TRILOGY news
"the property investor's mortgage broker"

NEWSLETTER | ISSUE 5

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INFLATION & INTEREST RATES – WHERE TO FROM HERE?

Speculation abounds as to what the Reserve Bank will do when they convene next week to make a decision on interest rates. Up, down or nowhere for the fifteenth consecutive month in a row?

Most are favouring the latter option right now, suggesting continued low inflationary figures will see them maintain the current status quo.

However, some analysts suggest that a one-dimensional assessment of inflation is missing the mark, and that the RBA's monthly interest rate deliberations are becoming increasingly complex as our domestic fortunes become more intricately enmeshed with the global economy.

Inflationary issues

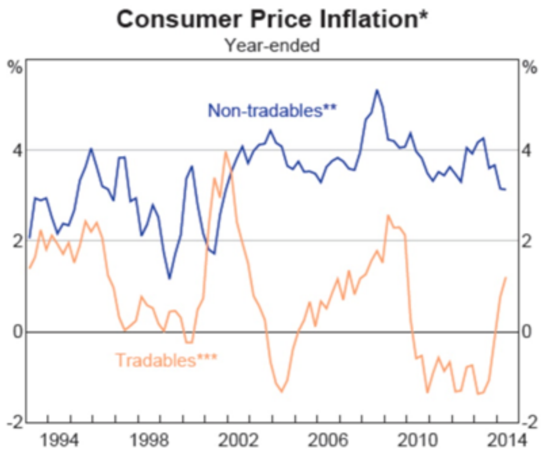
Inflation forecasting requires an intimate understanding of tradable and non-tradable goods. What's the difference? Well, essentially:

- The value and movement of **tradable goods** is largely influenced by international competition. Tradable goods are the things we buy that originate in overseas factories, or services supplied by global companies. Think TV's and computers, or overseas travel.
- **Non-tradable items** are more domestic based goods and services – things that by and large can only be provided locally, such as hairdressing, residential home construction and utilities. These are less directly exposed to global economic ups and downs, and more reliant on local fundamentals like wages, return on capital and net taxes.

The issue the RBA increasingly faces is a divergence between the inflationary rate of tradable versus non-tradable goods. This is particularly evident over the past two decades, with Australia's labour force and domestic service provision becoming more diverse at the same time as overseas markets have become more accessible.

The above graph demonstrates that inflation has been notably more stable and higher on non-tradables than tradables over the last twenty years, although the cyclical variations of both are relatively comparable.

While the official inflation target for the RBA is between 2 and 3%, inflation on non-tradable items has increased at a rate of 3.7% per annum over the past decade.



* Adjusted for the tax changes of 1999–2000
** Excluding interest charges prior to the September quarter 1998, and deposit & loan facilities to June quarter 2011
*** Excluding volatile items and tobacco
Sources: ABS; RBA

Australia has been enjoying the positive effects of an unprecedented, once in a lifetime terms of trade boom, which put upward pressure on the exchange rate, and in turn lowered the price of imported, manufactured goods.

This enhanced the spending power of Australian households and motivated consumers to pay more for domestic goods and services.

Experts suggest that as the terms of trade boom begins to unwind, which our stabilizing exchange rate would suggest is now occurring, inflation on tradable goods may moderate in the short-term, before increasing significantly over the next couple of years, particularly if the Aussie dollar drops to around US80c.

In turn, these lower terms of trade would weigh on domestic wages and stifle the buying power of Aussie households, a process potentially spurred on by rising unemployment.

Analysts suggest this could all represent a conundrum for the RBA, with the distinct possibility that inflation may surge in the short-term due to the exchange rate, while growth remains below trend.

The big question then is, will the RBA step in and attempt to correct things with an interest rate rise? Will they risk stalling domestic growth in a bid to curb imported inflation?

Watch this space for a special Trilogy Report next Tuesday, when we share the RBA's October interest rate decision and explore how the central bank is working with APRA (Australian Prudential Regulation Authority) to help put the brakes on Australia's property sector.

5 WAYS TO PROTECT YOUR INVESTMENT PORTFOLIO – ARE YOU PREPARED FOR AN INTEREST RATE RISE?

Most articles that promise words of wisdom as to how you can protect your investment property portfolio focus on things like insurances, cashflow buffers and 'the perfect' loan product. Our approach is a little different.

Really, the only way you can maximise your chance for successfully sustaining and growing a wealth generating property portfolio, irrespective of the financial climate we find ourselves in at any given time, is to start out with the right approach.

