GRANT'S

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Two hips joined

With news of another positive print in GDP growth—the announcement came two Wednesdays ago—the long-running Australian economic expansion eclipsed the 25½-year Dutch recession-free experience of 1982–2008 by one calendar quarter to set a new world record for the greatest streak of unchecked prosperity in modern times. Lucky Country, indeed.

How Australia managed to do what it did, and how much longer it can keep on doing it, is one topic of the essay now unfolding. Interest rates, the very idea of a business cycle and the trouble with prosperity are others. Interest-only mortgages (very popular Down Under) and the contemporary relevance of the Herbert Stein dictum, "If something can't go on forever, it will stop," also figure in the narrative.

It's writ in these pages that, as long as business ebbs and flows, recessions are not only inevitable but also salutary; you need them to correct the errors from the boom phase of the cycle (which is why they call them "corrections"). It's likewise *Grant's* doctrine that China's economy is perpetually teetering on the brink of something unbullish, even as its GDP continues to expand at the blistering, self-reported rate of 7% or so per annum. Our suspicions are not so original, admittedly. A highly leveraged, deeply corrupt one-party state is no obvious candidate for prolonged stability.

Australia long ago hitched its wagon to the red star of China's growth, in particular to that country's seemingly insatiable demand for raw materials. Thus, between 2000 and 2012, Australian mining investment bounded to A$94.2 billion (6.2% of Australian GDP) from A$4.9 billion (0.5%).

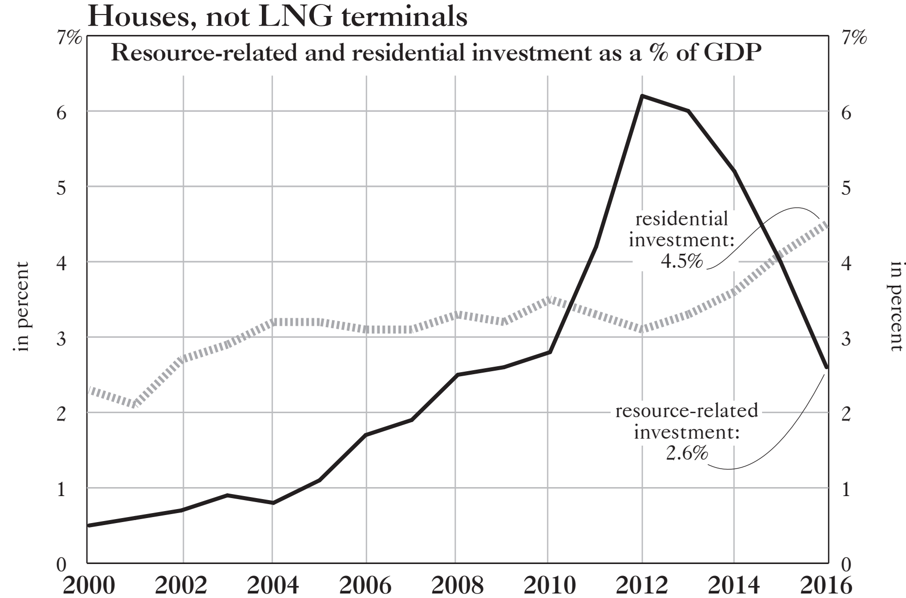
Grant's, dogged critic that we are of China's astounding debt boom, has had nothing good to say about the manifold benefits that Australia has derived from this phenomenon. An imminent deceleration in the pace of resource-related capital expenditures, we wrote four years ago, would lead to an economic downshift not discounted into the prices of Australian securities: "The resource-led investment cycle that has fed Australia's growth is fading," said we in the issue dated March 22, 2013. "What to do about it is the question before the house. An answer, we are about to propose, is to sell short a pair of at-risk Australian banks."

Little did we realize that, in so saying, we were contributing our journalistic might to one of the three worst ideas of the past decade or so, as an acquaintance identified those mistakes last week. Selling short Australian banks has worked no better than selling short Japanese government bonds, he remarked—and no better, he added, than wasting one's breath condemning central-bank policies to pump up the financial markets.

Westpac Banking Corp. and Bank of Queensland, Ltd. (WBC and BOQ on the Australian Stock Exchange), our picks not to click, have rallied by 6% and 25.3%, respectively, in U.S. dollar terms over the past four years, including reinvested dividends. At that, our stock-picking was flattered by a 28% decline of the Australian dollar against the greenback over the same span.

