Gold Rallies as Reserve Bank of Australia Cuts Rates to Record Low

Gold prices rallied strongly overnight to just over USD $1470 as traders covered short positions, whilst physical buying out of Asia continued unabated. Since the April crash, gold has now recovered over 11% in USD terms, and is currently locked in a trading range between the high USD $1440 range on the downside, and USD $1500 on the upside.

Whilst physical buying is helping provide support, negative sentiment still pervades the market, not helped by continued outflows for the largest gold ETF, GLD, which continues to see investor redemptions.

Sentiment has also not been helped by the recent report in Barrons highlight that John Paulson's "Paulson Gold Fund" has lost over 25% in April and now 47% for the year. Despite his well-know belief in the long-term fundamentals for bullion, it may well be that fund redemptions are forcing Paulson to sell at least part of his holdings in GLD.

The consolidation we've seen over the last two weeks was largely to be expected after the bounce we've seen, although the big question now is whether or not we see another 'bear raid' and a re-test of the mid April bottom, or whether we've seen the lows for this cycle and the bulls can finally push gold back above USD $1500 and beyond.

On that note, the recent announcements by the Federal Reserve (re-committing to the continuation, and possible expansion of QE), and the ECB (prepared to ease further if necessary) are certainly bullish for precious metals. Despite this, for now it would appear that the bears still have control of the market, so lower prices in the short term can't be ruled out.

The big news in the last 48 hours has been the Reserve Bank of Australia's (RBA) decision to cut interest rates to an all time low of 2.75%. This rate is 0.25% lower than the "emergency lows" that the RBA cut rates to a few years back at the height of the Global Financial Crisis (GFC). Back in 2008, Reserve Bank Governor, Glen Stevens described the 3% rate as a necessary response to "catastrophic economic conditions".

One wonders what a rate even lower than 3%, plus the expectation that rates will be cut further (as low as 2% in this cycle, some are already predicting) implies.

The RBA decision on Tuesday the 7th was a close call, with many economists thinking the board might have held fire until June. Ultimately, the RBA have decided that, inflationary pressures in the economy are so benign that they can afford to cut rates now in a hopeful attempt to stimulate the economy (link).

By cutting interest rates, the RBA is quite deliberately attempting to smooth out the Australian economy as the end of the mining boom inevitably dents GDP in the years ahead. For a refresher, capital expenditure in the mining sector has

grown from 2% to 8% of GDP over the last few years, a historically unprecedented boom without which Australia would not have largely side-stepped the worst of the GFC.

The RBA hopes that whilst the mining boom wanes, there will be an up-tick in both residential construction and in capital expenditure in the non-mining sector. On this front, the news is hardly encouraging for the Reserve Board down at Martin Place.

Whilst the cut in interest rates will no doubt be cheered on in the front pages of the mainstream press, as well as by our politicians in Canberra, with a focus on reduced mortgages for Australian homeowners, it's not necessarily good news.

This cut, which brings to 2% the amount rates have been reduced in this cycle since the RBA first started reducing rates in late 2010, represents a major challenge to Australia's savers and retirees who like to keep their money in Term Deposits or at call bank accounts.

Indeed, a cut from 4.75% to 2.75% represents a loss of over 40% in annual income one would earn with their money on deposit at a bank, notwithstanding the fact that each of the banks won't have moved rates exactly in line with the RBA rate.

This is a particular issue for trustees of Self Managed Super Funds – many of whom are in pension phase, and who, based on the latest data from the Australian Tax Office (ATO), hold over 30% of their money, or some $150 billion in cash and term deposits in this country.

