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MBMG Investment Advisory Update

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Australia: Still lucky or on the brink? *PART ONE*

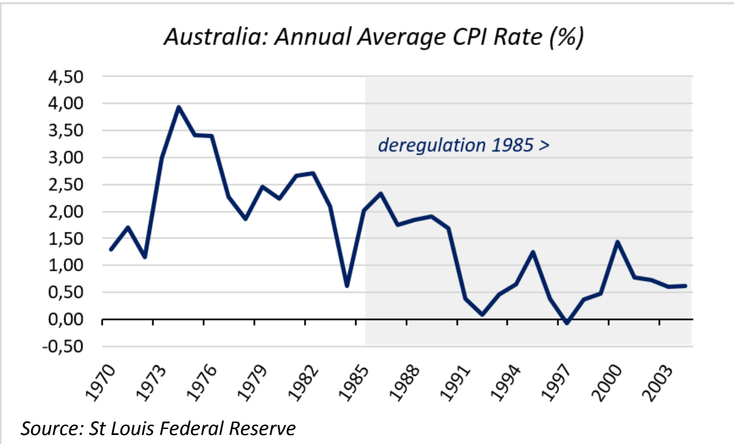
Paul Gambles, Managing Director

Is the Australian property market truly resistant to a bubble burst, or is it just a disaster that's taken a while, but is now ready to happen?

For the last five years or so, I've been warning about a future crisis in Australia. So far, it hasn't come to anything. But that doesn't mean to say that the danger has passed.

That's because this economic threat comes in the form of a housing price bubble. As any student of 2008, or even medieval and ancient history, will tell you – bubbles don't go away. Instead, they just inflate and inflate. The problem is we never really know when the maximum capillary length has been reached and the whole thing pops, taking investors with it.

In Australia, the bubble began in the mid-1960s but really came of age with the deregulation of the financial sector from 1985. This removed lending controls on banks, with the aim of opening financial markets up to greater competition, allowing savers to earn more interest and borrowers to take on loans at lower rates of interest.[1] This created a new low-inflation, low-interest-rate economic environment in Australia,[2] (mirroring other "liberalizations" that promoted similar consequences in many other markets).



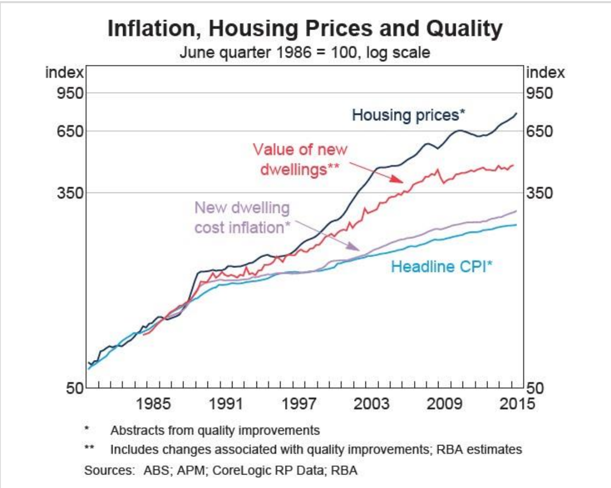
[1] http://fsi.treasury.gov.au/content/downloads/PubSubs/000090d.pdf

[2] See ABS data

This sounds all very good in theory: more competition in the banking sector means a better choice for customers, as commercial banks vie for market share. The problem is that when it comes to loans, as individuals, we don't necessarily know the full implications of what's on offer – as we all saw with the US subprime crisis in 2007/2008.[3]

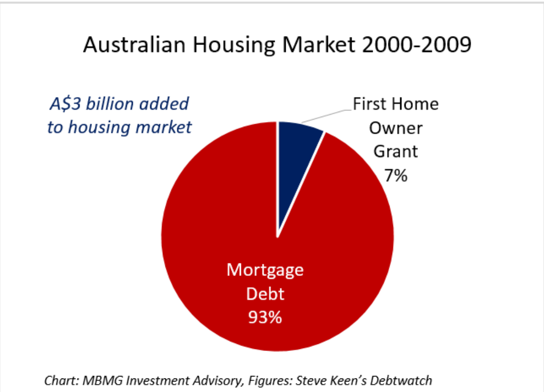
Once people get easier access to mortgages, house prices go up. As house prices go up, people have to borrow more to buy a place to live. In the face of escalating prices, the government embarked on a series of *First Home Owner Grant* programmes. The amount depends on the state: most give out between A$10,000 and A$15,000 towards a place and the Northern Territories government offers A$26,000.

