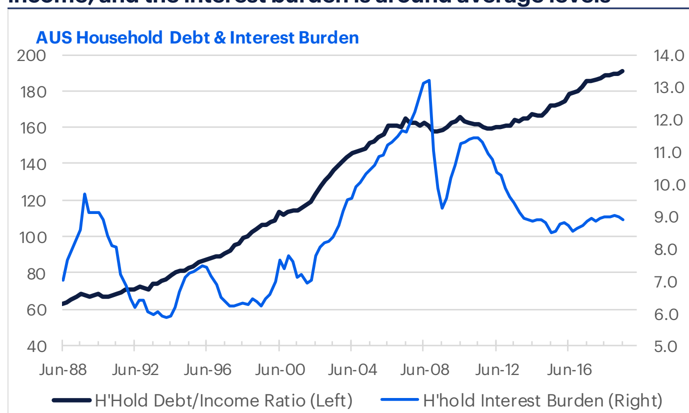
The housing rebound and intensifying moral hazard

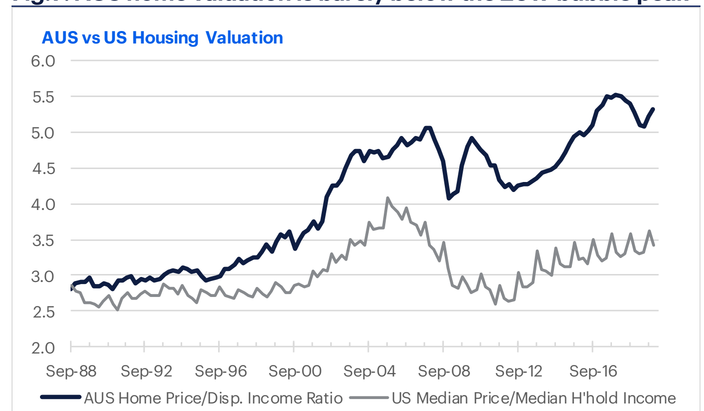
- The RBA's policy stimulus – supported by APRA's easing of its interest rate buffer regulation – has had its most significant impact in the established housing market. Home prices have rallied a sharp 5.7% and housing finance has rebounded 11.7% since mid-year low points. While transaction levels remain low, they are beginning to respond to the price recovery, with New South Wales residential settlement volumes up 2% YoY in October (though still down 5.4% YoY on a 3MMA and 29% from the peak).
- In our view, however, this surge of stimulus from the RBA and APRA occurred before the excesses of the prior boom had unwound. Consider the following:
  - **Record household debt:** At a record 191% of disposable income, debt levels have not been reduced at all by the housing downturn (Figure 6). This sharply contrasts with the US where household debt is now 96% of income, down from 134% at the pre-GFC peak. Even most of Europe has seen a material reduction in household debt.
  - **Extreme debt levels amongst those with mortgages:** With ~40% of households holding a mortgage, and mortgage debt 75- 90% of household debt, the debt ratio for households with mortgages is more like 4-5x disposable income on average.
  - **Near-bubble record home valuation:** After peaking at a record 5.5x disposable income, the value of the housing stock fell to 5.1x ratio, but this was the pre-GFC peak, hardly a low level (Figure 7). With the sharp rebound in home prices, combined with anaemic growth in incomes, the ratio has probably recovered to 5.3x, barely below peak levels.
  - **High interest burden:** With rates cut to about effective zero, we estimate the interest burden has fallen to ~8% of income, not far below the long-term average 8.7% (Figure 6). When combined with record debt levels, and the new enforcement of interest-only limits, we estimate the debt burden – including principal repayments – is around 17% of income. Again, this sharply contrasts with the US, where the debt burden is a record low 9.7%, down from a peak 13.2% pre-GFC.
- That said, the speculative end of the property market has been slower to respond to the RBA stimulus than owner-occupiers. In value terms, investor financing has bounced 8.3% versus a 17.3% bounce for owner-occupier (both ex-refinancing). The stock of outstanding investor loans is declining, albeit by just 0.2% YoY. This has reduced the share of investment loans – using updated RBA data – to ~37%.

