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Real Risk And Market Risk: A Mismatch Of Perceptions?

Highlights

- The media is littered with news of some of the most serious crises the world has faced in recent years – with seemingly obvious macroeconomic consequences for growth, trade and stability.
- The global financial markets are at significant risk of complacency as they have not adequately responded to price in the current levels of inherent risk to the global macroeconomy.
- These geopolitical concerns have had little impact on the Australian property market, which has continued to trend upwards – part of the reason for this appears to be the continuing lax monetary environment as well as the unprecedented demand from foreign investors dampening any potential shock.
- Higher levels of foreign investment in Australian real estate may lead to a "two-speed" property market, split between major urban centres, namely Sydney and Melbourne, and the rest of the country.

Introduction

In Greek mythology (which we at Trident Real Estate Capital are avid students of), Cassandra was a Trojan princess who was able to predict the future. She foretold the Trojan War and countless other woes that would befall the Trojans and yet time and time again was never listened to.

Of late, there have been many Cassandras all predicting the same thing - that the markets will soon be overwhelmed by geopolitical risk.

The world faces a number of geopolitical crises: ISIS threatens the stability of Iraq, Syria and the rest of the Middle East; war is fracturing Ukraine; the Ebola virus continues to gain momentum in West Africa; and China is becoming more bold as it clashes with its neighbours over ownership of the South China Sea. Olivier Blanchard, chief economist of the International Monetary Fund, has expressed worry in a recent World Economic Outlook Update over the lack of financial response to global turmoil, warning that financial markets are in-line for a rude awakening when the full impact of these crises have been fully understood.[1]

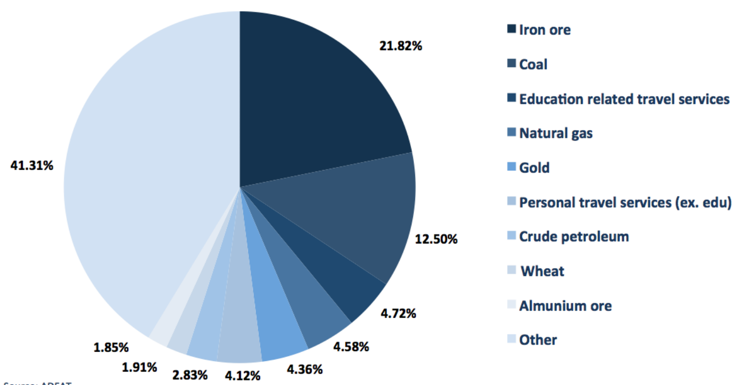
[1] Blanchard, O. "An Uneven Global Recovery Continues: World Economic Outlook Update; July 2014." *International Monetary Fund* (2014): 24 July 2014. Web. 21 Sept. 2014.

Geopolitical Risk And Its Relevance To Australia

With the relative isolation of Australia from the rest of the world, one may question why Australians should worry about these global concerns? Australia is, after all, one of the most geographically isolated continents, far from the madding crowd of Europe and North America. Why should the goings on of politicians and soldiers 10,000 miles away affect us?

The truth, unfortunately, is that Australia is far from isolated. Australia is heavily integrated with the global economy through our trade. Commodities, which are highly sensitive to geopolitical events, accounted for over 50% of Australian exports in the last three years, as shown in **Chart 1**, and multiple large export partners are currently embroiled in conflict. The Eurozone is threatened by the ongoing violence in the Ukraine, Scotland was on the cusp of seceding from the UK, and South Korea persistently faces nuclear attack by North Korea.

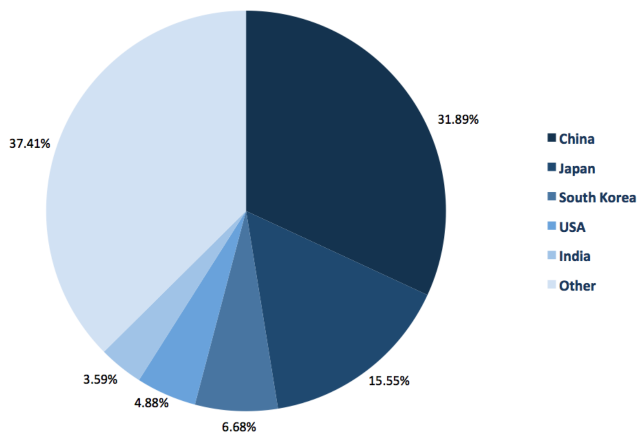
Chart 1: 2013 Australian Exports By Type



Source: ADFAT

Even if major trading partners are not directly subject to tensions, the increasing interconnections between trading partners means Australia is never further away from a second or third degree relation with a troubled party. Australia's reliance on exports to China, Japan, the UK, and the USA (as seen in **Chart 2**) mean that she is exposed to the crises in Syria, Iraq, Liberia, and the Ukraine.

