NEWSLETTER

July 2023

CARE FINANCIAL SERVICES AND ACCOUNTING

It's not just about numbers

Introduction

Welcome to the newsletter for July 2023. We recap the financial year in terms of the share market and residential property. And we also discuss one of the potential reasons for the RBA not to have increased interest rates this month.

Read on to find out more.

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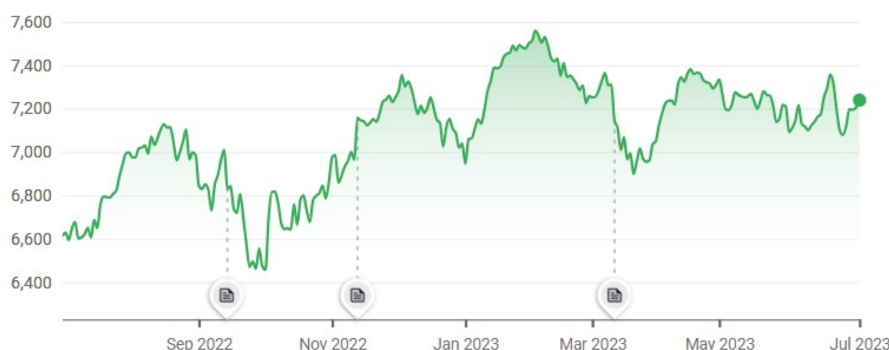
The Share Market

The Australian share market rounded out the financial year with a month of moving sideways, starting July in almost exactly the same place as it had started June. Here is how the month looked, thanks to Google and the ASX:

This meant that the market as a whole moved by just under 10% for the financial year, in a year of almost perfect 'two steps forward, one step back' progression:



Bear in mind that these graphs show what happened with *market prices* during the month and year. Changes in prices are only one of the two types of return for share market investors. The other is, of course, dividends, which can actually cause short term falls in market prices (we will come to that in a minute). The dividend yield on the ASX 200 tends to be around 4-5% per year. If we add that to the 9.5% capital growth, we see an overall average return of around 14% for the 2022/2023 year.

Not bad. Of course, that does need to be put in the context of inflation. Inflation figures come out with a lag, so we do not yet know what inflation was for the full 12 months of the financial year. But last week the ABS told us the inflation rate for the twelve months to the end of *May* 2023, which of course includes eleven of the months of the 2022/2023 year. That rate was 5.6%.

To get the financial year inflation rate, we need to add price movements for June 2023 and subtract price movements for June 2022. We expect that doing this will show an annual rate smaller than 5.6%, as June 2022 was a high inflation month. What's more, May 2023 actually saw the CPI fall. For these reasons, inflation in June 2023 is likely to be lower than it was in June 2022. Thus, the figure should fall below 5.6%.

This means that inflation was likely somewhere around 5% for the full financial year. 14% nominal return minus 5% inflation means a 'real' rate of return of around 9% for the average share investor. Not bad. Not bad at all. At this rate of return, if dividends are reinvested, then an investment is likely to double in real terms (that is, in purchasing power) every eight years or so.

As we observe below, residential property returns have tracked somewhat sideways over the last 12 months (capital growth has been negative but this is offset by rents). As a result, the Australian share market has easily outpaced residential property as the better investment for the 2022/2023 year.

As we say above, when companies pay dividends their share price often falls temporarily. This is because companies pay dividends on a particular date. But the dividends are paid to those shareholders who held shares at an earlier date. For example, dividends might be paid on March 30 to everyone who owned shares on March the 9th. The gap is necessary to let the company organise the administration of the dividend payments.

In this example, if you buy shares before March 9, you receive the dividend on March 30. If you buy your shares on or after March 9, you do not receive that particular dividend. As a result, shares are said to go 'ex-dividend' on March 9.

Investment logic tells us that the value of the share should fall the day it goes ex-dividend. This is because anyone buying the share will not get the next divided payment. Thus, the share entitles the new purchaser to a lower future stream of payments than the person who held the share the day before. The share is, therefore, not as valuable to the new purchaser. If nothing else happens, then the market value of the particular share will fall by pretty much the same amount as the dividend payment.

You can see this happening in the case of BHP, whose shares went ex-dividend on 9 March 2023:

We have marked the 9th of March and you can see that the price of the shares fell on that day (although they had also fallen the day before). The dividend was $1.36 per share, which is roughly what the market value fell by.

Using this concept of ex-dividend, if all the companies that make up the ASX 200 had decided not to pay dividends in 2022/2023, but instead had held on to the cash themselves, then we would expect the capital growth, or the growth in the market price of the constituent companies, to have risen by 14%.

