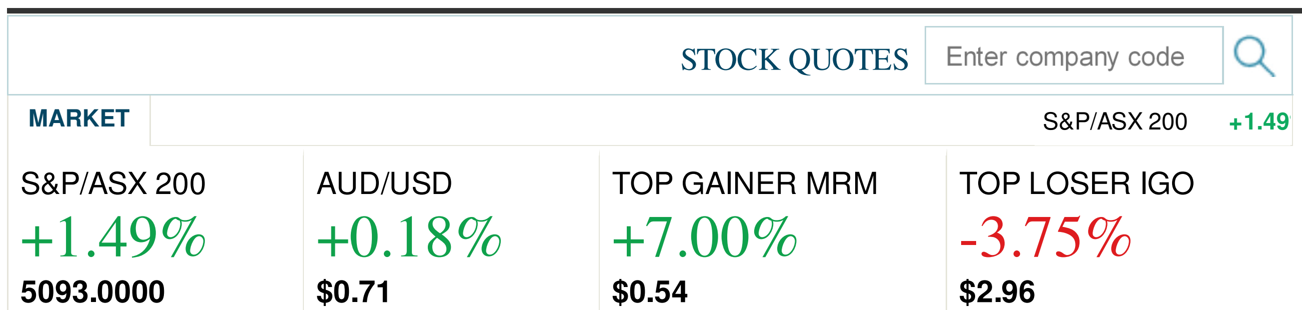
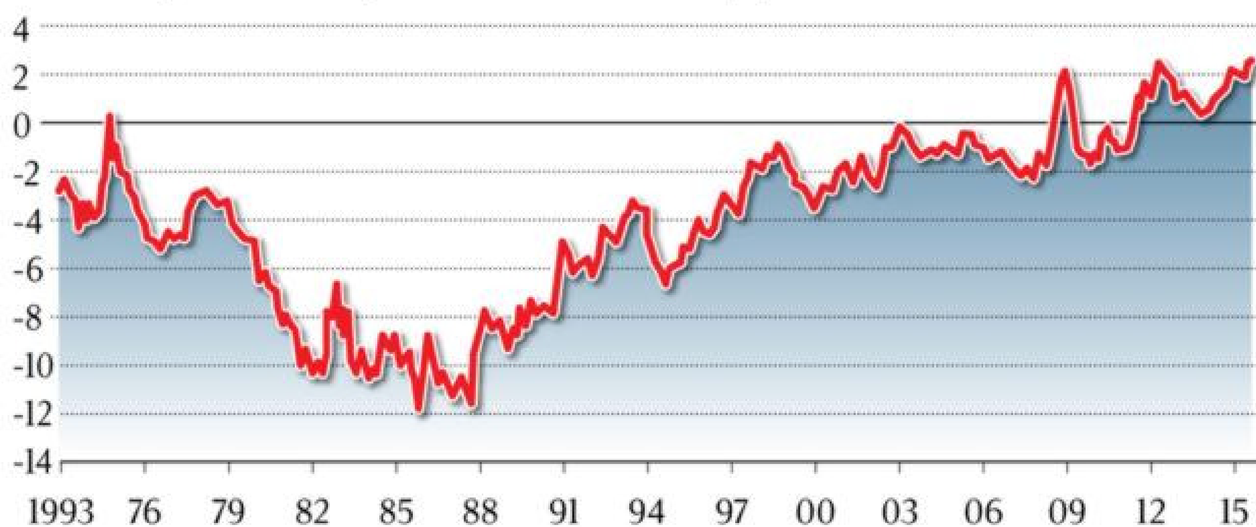


Back to the 70s? Inflation pushes Sydney out of reach

STIRLING LARKIN THE AUSTRALIAN SEPTEMBER 12, 2015 12:00AM



The ASX 200 yield less the yield of 10-year Australian bonds. Source: TheAustralian

There are very fundamental and rudimentary reasons why Sydney is a far more expensive city to live in than Melbourne and other Australian metropolises.

This is a highly topical conversation among Australian ultra high net worth investors who, on the whole, invest across a wider array of domestic fixed-income, real estate and equity market allocations than other siloed Australian investment communities.

Such costs of living matters across all of these communities, as purchasing power disparities affect all in equally discriminating proportions.

