NEWSLETTER
August 2018

AFFINITY WEALTH PLUS

Introduction

In this newsletter, we take a step back from the short term noise to look at some underlying demand factors that affect investment markets: the interplay between owner-occupiers and investors in the residential property market; and the semi-regular reactions to the threat of tariff 'wars' on global share markets. Please enjoy!

A look at history… the efficient markets theory

Chances are you have never heard of a chap named Harry Markowitz. Markowitz is an American economist who shared the 1990 Nobel Prize for Economics. He was born on August 24 1927, and will turn 91 later this month.

Markowitz is best known for his work on modern portfolio theory. This is an investment theory which suggests that investors aim for the most 'efficient' balance of risk and return in an investment portfolio. When plotted on a graph of risk and return, the different combinations of the most efficient risk for a given level of return form what is known as the 'efficient frontier.'

The efficient frontier informs almost all managed investment models – even those that try to beat the market do so by trying to perform beyond the efficient frontier. Those funds that try simply to match the market try to position their portfolios on the efficient frontier. So, Markowitz and his colleagues have had an enormous influence on managed investing.

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Property Market

In our last newsletter, we reported that residential property prices had fallen in general across Australia, with some regional variation. Here is how the ABS pictured things:

In this newsletter, we thought we would look a little more closely at some of the factors at play when prices rise or fall. This flows nicely from the observation that we have been making for many months and which is reflected in the graphic above: average prices for housing in Australia are falling.

The main two factors in any market are, of course, supply and demand. When demand exceeds supply, the potential purchasers compete to buy the available property. The only way to compete as a buyer is to offer a higher price. When many buyers do this, general prices rise.

When supply exceeds demand, sellers compete to attract the available buyers. The only way to compete as a seller is to offer a lower price. When many people do this, general prices fall.

One of the complicating factors in any market is the fact that participants in the market (buyers and sellers) respond to many different influences. In the property market, there is of course one over-riding influence: people need a place to live. In terms of purchasing (as against renting), this leads to demand from a particular group called 'owner-occupiers' – people who own the home they are living in (including those repaying a loan on that home).

When it comes to having a place to live, the alternative to owner-occupation is, of course, renting. Renters use property owned by investors. In this way, all residential property is owned by either an owner-occupier or an investor. Therefore, demand for residential property <u>must</u> come from one of those two sources.

Some of the influences on these two groups will be shared. Others will be unique to one or the other group. An example of this is the different lending requirements imposed on loans to owner-occupiers compared to loans for investors. Put simply, investors pay more for borrowed money. They tend also to need to meet other banking requirements as well.

Of course, there is also substantial variation within the groups. Compare, for example, a young first home buyer and an older 'downsizer.' They are both owner-occupiers. However, they will generally be responding to very different personal motivations.

Owner-occupiers and investors do have one fundamentally different motivation. Investors wish to make money from their investment. This money can be made in some combination of rent (known as the 'income return') or selling at a profit (known as the 'capital return'). Both of these returns are a function of demand, and so investors typically aim to buy or build properties for which <u>future</u> demand is likely to be high (or, at least, this is what they *should* be aiming for!).

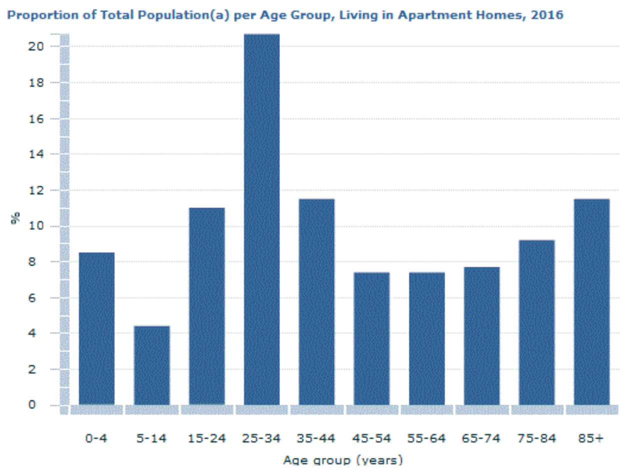
Owner-occupiers, on the other hand, are more interested in buying or building a place to live. There will be more personal factors that influence their decision.

There is, of course, some cross over between these personal factors and the general demand that investors are seeking. If the personal factors are shared between many owner-occupiers, then they will form part of that general demand. Many people like to live near a beach, for example. So, properties near to a popular beach will be attractive to owner-occupiers and investors alike.

