NARROW ROAD
CAPITAL

Credit Snapshots – March 2019

The RBA quietly admits responsibility for bubbly house prices

This month the RBA quietly admitted that low interest rates have played a big part in the rise in Australian house prices. This comes after years of denying the obvious. I say quietly admitted as it came in a "research discussion paper" on its website written by two of its economists. The older of the two is in his 50's and has worked in Treasury, at the OECD and at the US Fed over his career. Here's the summary of the paper:

We build an empirical model of the Australian housing market that quantifies interrelationships between construction, vacancies, rents and prices. We find that low interest rates (partly reflecting lower world long-term rates) explain much of the rapid growth in housing prices and construction over the past few years. Another demand factor, high immigration, also helps explain the tight housing market and rapid growth in rents in the late 2000s. A large part of the effect of interest rates on dwelling investment, and hence GDP, works through housing prices.

In the introduction they note the following key relationships for housing:

a) *Interest rates, income and housing prices have strong and clear effects on residential construction*
b) *Dwelling completions and changes in population explain the rental vacancy rate*
c) *The vacancy rate has a strong and clear effect on rents*
d) *Interest rates, rents and momentum have large effects on housing prices*
e) *Housing prices and construction are mutually determined, so examining bivariate relationships in isolation can be misleading.*

None of this would be surprising to someone who has observed the reactions of ordinary people (or the population as a group) to changing circumstances. But for economists who tend not to work with the real world so much this stuff is a revelation.

Note that the summary mentions lower world long-term rates, rather than directly attributing higher Australian house prices to lower Australian rates. I think that deflection may have been required to get this published as an RBA paper. However, it is clearly left open for people to read between the lines, that the RBA is mostly responsible for the house price growth in 2015-2017. With the benefit of hindsight, the RBA might have some regret over the four rate cuts in 2015 and 2016 that took Australian prices from overvalued to bubbly.

Greece gets an upgrade and a big bond issuance away

In March, Greece was upgraded by Moody's from B3 (B- in S&P terms) to B1 (B+). If this was a corporate credit rating that would be the difference between a company that can barely cover its interest from its earnings (i.e. 1:1, EBIT/interest for a B- rating) to one that has a decent level of coverage, roughly 1.5-2.0 times. On the back of this Greece issued €2.5 billion of ten year bonds at a 3.90% yield.

What an uniformed observer would take the rating upgrade to mean is that Greece is able to make a dent in its debt owed and is on the pathway to paying off its debts. However, some simple analysis shows that Greece is a long way away from making progress and is instead highly likely to default when the next decent downturn occurs. Greece's debt to GDP ratio is 179%, the same level it has been for 5 years. Greece's GDP bottomed in 2016 and has risen somewhat since then, so its debt is actually growing not reducing in nominal terms. The country has committed to running a primary surplus (excluding interest and principal repayments) of 3.5% for the next four years. Yet if the

3.90% interest rate just agreed was used, that would mean a deficit after interest of 3.4% of GDP. However, as Europe is offering Greece cheap funding it ends up at something closer to a balanced budget after interest.

The obvious conclusion is that Greece needs (a) continued economic growth and (b) cheap European funding just to balance its budget. If a recession arrives the budget position will worsen, sending the debt to GDP ratio higher and scarring off bond buyers. If the Germans get cold feet in continuing to subsidise Greece, or if the Greeks rebel against future budget cuts the game could end quickly. A default by Greece would likely see its bonds trading at 10-30% of their face value. Given the current situation, a default is the most likely outcome for the ten year bonds, with a repayment on time in ten years an unlikely outcome.

The standard view is that a default would mean Greece needs to leave the Euro, but the 2012 restructuring didn't require that. Greece would be better off leaving the Euro and having their own currency, which would then force self-reliance, i.e. spend only what you collect in taxes. A depreciating currency would allow Greece to compete with the likes of Poland on the cost of manufacturing and services.

Written by Jonathan Rochford for Narrow Road Capital on March 25, 2019. Comments and criticisms are welcomed and can be sent to info@narrowroadcapital.com

Disclosure

This article has been prepared for educational purposes and is in no way meant to be a substitute for professional and tailored financial advice. It contains information derived and sourced from a broad list of third parties, and has been prepared on the basis that this third party information is accurate. This article expresses the views of the author at a point in time, and such views may change in the future with no obligation on Narrow Road Capital or the author to publicly update these views. Narrow Road Capital advises on and invests in a wide range of securities, including securities linked to the performance of various companies and financial institutions.