Chart 2: 2013 Australian Exports By Country



Source: ADFAT

Furthermore, the region surrounding Australia is not completely isolated from instability itself. As mentioned earlier, the increasing escalation of tension around oil ownership and maritime rights between China, Japan and other Far East players over the South China Sea is a worrying and directly applicable threat in addition to the ripples felt from other global tensions.

Geopolitical Risk Should Affect More Than Just Oil And Gold Prices

Historically, geopolitical crises have been thought to largely impact oil and gold prices. Trident Real Estate Capital, however, considers that the plethora of crises in the world should have wider repercussions for many different global indices. And yet, the major Equity Volatility Indices, namely the S&P 500 VIX, FTSE 100 IVI and the S&P/ASX 200 VIX, depicted in **Chart 5**, show indifference to recent geopolitical crises.

Even oil and gold, whilst showing the correct volatility patterns, as seen in the behaviour of their fear indices in **Chart 3**, have trended downwards – the reverse of their historical behaviour in past geopolitical crises - depressed by weakening demand from emerging markets, and increased supply.

This is especially true for oil, which has been on a downward trajectory in price, dropping 15% between June 2014 and September 2014 (see **Chart 4**), in part due to the introduction of horizontal drilling and hydraulic fracturing in the US and increased production by Saudi Arabia.

[2] USA. U.S. Energy Information Administration. Washington D.C. *What Drives Crude Oil Prices? An Analysis of 7 Factors That Influence Oil Markets, with Chart Data Updated Monthly and Quarterly.* U.S. Energy Information Administration, 10 June 2014. Web. 21 Sept. 2014.

[3] Gulati, I. S. "International Gold Price Movements, 1972-1982." *Economic and Political Weekly* 17.46/47 (1982): 1861-870. Web. 22 Sept. 2014.

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Chart 3: Major Movements In Gold And Oil Volatility Indices ("Fear Indices") Coincide With Major Geopolitical Events.

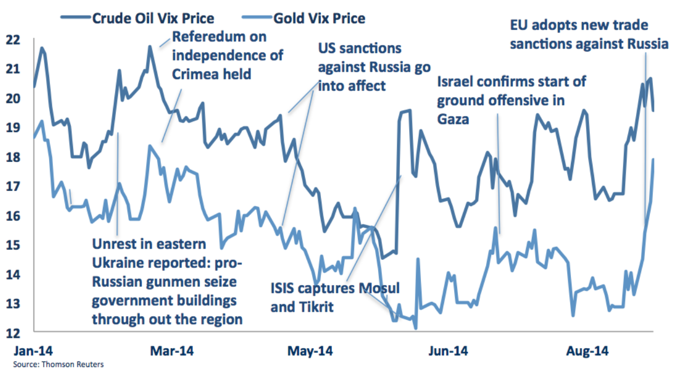


Chart 4: Yet Gold and Oil Prices No Longer Seem To Reflect Geopolitical Turmoil

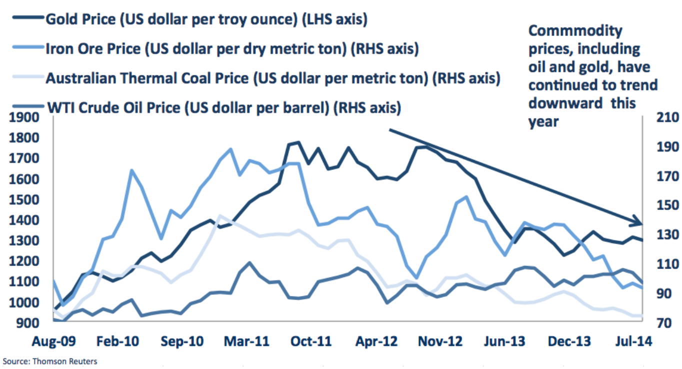
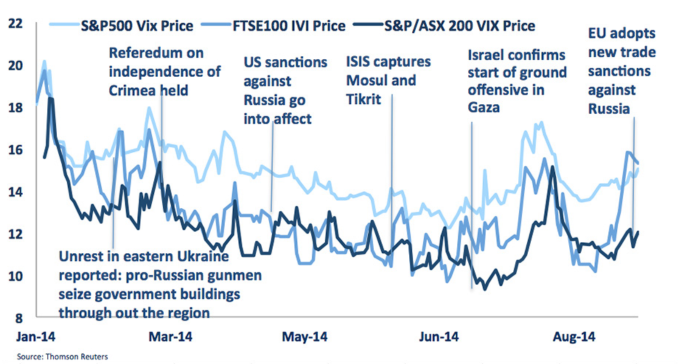