We were correct about the call on mining investment, which halved to

Houses, not LNG terminals



sources: IMF, Australian Bureau of Statistics

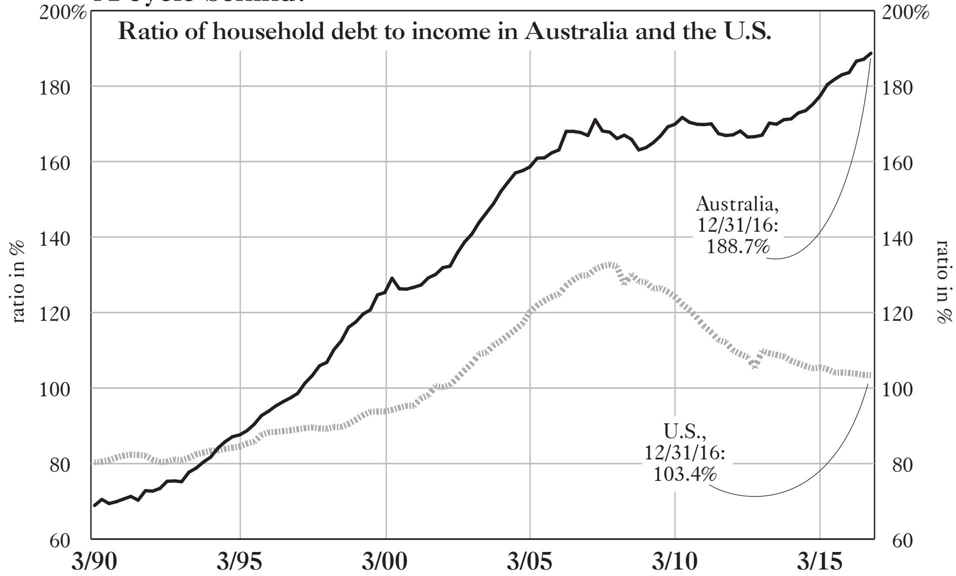
A$43.2 billion (2.6% of GDP) in 2016 and is likely—say we—to keep shrinking. What we didn't anticipate was that Australia would ignite a housing boom to replace the fading mining bonanza. If a housing bust is in the cards, high-yielding Aussie bank stocks may yet take a tumble. Even in the absence of such a slump, we think, highly leveraged households are set to disappoint the expectations which are built into the share prices of certain Australian retailers (JB Hi-Fi, Ltd., the local version of Best Buy, for instance). Perhaps the Aussie dollar might similarly prove a rewarding short sale. These ideas we float for discussion. We write not so much to promote a trade as to explore the financial ecology of two interconnected economies, the larger of which being (in our opinion) the world's most inflammable.

We reiterate: What precipitated Australian growth in the dozen years through 2012 was the investment to extract resources, not the extraction itself. Key to our story is that such investment is waning, as illustrated, for instance, by a pair of supersize liquefied natural-gas projects: Wheatstone, developed by Chevron Corp., and Ichthys, built by INPEX Corp. Each is near completion. "We expect the trough [in resource-related investments] to be in 2018/2019 at A$28.4 billion," Adrian Hart, senior manager at BIS Oxford Economics, tells colleague Evan Lorenz. "So, obviously it is a long way from top to bottom. It is still declining over the next couple of years because of that oil and gas story."

That *Grant's* could spot the coming slowdown all the way from lower Manhattan meant that it was no secret to the Reserve Bank of Australia (RBA) in Sydney. The central bank seemed to take to heart the advice that Paul Krugman so helpfully proffered to the Federal Reserve in an Aug. 2, 2002 *New York Times* column: "To fight this recession the Fed needs more than a snapback; it needs soaring household spending to offset moribund business investment. And to do that, as Paul McCulley of Pimco put it, Alan Greenspan needs to create a housing bubble to replace the Nasdaq bubble." Even without the invaluable counsel of Krugman and McCulley, Australia seems to have blundered into the same trap.

"Between May 1, 2012 and Aug. 2, 2016," Lorenz relates, "the RBA reduced its target rate to 1.5% from 4.25%. These cuts had two important effects.

A cycle behind?



source: The Bloomberg

The first, as most mortgages in Australia are floating-rate, was the lowering of the cost to borrow increased household income. Retail-sales growth slowed down to 2.6% in 2010 and 2011 after a 5.9% year-over-year jolt in 2009. From 2012 through 2016, retail sales compounded at an annual rate of 4%.

