TRILO3Y & news

"the property investor's mortgage broker"

NEWSLETTER | ISSUE 8

EXPERTS PLACE THEIR INTEREST RATE BETS FOR 2015 - BUT WHOSE ODDS ARE BEST?

Interest rates have been a hot topic this year. Of course they're always on the agenda of finance media commentary, given their use as a litmus test for the overall economic viability of our nation at any given time.

But across these markedly different last 15 months, where the Reserve Bank has sat politely on an all time low 2.50% cash rate, you virtually trip over a new opinion piece about what's happening and where rates are heading every time you open your email (I say ironically) or read a newspaper (they still exist I'm told).

I don't think this has happened by chance either. I think it's got a lot to do with two things:

1. There are now **many more micro and macro fundamentals** in a state of significant transition within our increasingly connected global economy. Superpowers are shifting and economies are changing considerably as a result.

It's become nigh on impossible to work out exactly what's going on within the world's political circles and in turn, much more difficult to get a handle on the future fiscal fate of any country really.

Fundamentals are now very much influenced by increasing political interplay and policy, which generally changes with every new elected government, and it's not just on a local level, but a global one.

2. The media mechanisms have a lot more muscle. If you want people to talk about something to do with economic markets, publish it as a news headline with hyped up commentary and scary rhetoric.

We've seen a lot of 'fluff' about our property and finance sectors over 2014 and much of it has been intended to do one of two things – a) increase the current higher levels of demand and activity or b) slow it down…depending on which side of the fence you stand.

It's not just some of the messages that are muddying the waters for all the statistical seers gazing into their crystal balls either, but the sheer volume of news we're inundated with in the 21st century.

Social media, along with digital and print media, has made the delivery of news almost immediate. This precipitous media shift became very apparent when most of the world watched as America's World Trade Centre buildings collapsed on live television back in 2001.

Today's rapid-fire delivery of news is increasingly fuelling market sentiment; causing shorter cycles for the share and housing sectors in Australia, as well as most other developed and developing nations.

Rhetoric or Regulatory rough housing?

Demonstrating the increasing power of media influence, industry regulators APRA and the RBA started talking up the introduction of macroprudential policy around the middle of the year.

They introduced the idea of tightening regulations around 'riskier' lending in the wake of a significant increase in the number of investors flooding certain pockets of the property markets – particularly around Sydney - and causing values to skyrocket in the wake of increased competition for limited stock.

Some suggested this was a tactic intended to put the brakes on all the excitement, in light of a continuing quandary for the RBA…either raise rates and risk stalling the Australian economy entirely (with already weak consumer and business confidence), or sit on them to stimulate the economy, while cashed up investors swoop down on a more affordable (due to the lower cost of mortgages) property market.

Interestingly, market activity did in fact ease slightly at the prospect of investor loan policies becoming more tightly controlled. But was it enough for APRA and the RBA to back off?

Well if last week's announcement is any indication, it seems the monetary policy Gods might be coming to terms with having to sustain the current lower cash rate environment into 2015, but still feel the need to force a slowdown in the property sector.

Investor loans under scrutiny

The Australian Prudential Regulation Authority and Australian Securities and Investment Commission have now joined forces to impose elevated "supervisory intensity" on the rapid growth in loans to investors and related forms of 'higher risk' lending by banks, over coming months.

Lenders deemed to be taking 'undue risks' could be hit with a lift in their target minimum capital ratio by APRA, with some of the 'red flags' including a growth in investor loans of more than 10 per cent and a large volume of higher loan to value ratios.

ASIC also advised it would conduct 'surveillance' into the provision of interest only loans, "as part of a broader review by regulators into home-lending standards." This came off the back of data that revealed IO loans, as a percentage of new housing loan approvals by banks, reached a high of 42.5 per cent in the September 2014 quarter.

APRA also made it clear that they're keeping an eye on the rising trend of owner-occupiers being offered IO loan products by lenders, concerned that this is a reflection of people not being able to service increasingly large mortgages.

This action is a direct response to "strong house price growth in Sydney and Melbourne." With the Council of Financial Regulators, APRA the RBA, ASIC and the Treasury demonstrating a united front in "working together to monitor, assess and respond to risks in the housing market."

