NEWSLETTER

June 2022

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FINANCIAL SERVICES

Introduction

Welcome to our June newsletter – our first since the Federal election. Given there has been a change in Government, we discuss the potential impact for residential property, which is still Australia's largest asset class, as well as examine any likely effect of the change on share market prices. Enjoy!

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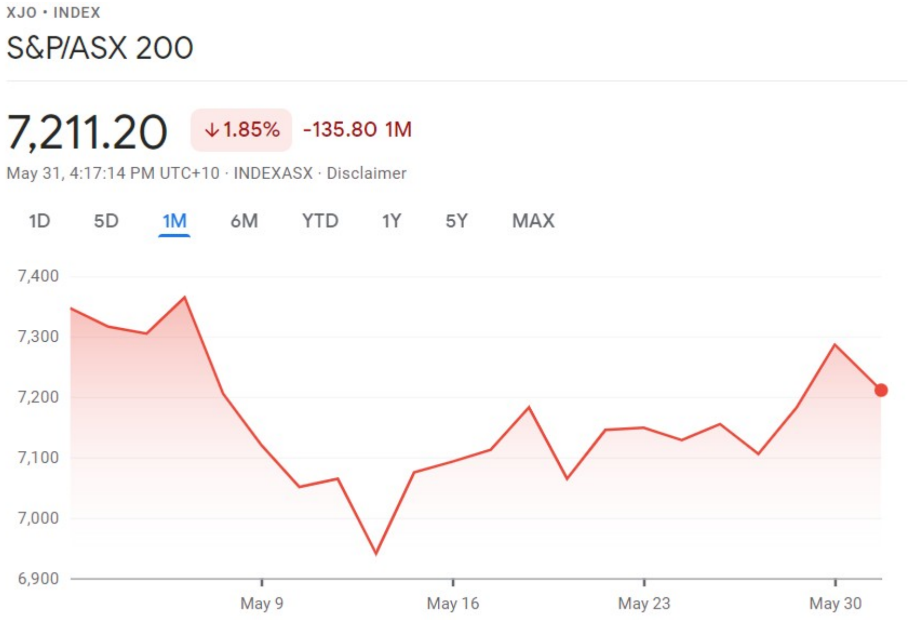
The Share Market

As you know, May was a month of change in the Australian economy. On May 21, a new Federal Government was elected. This is being hailed in many quarters as a major change for the country - but not so much for share investors, judging by the performance of the Australian share market for the month of May.

That performance was slightly negative overall, with the ASX 200 index down by a little less than 2% across the entire month. Here is how it looked, thanks to Google and the ASX:



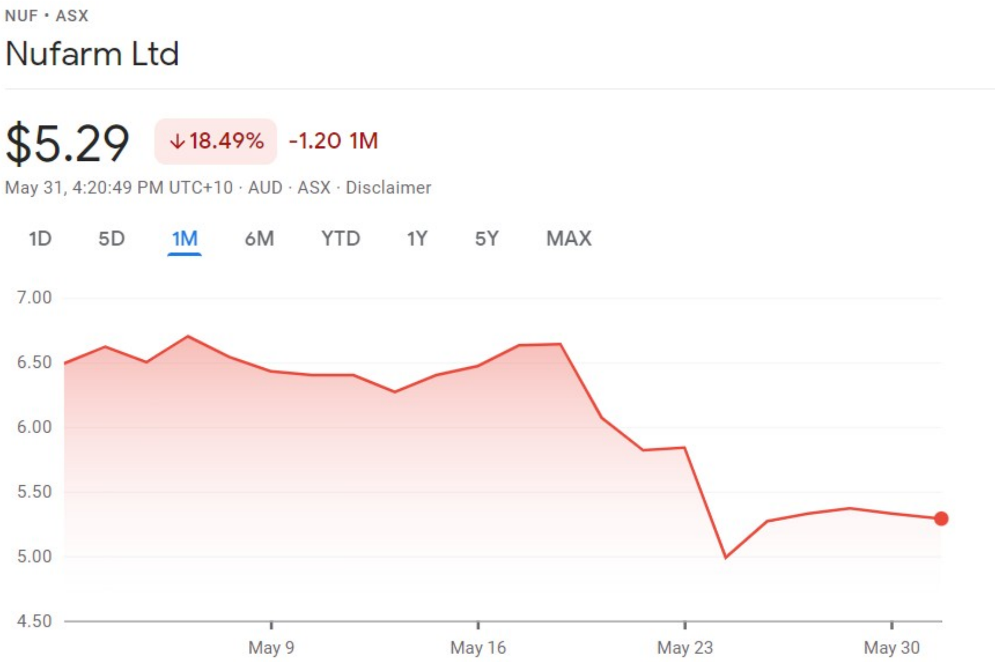
The falls for the month took place mainly in the first half, with the index dipping below 7000 briefly on May 12. That is, the falls took place before the election (and probably had more to do with the inflation story that was coming out of the US than anything happening here in Australia). The election on May 21 barely had any impact on the market – demonstrating that the market had correctly predicted the result anyway, so that the election result was not a surprise.