Chart 5: Major Movements In Equity Volatility Indices ("Fear Indices") Across The Globe Do Not Coincide With Major Geopolitical Events



Why Geopolitical Risk Is Not Being Correctly Priced By The Markets?

Part of the reason for this appears to be the continuing lax monetary environment dampening any potential shock. Interest rates are at historic lows around the globe, with the Reserve Bank of Australia holding the cash rate at 2.5%, the Federal Fund rate is steady at 0.25% and the European Central Bank's interest rate is at 0.05%. Repercussions are feared for when one player finally moves to raise these above their current de minimus equilibrium.

Quantitative easing and currency wars also mean that governments are determined to push their currencies downward to ensure exports remain competitive. This can be seen most prominently in the US dollar and Japanese yen, which have fallen 33% and 36%, respectively, against the Australian dollar since November 2008. The US Federal Reserve's Quantitative Easing programme, and the three arrows of Abenomics in Japan, can be credited with the depreciating exchange rates as well as contributing to rising equity markets, and increased consumer confidence, as seen in **Charts 6 and 7**.

Chart 6: Quantitative Easing Has Led To Rising Stock Markets

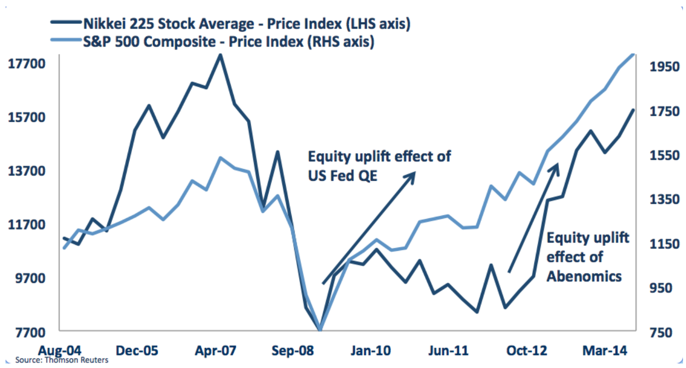
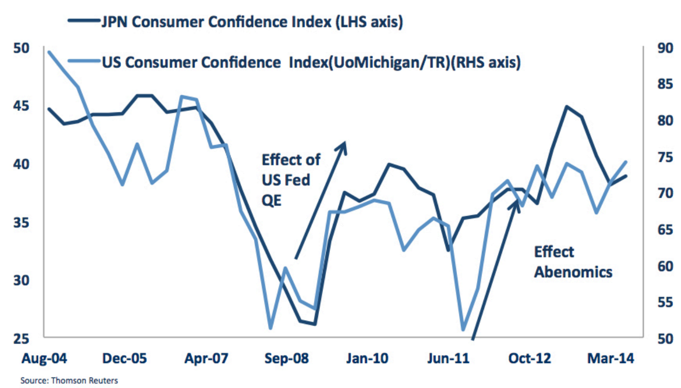


Chart 7: Quantitative Easing Has Led To Increasing Consumer Confidence



The effect of keeping credit relatively loose in many Western Countries has thus far hidden the potential impact of supply side shocks by temporarily raising demand. Under the current regime of macroeconomic policy, geopolitical events have been relegated to mere background noise in the minds of investors, with many seemingly quite content to focus on the companies and cash flows that underpin their investments, as Gideon Rachman has argued recently in the Financial Times[4]. If geopolitical concerns prove to persist, their full effect may only be felt if demand stimulus is gradually withdrawn, interest rates are raised, and investors begin to pay attention to broader global themes.