However the regulators still seem to be talking things up, rather than taking any real assertive action for now.

What about interest rates?

The reason I spent so much of this piece explaining the evolution of influential interest rate and market fundamentals is to demonstrate how difficult it is to gaze into the future and make any type of accurate forecast. But it's still interesting to see what industry insiders are placing their bets on for 2015 – ups, downs or otherwise.

So here's a quick snapshot of rate movement predictions as we farewell what will be remembered as an interesting and eventful 2014 in the annals of Australian residential real estate.

The banks – Some of the Big 4 have done an about face in the wake of a weakening Aussie dollar. NAB's gloomy business sentiment survey results from the beginning of December, with a drop in confidence of four points and its lowest position since mid-2013, caused it to predict two 25 basis point cuts in 2015.

The NAB said a further drop was 30 per cent likely; otherwise things would remain unchanged until late 2016. Westpac agrees rates will drop further, with their decision motivated by weaker than anticipated GDP figures for the beginning of December.

The economists – 32 economic analysts were surveyed by Bloomberg, with the majority all concurring that while a steep percentage point increase is unlikely, the chance of the cash rate rising by at least one per cent was pretty high.

Speaking to SmartCompany, CommSec economist Savanth Sebastian suggested, "The economic environment is still very patchy…rates won't go back to super aggressive levels anytime soon."

But he added that because forward indicators are improving, some movement toward the end of 2015 is expected; "We will see steady increases next year…even if everything goes right it's unlikely they'll raise by that much. It would create pain in the economy, especially for first home buyers who have taken out loans with wage growth being at the second lowest rate on record."

Sebastian and industry colleague, JP Morgan chief economist Stephen Walters, are both backing a 1 per cent cash rate increase over the course of next year.

In conclusion

In our ever expanding backyard, where so many fiscal fibers are weaving an ever more intricate web of influence over our economic prosperity as a nation, it's difficult to know what might happen in two months, let alone 12. But I would be very surprised if interest rate movements will be bearish enough in 2015 to make much of a difference to your bottom line as a property investor…and I'd lay odds on that.

PROPERTY INVESTING & BEHAVIOURAL BIASES - WHAT INFLUENCES YOUR PURCHASING PREFERENCES?

I don't know about you, but I find psychology rather fascinating. It's interesting that certain external factors and cultural distinctions can influence our behaviours so dramatically.

And let's face it, how humans behave has a major impact on the world around us, particularly when it comes to our financial fortunes and investment markets.

Consider property for a moment and the cyclical nature of our housing markets, which is largely determined by consumer sentiment, among other economic fundamentals.

It's called 'the herd mentality' for a reason. When everyone seems to be positive and upbeat, happy to part with their money for a large, life changing purchase like residential real estate, it seems we all generally feel the same warm, fuzzy and positive consumer glow.

Likewise, when things start to transition and media messages are full of negativity, people tend to lose confidence and become a little more Scrooge-esque with their bank accounts.

Behavioural bias

Standard economic modelling tends to assume that people make decisions by logically weighing up all the variables and available information. However, this doesn't account for human emotion and what psychology experts refer to as 'behavioural bias'.

More studies are being conducted on a global scale to assess the decision making process, in a bid to provide a better reflection of how human behaviours influence financial markets, as opposed to the common theoretical models of how markets should operate – if we were all robots.

Remember I mentioned 'herd mentality'? 'Herding', as the experts call it, is one of the things that can influence investors to make decisions that on any other day might seem a tad irrational. But they get caught up in the pervasive fear mentality and all reasoning goes out the window.

A 2012 article published in the Journal of Investing by Todd Feldman, entitled The Most Destructive Behaviour Bias, sought to test four behavioural biases that can cause investors to make poor financial choices, being:

1. Overconfidence – those investors who believe they are superior decision makers and are therefore more likely to take risks with their investments.

2. Recency or anchoring – investors are inclined to make future decisions based on immediate past events, believing future outcomes will directly correlate with recent occurrences.

3. Loss aversion – the experience of a perceived 'loss' can feel more pronounced than gains to some investors, so they avoid making decisions considered 'too risky', or react and sell assets in the wake of market negativity.