This ability to not change when something major happens is an element of the share market that many people find difficult to understand. Today's market price for any given company's shares is based mostly on what people expect for the future performance of the company. It is not so closely linked to things that have already happened – or even that are happening right now.

This means that, when a company announces results that were expected by the market, there tends not to be any impact on prices. On a larger scale, when an external event such as an election result is anticipated correctly by the market, that result in turn does not impact market prices.

Ok, so what does impact prices? Prices are impacted by unexpected things happening, that change people's expectations about the future of a company. A great recent example of that was Nufarm, one of Australia's largest producers of agricultural products such as pesticides. On May 19 2022, Nufarm announced it's financial results for the half year ended 31 December 2021. If you knew nothing about Nufarm, the news seemed to be all good: profits were substantially higher and the company reinstated an interim dividend for the first time in four years (interim dividends are dividends paid to shareholders during the financial year. Final dividends are paid to shareholders after the financial year ends).

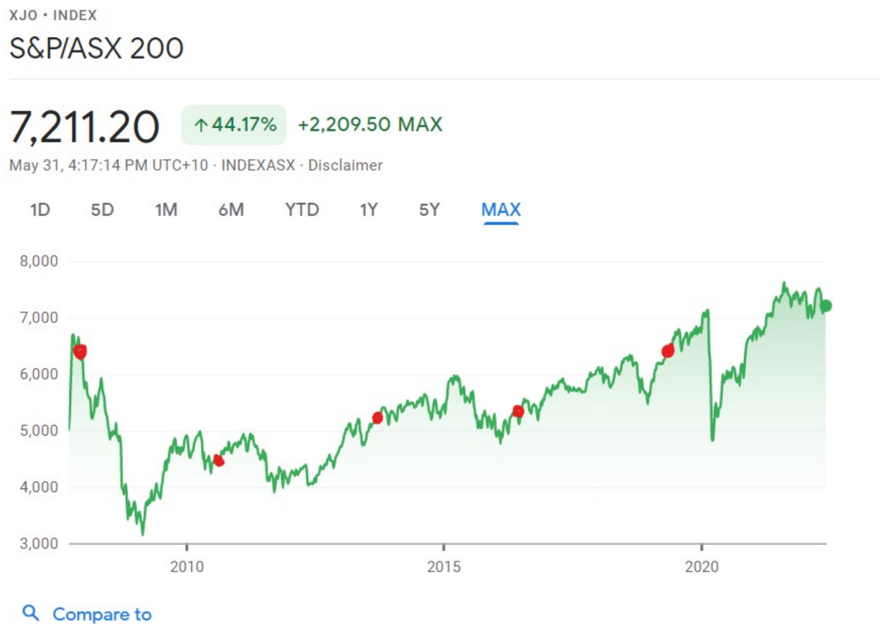
Despite this, the share price for the company fell markedly, finishing the month of May more than 18% lower than it had started. This graph shows what happened (source: Google):



While the company was announcing what seemed to be good news, the market had anticipated news that would have been even better. The 'good news story' told by the interim results was actually a bad news one compared to what people thought was going to happen. Investors had expected even bigger profits and had 'bid up' the company's share price accordingly.

