Borrow

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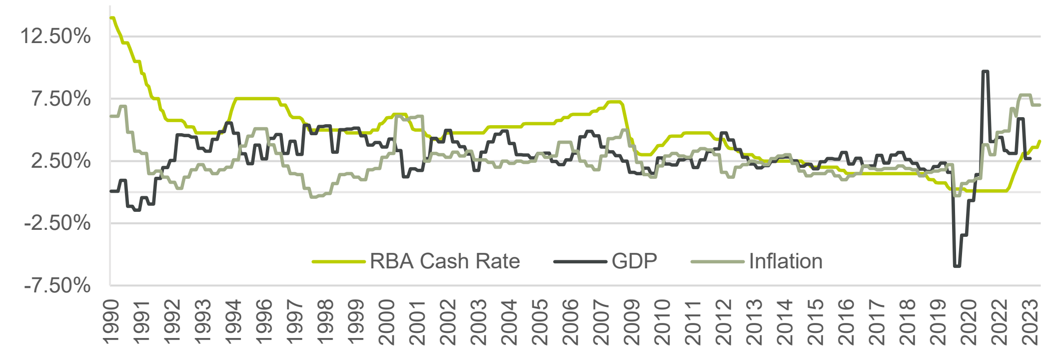
A bumpy path ahead? Is it possible to reduce inflation rates while maintaining positive GDP, low unemployment and wage growth? While optimists would suggest this is possible, history and reality would suggest it is not. Beware of the bumpy path ahead.

Cash Rates, Inflation, Wages and Asset Pricing

- Following the Australian Bureau of Statistics (ABS) release of the latest inflation rates of 7.0% in April (4% above the top of the target range), it was a foregone conclusion the RBA would lift interest rates in June. Accordingly, they did on 6 June, lifting the cash rate a further 0.25% to 4.10%. In doing so, the RBA said, "*Inflation in Australia has passed its peak, but at 7 per cent is still too high, and it will be some time yet before it is back in the target range. This further increase in interest rates is to provide greater confidence that inflation will return to target within a reasonable timeframe.*"
- In Phillips Lowe's speech on 7 June at the Morgan Stanley 5th Australia Summit, he made it clear the RBA would not compromise on its mission to lower inflation to within its target range. In his speech, he made it particularly clear that should this come at the cost of lower GDP and higher unemployment, then this was a necessary cost to reset the inflation base. For borrowers (as this paper mentions), this is particularly important as higher interest rates and higher inflation lead to a material reduction in borrowing power. The issue we see is that the RBA is fighting the battle with one hand tied behind its back, as the federal and state governments appear disinterested in helping with what would be the unpopular short-term task of reducing consumer spending and improving productivity (before mandating higher wages). Instead, they appear more intent on supporting the voting population with hand-outs.

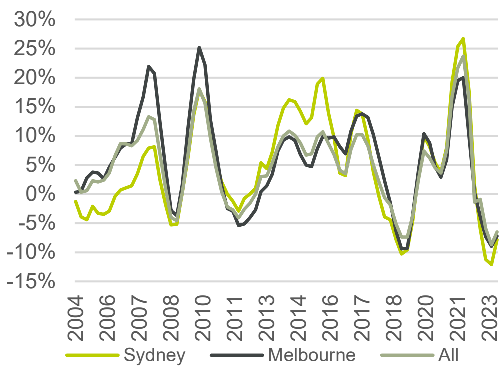
Exhibit 1: GDP, Inflation and RBA Cash Rate



Source: ABS, RBA

Exhibit 2: Wage Growth and Unemployment

Exhibit 3: Annual House Price Movements



Source: ABS, RBA, CoreLogic

Funding Costs

- There now appears to be a noticeable reduction in the RBA asset position; however, not yet enough to reverse the COVID-linked expansion. We expect to see more come off as the major and regional banks repay their COVID term funding facilities which are due for repayment on or before March 2024 (outside of the impact of market conditions to borrowers, this also should be considered a risk to the banks' ability to maintain funding growth should this cause them to have short term capital structure issues).

- Notwithstanding the latest rate rise, the longer-term government bond rates have remained around 3.2% to 3.5% for the coming 2-to-10-year period. Which is probably reasonable given the short-term rate rises appear needed in the next 1-2 years (due to inflation).

- Household assets to income ratio, as expected, declined slightly over the past quarter due to real estate asset price declines. Household debt to income remained stable, not due to income growth but due to reduced lending growth. As rates and unemployment go up, these will change further.