Indeed, a canny property investor will be seeking a property that is also attractive to owner-occupiers. This will maximise their return – especially their capital return – as demand will be higher. The idea of successful property investment is to buy a property that many people may wish to buy from you later on.

That means that a property investor needs to think about what type of property owner-occupiers want to live in, both now and in the future. Much of this is done intuitively, but there is also some empirical data that can be very useful.

According to the 2016 census, 59% of people living in apartments were renting that apartment. This compares to just 21% of people living in separate houses. What is more, it looks like those people who are currently renting an apartment will go on later to buy a separate house. Here is the breakdown of age and apartment dwelling, provided by the ABS:

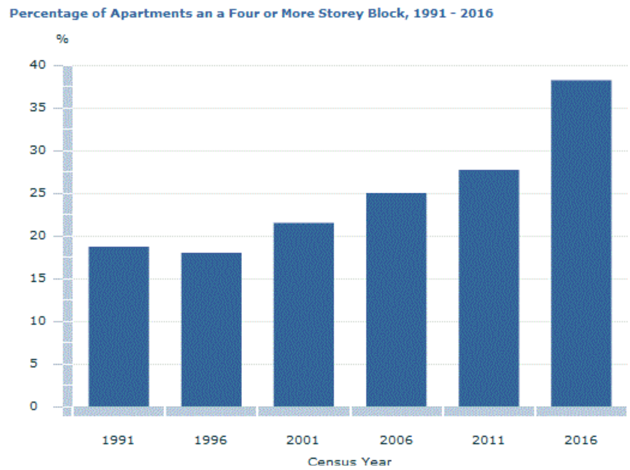


The graph shows that the highest proportion of the population living in apartments is people aged 25-34. This is, of course, also the age group within which people are most likely to be single and least likely to live with a family: people younger than 25 are likely to still be living with their parents. People older than 34 are likely to be living with their own children.

At a very basic level, the data shows that owner-occupiers generally prefer to live in separate housing. For investors, and especially those who seek to get more of their return in the form of capital growth, this should be a signal for them to **prefer separate housing over apartments**. If the ultimate aim is to own a property that could later be sold to any one of several competing owner-occupiers, then buying separate housing is the way to go.

This may be reinforced by the changing profile of the housing market. Also in 2016, the ABS reported that 1 in 6 of all households lived in an apartment. This was an increase from 1 in 8 in 1991. So, over a 25-year period, apartment living became more popular. The figures actually represent a 33% increase in the number of households living in apartments. Apartments comprise a greater proportion of all housing.

Much of this increase is facilitated by the increase in high-rise apartments. In 1991, less than 20% of apartments were in blocks of four or more storeys. By 2016, this had doubled:

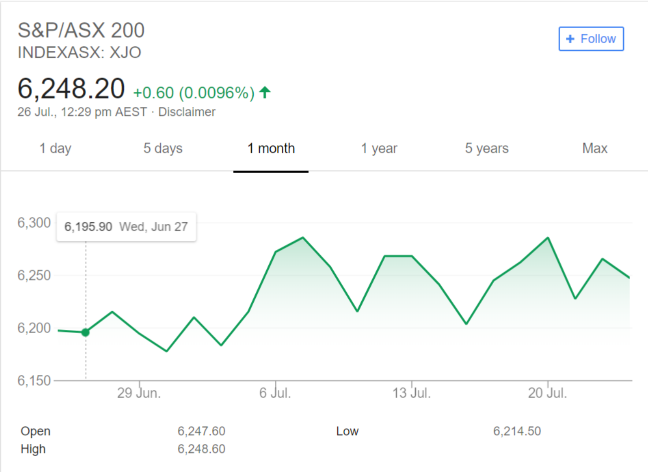


At first glance, this might encourage investors to lessen their preference for separate housing and think more positively about apartments. But this would be missing a key point: as the proportion of all housing that is separate (that is, not an apartment) falls, this type of property becomes *more scarce*. That is, the relative supply of separate housing reduces. As we know, when supply falls, prices rise, unless there is a fall in demand at the same time.

So, as separate houses become relatively less available, their general prices will stay higher relative to apartments. This is inevitable, because apartments are less attractive to owner-occupiers, the largest buying sector of the market.

The Share Market

The month of July was another 'bumpy' one for the Australian share market. As we went to press, here is how the month looked for the ASX 200 (thanks, Google!):



As the graph shows, the market generally wanted to move 'up' (that is, overall there was more sentiment to buy than sell). But at least three times there were substantial reversals in the prevailing sentiment. Prices dropped across the board.