4. Disposition affect – this is essentially where you sell your 'winning' assets early and hang on to your 'lemons' for far too long.

The experiment

Feldman studied four groups of investors who displayed these specific behavioural biases and applied their decisions to a 'virtual investment market'; in order to examine how they're actions influenced the simulated environment.

Depending on their bias, a different amount of funds were invested in equities, as opposed to cash and the investors rebalanced at the end of each period based on share market moves and their methods of investment.

For instance, each month the rational investor would rebalance their investment portfolio back to where they started, based on the long-term variance of the share market. So if the initial investment was based on a 60/40 split in favour of equities, they tried to maintain this.

Whereas the recency investor would consistently look to yesterday to make his or her decisions, putting less emphasis on long-term fundamentals. Therefore, if the market experienced a period of volatility, they were more likely to decrease their equities investment based on the assumption that the recent market instability would continue.

If the market took a bit of a battering, the loss averse investor also pulled back on their equities investment, attempting to lower their exposure. While the disposition investor either bought more or hung on to everything while the market was falling, before selling it all as things started to pick up.

Feldman concluded that the various behavioural bias displayed by the investor groups had a significant bearing on their success in the simulated investment market.

Overall, portfolios owned by those investors who focused on recent events to make their decisions were the greatest underperformers, with the loss averse and disposition investors still not faring as well as the rational investor, but doing slightly better than the recency investor.

Interestingly, the amount of trading carried out was different to each investor group, yet did not determine overall success at the end of the day. The loss averse investor was the most active and ended up with additional transaction costs as a result, but not the best performing portfolio.

What it means for property investors

Although the Feldman model focuses on equities as an investment vehicle, the findings have significance to all investors, including those who trade in residential real estate.

Understanding your own personal behavioural bias is an important aspect to the planning process and in particular, devising an appropriate risk management strategy when it comes to growing your investment portfolio safely.

The more knowledge you have, the less likely you are to be influenced by such biases and instead, make clear, rational decisions guided by your long term objectives and investment roadmap.

Investing requires a disciplined, rational approach, and knowing who you are as an investor will make all the difference when it comes to whether you act from insight and understanding or react from emotion and fear, when presented with different market movements.

THE RBA – EVERY BORROWER'S BFF IN 2015

As we make the momentous transition from 2014 to 2015, ringing in another new year full of hope and possibilities, suggestions abound as to what the Reserve Bank should do with interest rates from hereon in.

After well over a year of an unprecedented low rate environment, officially sitting at 2.5%, the monetary policymaker has gathered its fair share of both critics and supporters from various factions.

Some say it's created much-needed economic stimulus by boosting waning consumer confidence, while others staunchly believe the RBA's ongoing 'do nothing' stance is causing more problems for a property sector, already teetering on the brink of serious affordability and 'bubble' crises.

So whose side will the Central Bank favour when they resume affecting Australia's economic fortunes on February 3rd next year?

A little bit lower now

Research analysts with investment bank Credit Suisse, Damien Boey and Hasan Tevfik, are two advocates for change when it comes to the official cash rate.

They suggest that high unemployment, along with weakening consumer confidence and business sentiment, are good reasons for the RBA to lower the cash rate considerably in coming months.

"We believe that the RBA is not done with its easing cycle. We think that the bank needs to cut rates below 2 per cent," the pair said.

Despite acknowledging the very real conundrum the Central Bank is facing, with serious concerns as to further cuts adding impetus to an already accelerating housing market, Credit Suisse says the cash rate needs to fall slightly below 1.5% to address certain weaknesses in the Aussie economy.

The investment bank claims, according to its forecast modelling, that borrowers should not anticipate another rate rise before late 2015 or early 2016.

"Private sector confidence has declined to below-average levels consistent with weak credit growth," read a Credit Suisse statement.

"The unemployment rate has risen to a cyclical high of 6.2 per cent and is still increasing, consistent with rising spare capacity and subdued inflationary pressure.

"We believe that the model is telling us about the Australian economy's struggles to adjust to a post-mining boom in a post-Global Financial Crisis world."