Exhibit 4: Reserve Bank of Australia Assets
$billion

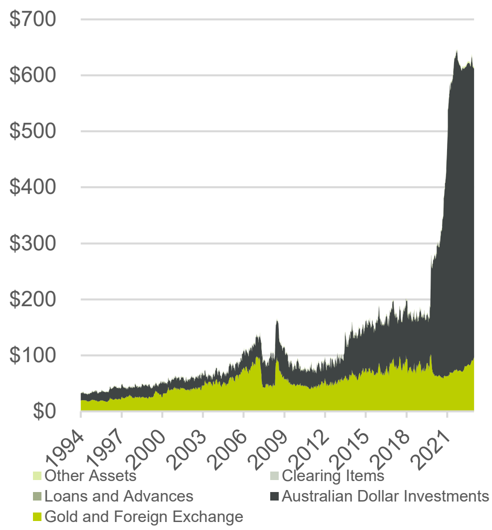
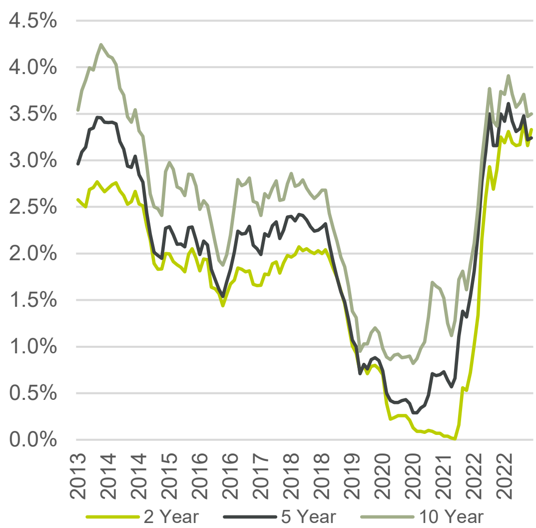


Exhibit 5: Australian Government Bond Yield



Source: ABS, RBA

Exhibit 6: Household Income and Consumption

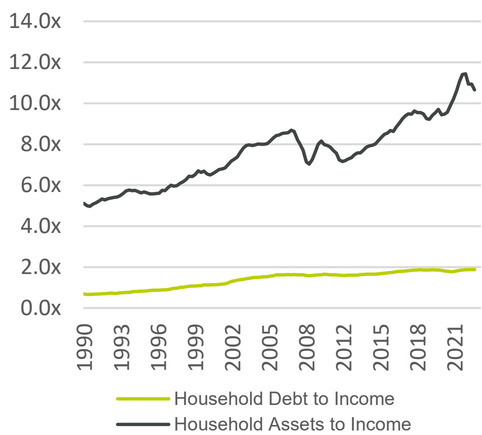
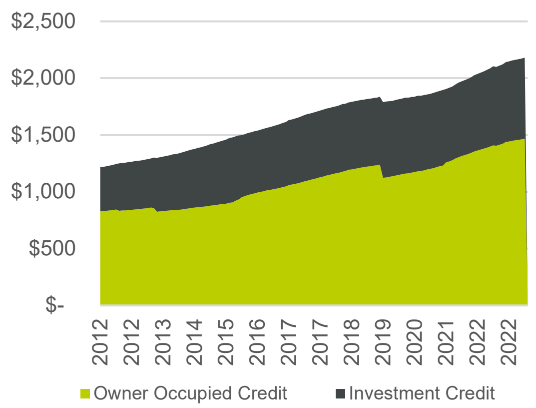


Exhibit 7: Housing Loan Commitments
$billion



Source: ABS, RBA

Historical House and Business Rates

- Residential and business interest rates continued to climb in response to last month's rate rise. This will rise again over the next month. It appears the margin between the outstanding interest rates (i.e., for borrowers who have not refinanced within the last three years) is still 0.96% higher than those that have recently refinanced.

Exhibit 8: Owner-Occupier Home Rates
Outstanding and new loans in % per annum

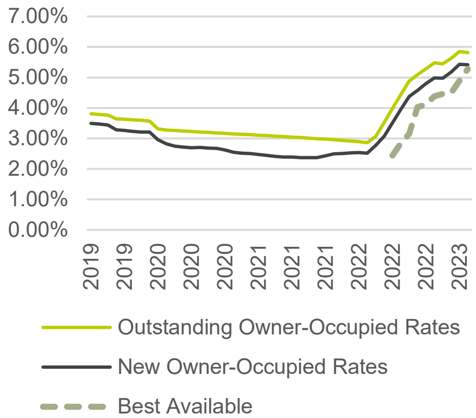
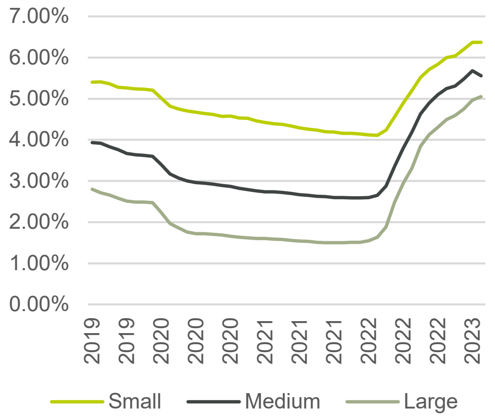