That means blocking out the background hype that often circulates around our property markets and getting right to the heart of your own, personal reasons for becoming an investor and seeking financial freedom through real estate.

Often when there are changes in circumstances that impact property investors, such as interest rate fluctuations, the ones who continue to prevail are the ones with a watertight strategy.

5 WAYS TO PROTECT YOUR... (CONT.)

So here are 5 ways you can prepare yourself to survive the inevitable, upward ascent of interest rates, whenever it happens.

1. Cut through the noise

This is difficult because property and finance spruikers, along with enthusiastic media commentators, are yelling ever louder in their efforts to be heard. The trick is to focus on your own personal investment strategy, working confidently toward your goals in a methodical, planned way.

Having a solid, risk assessed approach will mean you've accounted for the highs and lows of property cycles, as well as interest rate environments and taken the necessary precautions to maintain your foothold when financial markets move in a different direction.

2. Avoid being reactive

It's easy to look around at the bevy of activity currently underway in most major housing markets and feel like you're missing out if you don't buy something immediately!

Usually though, when everyone else is jumping on the bandwagon, you're better off making an exit. If another property acquisition is timely for you right now and complements your current position, property portfolio and overall investment strategy, then by all means shop away. Just don't be fooled into thinking you'll lose out on an opportunity by remaining on the sidelines for now.

3. Count your chickens

Times like these are a good opportunity to reflect on how far you have travelled on your property investment journey and review your portfolio. Critically and objectively assess your investments against your set goals and measure where you are at this juncture. Is this where you wanted to be? Do you have some catching up to do? Or have you exceeded expectations?

Depending on your assessment, you will know whether now is a good time to buy or not. And maybe, if you happen to have a bit of an investment lemon in the pack, it could be a good opportunity to liquefy an asset and look for a better replacement?

Importantly, review your property investment finance structure. Are there better banking deals you could be taking advantage of, or is now the perfect time to access existing equity and refinance?

4. Be selective when taking advice

The hotter our property markets become, the more armchair experts emerge at dinner parties and backyard barbecues, proclaiming their extensive knowledge of all things bricks and mortar and extolling the virtues of some new property investment strategy or spruiker.

Don't be tempted to take advice from Uncle Ian, no matter how compelling his argument for investing in Guatemalan pigmy enclosures might seem.

Instead, continue to seek out guidance from those experts within your investment circle who understand real estate and are an integral part of your journey, including a qualified accountant, mortgage broker and buyer's agent.

5. Don't get caught up in timing quandaries

Many property investors end up missing opportunities because they become distracted and lose focus on their own path. Likewise, some jump at opportunities that would be better left alone and end up creating obstacles for themselves and their investment portfolio's long-term success.

Timing the purchase of property assets must be based solely on your own life circumstances and investment ideals. Market timing should never become a major influencer in your overall approach.

Just because interest rates are low and 'everyone else is doing it', is not a good enough excuse to throw yourself into the current frenzied property waters, especially if doing so might jeopardise your long-term retirement income.

Staying on track rather than following the herd is the best way to protect your financial and property investment portfolio. This approach sees successful investors climb all the way to the top of the property ladder; navigating any interest rate bumps along the way, without missing a beat.

HOW TO THE COMPARERS COMPARE?

With a growing array of credit and insurance products floating around Australia's financial ether, product comparison sites are increasing in popularity with consumers.

But how do the comparers compare in terms of quality of information and resource provision? And how do you, the consumer, utilise these product finders to your advantage?

When cute meerkats don't cut it

New player **Comparethemarket.com.au** – yes the one with the meerkats – muscled its way into the Aussie online comparison arena in recent times. However the UK based company has fallen short of its goal to dominate the digital space, alienating wary users who are required to provide their name and a valid email address before utilizing the product finder.

This has been a boon for local site **Finder.com.au**, with Compare the Market failing to represent any real threat to their surging business success.

According to website ranking service Alexa, Finder.com.au enjoys the lion's share of visitors to its product comparison portal. Not only does it boast 17 page views per visitor and more than 15 minutes on average spent surfing the site, it also lays claim to 10% of all new credit card applications originating from its product finder.

Inside information suggests Finder.com.au, which originally commenced in 2006 as creditcardfiner.com.au, generates up to $1million in revenue every week. The site currently has 13 product segments for consumers to browse and is blitzing the Brits' Comparethemarket.com.au, despite their popular and extensive meerkat marketing campaigns.

More products and less clever promos

Aside from the issue of users navigating away from the site when asked to provide personal details, industry experts say the range of comparable product sets on Compare the Market is not extensive enough to pose any real threat to Finder's ongoing popularity.