The markets are apparently of the opinion that the geopolitical crises will be short lived and immaterial in their financial impact as implied by the recent behaviour of equity volatility indices (shown in **Chart 5**). However, this is open for dispute. It seems likely to Trident Real Estate Capital that geopolitical tensions will have a material impact on global trade, as markets, and the regulations and entities that inform them, are *dynamic*. Investor sentiment will eventually wake up to the world around them, once they have overcome the prolonged "sugar rush" created by Central Banks around the world.

Geopolitical Risk: Its Impact On The Australian Housing Market And The Australian Economy

The return of confidence in the Australian housing market has been the defining feature of 2013 and 2014. The stimulatory effects of low interest rates have resulted in house prices jumping at an annualized rate of 10.9% over the last 12 months and 18.7% over the current growth phase with auction clearance rates remaining well above average, and in some States even edging beyond 80% according to RP Data CoreLogic Home Vale.

For the Australian property market, one reason why prices have been insulated from external shocks is the rising demand for Australian property from overseas investors. Foreign direct investment increased 32% between 2008 and 2013 in Australia. Data from the FIRB[5] shows that real estate in major urban areas, such as Sydney and Melbourne, has benefited from foreign investment, with a recent paper published by Credit Suisse[6] suggesting that close to 20% of new property supply in Sydney was purchased by Chinese investors in 2013.

Whilst insulating the Australian property markets from the worst of the Global Financial Crisis, this rise in foreign investment has increased our long-term dependency on external players. Thus, given the buoyant state of the Australian housing market (see **Charts 8 and 9**), frequently referred to in terms of bubble formation, Trident Real Estate Capital is concerned that macro turmoil may cause a re-evaluation of current pricing in the Australian housing market.

The Australian government shares these concerns. At the September 2014 summit of the G20 finance ministers in Cairns, the Australian treasurer, Joe Hockey, hinted at a willingness to bring roaring house prices to an end by introducing limits on loans that banks can issue to prospective home buyers, and by using other similar macro prudential tools to strain housing demand.

Chart 8: The Australian Housing Market Is Strong For Now, But Is It A Bubble?

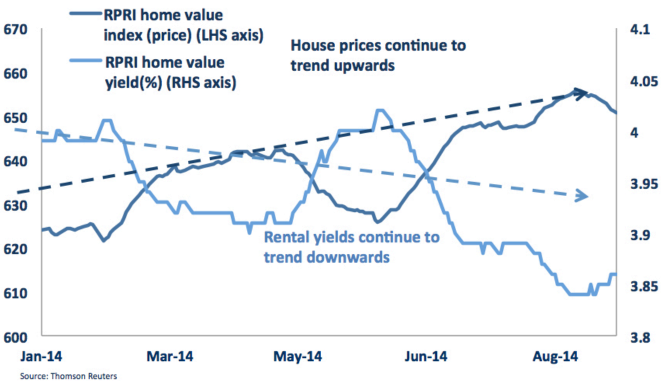
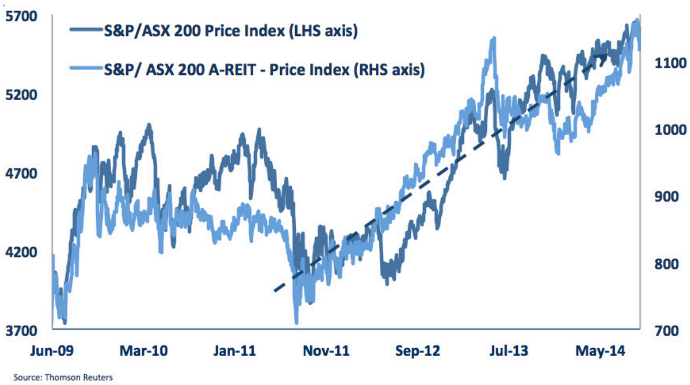


Chart 9: Australian Listed REITs And Australian Equities Have Recovered Well From Lows In 2011 But Can This Upward Trend Continue?



