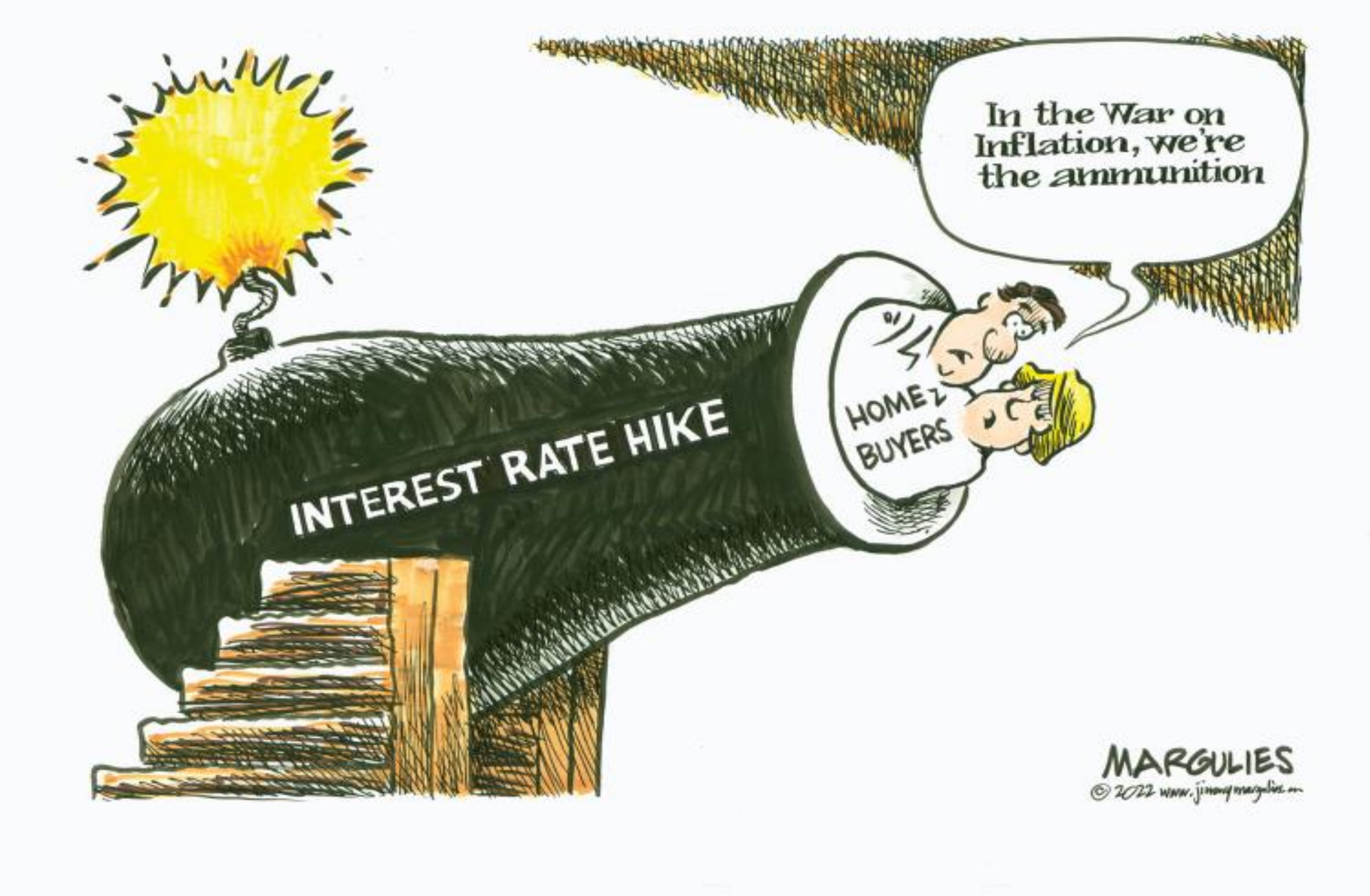
The End of Free Money

And What it Means for Your Portfolio



[1]

The End of Free Money

BY PAUL MIRON

The most recent inflation figures, both here and in the US, reinforce that inflation is here to stay, with US inflation having risen to 3.7% in August 2023 (up from 3.2% in July 2023),[2] and Australian inflation remaining elevated at a rate of 5.2% in June 2023.[3] At the same time, expectations of higher oil prices have been adding to inflationary pressures and dashed hopes that interest rates will be cut in early 2024.[4] A structurally elevated cash rate is seen as a reality and has opened the door to further interest rate hikes.