"The second effect," Lorenz continues, "was the decline in rates, as well as a relaxation in banks' underwriting standards. This helped ignite the Aussie housing market. In the five years through May, house prices in Australia's capital city rose by 49%. This then led to a surge in housing-related activity. Housing investment, which includes the new construction and remodeling of existing homes, jumped to A$74.8 billion (4.5% of output) in 2016 from A$47.8 billion (3.1% of output) in 2012."

The boom wasn't built on bedrock. Household debt as a percentage of income was 167.1% on March 31, 2012, even before interest rates started to fall. As of year-end 2016, that figure stood at 188.7%. According to the Organization for Economic Co-operation and Development, Australian households rank fourth among the world's most-indebted states, trailing Norway (222%), the Netherlands (277%) and Denmark (292%). During the U.S. housing bubble, the American debt-to-income ratio peaked at 132.7%; it has subsequently declined to 103.4%.

EZ credit has proved as potent a leavening agent in the southern hemisphere as it has in the northern. At last report, according to the 13th Annual Demographia International Housing Affordability Survey, the median ratio of house prices to income in Australia's major markets hovered at 6.6 vs. 3.9 in the United States. The price-to-income ratio in Sydney, the second-most expensive city in Demographia's survey, towered at 12.2, after Hong Kong (18.1) and above other high-flying Anglophone cities like Vancouver (11.8) and San Francisco (9.2).

It's investors who have paced the demand for Australian housing debt. Overall, in the five years through April 2017, residential-mortgage credit has grown by 35%, to A$1.7 trillion. Over the same half-decade, mortgages to finance rental properties and the sport of house-flipping have climbed by 47%, to A$579.7 billion.

Can you afford your own home? In the early 2000s, Americans—many answering that query in the negative—turned to interest-only mortgages to square the circle of inflated values and inadequate incomes. Australians, too, are warming to non-amortizing loans. According to the RBA's April 2017 Financial Stability Review, 23% of the mortgages on owner-occupied dwellings are interest-only, whereas 64% of the mortgages on rent-or-flip properties are IO.

The Australian tax code only fans such speculation, as households may claim losses on investment property against ordinary income. In fiscal 2015, Australian landlords in aggregate asserted A$39.7 billion in rental income and A$21.9 billion in operating expenses. The resulting $17.8 billion in operating income did not cover the $21.5 billion in related finance expenses.

However, what the tax code has given, the regulators have begun to take away. Last July, the Australian Prudential Regulation Authority (APRA) raised the amount of capital that banks must hold against mortgages. In March, APRA set new speed limits: The year-over-year growth in mortgage loans to investors cannot exceed 10%, and banks must limit IOs to no more than 30% of new originations. In addition, APRA tightened underwriting guidelines with respect to income buffers and loan-to-value ratios.

Squeezed by the regulators, lenders have responded with higher mortgage rates—up by as much as 0.90%. It may not sound like much, but mortgagees are heavily encumbered. And because most Australian mortgages are variable-rate, a rate hike smites all the net debtors.

"There has been a dramatic slowdown in the past couple of months," Hasan Tevfik, Australian equity strategist for Credit Suisse, tells Lorenz. "Everything stopped. Retail sales stalled. My brother's partner administers St. Vincent's Hospital, which is the main hospital in the center of Sydney. She was saying that elective surgeries have stopped. If you need some surgery that is not critical, people are delaying it. There is mandatory private health insurance in Australia that you still have to pay excess [for], whether that is A$1,000 or A$2,000. She knows a hand surgeon who usually gets 20 inquires a week, and now it has dropped to seven. Everything has stopped, and I think a lot of it has come down to the fact that there are a few macro prudential measures that have been put in place which are designed to alleviate some of the excesses in the housing sector, and that has been to the detriment of consumer demand. That is on top of the issue that house prices are just so damn expensive. It leaves very little for discretionary spending."

There is a Chinese angle to the vertiginous rise in Australia's house prices. Foreigners are, with some limited exceptions, prohibited from purchasing so-called existing homes, but they are big buyers of new construction. The exact extent to which Chinese money has made its way into the Aussie housing market has been, until recently, a mystery.

Work by Tevfik in 2015 suggested that the Chinese were acquiring a low-single-digit percentage of new houses. That supposition sparked a national outcry and led to federal and state taxes on foreign-home transactions in mid-2015. The very existence of these taxes means that data on foreign transactions are now being collected.