This brings us to wonder about the impact that the change of Federal Government is likely to have on our investment markets. The short answer is: not much! This reflects the fact that the two major parties did not go to the election promising much that was different from the other, in terms of the economy. At this stage, there are few significant changes to expect, and changes that have been made will likely take time to have an economic impact (for example, the incoming Government have promised some extra spending in the areas of aged care and child care, but these changes will come into effect gradually over an extended period).

As a result, Australian elections tend not to have much impact on the Australian share market. You can see this in the following graph, in which we have marked the dates of the previous five federal elections with red dots.



As you can see, the only time that an election preceded a significant change in average share prices was in 2007, when the ALP took Government in late November. However, that was also the time that the Global Financial Crisis took effect. That crisis halved share market values around the world, meaning that the change of Government in Australia was not the cause of the very sharp falls that we experienced. This is especially the case when you consider that Australia's response to the GFC was actually quite good – we were one of very few significant economies to avoid even going into a technical recession.

Clearly, the Australian share market generally adopts a 'business as usual' attitude for share prices when our Federal Government changes. This year has been no different.

The Property Market

With the changing of the Government, we thought we would look at some of the policy changes that are likely to impact on the residential property markets around Australia. Next month, we hope to be able to bring you some up-to-the-minute data on any impact that the recent increase in interest rates are having on residential property prices. We will also be keen to discuss whether the RBA increases rates further in June.

The major housing initiative that the ALP took to the Federal election was a 'Help to Buy' scheme whereby the Commonwealth would effectively become co-owners of property for up to 10,000 property purchasers each year. The program is open to people on average-to-low incomes (the upper limits of annual income are $90,000 for a single person or $120,000 for a couple). The price of the target property is also capped, with the caps varying according to the region where the property is located. The most expensive properties eligible for the scheme will be capped at $950,000. You can guess where (Sydney, of course!)

The scheme is limited to people who will become owner-occupiers and who do not currently own a home. Significantly, it is not a first home buyers' scheme, meaning that the scheme will be available to special groups, such as people who needed to sell or leave a family home following a divorce. This may turn out to be the most significant element of the scheme, as single women aged over 60 are the most likely group in Australia to be living in poverty – usually because they do not own property assets and have little in super at a time when their income is falling.

Participants in the scheme do not need a large deposit (the deposit can be as little as 2% in some cases). The Commonwealth will provide up to 40% of the purchase price of the property for a new build and 30% for an existing property. The Government then continues to own this stake, although the Government can be 'bought out' over time. So, a person who borrows, say, 50% of the purchase price would normally pay back their lender first. Once this is done, they can then start to 'buy out' the Government. The amount belonging to the Government will vary according to the market price at the time of each instalment.

An example may assist here. Say a participant purchases an existing property for $500,000. The Commonwealth contributes $150,000 (30%). The participant had $50,000 of their own money saved as a deposit, and so they borrowed an additional $300,000 (we will ignore purchasing costs such as stamp duty here – although these will need to be paid by the participant) to complete the purchase.