Fig.6: AUS household debt is a record 191% of disposable income, and the interest burden is around average levels



Source: Datastream, EL&C Baillieu

Fig.7: AUS home valuation is barely below the 2017 bubble peak

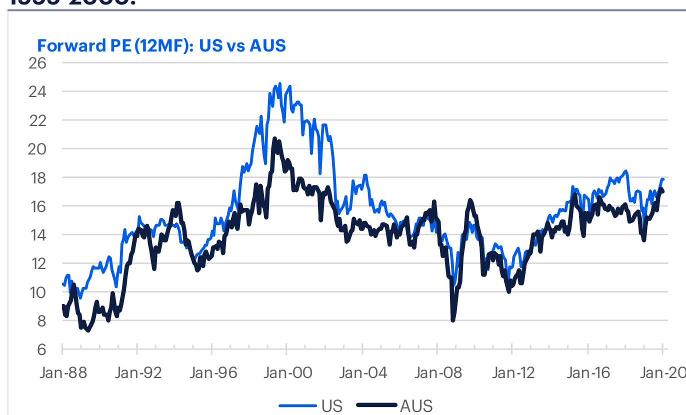


Source: Datastream, EL&C Baillieu

The dangers of moral hazard

- As in prior home price downturns, the RBA "put" has come into effect, with RBA rate cuts rescuing the market. Indeed, in the home price declines of the GFC, the resources boom and the current downturn, the RBA has eased policy on each occasion, limiting the downturn.
- These pre-emptive policy actions, designed to reduce economic volatility and prevent downturns, have had the undesirable effect of encouraging home price speculation and debt accumulation. This moral hazard is now reaching a breaking point, with another speculative price burst, at near-record valuations, but with rates now pushed to effective zero.
- Home owners and investors seem to believe that this policy strategy can go on ad infinitum, but the limit has been reached. On our bank analyst view, the RBA's next 25bps rate cut will likely see just a 6-9bps pass-through by the banks, with the final rate cut to a 0.25% cash rate seeing an even smaller response.
- The equity market is seeing a smaller version of the same phenomenon. Maturing term deposits are being shifted into the equity market in an effort to preserve incomes. Investors are yet to appreciate that this shift out the risk curve is associated with downside – as well as upside – volatility.
- On most metrics the Australian equity market is on the highest valuation outside the period during the US TMT bubble of 1999-2000. The forward PE of more than 17x is just 5% below the US valuation (Figure 8). Adjusted for sector weight differences, Australia is actually trading on a 4-26% premium to the US (Figure 9). Stripping out Resources and Financials, the valuation is an extreme record of more than 24x (Figure 1).
- This valuation is not being driven by expectations of a strong rebound in earnings growth. In fact, it is quite the opposite: earnings revisions over the past four months have been very negative, down 5.7%, reflecting weak bank earnings, a broad range of profit warnings and a softening of Australian commodity prices.
- On the contrary, it is a reflection of the RBA's liquidity support, driving rates to effective zero (ZIRP). As noted earlier, this pre-emptive emergency policy contrasts with the US and Europe which adopted these policies in response to an emergency. In our view, extreme policy measures should only be used in extreme circumstances, not as part of normal counter-cyclical policy. Consider the policy options open to the RBA should a China downturn, intensified global trade war or domestic downturn – not our forecasts, but real possibilities – happen in 2020-21!

Fig.8: AUS PE above 17x is the highest since the TMT bubble of 1999-2000!



Source: Datastream, EL&C Baillieu

Fig.9: On a sector-adjusted basis, AUS is on a 4-26% premium to the US market

Sector	ASX200 Fwd PE	S&P500 Fwd PE
Cons. Discr.	21.8	21.4
Cons. Staple	23.8	19.8
Energy	14.5	16.6
Financials	14.5	12.9
Health Care	34.7	15.5
Industrial	27.2	16.7
Info Tech	33.5	20.7
Materials	13.1	17.6
Real Estate	17.5	43.3
Communic.Services	18.4	18.3
Utilities	22.8	19.5
Total	17.3	17.8
ASX200 on US wts.	22.4	26%
S&P500 on AUS wts.	4%	16.7

Source: Datastream, EL&C Baillieu

Investment implications

- The RBA faces difficult policy choices – in continuing to ease policy, despite signs of limited success, it risks further stoking asset and debt bubbles. With an expensive equity market, with declining earnings expectations, we see better options in international equities. World equity markets are more than 1 PE point cheaper than Australia at 15.9x. In addition, they are supported by policy easing and are without the systemic challenges facing the RBA. Investor sentiment is also generally cautious, particularly in the US. As such, we are overweight international equities, with a bias to ex-US markets.

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