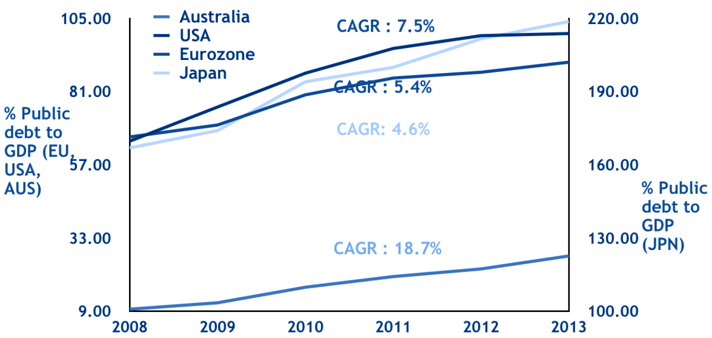
However, this dependency on external players is not limited to Australian real estate, and neither should be the Australian government's focus. Australia's economic fate as a whole is tied to that of the global economy's, particularly to its largest trading partners. As **Chart 2** shows, 32% of Australian exports went to China, an amount larger than the sum of the exports received by the next four largest export markets. Australia's economy is over-reliant on Chinese demand for its goods and services.

Trident Real Estate Capital's most immediate worry is that following the European summer break, which has perhaps nullified some degree of impact on financial markets, there will be a greater adjustment in valuations in crisis areas, as portfolio adjustments are made and economic sanctions take hold.

4 Rachman, G. "Why Investors Are Ignoring War, Terror and Turmoil." *The Financial Times* [London] 8 Sept. 2014: Web. 21 Sept. 2014.
5 Australia. Federal Investment Review Board. Parkes, ACT. *Foreign Investment Review Board Annual Report 2012-13*. Parkes: Federal Investment Review Board, 2014. Print.
6 Boey, D., and H. Tevfik. *Australian Investment Strategy: The Chinese Property Boom Down Under.* Rep. Sydney: Credit Suisse, 2014. Print.

This adjustment in valuation is of particular concern in Europe and other major Western economies, which are in conditions of fragility. However, Australia should be careful not to be complacent. It has so far been lucky: its low level of public debt (see **Chart 10**), resilient banking system, and high exposure to China[7] has allowed Australia to escape from the major impacts of the Global Financial Crisis. These factors will not save Australia if China's demand suddenly weakens. The recent drop in iron ore prices, which at the time of writing this paper had fallen below $US80 a tonne, is a stark example of China's weakening appetite for Aussie commodities.

Chart 10: Australia's Low Public Debt Has Helped Shield Its Economy From The Worst Of The GFC…But Public Debt Has Grown Fast In The Last Few Years



Source: ABS, USBPD,Eurostat, Cabinet Office Of Japan

The Negative Role Of Social Media

Part of the problem for investors is identifying which crises are of sufficient severity to warrant further impact to their portfolios, and to what extent the alleged severity of these crises is a case of "boy who cried wolf". Market participants are so used to hearing negative news and sensationalist stories of impending world catastrophes, which are not realised, that it has made it harder for them to identify real crises that pose actual risks. This has in no way been assisted by the rise of social media in recent years.

Whilst the rise of social media has undoubtedly improved the awareness of the ordinary person of global issues, it has also overwhelmed them. In 2003, the sum of all human knowledge was estimated to be around five exabtyes in size. That amount of information is now created every two days. [8]

Subsequently, it is harder to distinguish between pertinent and irrelevant data, leading to a state that the futurologist Alvin Toffler termed "information overload" [9], where an abundance of information paralyses decision-making. With the sheer amount of information available, how is an investor supposed to be able to gauge the impact of a political event like the Ukrainian crises on the price of a commodity? How is the average participant in the housing market, supposed to judge the potential extent to which interest payments on a mortgage could rise once interbank rates are increased from their low base?

The Danger Of Low Interest Rates

An environment of low, stable interest rates, as well as unsustainable levels of consumption and business investment with cheap credit, has left investors blind to interest rate risk. One example of this is seen in the compression of capitalisation rates for commercial real estate in Australia, with the Property Council/IPD Australia All Property cap rate falling from 7.5% in 2010 to 7.0% as of August 2014. [10]

Low rates have created a situation where the extent of the impact of external crises on the Australian economy is dependent to the relative friendliness of Australian monetary policy with respect to the global macro environment, rather than the soundness of Australian businesses and assets. If monetary policy were to tighten, it is highly likely that external geopolitical events would have a much greater impact on the Australian economy, and the housing market in particular.