But companies do not do that. Most of them issue dividends periodically, meaning that the market value of their shares is lowered between one and four times a year (depending on how often dividends are paid). Because this tends to happen year after year, it is still quite fine to consider changes in market prices between longer periods such as financial years. Also, when we are looking at market averages, the fact that different companies pay dividends at different times also has a smoothing effect.

Investors, though, should take care when looking at the price movements of individual companies over shorter time periods. For example, if you looked only at BHP's market price on March 10 you might conclude that something bad had happened to the company the day before. But the payment of a dividend is actually a good thing. On a day-to-day basis, good things can cause prices to fall.

The Residential Property Market

Residential property continued it's slow growth in June. Respected market analyst Corelogic released their monthly property value index earlier this week. It showed an 1.1% increase across the nation for the month of June.

Once again, the national data was skewed by Sydney's outsized impact in terms of the size of that market. The Sydney market rose by 1.7% during June. Brisbane rose by 1.3%, but all other capitals rose by less than 1%, with Hobart still in slightly negative territory with falls of 0.3% for the month. Regional growth was 0.5% on average. Here is how Corelogic present the information themselves:

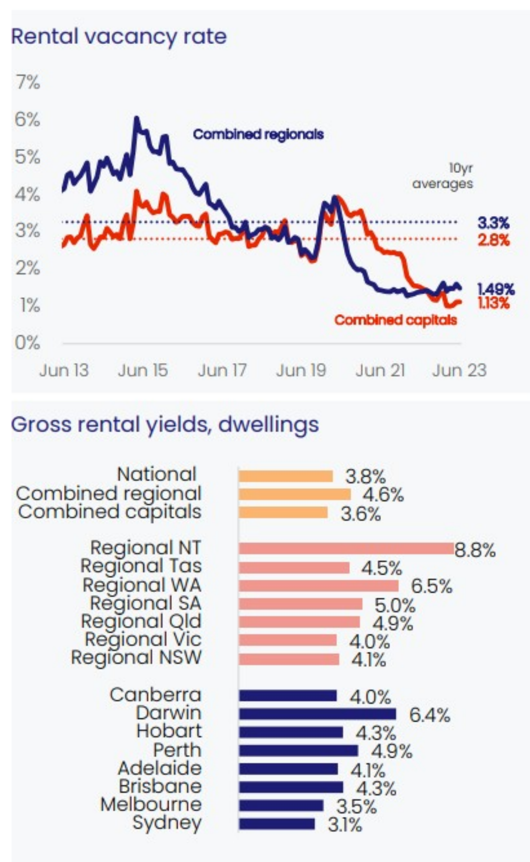
Index results as at 30 June, 2023	Change in dwelling values				
	Month	Quarter	Annual	Total return	Median value
Sydney	1.7%	4.9%	-5.1%	-2.2%	$1,073,924
Melbourne	0.7%	1.8%	-5.7%	-2.6%	$762,537
Brisbane	1.3%	3.0%	-8.2%	-4.1%	$725,397
Adelaide	0.9%	2.1%	0.0%	3.6%	$663,136
Perth	0.9%	2.8%	2.5%	7.3%	$588,454
Hobart	-0.3%	0.1%	-12.7%	-9.0%	$651,187
Darwin	0.5%	-0.3%	-1.0%	4.7%	$492,081
Canberra	0.4%	0.8%	-8.8%	-5.2%	$830,217
Combined capitals	**1.2%**	**3.3%**	**-4.8%**	**-1.4%**	**$789,649**
Combined regional	**0.5%**	**1.1%**	**-6.5%**	**-2.4%**	**$586,645**
National	**1.1%**	**2.8%**	**-5.3%**	**-1.6%**	**$723,006**

As we have written in previous months, property prices are rebounding, and have been for a little while now. The quarterly increase in Corelogic's index was 2.8%, implying an annual rate of growth of almost 12%. But the annual rate of increase has been held down by the negative price movements earlier in the 2022/2023 year, such that prices are still just over 5% lower than they were at this time last year. Property has had a 'bad' year but a 'good' recent few months. (Unless of course you are looking to buy your first property, in which case you can switch those adjectives around!).

As we wrote above, we expect annual inflation for the 12 months to June 2023 to be around 5-5.5%. So, in real terms, house prices are around 10-11% lower now than they were 12 months ago.

There has also been plenty of news lately about rents. Corelogic tell us that the vacancy rate is rising slowly and is now 1.5% nationally, although this is still well below the long-term average of 3.3%.