Exhibit 9: Outstanding Business Rates
Small, medium and large businesses in % per annum



Source: ABS, RBA

Lending Standards and Credit Policy

- The latest rate rises, and further expectations of 1 to 3 rate rises to support the fact that borrowing capacity will worsen further than originally thought. Based on our current estimates, we expect a 44% decline in borrowing capacity from 12 months ago to the next 12 months. In other words, a household with $500,000 in gross income was able to borrow $3.65 million 12 months ago; in the next 12 months, that will be reduced to $2.0 million—a $1.65 million decrease.
- Unfortunately, this assumes that inflation returns to 2-3% within the next 12 months. This assumption is no longer plausible. If inflation stays higher for longer, it will result in higher living costs, which will further reduce borrowing capacity. The only solution for this is labour productivity gains (which there have not been since the start of COVID).

Exhibit 10: Indicative Credit Policy Measures

	12 m Ago	Current	12 m Forecast	Consumer Effect
Loan to Value Ratio (without LMI)	80.00%	80.00%	80.00%	**Unchanged** – However, we are seeing reductions in house prices.
Debt to Income Ratio	~7.0x	<6.0x	<6.0x	**Negative** – Lenders are looking to reduce consumer leverage, given increased interest rates.
APRA Servicing Buffer + Reference Rate	4.45%	8.28%	9.83%	**Negative** – Material increases in interest rates
Household Expense Measure (2 Adults, 2 Children, Modest Lifestyle)	$6,045	$6,500	$6,825	**Negative** – Material increases in household expenses due to inflation
Indicative Borrowing Capacity - For $500,000 Income Household	$3,645,039	$2,379,792	$2,037,717	**Negative** – Material decreases in borrowing capacity
		-34.7%	-44.1%	

Source: Cashel Family Office, Refinitive

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Borrower Loan Rates

- The divergence of interest rate expectations is growing to the upside. It is highly probable now that rates are likely to rise higher and last longer, which can be seen in the Forecast (maximum consensus) below.

Exhibit 11: Owner-Occupied Rates

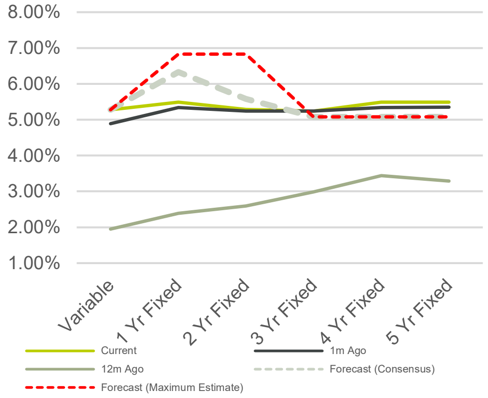
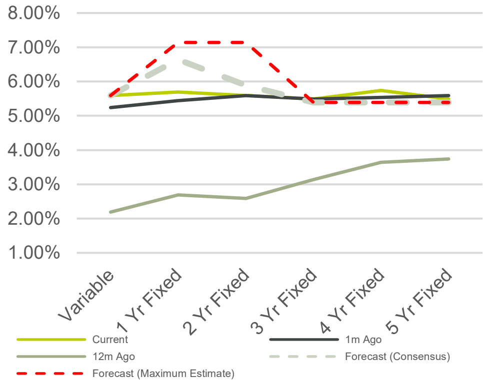


Exhibit 12: Investment Rates



Source: Cashel Family Office, Refinitive, Connective

Exhibit 13: Home Loan – Indicative Available Interest Rate Hedging

	Current	2024	2025	2026	2027	2028
Variable Rates	5.28%	6.33%	5.58%	5.08%	5.08%	5.08%
1 Year Fixed	5.49%	5.49%	5.58%	5.08%	5.08%	5.08%
2 Year Fixed	5.29%	5.29%	5.29%	5.08%	5.08%	5.08%
3 Year Fixed	5.24%	5.24%	5.24%	5.24%	5.08%	5.08%
4 Year Fixed	5.49%	5.49%	5.49%	5.49%	5.49%	5.08%
5 Year Fixed	5.49%	5.49%	5.49%	5.49%	5.49%	5.49%