However Compare the Market still attracts more visitors than either **InfoChoice** or **Canstar**, with the latter, Brisbane based organisation being the oldest of all comparison services. Canstar is best known for its widely recognised gold star ratings and alongside InfoChoice, claims 2 million site visits per year.

Nine Entertainment's RateCity, which draws its data from Canstar, is the second most visited banking product comparison resource in Australia at present.

However while the quantity of visitors to RateCity might be impressive, the quality is an entirely different issue, with Alexa reporting that site surfers only remain for an average of three minutes and click through to just 3 pages.

Then there's relative newcomer Mozo, which relies heavily on its partnership with Fairfax to generate click-throughs to financial institutions. Mozo insists it is Australia's largest banking product comparison service, although it attracts the least site visits of all the major players.

HOW DO THE COMPARERS... (CONT.)

How do you compare?

A recent Financial System Inquiry suggested these types of product comparison services should be more entrenched in the fabric of the local finance industry.

Of course product finder companies have latched onto this idea and say it would provide better transparency and enhance healthy competition to benefit consumers.

Such a move would undoubtedly see more of these sites popping up in increasing numbers over coming years, particularly as savvy online shoppers continue to seek out comprehensive information around large financial decisions like loans, credit cards, insurances and other financial services.

While these sites can be incredibly useful for these smaller ticket items, there are still limitations when it comes to home loan products.

Given the ease of access people have to mortgage brokers nowadays, going it alone, even with the assistance of an online resource, is something I would advise clients against.

This is particularly true for property investors, whose debt structure should closely align with their overall investment objectives and strategy in order to ensure ongoing sustainability and success of their investment portfolio.

If you want to gain true insight into the best banking products for you, as a serious property investor, you simply can't go past the efficacy of a properly qualified and experienced broker who has firsthand experience and investment knowledge. Maybe the next online service we will see is a mortgage broker comparison site…or one that does actually compare meerkats?

DO YOU NEED A BUYER'S AGENT?

Offering consistent returns and tangible bricks and mortar security, it's not surprising that more Australian investors are choosing to add property to their retirement portfolio.

As an investor, you must ensure that any asset purchased meets your long-term financial objectives and more importantly, is feasible with regard to your capacity to derive the desired economic benefit.

But do beginning investors have as much ability to make savvy, wealth producing property acquisitions as the Donald Trumps of this world? Or should you seek expert guidance before jumping headlong into a property deal?

Qualifying property

Australia's housing markets are in constant flux. Right now, while property values are increasing across some major city locations on an almost monthly basis, other areas are experiencing stagnant or declining prices.

Then there's the question of what type of asset would best complement your property portfolio and ensure your continued success in building a viable post-work income.

A properly qualified, professional buyer's agent can be an invaluable source of knowledge on any location you might be considering. They can help you qualify an area and property investment based on:

1. The historical rate of growth and potential future capital gains.
2. Specific streets that represent best value for money and buying opportunities for investors.
3. Local tenant and owner-occupier demographics and what type of property is in constant market demand.
4. Underlying drivers, including the strength and viability of the local economy and industry.
5. Your personal investment strategy and objectives.

Importantly, buyers' agents often have well-established relationships with local real estate agents and as such, may be able to access stock before it is advertised on the open market, giving you the potential to pip the buying competition at the post.

Seal the deal

When it comes to finalizing your property investment acquisition, the fee you pay a buyer's agent can prove to be a very smart investment indeed. A buyer's agent can:

1. Save thousands when negotiating on your behalf, understanding how to parley effectively with other parties and accurately assess the maximum price you should pay for a property, without over-capitalising.
2. Remove the emotion from the transaction to ensure you invest with your head, based on facts and figures, and not your heart.
3. Stand in for you at auctions, using their knowledge of the process to help secure the property at the right price and again, ensure you don't get caught up in the excitement of a bidding war and end up paying too much at the fall of the hammer.

What will it cost me?

So what sort of investment will you have to make to secure the assistance of a properly qualified and experienced buyer's agent? While fees vary, depending on the level of service you engage your buyer's agent to provide, generally the associated costs will be around 1.5 to 3% of the purchase price, plus GST.

If you engage a buyer's agent for the sole purpose of negotiating a deal on your behalf, the charge is typically set at around 1% plus GST of the end purchase price.

Generally, a set fee of around $500 plus will be charged if you hire a buyer's agent to literally 'do your bidding' at auction, with the potential for an additional commission arrangement should they successfully secure the property.