Largely, this was due to international influences on market sentiment. Much of the international mood of late comes from the US (the world's largest economy) and its decision to impose tariffs on various imported products.

These tariffs are having a big impact on share markets around the world.

So, what exactly is a tariff? Economist William Hauk defines tariffs as follows:

> *A tariff is basically a tax on imports that raises the price of foreign company's products for American consumers, putting imports at a disadvantage to domestic producers.*

In March 2018, the US imposed tariffs of 25% on imported steel and aluminium. While much of the commentary around this seemed to suggest that

the move targeted China as a producer of imported steel (the idea was 'sold' on national security grounds), in fact the largest producer of steel imported into the US is Canada, its northern neighbour.

The last part of Hauk's definition is the important part: the idea of a tariff is to encourage domestic producers by making their products comparatively cheaper than imported products.

In theory, this can sound fine. Tariffs help domestic producers. But in reality, markets do not like the idea of tariffs. This is because tariffs distort the natural economy, by encouraging domestic manufacturers to make things that could be made more cheaply elsewhere. Economic theory says that each component of an economy should focus on those goods and services which it provides most efficiently. Across the whole economy, this should minimise the cost of production and, as a result, maximise output.

'Maximising output' is another way of saying 'maximising the number of things that are being produced in the economy.' If we accept that the things an economy produces make life better, then maximising these things will make life as good as it gets.

If we think of the world as one large economy, which is increasingly the case, we see that tariffs discourage this specialisation. Countries that impose tariffs encourage their manufacturers to continue to make things that could be made more cheaply elsewhere. The net effect is that fewer things get made across the whole world.

But this is not the worst of it. The worst of it is that the countries who lose business because of the tariffs – the countries that produce the goods on which tariffs are imposed – become annoyed. They can tend to retaliate by imposing tariffs on goods that they import, which is what leads to talk of 'trade wars.'

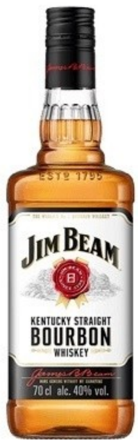
A tariff war such as this leads to bigger problems through the impact on prices in the domestic markets in which the tariffs are imposed.

To give an example, China buys around $US 116 billion of goods from the US each year. So, if it imposed tariffs on US-made goods, this would

have some negative impact on these exports (from the US point of view). However, China sells more than $US500 billion of goods to the US each year. Tariffs raise the price of goods, and so tariffs make at least some of these goods more expensive to US consumers. As you know from managing your own household budget: higher prices means fewer purchases. Life gets more expensive.

History gives us a guide as to just how much more expensive. In 2001, the Bush administration imposed similar tariffs on steel imported to the US. Later analysis suggested that, for every job in the domestic US steel industry that was saved by the tariff, the loss to the economy as a whole, driven by higher prices paid by US consumers, was $US 400,000. The main users of steel were the construction and the automotive industries, which bore the major brunt of these higher prices. US car manufacturing suffered in particular: domestic automotive sales in 1982 were the lowest of any year between 1977 and the present time. Simple proposition really: tariffs made steel more expensive. This in turn made cars more expensive – and so fewer people bought them. (Oil price rises at the same time did not help).

This was just the effect in the domestic US economy. In the event of reciprocal tariffs being imposed, the impact will also be felt in the country that reciprocates. Indeed, reciprocation is already being seen: Canada, for example, have imposed the same tariffs on steel imported from the



US. This now means that the price of steel has risen in both the US and Canada, with the collectors of tariffs being the only winners. Canada has also imposed some more strategic tariffs on localised industries in the US: whiskey, orange juice and maple syrup (of course). These tariffs are thought to have been imposed to create particular problems in parts of the US where political representatives have more influence – the house leaders of the US Senate is from Kentucky, the US's pre-eminent manufacturing state for whiskey.

So, what is the impact of all this on you and/or your super? Well, if global production moves away from maximum efficiency, then so will global profits. And if global profits fall, then owning a company is not worth as much. This makes shares less attractive, which leads to less buying demand, which sees share prices drop.

Of course, there is always more than one thing influencing the share market. And the day to day volatility of the market in July shows that the 'jury' remains undecided about whether a tariff war will eventuate – basically, daily statements from the major players leave people feeling more or less optimistic each day.

The fact that there has not been a prolonged period of pessimism (prices rose for the month in general) shows that many people remain optimistic that a trade war will not eventuate.

Here's hoping. Most households can't afford one.

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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