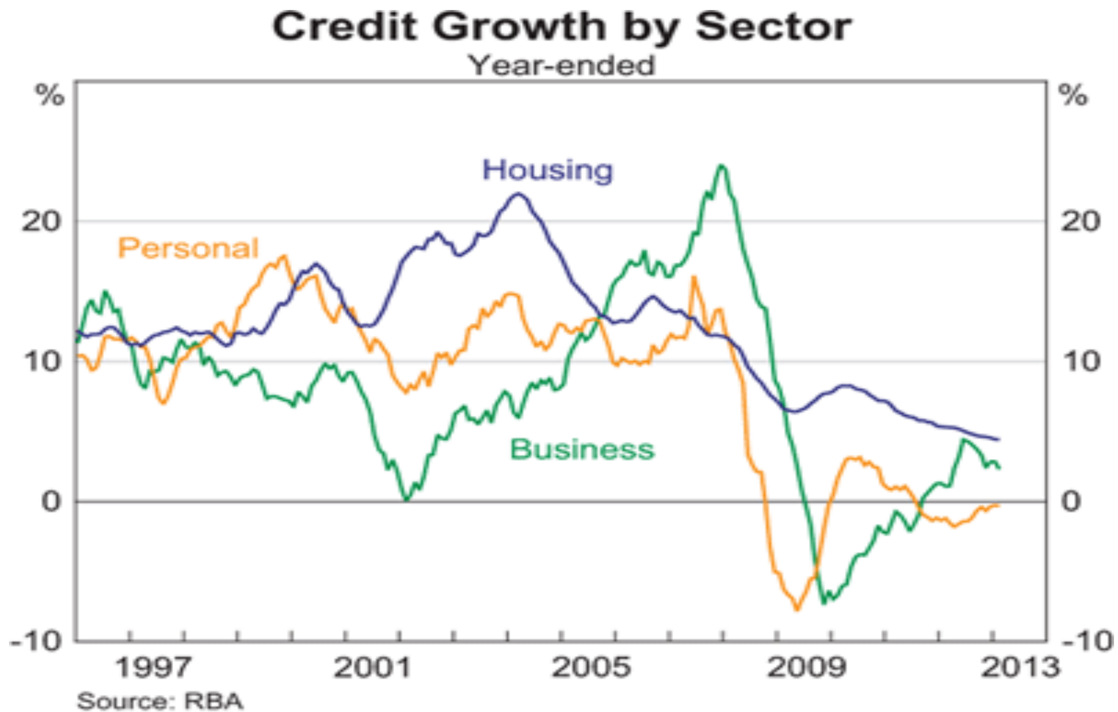
With rates low and headed lower, we can expect that many trustees will look to move a portion of their capital elsewhere, which will merely be a continuation of a trend that has helped, amongst other things to drive up the prices of bank shares in the last year.

This could pose risks all of its own, with a recent report from UBS highlighting investors in this sector are currently paying the most they ever have to own banking stocks, based on price earnings ratios. I'd recommend the following article, even just to check out the graph on Global Bank Market Capitalizations: (link).

The fact that Australia represents only about 2% of global GDP yet has 4 of the 11 most expensive banks in the world by market capitalization suggest potential trouble ahead, especially when one considers the challenges the major banks will face in the years ahead. These challenges include likely lower demand from first home buyers (a recent report in The Age highlighted the fact that despite the rise in investor appetite for home lending, the value of loans to first home buyers fell by 16%)

Credit growth across the nation is significantly lower than the glory days of the early mid 2000s, and is either trending down year-on-year, or is only marginally positive for housing, personal credit and business investment.

This is a far cry from the +20% year-on-year increase in credit growth for housing we saw a decade ago, and a similar figure for business just prior to the GFC, as the following chart from the RBA highlights.



Therefore, investors in bank shares today are paying all-time highs for the stock at a time when the business themselves face their largest challenges in decades, and all for a yield of circa 5% which, whilst attractive relative to today's cash rates, is below the long-term average RBA cash rate.

Whilst lower rates will definitely make servicing the mortgage easier (a saving of roughly $750 on a $300,000 mortgage), it won't necessarily cause a flood of new home-buyers to enter the market, with Australian home prices only rising 2.6% per annum this past year, according to the latest data from ABS.

Indeed, if it weren't for Darwin and Perth (up 8.0% and 6.1% year-on-year) respectively, housing across the nation may have again appreciated at a rate lower than inflation, with Melbourne, Brisbane, Adelaide, Hobart & Canberra all recording increases of 1.5% or lower.

MARCH KEY FIGURES

Established house prices	Dec Qtr 12 to Mar Qtr 13 % change	Mar Qtr 12 to Mar Qtr 13 % change
Weighted average of eight capital cities	**0.1**	**2.6**
Sydney	0.0	3.6
Melbourne	0.2	1.1
Brisbane	-0.3	1.4
Adelaide	-0.1	0.9
Perth	1.2	6.1
Hobart	-0.3	-1.9
Darwin	1.9	8.0
Canberra	0.2	1.5

Indeed, the struggles that home- (and particularly unit-) builders are having selling newly built dwellings has come into the spotlight lately, with developers needing to provide all kinds of additional incentives to encourage potential purchasers to sign on the bottom line. Some of the incentives include

- Bonus berths at local marinas for 17 years, worth $120k
- $40,000 designer furniture packages
- Stamp duty savings of up to $45,000

