Beware “Cheap” Debt in a Deflationary World

Our roadshow around Australia took place in July and August. If you couldn’t make it, a recording of the event is available on our Youtube channel. Despite the funds’ poor performance, I wasn’t investors’ number one villain. Dr Phillip Lowe, governor of the Reserve Bank of Australia, was even less popular than me.

The RBA board had just cut the official interest rate to 1%. It has since been cut again to 0.75% and Lowe is openly talking about Australia’s own version of quantitative easing. We’re soon to join Japan and Europe in the zero club. The US might not be far behind us.

Many investors assume that “what goes down must go up”. Many of our clients lived through the inflation of the 70s and 80s and and see its return around every corner. But what if that period was the anomaly rather than the rule? We all thought the stimulus and growth in money supply after the financial crisis was certain to kick start an inflationary spiral. It hasn’t. In fact, inflation has been worryingly low. Best prepare, I would suggest, for a sustained period of zero rates.

More importantly, what do these zero rates imply about the future of the economy? What if, rather than rates going back up, we are headed for a long period of deflation?

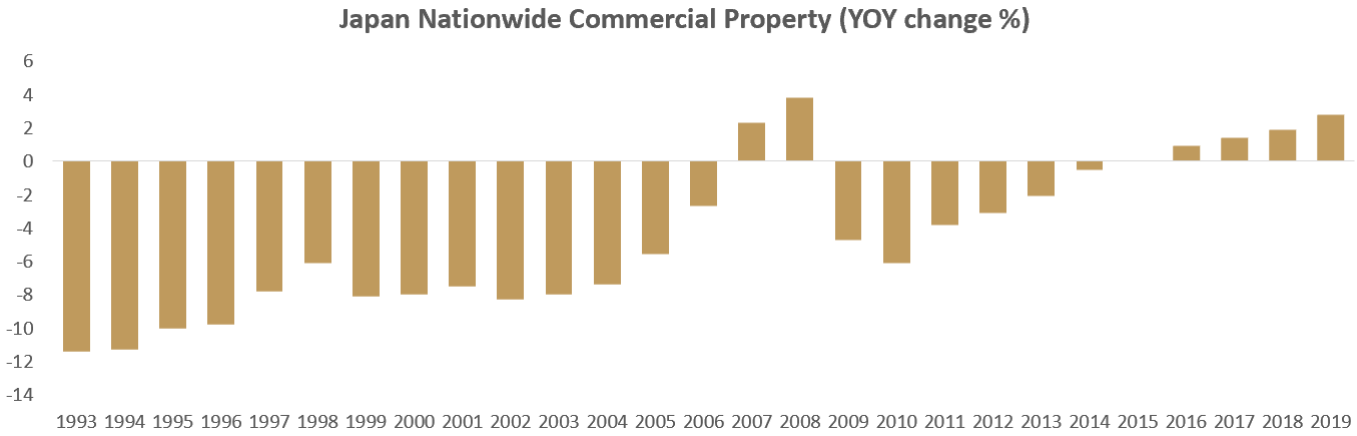
Low nominal rates are not necessarily a panacea for borrowers. It feels like it, because the interest payments today are so low. But, if we are headed for a deflationary world, it’s repayments later in life that you need to worry about.

Turning Japanese

Back in 2011 and 2012 I spent a significant amount of time looking at two Japanese property trusts listed on the ASX. Both had been created prior to the financial crisis and were trading at significant discounts to their net asset value in its aftermath.

Even prior to the discount, Japanese commercial property looked attractive. You could buy an office building in the mid 2000s on a cap rate, or net rental yield, of between 5% and 6%. Debt was freely available at interest rates of less than 1%. A purchaser funding a building with half debt and half equity could earn a 10% return on their investment. Not bad in a land where you get nothing on your bank deposits.

The catch became clear the more I investigated the history of Japanese office property. In 18 of the previous 20 years, property prices had fallen. Almost every year wages fell, rents fell and property values went down in tandem. Within a decade, that investor who thought they were earning 10% per annum found themselves the proud owner of property that was worth less than the outstanding debt.



Source: Bloomberg

Today's borrowers need to give that scenario some thought. Yes, it might look like you can safely borrow millions of dollars at today's extremely low rates. But what if your wage and the value of your property march steadily down over the next 20 years? Back in 1953, my grandparents borrowed £2,000 to buy their home in Sydney. The initial mortgage payments were a significant proportion of their combined incomes at the time. By 1978, when they made the last payment, the payments were barely noticeable. Today's borrowers could have the opposite experience.

There are important differences between Australia and Japan. Our population is growing. Our central bankers have the benefit of observing Japan's experience and attempting to avoid the same mistakes. But today's low rates are sending a very important signal. The world is turning more and more Japanese.

This is an excerpt from the September 2019 Quarterly Report - you can read the full report *here.*