Source: Cashel Family Office, Connective

Exhibit 14: Investment Home Loan – Indicative Available Interest Rate Hedging

	Current	2024	2025	2026	2027	2028
Variable Rates	5.59%	6.64%	5.89%	5.39%	5.39%	5.39%
1 Year Fixed	5.69%	5.69%	5.89%	5.39%	5.39%	5.39%
2 Year Fixed	5.59%	5.59%	5.59%	5.39%	5.39%	5.39%
3 Year Fixed	5.49%	5.49%	5.49%	5.49%	5.39%	5.39%
4 Year Fixed	5.74%	5.74%	5.74%	5.74%	5.74%	5.39%
5 Year Fixed	5.49%	5.49%	5.49%	5.49%	5.49%	5.49%

Source: Cashel Family Office, Connective

Exhibit 15: Personal, Asset, Commercial and Business Lending Indicative Interest Rates

	Indicative Rates
Home Mortgage (Full Doc)	5.28%
Home Mortgage (Low Doc)	6.62%
Investment Mortgage (Full Doc)	5.59%
Investment Mortgage (Low Doc)	6.82%
Commercial Loan	4.79%
Investment Mortgage (Private Doc)	9.25%
Margin Loan	9.00%
SMSF Loan	6.55%
Chattel Loan	6.57%
Personal Loan	5.74%
Credit Card	19.94%
HECS	7.10%
Outstanding Taxation	10.90%

Source: Cashel Family Office, Connective, NAB, ATO and comparethemarket.com.

Implications of Interest Rate Outlook

- Based on new consensus forecasts, the expected peak cash rates may be as high as 4.85% (3 more rate rises) with a median of 4.35% (1 more rate rise). As mentioned in last month's research, we tend to believe the median consensus is underestimated, and the likely outcome will be much higher, especially if the fiscal policy is neutral or unhelpful (as it appears to be). On this basis, we expect to see home loan rates closer to 6.83% for recently refinanced borrowers and as high as 8.33% for older (carefree and loyal) borrowers. In the case of investment loan borrowers, this may be 7.14% for new borrowers and 8.86% for older borrowers.

Exhibit 16: Impact of Interest Rate Forecasts and Fixed Rates on $1 Million Borrowing

	Jun 2023	2024	2025	2026	2027	2028
Current Available Rates (Home)						
Variable Rates	5.28%					
Fixed Rate		5.49%	5.29%	5.24%	5.49%	5.49%
Current Available Rates (Investment)						
Variable Rates	5.59%					
Fixed Rate		5.69%	5.59%	5.49%	5.74%	5.49%
Cashel Consensus Forecast						
Inflation	7.00%	5.00%	4.00%	3.00%	2.50%	2.50%
RBA Cash Rate	4.10%	4.35%	3.60%	3.10%	3.10%	3.10%
Variable Rates - Home	5.28%	6.33%	5.58%	5.08%	5.08%	5.08%
Variable Rates - Investment	5.59%	6.64%	5.89%	5.39%	5.39%	5.39%
Monthly P&I Payments on $1m	$5,541	$6,209	$5,728	$5,417	$5,417	$5,417
Change in Monthly Payments ($)		$669	$188	-$123	-$123	-$123
Change in Monthly Payments (%)		12.1%	3.4%	-2.2%	-2.2%	-2.2%

Source: Cashel Family Office, RBA, NAB, Westpac and ANZ

Recommended Strategies

Consider fixing for 3 years.

- Given the current and forecast variable rates, the 3-year fixed rates for investment and home loans look the most attractive. For many Borrowers, it will be lower than their current variable rate and provide a hedge against the expected (and unexpected) interest rate rises. Before doing this, please consider any extra unscheduled repayments you intend to make, as this element should not be fixed.

Be vigilant about your interest rates – do not be carefree or loyal.

- If you are not already paying the lowest variable or fixed rates, you should look to do so. We can aid with renegotiating with your current lender or refinancing to a new lender. On average, there is likely to be a 1.14% improvement in new mortgages compared to old ones. If you are not prepared to refinance, do not be surprised when you are paying 8.33% to 8.64% for home and investment loans.

Position for opportunities

- While there appears to be some news of housing price increases, we expect this to be false and selective. We expect further weakening (or at least stagnation) in real estate prices over the next 12 months and increased opportunities for buyers to take advantage of distressed sellers.

Review your costs, credit cards and ensure you are refinancing-ready!

- If you have not already, you should be reviewing and reducing your discretionary costs. At the same time, you should repay any short-term debt facilities as a priority (including car and credit cards) if you intend to maximise your home and investment borrowings.

Reach out to your Cashel Relationship Manager for help and advice on any of these strategy recommendations.

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