The Positives To Geopolitical Risk

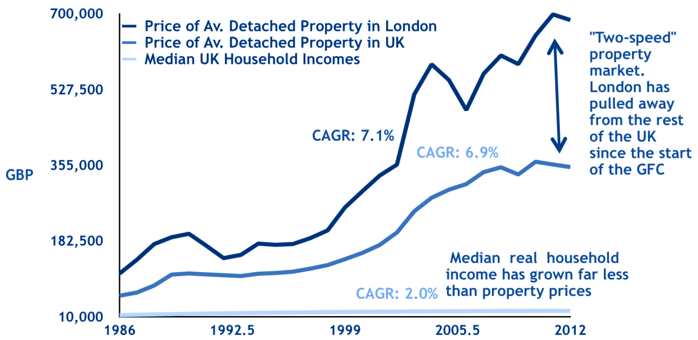
There are some upsides to geopolitical risk. Whilst commodity prices have reached a relatively low level (as seen in **Chart 4**) and are close to returning to pre-2008 levels, there is a possibility, that in time, prices could correct upwards given the high concentration of commodity production in regions currently facing instability. This uplift in commodity prices could provide much needed relief to Australia's troubled resources sector, and help prop up exports.

[7] Australia. Reserve Bank of Australia. Canberra. *Reserve Bank of Australia Annual Report 2009*, 13 Aug. 2009. Web. 22 Sept. 2014.
[8] Schmidt, E. "Main Panel." Technonomy. California, Lake Tahoe. 4 Aug. 2010. Address.
[9] Toffler, Alvin. *Future Shock*. New York: Random House, 1970. Print.
[10] IPD. *Australian Commercial Property Returns Highest in Two Years*. IPD. MSCI, 14 Aug. 2014. Web. 23 Sept. 2014.

Foreign investment in Australian real estate, as well as insulating the real estate market from external shocks, may be driven by the increases in external geopolitical instability. Australian real estate benefits from being perceived as a safe haven asset by foreign investors due to a relatively transparent property market, clear property tenure and political stability. Increased political instability abroad may lead to higher levels of foreign investment in Australian real estate, as a result of a "flight to quality". A recent paper by Ramadorai and Badarinza of the Said Business School [11] has documented the strong, positive correlation between rises in prime property prices in major political safe haven cities and geopolitical turmoil around the world.

In London, for example, Russian and Arab investors, looking for a safe-haven to place their capital in, have invested heavily in property accounting for over 69% of new build buyers [12], leading to a "two-speed" property market, split between London and the rest of the UK, as depicted in **Chart 11**. Whether such a degree of stratification between major urban centres such as Sydney and Melbourne and the rest of the country will occur in Australia remains to be seen.

Chart 11: The "Two-Speed" UK Property Market



The Bottom Line

There are a number of geopolitical events playing out across the globe at the moment. Whilst Australia is isolated in its geography, its trade with other nations makes the country privy to the geopolitical crises that afflict the world. Markets, both in Australia and globally, have appeared uncaring due to lax monetary policy and the glut of information available via social media. Australia has also been insulated from shock by rising foreign investment, which, whilst undoubtedly a positive, has increased Australia's long-term sensitivity to external events. This is in no way helped by Australia's over-reliance on the Chinese export markets.

However, there are some upsides to geopolitical turmoil, namely rising commodity prices and increased demand for Australian real estate, an asset class that is often seen by foreign investors as a safe haven. And whilst we have several concerns regarding the Australian economy, we remain optimistic of its future outlook, as the degree to which markets price in these concerns is governed by momentary and fiscal policy. Much will depend on the upcoming actions of the Reserve Bank of Australia and the Australian Treasury Department.

The May 2014 Federal Budget suggests that the Australian government is aware of the long-term difficult issues that lie ahead. With any luck, the Australian Senate will also play its part and cooperate. This gives us hope that, unlike Cassandra, we will not have to watch the fall of the city we love.

[11] Badarinza, C., and T. Ramadorai. "Preferred Habitats and Safe-Haven Effects: Evidence from the London Housing Market." University of Oxford - Said Business School; University of Oxford - Oxford-Man Institute of Quantitative Finance, 17 Apr. 2014. Web. 22 Sept. 2014.

[12] Bailey, L. "International Buyers in London." *Knight Frank*. Oct. 2013. Web. 22 Sept. 2014.

Our Team

Trident Real Estate Capital is a real estate investment and advisory firm which is active in the Australian commercial property market. We draw upon 30 years of real estate market experience and utilise an advanced suite of property data and analytical tools to provide client tailored specialist real estate advice including market assessments and forecasts, due diligence and location analysis to a variety of corporate, investor and institutional clients.

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