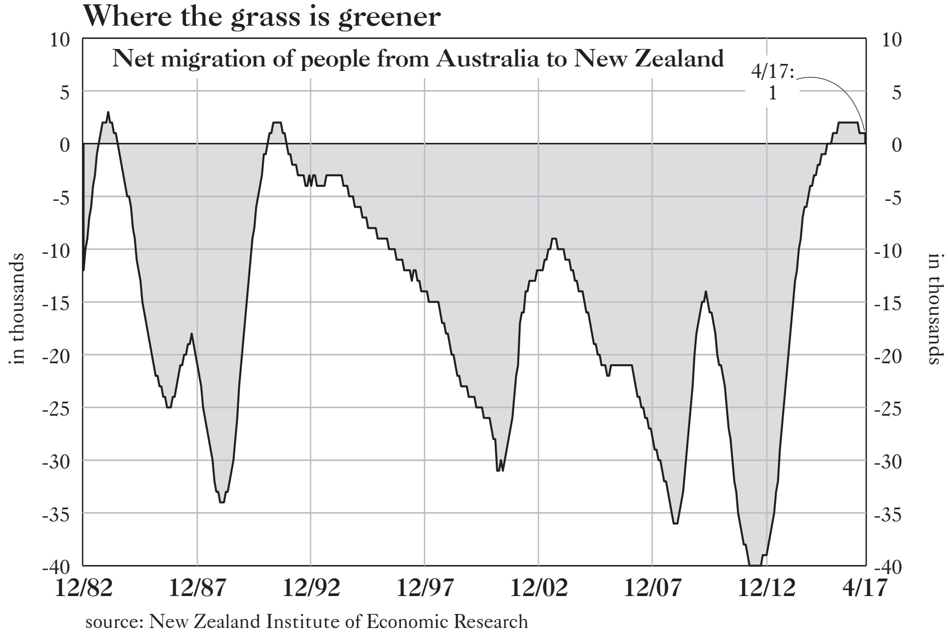
"We have the Freedom of Information Act," Tevfik says, "so we made four requests: one to each of the states on the East Coast which have taxes on foreign purchases, and a request of the federal government. Of the four, two have come back." Based on that information, Tevfik calculates that foreign buyers account for 25% and 16% of all new supply in New South Wales and Victoria and that 77% of them are from China. Not surprisingly, the proportion of foreign buyers matches up with price appreciation. In the five years through May, house prices in Sydney and Melbourne, the capital cities of New South Wales and Victoria, have soared by 75% and 55%, respectively.

So far, China's crackdown on capital outflows hasn't impinged on the demand for Australian property. Following the Aug. 15, 2015 renminbi devaluation, Beijing plugged many of the monetary escape hatches from the mainland. Nonetheless, Chinese buyers still found ways to send money. "It is a pint glass being poured into a shot glass," says Tevfik. "We are underestimating how big China is and how much wealth is in China looking to come out. There is an entire industry in Australia set to cater to the Chinese buyer."

"This may be starting to change," Lorenz observes. "Authorities continue to block the monetary exits, including the ones that Chinese corporations were using to buy foreign assets. The chairman of Anbang Insurance Group, which bought the Waldorf Astoria, has been detained by authorities following an aborted bid for 666 Fifth Avenue in Manhattan. Wanda Group cancelled its bid for Dick Clark Productions in March. The crackdown is trickling down to ordinary citizens, too. 'Melbourne's property market is facing a downturn as Chinese investors pull out of apartment purchases, with many either forfeiting deposits or selling their apartments at a loss,' according to a May 25 Australian Broadcasting Corporation bulletin. And to judge by recent turns of the capital-controls screw, it's only going to get harder to move meaningful sums of money out of the People's Republic."

Then, again, Chinese demand can explain only so much of the high spirits in Australian residential real estate. It wasn't China's central bank that cut the interest rates but Australia's own. "We have small cities with unprecedented expensiveness," Gerard Minack, the eponym and principal of Minack Advisors Pty. Ltd., tells Lorenz. "These are not cities where you can claim it is Chinese buying or supply shortages or the other justifications. You have cities you have never heard of on 7–9 times [house price-to-] income [ratios]. Try this for some of your readers: Tweed Heads, Port Macquarie, Coffs Harbour. These are all cities over 7.5 times income. Tweed Heads is on 9.5 times, the same as San Francisco. You might be able to justify San

Where the grass is greener



source: New Zealand Institute of Economic Research

Fran as a global city with Chinese buying; Tweed Heads, no way."

Many along the eastern seaboard of Australia are praying that Jean-Baptiste Say was right when he propounded that supply creates its own demand. "We'd never seen apartment construction running above 60,000 per year before 2010," says Minack. "Now we are running at 150,000. It's localized. It will be most prevalent in Brisbane and Melbourne."