At the same time, the US bond market has gone into a frenzy, with the 10-year Treasury yield rising to 4.80% in early October, from 4.10% in August.[5] Again, higher inflation is to blame as investors anticipate more interest rate hikes. Australian government bond yields have been behaving similarly, having risen to 4.50% in early October.[6]

When an investor who is prudent and conscious about their risk appetite examines current market conditions, they may very well

---

[1] https://www.cagle.com/jimmy-margulies/2022/05/interest-rate-hikes.

[2] https://www.bls.gov/cpi/#:~:text=In%20August%2C%20the%20Consumer%20Price,over%20the%20year%20(NSA),; https://www.bls.gov/opub/ted/2023/consumer-prices-up-3-2-percent-from-july-2022-to-july-2023.htm#:~:text=The%20Consumer%20Price%20Index%20for,energy%20prices%20decreased%2012.5%20percent.

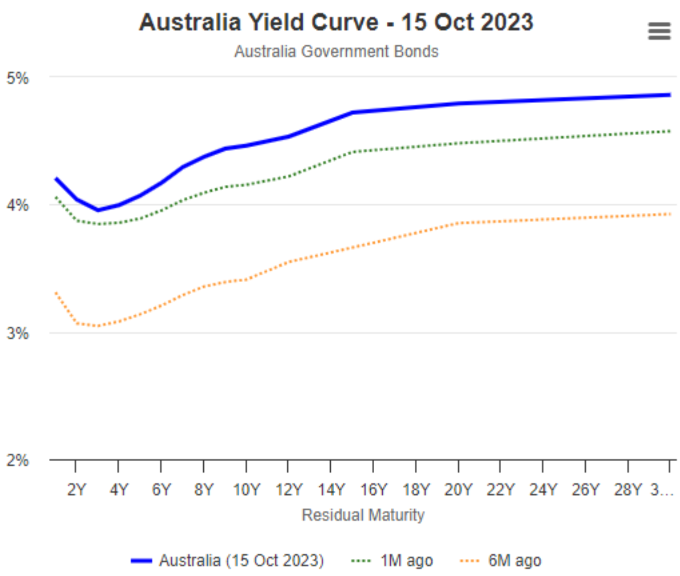
[3] https://www.abs.gov.au/media-centre/media-releases/monthly-cpi-indicator-rose-52-annually-august-2023#:~:text=The%20monthly%20Consumer%20Price%20Index,Bureau%20of%20Statistics%20(ABS).

[4] https://www.afr.com/world/middle-east/it-s-not-1973-but-oil-could-turn-ugly-on-hamas-attacks-20231008-p5eak7.

[5] https://www.cnbc.com/quotes/US10Y.

[6] https://www.worldgovernmentbonds.com/bond-historical-data/australia/10-years/.

end up asking the following question: "After more than a decade of free money, has the market wholly factored in these new risks?"



7

In a heightened inflationary environment such as this, it is crucial that investors are aware of the significant risks associated with many asset classes due to longer-than-expected higher interest rates to combat rampant inflation. In other words, how will the world adapt to consumers and corporations no longer being able to tap into cheap and easy credit? Have we all grown too accustomed to cheap money over the past 15 years?

The evidence is clear that higher interest rates increase the risk associated with all asset classes. As the famous saying goes, "History never repeats itself, but it does often rhyme."[8] Perhaps the most remarkable observation is that we have seen little impact or changes to asset classes in the current market cycle. Inherent risks persist within the market; however, it is investors' heightened awareness and shrewd portfolio adjustments that result in superior, steady returns.