The basic economics that most have missed is that Sydney has become far more sensitive to what is referred to as "cost-push" inflation, than any other Australian hub.

Reinforcing this oversight has become the "modus operandi" for the Reserve Bank and Australian Bureau of Statistics because acknowledging that this inflation conduit exists would also result in acquiescence that official Consumer Price Index inflation measures are grossly misrepresentative.

No one in their right mind truly believes the true cost of living in Sydney has only been accreting between 1.5-2.5 per cent annually.

No one.

The closest acceptance by an official of this reality came during a speech on Monday (September 7) when the head of the RBA's Financial Stability Department, Luci Ellis, discussed the degrees of uncertainty that exist between the "cause and effect" of Australian credit and asset price cycles.

Her speech tacitly acknowledged that the RBA remained uncertain as to why the relationship between property prices, credit, financial stability and the real economy, continued to run anticyclical, let alone within any observable cycle.

But better understanding of "cost-push" inflation, and the mechanics surrounding how it works in practice, allows the global investor to not only better appreciate their own existing investments but also how Australia, until now, has delayed a recession that its closest economic peer, Canada, has

succumbed to.

Cost-push inflation is caused by higher costs of production in an economy — and, in this instance, that refers to domestic Australian costs multiplied by imported Chinese costs — seeing a reduction in the growth in supply of new goods or services, which, at the exact same time, results in consumer prices being pushed upwards simply because demand for these in large metropolises remains consistent.

In larger and commercially driven cities, such as Sydney, this causal-nexus is both amplified and sped up.

With international ZIRP — zero interest rate policies — still driving the relatively limited supply of Australian Government Bonds to record higher prices, as the graph stresses, Australia has this week seen the divergence between stockmarket dividend and AGBs yields reach a 42-year record.

This watermark moment matters to Australian UHNW investors, as this divergence represents "déjà vu" for many of them, who remember the 1973 OPEC crisis and linked 1973-1975 recession far too vividly.

The 1973 OPEC crisis — which saw a cartel of oil exporters "cost-push" inflate their prices overnight — saw almost instant international "hyperinflation", which hit Australia during a time, when issuances of what we today refer to as AGBs, were at record high levels.

These high levels were due to the debt financing requirements of Australia's military contributions to the Vietnam War.

Even though Australia withdrew from the Vietnam campaigns in 1972, the debt hangover remained with us well into the 1980s.

While eerie similarities exist between Australia of 1973 and that of today, with focus on the graph's gap, the primary difference between eras is that today, even though AGB prices are once again high, there are far fewer AGBs is circulation.

Australian governments have found more contemporary ways of financing debts.

But what is strikingly similar between eras is that, identical to Australia of the early 70s, we are once again facing the tail-end of an Australian equities bull market, plus Sydney remains the primary real estate market.

The early 70s saw a spectacular end to the then bull market, with the collapse of legendary mining company Poseidon NL; the so-called "Poseidon Bubble".

The highly ironic twist between the Poseidon Bubble, Canada, Australia's record AGB yield spread and the Vietnam War — which caused Australia's AGB overhang — was that it was due to the high demand for nickel during the Vietnam War and a shortage of supply because of industrial action against the major Canadian supplier, Inco, which originally caused Poseidon shares to rocket.

Taking a deeper look at the ASX 200 today and questioning current payout ratios, the UHNW global investor must determine whether this week's graph represents an omen or an auspice.

The combination of a market at 2-year lows, AGB yields still close to record lows and the completion of another year of dividends growing faster than earnings — ASX 200 dividends per share increasing 25 per cent while EPS only increasing 5 per cent since financial year 2011 — has created an elevated ASX 200 payout ratio, which now sits around the 75 per cent level versus the 30-year average of 65 per cent.

The ASX 200 architecture of today demands that large dividend cuts are avoided for price stability, simply because far more Australian investment communities, especially SMSFs, now rely on ASX distributions for income compared to investors in the 70s.

This will be particularly difficult for listed Australian miners, who are both currently servicing dividend payout ratios of more than 120 per cent of forecast financial year 2016 earnings combined with the foreseeable falls in spot iron, copper and nickel prices to their lower long-term averages.

Remembering that recessions deflate inflation levels indiscriminately and that Sydneysiders haven't seen such reprieve since September 1991, it is little wonder why Sydney has become the most expensive city in the world.

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