High-paying jobs would help the cause of absorbing the overhang of residential real estate, but house-building doesn't pay like yesteryear's construction work. The unemployment rate has gradually moved up over the course of the housing boom, to 5.7% in April 2017 from 4.9% in June 2011, and wage growth has been disappointing. In the first quarter, the wage cost index climbed by 1.9% year over year—the smallest rise since the Bureau of Statistics began the series in 1998 and less than the corresponding 2.1% rise in the CPI.

"What is interesting to me," says Minack, "is if you look outside Melbourne and Sydney—they are only two cities, but they are about 40% of the country—if you look outside those two cities, we've had almost no domestic demand growth for four years. Despite that, you've still had employment growth. It's been weak. It's been low-calorie employment growth, but we've forestalled outright job loss."

Not all Aussies are staying in Australia. The quickening pace of out-migration is another sign of trouble Down Under. New Zealand and Australia allow each other's citizens to work without a visa. As Australian GDP per capita is higher than New Zealand's—$51,850 vs. $38,345 as of 2016—the migration has been one-sided. According to data crunched by the New Zealand Institute for Economic Research (NZIER), a net five million New Zealanders moved to Australia between November 1991 and September 2015. In that 23-plus-year period, net migration to Australia was positive every month.

No longer. In October 2015, net migration to New Zealand from Australia turned positive. Through April 2017, a net 26,410 people moved from Australia to New Zealand. For the 19 months through April, net migration to New Zealand was positive every month.

NZIER tracks migration data back to December 1982. Historically, net migration from Australia to New Zealand has only been positive around the time when Australia's economy slipped into a recession, namely, from August 1983 to June 1984 and from February to October 1991. That net migration to New Zealand from Australia is positive in what continues, statistically, to be a time of growth (first-quarter GDP expanded by 1.7% from the year-earlier period) is a sign of stress that the statistics don't yet register.

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Energy prices are one source of this discombobulation. Curiously, for a major exporter of coal and natural gas, Australia is suffering from a bout of spiking energy prices and irksome electricity outages. There are many reasons for this anomaly. The country's massive liquefied natural-gas terminals have committed to export all their production. Utilities are retiring old but reliable coal-fired generation and replacing the lost capacity with intermittent renewable-energy sources. Last September, a storm in South Australia led to a shutdown of wind-generating capacity, resulting in the first statewide power outage in more than 50 years.

So it was in the first quarter that the electricity component of the CPI rose 7.5% year over year. On Bloomberg you can look at base-load electrical futures for each state in Australia. The front month for power in New South Wales has soared from around A$40 per megawatt hour in 2015 to A$118.15 today.

In the May 8 episode of the Australian Broadcasting Corporation's *Four Corners* (Down Under's *60 Minutes*), reporters warned that electrical prices may spike 30% year over year in June alone. "Big parts of Australian industry are now looking over the precipice," Innes Willox, CEO of the Australian Industry Group, told *Four Corners*. "What was once a huge competitive advantage for Australia has now become a millstone around industries' neck. We're seeing gas prices double and triple and more than triple. We're seeing electricity prices more than double."

Witnesses to America's financial crisis may now be nodding their heads. In July 2008, the price of West Texas Intermediate soared to $145.29 per barrel. This surge in energy prices pushed the household-energy and motor-fuel components of the U.S. CPI up by 18.4% and 38.4% year over year, respectively, in July. The result was even more pressure on overleveraged U.S. households and even greater declines in consumer spending.

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Australian retailers would seem to stand in the line of fire. Fading fast is the Chinese credit impulse that had lifted commodity prices worldwide (*Grant's*, Jan. 13). Since peaking at $94.86 per metric ton on Feb. 21, the price of iron ore delivered in China has dropped by 44% to $53.36 per ton. The Chinese-led commodity reflation was a boost to Australian activity in the first quarter but will turn into a drag in the second.

Apparently healthy Aussie retail sales—up by 3.1% year over year in April—mask growing problems. Sales of household goods nearly flatlined in April at 0.7% year-over-year growth (down from 11.3% as recently as June 2015), and department-store sales expanded by 0.1% (in fact, such sales peaked in nominal terms in October 2015). Then there's the digital problem. Mates, say g'day to Jeff Bezos.

While Amazon.com, Inc. sells $1 billion in merchandise to Australia today, according to Morgan Stanley's estimates, the e-commerce giant ships from overseas. On April 20, Amazon announced its intention to build warehouse and distribution facilities in Australia to offer a wider range of goods and services, including the Prime membership program, at lower prices.

