Avoiding a recession low rates won't fix

We need a different strategy to pull the economy out of its vicious spiral

ROGER MONTGOMERY

The Australian economy is barely growing. In fact, as measured by gross domestic product, it grew most recently at an annual pace of only 1.4 per cent, which was the slowest rate of growth since the 1.7 per cent recorded during the global financial crisis, and the lowest rate since the 2000 tech wreck.

Seasonally adjusted, retail turnover fell 0.1 per cent in July, according to the Bureau of Statistics.

In NSW, state final demand, a broad measure of spending, stopped in the quarter to June 30.

Meanwhile, the Reserve Bank reported earlier this month that Australians had nearly twice as much debt as income. Debt to income rose to 191.1 per cent in the June quarter, up from 189.4 per cent in March. Household debt to income jumped to 140.4 per cent, from 139.8 per cent.

And its income that is now in recession for many Australians. With term-deposit rates of less than 1.75 per cent, many retirees have been enduring a worsening "income recession" for years.

It's a vicious spiral. Rates are cut to spur investment, but for the oldest individuals and couples in the largest cohort of the population (the baby boomers), incomes fall and spending must dry up. The consequent slowing in the economy requires more rate cuts and the cycle continues.

Rate cuts are clearly insufficient to get the economy going and the heavy lifting must be accompanied by fiscal measures, meaning government spending and/or tax cuts.

For Australia, however, it could get a whole lot worse soon.

Residential building approvals, which I have warned about in this column for more than a year, is down 40 per cent. It's a leading indicator for construction activity, meaning the ranks of those suffering from income reductions will include architects, surveyors, landscape gardeners, brickies, sparkies, plumbers, chippies, tilers, painters and roofers.

That's more than 3.5 per cent of the nation's workforce who, by Christmas or early in the new year, will be earning less income even if they keep their jobs or contracts. In turn, that could have an adverse impact on retailing, which is the nation's second-largest employer.

As you can see, giving 3.5 per cent of the workforce 40 per cent less work will mean less spending at the shops, which could lead to store closures or cost cuts, leading to unemployment in retail. Add that to the multitudes of retirees already tightening their belts and Houston we have a problem.

Forget the official definition of a recession, a large portion of Australia is already in an income recession and a bunch more are about to enter one.

A better idea

It makes perfect sense, therefore, that our Reserve Bank would cut interest rates. Unfortunately, what I know from my conversation with the RBA's assistant governor is that while the intention — to help keep people in a job — is to be commended, rate cuts incentivise businesses to invest in technology that displaces labour.

As revenues fall, businesses are forced to find cost-out solutions and automation is high up on the list, especially when there are tax rebates for doing it.

The labour displaced by automation and robotics is a major reason interest rates are as low as they are globally. Low rates have spurred a boom, and perhaps a bubble, in AI, 3D-printing, electric vehicles, autonomous vehicles and the list goes on. The primary purpose of some of this technology, of course, is to lower costs by replacing humans. So as central banks cut rates, they incentivise investment in technology that displaces labour, forcing central banks to cut rates further.

The other issue, of course, is that rate cuts are justified on the basis of a global savings glut, the currency war, inflation being low and on the basis of the aforementioned desire to improve employment. Any recession is anathema to central banks. However, more frequent shallow recessions are much better than deep, prolonged slowdowns, even if they are less frequent.

Meanwhile, rate cuts also help lift the price of real estate, which benefits those who already own assets but does nothing for those bereft of assets. And so, rate cuts widen the inequality gap.

What's needed are permanent and enduring tax cuts for those on lower incomes. Lower-income earners spend a higher proportion of their income and cutting rates for lower-income earners increases the velocity of money — the frequency with which it circumnavigates the economy.

As the economy continues to slow, you will be hearing a lot more about the need for government spending on infrastructure to stimulate the economy. The problem with this, of course, is the "long lead time".

A better idea is the NSW schools maintenance program that has just been announced by the NSW government. This is more immediate and employs more people than a tunnel project. In its economic effect, it should be akin to the school building program run during the GFC.

While governments and their advisers might be more inclined to pay for one-off projects, such as a few schools to be fixed, or for a hospital to be given a coat of paint, the pace and potential depth of economic slowing may require something broader and more permanent.

A tax cut for lower-income earners is a strategy that needs to be considered to avoid a recession we don't have to have.

Roger Montgomery is founder and chief investment officer of the Montgomery Fund.

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Early-learning centres offer yield opportunities

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It is school holidays again and my morning commute features some new guests accompanying their parents in the traffic.

With the cost of living rising and wage growth stagnant, the latest Australian Bureau of Statistics data on the rates of "dually employed" couples doesn't come as much of a surprise.

According to the ABS, 67 per cent of couples with dependants are both employed, up 4.6 per cent in five years.

Notably, the proportion of couples with children aged 0-4 years where both parents are working full-time rose 3 per cent over the same period — and almost 7 per cent over the decade.

Considering these statistics, early learning centres are particularly well positioned to capitalise on a shift in working patterns.

One such stock is the Arena Real Estate Investment Trust.

Arena's $826m property portfolio ranges across Australia, with a majority in Queensland, Victoria and NSW.

The portfolio consists of 216 early-learning centres equating to about 85 per cent of its entire portfolio, with the remaining 15 per cent spread across 10 healthcare assets, which now include disability services.

Earlier this year Arena raised $55m via an institutional placement and a further $10m through a security purchase plan.

Moreover, $62m of funds raised were invested across three early-learning centre properties, eight early-learning developments and three specialist disability accommodation properties.

The acquisition presents a diversification into what is a burgeoning sector backed by federal support through the National Disability Insurance Scheme.

Arena's portfolio constituents are committed to long-dated leases with a weighted average lease expiry (WALE) of 14.1 years.

This provides the ability to achieve ARF's objective of predictable distributions and earnings growth via rental review uplifts with tenants.

> Early-learning centres are well positioned to capitalise on a shift in working patterns

In the full-year results, management guided to a distribution increase for the 2020 financial year of 5.9 per cent to 14.3c per share, which currently represents a 5 per cent yield.

While the REIT is trading at a premium to its $2.10 net asset value (NAV), the long-dated WALE and 3.6 per cent average annual rental increases mean that the NAV should gradually increase year on year.

Separately, the gearing is low for Arena at 22.8 per cent and we note management has suggested there is room for further acquisition opportunities.

Hugo de Vries is an analyst at Clime Investment Management. Clime owns ARF across some mandates.

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