Yet again, though, this helping hand has contributed to a further increase in the price of a home at a rate way above inflation and actual values.



Source: Steve Keen

In just the first nine years of the grant scheme (2000-2009), the public sector contributed A$200 million to the housing market to date. Yet, at the same time, there was an A$2.8 billion increase in mortgage debt – *Australia's sub-prime lite* as Steve Keen, my colleague at IDEAeconomics, called it.[4]

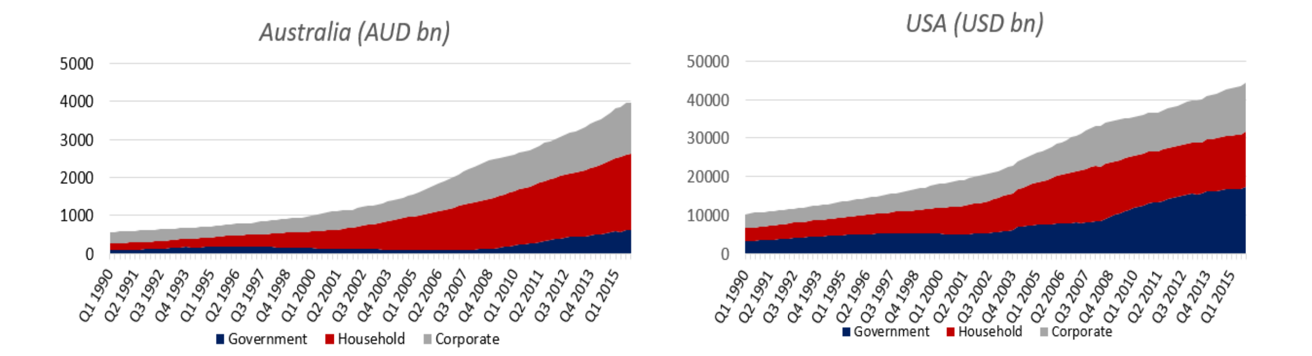


[3] http://www.investopedia.com/articles/economics/09/financial-crisis-review.asp

[4] http://www.debtdeflation.com/blogs/2009/03/22/fhb-boost-is-australias-sub-prime-lite/

The consequence of all this is spiralling household debt; which Australia has been experiencing since the early 1990s (see chart below).

Private & Public Debt



Source: BIS

The global economic situation doesn't help Australia either: largely due to asset values and interest rates. Overall, share prices have risen significantly over the last seven years. This was particularly true between 2009 and 2013 when, then Federal Reserve chairman, Ben Bernanke used quantitative easing to deliberately push up stock prices, in an attempt to boost US economic growth.[5]

Between 2011 and the end of 2014, bond prices were also on the up; although since then government bond prices in general have tailed off.

In addition to QE, several central banks have embarked on zero-interest-rate, or even negative-interest-rate, policies in a forlorn attempt to promote consumption, through cheap borrowing. The problem with this policy is that it was private debt which was a major contributor to the global financial crisis in the first place. In fact, whilst public debt levels seem to gain governments' concentration, they are dwarfed by private debt.

As Steve Keen recently pointed out, a large part of the growth that Australia has enjoyed since the GFC, while many other countries plunged into recession, has been fuelled by a 60% rise in household debt, encouraged by the RBA. He explains that Ireland did the same thing when they called themselves the Celtic Tiger, "and they don't call themselves that anymore," he added. "Spain was doing the same thing during its housing bubble and [Australia has] replicated the same mistakes."[6]

In the context of global economic performance – certainly in the form of stagnant GDP amongst the G7 countries, as well as Australia – all this means that assets are hugely overpriced and there is still a mass of household debt.

[5] http://www.washingtonpost.com/wp-dyn/content/article/2010/11/03/AR2010110307372.html

[6] http://www.abc.net.au/news/2016-07-29/australia-headed-for-recession-next-year,-professor-keen-says/7674154

In Part Two, I look at the excuses being made for house price overvaluation, why the bubble hasn't yet burst and what could happen when it does.

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For further information, please contact us by e-mail on info@mbmg-investment.com or call +66 2 665 2536.

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