How do I qualify a buyer's agent?

As with anything, not all buyers' agents are created equal. Identifying a good buyer's agent can obviously make all the difference to the success of your property investment endeavours. So how do you sort the chaff from the hay?

1. Are they personally familiar with the property investment game? You want someone who has walked the talk, and has a personal interest in utilizing real estate to create their own extensive property portfolio.
2. Are they qualified? Find out if they have the appropriate knowledge of the property industry and are properly equipped to offer advice on the housing market.
3. What is their track record? Ask to see a history of their recent purchases on behalf of clients and seek out client testimonials.
4. Are they familiar with the local area? You want someone who understands the intricacies of the market you're looking at and the underlying drivers for housing in the area.
5. Do they have the contacts required to find out about deals before they hit the market?
6. Are they industry accredited and associated with a governing body such as the Real Estate Buyers Association of Australia (REBAA)? Do they practice according to a set standard of professional guidelines?

Perhaps the most important question you should ask to qualify a potential buyer's agent is whether they are truly 'independent'. If they accept any type of commission from real estate agents, vendors or developers, you should be skeptical as to their objectivity when suggesting a certain product. Likewise, be wary of a buyer's agent who has his or her own product to sell!

Amid growing concerns that Australia's housing markets are tipping toward a property ownership imbalance, regulators are getting serious about stepping in to slow down the property investment juggernaut.

Some suggest we are now witnessing the side effect of a surge in speculative activity on the part of future retirees, looking to cash in on "generous tax incentives" for Aussie landlords.

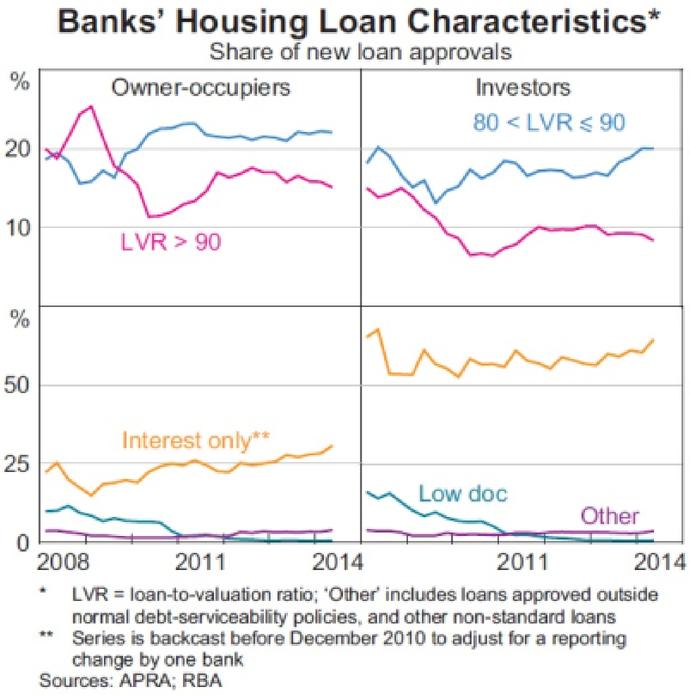
These so-called "speculative investors" have drawn the spotlight in today's swelling wave of market activity. Interestingly, the Reserve Bank of Australia released an article in its September Financial Stability Review, citing the characteristics of Australian property investors and how they've changed over time.

Who are these investors?

Using data from the ATO and the Household Income and Labour Dynamics in Australia survey, the Central Bank tracked changes to the market and its composition.

The report determined that investors are more likely to take risks with their property acquisitions than owner-occupiers, because of our "favourable tax environment" – i.e. negative gearing policies.

For instance property investors, "have stronger incentives than owner-occupiers to take out interest-only loans". Sixty four per cent of all IO loans were attributed to investors between 2008 and 2014, compared with just 31 per cent for owner-occupiers. (See below chart)



Some say the reason is obvious; interest expenses are a tax deduction for property investors, so an IO loan maximises that deduction. Conversely, owner-occupiers take up these loans to save on costs in those first few years of home ownership.

Really though, does this not amount to the same thing for both purchaser groups? Saving money? Saving costs on your loan? So why are investors copping such a hard time? Particularly when the government has incentivized property investment with various policy and regulatory reviews over the last few decades.

And while we're discussing risk, what about the fact that property investors are more likely, according to the RBA report, to hold a lower loan-to-value-ratio than owner-occupier borrowers, thereby reducing their debt exposure?