Impact on Asset Classes

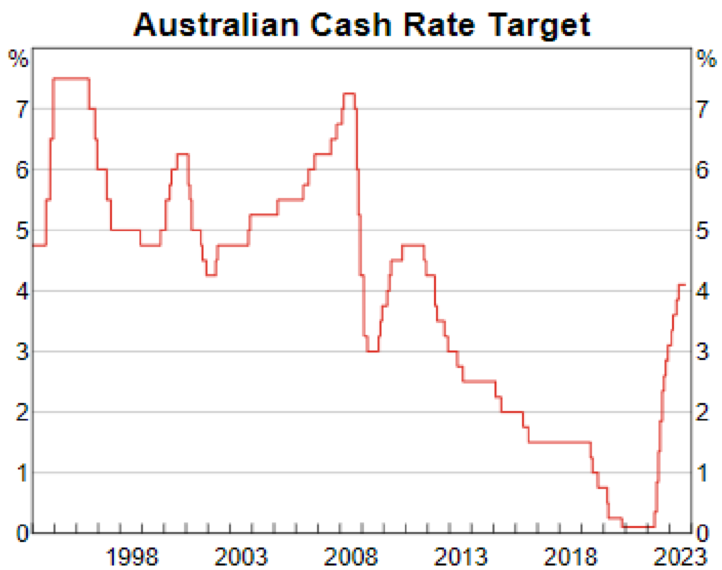
The effect of rising interest rates extends to various asset classes, including corporate bonds, real estate, and equities. We have been closely monitoring these developments as they affect our investment decisions.

Corporate Bonds

Sub-prime corporate borrowers, especially those financed by non-bank lenders during the "low-for-long" interest rates era,[9] face significant challenges when refinancing maturing debt amid rising rates and a backdrop of increased defaults.

Private credit funds are not immune to the increased risks associated with interest rate hikes and other debt-style products. As interest rates stay buoyant for longer, borrowers' risk of default increases. With rising living costs and elevated interest rates, there will be an inevitable margin squeeze on company profits. As a result, more companies will be burdened by excessive debt, leading to their collapse.

Investors should not be afraid to be inquisitive, prudent and agile when attempting to understanding the nature of private credit investments. What is the manager's experience? What is the security to the loan? What is the loan-to-value ratio (LVR)? What does the risk-reward ratio look like? These are the questions one must ask to carefully construct and adjust their portfolio to changes in risk.



10

Wider Real Estate Market

US and European real estate markets have witnessed price declines over 2023 (albeit with small improvements in Q3 2023), in large part due to rising interest rates.[11] This poses challenges for

---

7 http://www.worldgovernmentbonds.com/country/australia/.
8 https://www.imf.org/en/Blogs/Articles/2018/11/05/blog-when-history-rhymes.
9 https://www.imf.org/en/Blogs/Articles/2020/12/14/what-to-do-when-low-for-long-interest-rates-are-lower-and-for-longer.

10 https://www.rba.gov.au/chart-pack/interest-rates.html.
11 https://fred.stlouisfed.org/series/QXMN628BIS; https://ec.europa.eu/eurostat/statisticsexplained/index.php?title=Housing_price_statistics_-_house_price_index.

investors with exposure to commercial property as prices are still expected to contract. Furthermore, REITs have been under pressure from a run on investor money, pressure from financers to amortise debt, and liquidity issues as many large well-known funds have been freezing redemptions.[12]

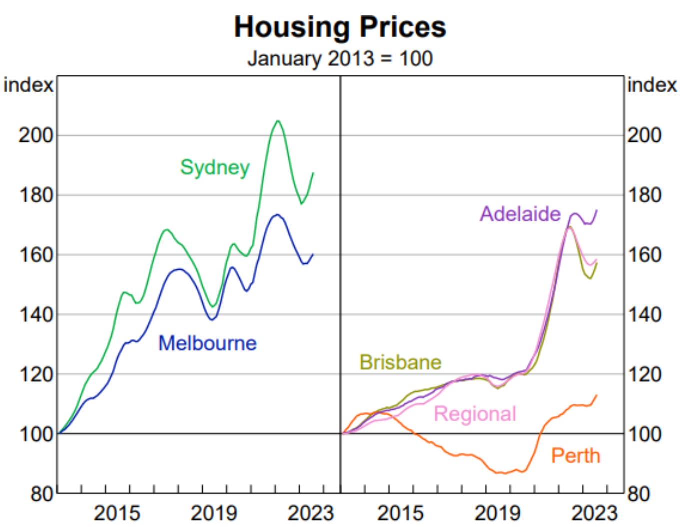
Equities

The allure of equities has been tested as the prospect of higher interest rates weigh on the discounted cash flow models used in company valuations. Companies with high debt levels may experience higher financing costs, leading to their profits slowly being squeezed.