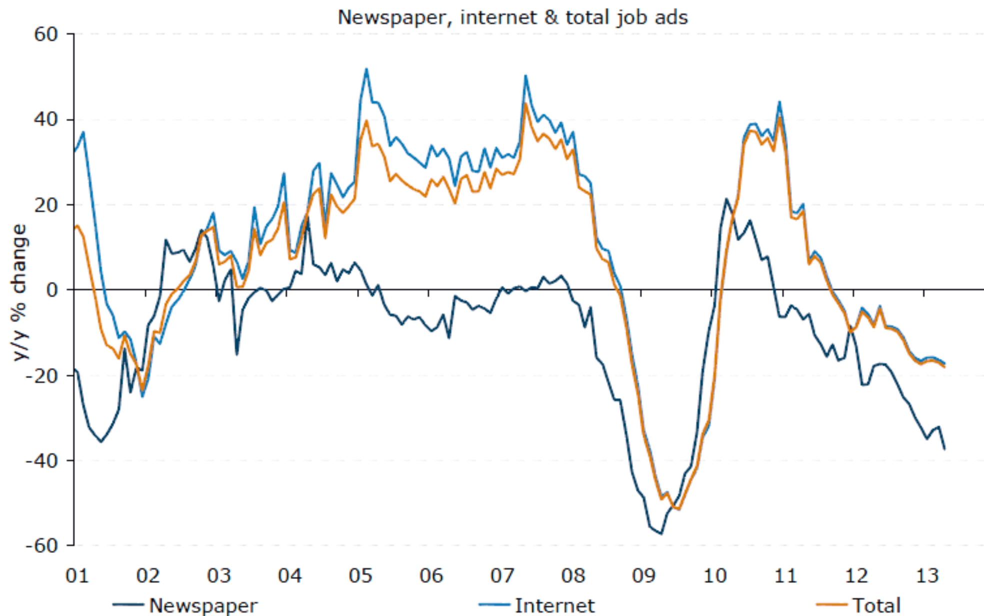
If the market really were booming in response to record low interest rates, it's hard to think that so much effort would be required to shift product.

It must also be stated that the money saved on the interest rate cut will partly be needed to fund the recently announced 0.5% increase in the Medicare levy which has found bi-partisan support in Canberra, and which will likely be legislated into existence before the upcoming election.

The increase in the levy, along with all the noise around the deficit, is believed to be the major reason why consumer confidence in Australia plunged over the last two weeks.

The other great hope for the RBA in transitioning the economy away from the mining boom is an increase in activity in non-mining investment. Again, here the numbers are not encouraging, with Dunn & Bradstreet today releasing a survey of business intentions in what is the essentially the non-mining sector (retail, manufacturing etc.), highlighting that investment intentions are waning in these areas, as are plans to increase employment (link).

With the outlook for employment as uncertain as it is (see image below of year-on-year change in job advertisements from ANZ – which is starting to resemble the GFC), it's hard to see either business activity, or home prices rising substantially, no matter how low the RBA cuts rates.



That is exactly what has happened in the US and large parts of Europe. Eventually people get to a point where they just aren't willing to go any further into debt, no matter how cheap additional credit is.

This is the likely situation we face here in Australia. With interest rates already at all-time lows, and with governments already running deficits (which are set to get worse over the next decade), fiscal and monetary policy are already very supportive by historical standards.

Of course, the government could cut taxes or raise spending in an attempt to stimulate growth, but this would increase the size of the deficit even further, adding to the nation's debt burden. The RBA could also punish savers further by reducing interest rates to 2% or even lower. There is also the option of 'going nuclear', and printing Australian dollars in an attempt to push down the value of the AUD.

I fully expect the chorus of economists suggesting either (or both) of these steps to grow larger in the months and years ahead, although, like the rest of the world, it won't help improve the **real** economy.

What it will do is push up inflation significantly, as the strong AUD is one of the major reasons that inflation has been relatively benign to date.

Over the last few years, costs for 'tradables' (i.e. things we can import like motor vehicles, clothing) have been very well controlled, and are in fact running at abelow zero inflation rate on a year-to-year basis.

On the other hand, 'non-tradables' (i.e. things we can't import like utilities, health care, housing) have been increasing at over 4% per annum. This is shown clearly on the chart below.

A lowering of the AUD will most certainly add inflationary pressure to the economy, as import costs will rise, and will narrow further (if not make outright negative) the real return more cautious investors are earning by leaving their money in the bank.

Inflation of 4% plus and interest rates of 2.5% or lower could well be on the cards for Australia in the next couple of years.

Whilst it won't happen overnight, a deterioration in the local economy, as well as lower interest rates and a potentially lower AUD can all be expected to push more and more Australians to invest in physical bullion, as investors all the round the world have been doing these past few years.

It's a topic I'll be discussing at length at the upcoming SMSF Trustee Empowerment Seminars being held in Melbourne, Brisbane and Sydney between the 18th and the 25th of May (link).

Until next week,

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