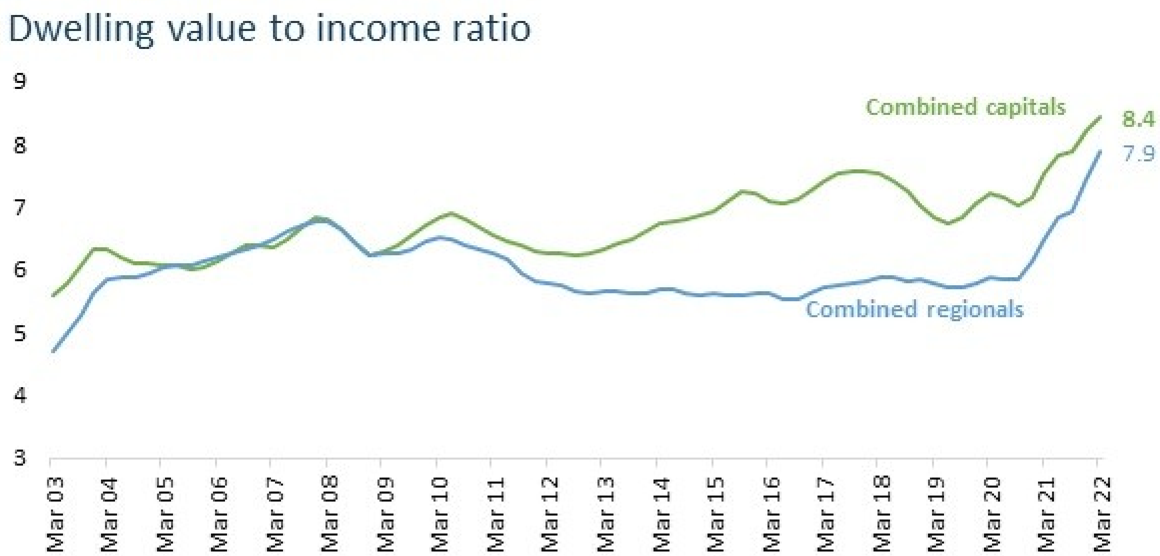
The participant takes ten years to repay the bank loan of $300,000. By that time, the property has increased in value to $800,000. The Government's share of the property is now worth $240,000 (30% of $800,000). If, during that year, the participant pays $40,000 to the Commonwealth, the Government's share will now only be worth $200,000. This is 25% of the then current value of $800,000. The participant will have used their $40,000 to buy a further 5% of their home.

Five years later, the property has increased in value to $960,000. The Government's share is now worth $240,000 again (25% of $960,000).

So, you can see that the Government's 'equity share' in the property will increase if the value of the property rises. But so does the share that is owned by the participant. In this example, after fifteen years, the participant owns $720,000 worth of equity in the home.

There will be more detail about the scheme released over time. But many people point out that helping people 'buy more house' may put upward pressure on prices – which has been the experience with other schemes that have been rolled out over the last 20 years (first home buyer grants – we are looking at you!). Hopefully, the caps on the number of participants, their eligible incomes and the value of the target property will prevent the scheme from adding even more demand-side pressure to residential property markets.

We hope this is the case because, to be blunt, there is currently a serious problem with housing affordability in Australia. Put very simply, it takes more years of work to buy a house now than it has at any time in the last 20 years, as this graph showing the ratio of average dwelling prices to average incomes shows (Source: Corelogic):



In 2003, it took less than 6 years of average full time earnings to buy an average dwelling in a city, and less than five years in regional areas. As of today, it takes 8.4 years of earnings in a city and almost 8 years in the regions to buy that same house.

It is figures like this that mean that Governments must be careful not to introduce 'homebuyer' schemes that cause even higher prices by stoking demand for housing. What is really needed is an increase in the supply of housing, along with an increase in average incomes, which could combine to try to lower the ratio shown above without the current value of housing needing to fall.

The incoming Government has announced that it will establish a National Housing Supply and Affordability Council. This council will presumably be charged with finding ways to make housing more affordable – but without causing existing prices to fall. After all, falling house prices would be bad news for the 5.4 million or so households who own the home they live in.

That will be quite a balancing act.

The Legal Stuff

General Advice Warning

The above information is general in nature and does not take into account your personal situation. You should consider whether the information is appropriate to your needs, and where necessary, seek professional advice from a financial adviser.

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