Investors versus owner-occupiers versus tenants

Owner-occupiers, tenants (who apparently all want to own a home) and investors are being pitted against one another, in the battle for affordable accommodation on the one hand and a decent retirement fund on the other.

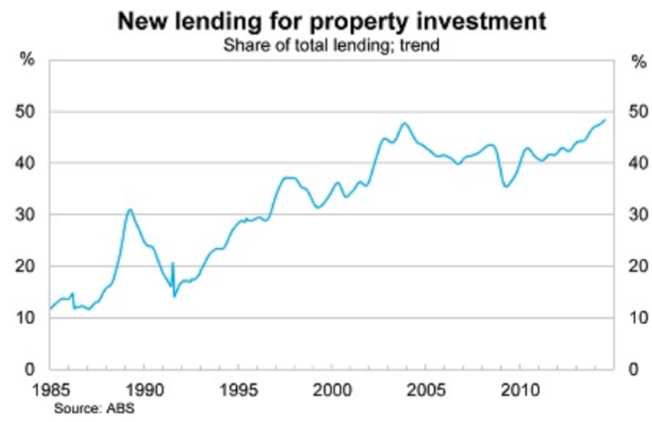
This is being fuelled by media commentaries that teeter on the precipice of scapegoating; with property investors targeted as the primary cause for the latest upward market swing and shift in traditional Australian property ownership ratios.

Analysts have cited the current low interest rate environment and hype around SMSFs, along with favourable tax treatment of income derived from real estate assets, as the reason for investors dominating major capital city markets across Australia for the last 24 months. Oh, and of course, housing affordability.

But really, Australia has long been an anomaly among the rest of the developed world when it comes to our traditional, 70 per cent home ownership statistic. So could it be that we are starting to catch up, with that figure now sitting at 67 per cent?

Forced slow down imminent?

Irrespective of its root cause, the RBA is becoming increasingly concerned with the amount of new investor lending activity over the past few years. The below graph demonstrates a spike from around 2011, with similar peaks apparent around 1990, the end of the last decade and between 2002-2005.



The banking regulator is not entirely convinced that this lending represents a systemic risk, noting most of the "risks associated with lending behaviour are likely to be macroeconomic in nature".

However, it says the broader risk remains due to the $5 trillion tied up in property assets, which accounts for the majority of household wealth and essentially the lifeline for banking sector profits in Australia.

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Concerns over this increasingly "imbalanced lending activity" are now driving the RBA and the Australian Prudential Regulation Authority (APRA), to consider the introduction of macroprudential policies to take some of the steam off property investor activity.

Many experts suggest this couldn't come soon enough, with prices continuing to rise sharply across Sydney in particular.

It's anticipated that the two financial authorities may introduce alternative measures to slow lending in lieu of monetary policy, given their continuing quandary with interest rates and inflation.

With Australian banks among the most leveraged financial institutions in the word, you can understand the RBA and APRA feeling a little skittish about the potential for the wheels to fall off, should the property market swing too far in one direction.

For instance, what happens to all the investment properties those asset-rich, cash-poor baby boomers purchased early last decade (when they were 40-something)?

Those same baby boomers that are now edging closer to a time when they will perhaps need to liquefy a property or two in order to pay for their retirement? Given affordability is already an issue for young Australians, who will have the necessary buying power to purchase that housing stock?

These questions have obviously weighed on RBA Governor Glenn Stevens' mind of late, with him recently suggesting that baby boomers would do well to diversify their asset holdings.

The RBA and APRA have the backing of the Australian government, with Treasurer Joe Hockey giving them the green light to pursue a broader set of policies.

The RBA would not be alone in pursuing this type of intervention, with other world banking regulators taking their own action to exert some force in order to shift the fortunes of local property markets.

In June this year, the Bank of England introduced new rules under which only 15 per cent of new home loans will be allowed to have loan to income ratios of 4.5. This occurred on the back of the Reserve Bank of New Zealand introducing temporary restrictions on lending with higher LVR's.

What could it be?

These sorts of changes to macroprudential policies in Australia are unlikely. Instead, it's anticipated that such measures would be in the guise of enhanced interest rate buffers during periods when interest rates drop low.

Much ado will be made if such macroprudential policies get the go ahead here in Australia. Certainly, it could serve to make the growing issue of home ownership for younger generations more problematic.

But experts say we must remember that this is not a move to address affordability, but to reduce the systemic risk within the financial sector.

Fixing the affordability barrier is a whole other ball game, requiring reform around supply and demand factors with all tiers of government addressing planning and zoning practices to create a more responsive housing supply chain. But that's a debate for another day…