It won't be easy—the Australian land mass is only 22% smaller than the 50 states, yet Australia's population of 24.2 million is less than a tenth of America's. Then, again, when has mere difficulty stopped Amazon?

JB Hi-Fi is front and center for Amazon and the problems facing the Aussie consumer. The company is a retailer of consumer electronics, home appliances, DVDs and software. On Nov. 28, 2016, JB purchased the Good Guys Caringbah Pty. Ltd., an Australian appliance retailer, for A$870 million, or 11.7 times normalized pro forma earnings before interest and taxes. Post-acquisition, the company operates 302 stores in Australia and New Zealand. In the six months ending Dec. 31, 2016, Australia accounted for 95% of total sales and New Zealand 5%.

After the purchase of the Good Guys, appliances account for 26% of company-wide sales compared with 4% before the acquisition. Stretched consumers and a slowdown in housing activity aren't the most promising context for big-ticket purchases of white goods. As for what might happen in the face of a housing bust, U.S. appliance sales, as measured by the Association of Home Appliance Manufacturers AHAM 6 index, fell by 24% between 2005 and 2012.

"For now," Lorenz points out, "all would seem to be well at JB Hi-Fi. First-quarter same-store sales showed healthy growth (thanks in part to a boost from a competitor's liquidation), and the post-acquisition balance sheet is not unduly leveraged. Still, Amazon knows how to sell consumer electronics, as the commercial deaths of American rivals Tweeter (in 2008) and Circuit City Stores (2009) attest. Perusing JB Hi-Fi's website and adjusting for Australia's goods and service tax and the exchange rate, you find that the Samsung Q7 Series 65" UHD HDR QLED TV is 9% pricier than it is on the Amazon website for American shoppers, and that the Canon EOS 5D Mark IV camera and the Apple MacBook Air 13-inch laptop with a 128 gigabyte hard drive are 7% and 15% more expensive, respectively. Excluding acquisition-related expenses, JB Hi-Fi's operating margin in the six months ending Dec. 31 was 7% of sales. In America, under the lash of Amazon's competition, Best Buy ekes out an operating margin of 4.5% of sales.

"In a genuine housing bust, it will not take much skill to select Australian equities to bet against. Barring that dire outcome, JB Hi-Fi and Australian retailers look set to struggle."

(On an average trading day, A$24.6 million worth of JB Hi-Fi shares change hands; they're quoted at 11.9 times estimated fiscal 2017 earnings. Analyst opinion is mixed, and 11.5% of the A$2.5 billion float is sold short. Management would seem no more confident than we are. Over the past 12 months, insiders have net sold 80,179 shares for proceeds of A$2.2 million.)

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The Australian exchange rate has long served as a shock absorber in that small, open economy. At the height of the financial crisis, the Aussie dollar sold off by 39% to $0.6013 between July 15 and Oct. 27, 2008. Following a prior extended bear market in commodities, between 1996 and 2001, the Aussie traded down by 41%, to $0.479. And since 2011—about the time China's economic model began to wobble—the AUD has weakened by 32%.

Today's exchange rate of $0.7538 is not so far from the average $0.7643 USD/AUD rate that has prevailed since 1990. And even if Australia's souring economic backdrop does not lead to a sell-off in the local currency, a hawkish Fed and a dovish RBA might do the trick. After we go to press, the Fed is expected to hike its target rate by a quarter of a point, to between 1% and 1.25%. There are no such expectations for the RBA—indeed, the futures markets place a 13.1% chance that the RBA will cut its target rate by December.

Long-term options on the AUD are available for the plucky institutional investor. A two-year put, struck at the money for $1 million of notional exposure, costs $70,593.63, or 7.1% of face. Such options would be in the green for exchange rates below $0.7008. Retail investors have fewer options, which, given the vicissitudes of currency speculation, might not be a bad thing.

The opening words to the final chapter of Donald Horne's *The Lucky Country*, published in 1964 (the book from which Australia's nickname derives), read as follows: "Australia is a lucky country run mainly by second-rate people who share its luck. It lives on other people's ideas, and, although its ordinary people are adaptable, most of its leaders (in all fields) so lack curiosity about the events that surround them that they are often taken by surprise."

Perhaps another way of saying it (Horne's words striking the ears of Australia's American admirers as a little severe) is that the land Down Under is currently deriving its economic vitality from the People's Republic of China. And China's luck, at least according to the view from lower Manhattan, seems to be running out.

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