Stevens says…

Adding credence to the Credit Suisse take on interest rates as we head into 2015, Reserve Bank Governor Glenn Stevens made headlines recently by announcing the RBA's willingness to keep interest rates low for some time to come…as long as the housing market remains in check.

In a speech delivered to the Committee for Economic Development in Melbourne on 18th November, Stevens said the need for stronger growth outside the resources sector justified more "accommodative" monetary policy.

"Inflation is well under control and is likely to remain so over the next couple of years," he said.

"In such circumstances, monetary policy should be accommodative and, on present indications, is likely to be that way for some time yet."

Acknowledging concerns from analysts regarding 'too much, too soon' within certain pockets of the property markets, largely due to investor driven demand, Stevens was quick to add: "But for accommodative monetary policy to support the economy most effectively overall, it's helpful if pockets of potential over-exuberance don't get too carried away."

Answering the big questions

While Stevens is aware of the dangers associated with our fiscal fortunes being too tied up in the housing sector and associated borrowing activities, he assured listeners at the Economic Development 'do' that he's not losing too much sleep over it.

He says while there are signs in the investor housing market that "some people might be starting to get just a little overexcited," he's comfortable with the current per annum rise in credit outstanding to households of 6 to 7%.

Stevens notes, "It is not clear whether price increases will continue or abate. Furthermore, it is not to be assumed that investor activity is problematic, per se.

"A proportion of the investor transactions are financing additions to the stock of dwellings, which is helpful. It can also be observed that a bit more of the 'animal spirits' evident in the housing market would be welcome in some other sectors of the economy."

Commenting on the hype surrounding a potential team effort from industry regulators APRA and the RBA to address lending standards through regulatory change – particularly around higher risk borrowing practices – Stevens says it's all about sustainability and is in no way an attempt to "restrict lending via direct controls."

He adds, "It is not an attempt to restrain construction activity. On the contrary, it is an attempt to stretch out the upswing."

As for any plans to adjust interest rates purely off the back of investor driven market sentiment fuelling property price growth, Stevens says this is not even a remote consideration right now.

What it means for mortgage owners

For a start, think carefully before you consider locking in a fixed rate just yet. Ask yourself, have the banks been particularly generous with their fixed rate offerings of late because they could smell further cuts in the wind? For now, I would be waiting and watching rather than fixing.

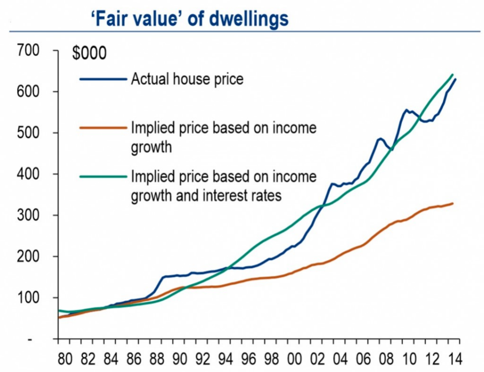
On the upside, it seems that mortgage owners can look forward to ringing in 2015 with a glass of bubbly, celebrating the good fortunes and higher returns afforded by the certainty of lower rates for some time to come. Cheers to that!

Notoriously outspoken regarding Australia's so-called housing affordability crisis and a staunch critic of the negative gearing policies he believes to be the catalyst for over-inflated property values, Saul Eslake seemingly did a 360 recently, on the back of new evidence that our property markets may actually be undervalued.

Merrill Lynch's chief economist released a chart earlier this month that indicates the overall median house price in Australia is actually below implied price, based on income growth and interest rates – see below.

Speaking to Business Insider, Eslake said an anticipated 3.5 to 4% increase in values across 2015, with no change to interest rates, would cause house prices to "converge with 'fair value' estimates based on household income growth and mortgage rates."

He adds that when the RBA starts lifting the cash rate in 2016, as most economists predict, we could witness a deceleration or possible decline in real prices.