Such low vacancy rates are having a predicable impact on rents. Here are two graphs, again from Corelogic, showing the long-term movement in vacancy rates and average rental yields for each Australian capital and region:



The rental yield is calculated by dividing the gross rent received into the market value of a property. So, lower rental yields are not necessarily a sign of lower rent prices – they are usually also a sign of higher property prices. This is certainly the case in Sydney and Melbourne, which have the lowest rental yields in Australia but also the highest prices. Neither of those cities is cheaper to rent in than other parts of Australia!

Interestingly, and perhaps a little frustratingly for people with debt and/or people who rent a property from someone with debt, the Reserve Bank appears recently to have acknowledged that higher interest rates are making life harder for renters, by driving up rents. In something that we think went oddly unreported, the ABC reported these comments from the RBA on May 31:

> *Dr Lowe [The RBA Governor, speaking before a Senate Estimates Committee] said the RBA was lifting interest rates to dampen inflation, and inflation was coming down in important areas of the economy, but higher rates were unfortunately driving rents higher, and that was feeding inflation in other areas of the economy.*
>
> *He said it was a problem because rents were the "single largest" component of the consumer price index (CPI), and the RBA expected growth in rents to be about 10 per cent this year and to remain elevated for some time.*

That is to say, Governor Lowe is reported as stating the following:

1. Interest rates are dampening inflation; and
2. Interest rates are causing rents to rise; and
3. Rents are a big cause of overall inflation.

Somehow, higher interest rates are both reducing *and* causing inflation. At the same time.

Inflation & Interest Rates

As we go to press, the RBA has just held it's monthly Board meeting. Speculation was rife as to whether the RBA would decide on a 13th increase in 14 months.

As we write above with regard to rents, the impact of interest rates on inflation is a messy one. The theory goes that higher interest rates reduce spending by leaving less money in purchaser's hands, through the combination of discouraging new borrowing and/or forcing existing borrowers to pay more in interest, which reduces their ability to spend money on anything else. These effects target the 'demand' side of the economy, by reducing people's ability to buy (or demand) things.

But, as is the case with rents, higher interest rates can actually cause some prices to rise. This is because higher interest rates can also be a cost of 'production,' and if the seller of a good or service has what is known as 'pricing power,' they can pass this higher cost on to their customers in the form of higher prices.

In terms of housing, a landlord is a 'seller' of a housing service and their tenant is the customer. At the moment, there is a shortage of rental accommodation in most parts of Australia. What's more, accommodation is an essential service. Renters, therefore, face a situation in which (i) they have to purchase the service and (ii) they can't take their 'business' to another provider. This gives the landlord pricing power – he or she does not have to worry about losing business if they raise their prices to offset their higher costs. Someone will rent their property.

To better understand this, think about how the opposite can happen in a street with a lot of cafes. To begin with, all of the cafes are selling coffee for $5 a cup. Then interest rates rise, meaning that those cafes with debt now face higher business costs. These café owners have a dilemma. If they raise their prices to recover the increased costs, their customers might decide to buy their coffee from the café next door, where the price is still only $5. This means that each individual café owner does not really have pricing power. Their customers can easily choose to buy a cheaper coffee somewhere else. In this case, higher interest rates do not cause further inflation. (Although they may drive one or more cafes out of business altogether).

So, pricing power tends to be held by sellers if and when (i) they are selling an essential good or service that people have to buy and (ii) there are relatively few providers of this good or service.

All this is important because if inflation is occurring in areas where sellers have significant pricing power, then higher interest rates can actually make inflation worse. Sellers with pricing power can pass their higher interest costs on to their customers. This seems to be what is happening with rent.

In the Australian economy, there are many areas where sellers have pricing power. Groceries, for example, with there really only being two major supermarket chains. Energy providers are another example. People need to buy energy. And changing providers is often either difficult or actually not possible. So, the providers can pass their costs on – pushing inflation up in the process. Australia's CPI is perhaps particularly vulnerable to being pushed up by higher interest rates.

We are sure that the RBA had all of these things in mind at this week's Board meeting. And this is perhaps why they took the unusual decision not to increase the interest rate.

A big relief for many borrowers.

The Legal Stuff

General Advice Warning

The above suggestions may not be suitable to you. They contain general advice which does not take into consideration any of your personal circumstances. All strategies and information provided on this website are general advice only.

We recommend you seek personal financial, legal, credit and/or taxation advice prior to acting on anything you see on this website.

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