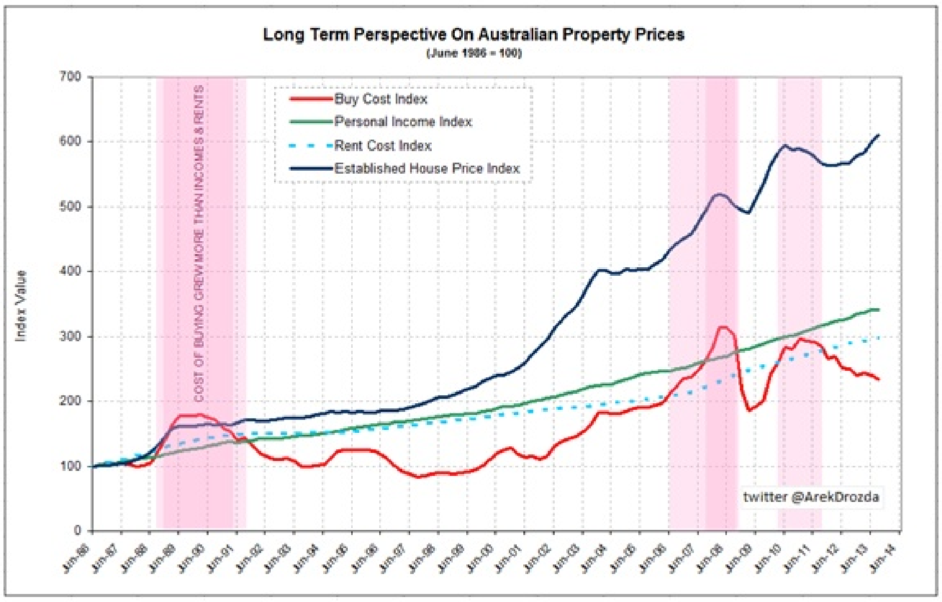
Source: BofA Merrill Lynch Global Research, ABS, RBA

Affordability not "the issue"

Eslake's backflip and the data used to support his revised stance on the state of Australia's housing markets, makes the argument of affordability as a major driver of the property sector in isolation somewhat moot, with an emphasis instead on changes to household income along with interest rates as primary influencers.

Of course, this chart also causes one to question the validity of scaremongers' claims that inflated house prices are causing a bubble.

While there will be some critics who favour price-to-income measures as an isolated indicator, the fact remains that you can't really talk about housing affordability without weighing up all of the interconnected factors at play and logically, that includes interest rates – as is obvious by the increase in market activity off the back of our current, low rate environment.



More at play

Much ado has been made of the disparity between 'disposable household income' and property prices in the past, with this often cited as direct evidence that house prices in Australia are dangerously inflated.

While it's true that median property prices are now as high as six times the average disposable household income, this fact alone is not enough to draw conclusions about affordability.

In order to shed clearer light on what is actually occurring with regard to house prices, independent analyst Arek Drozda says we need to look at several key influences and how they interplay including;

1. Incomes. With a better indicator being double income households as opposed to general 'disposable household income' data that accounts for the averages based on every Australian – employed or not, which is not really a true representation of affordability.

Why? Because for a start, most households that don't have at least one full time breadwinner are unlikely to secure a home loan and therefore, do not accurately represent the average Aussie homebuyer.

2. Rental prices. These are required in order to compare the relative cost of accommodation, since renting is the only other option as opposed to becoming an owner-occupier.

3. Cost of buying. With loan sizes getting bigger and loan terms getting longer, cost of buying is not just about the initial purchase price, with much more consideration given to the ongoing cost of owning property for the long term, including interest repayments, council rates, maintenance and so forth.

When you start to drill down into these measures, the affordability debate requires a lot more detail and analysis than the simplistic 'disposable household income to property price ratio' commonly referred to by many media commentators and analysts.

Testing the theory that all of these interconnected indicators provide a markedly different picture as to the state of housing affordability in Australia, Drozda published his findings in Property Observer at the beginning of 2014.

Drozda's findings reveal that even though property prices have increased six-fold in Australia since the mid-eighties, the cost of purchasing a median priced house has risen less than two and a half times for the same period.

In fact, the increase in personal incomes has been substantially higher over the last three decades, than the corresponding rise in the cost of buying and renting. In other words, buying a house today is actually more affordable than it was almost 30 years ago.

So next time your adult son or daughter complain about the baby boomer generation exerting too much pressure on the housing markets and making their Great Australian dream of home ownership unattainable, maybe you should sit them down and show them a more balanced perspective.