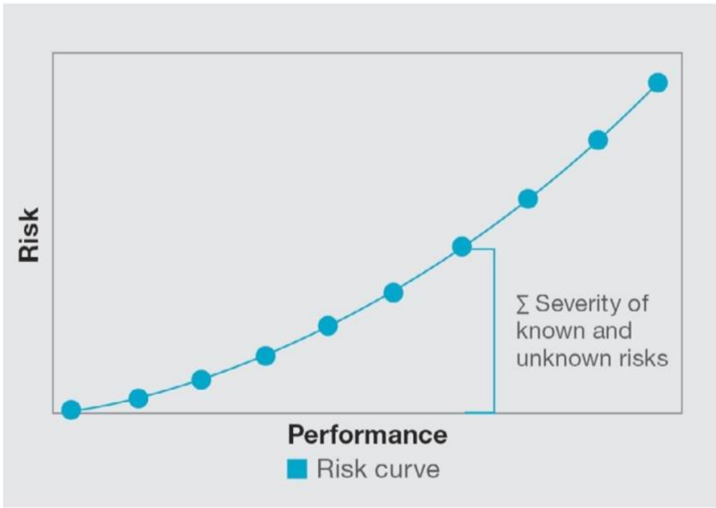
Residential Property

Perhaps one of the biggest surprises has been the resilience of house prices despite the official cash having risen from 0.10% to 4.10% in a little over a year.[13] According to CoreLogic, property prices have recovered since the interest rate tightening cycle began.[14] The strength of residential property can be attributed to high net migration and a systemic lack of supply – a twin threat that is unlikely to be remedied anytime soon.

Fund managers and investors must acknowledge that higher interest rates bring potential challenges and opportunities. Investors, particularly those that are leveraged and exposed to growth-oriented, rate-sensitive cyclical assets, may experience increased volatility. These challenges are particularly pronounced in commercial real estate, private equity, and high-yield bonds.



This results in a flight to safety to alternative asset classes, with private credit garnering the most media attention recently due to its asset preservation qualities and consistent returns. The highly-regarded President of Blackstone Group (the world's largest alternative asset manager), Jonathan Gray, was quoted as saying that we are presently in a golden moment for private credit, with investors obtaining equity-like returns with little downside risk.[15]



[16]

Rates and Risk

With higher interest rates comes higher systematic risk across asset classes. Both investors and fund managers need to be aware of the trap fund managers can often walk into when they blindly follow the industry standard of indexing their fund's target return to a fixed margin above the official cash rate. The issue with such indexing is that funds will be forced to go up the risk curve without their investors being fully aware that their investments are taking on more risk to chase that higher return. This is especially the case for private credit funds.

For example, when the official cash rate was sitting at 0.10%, Msquared Capital was offering our investors a 6.50% p.a. return secured against a residential security with an LVR no higher than 60%. In this situation, the borrower was paying approximately 8.00% p.a. interest on their loan.

With the official cash rate having increased to 4.10%, for investors to receive an additional 6.40% return above the cash rate (so 10.50% in total), the loan would likely have to reach into 2nd registered mortgages, construction loans, regional property, or

[12] https://www.afr.com/property/commercial/redemption-returns-as-issue-for-property-funds-20230719-p5dphj.
[13] https://www.rba.gov.au/statistics/cash-rate/.
[14] https://www.corelogic.com.au/news-research/news/2023/home-value-index-up-0.8-in-september-as-demandsupply-imbalance-continues-to-push-values-higher.
[15] https://pws.blackstone.com/apac/.
[16] https://globalfinancialdevelopers.com/risk-profile-illustrations/.

land with an LVR closer to 70%. In other words, this is a completely different risk profile to what may have originally been envisioned.

This is especially the case for pooled funds, where the fund manager is bound by a mandate that stipulates a fixed margin above the cash rate and would need to completely change the composition of their portfolio to meet the mandate. Therefore, investors need to be aware of these risks, assess all their investments, and monitor the risk-reward profile of investments given current elevated interest rates.

However, not all private credit is the same and investors should have a strong understanding of the risk-reward characteristics of each investment. Private credit covers various segments of the debt space: fully secured direct debt, debt against construction sites, debt against small businesses, corporate debt and sovereign debt. When assessing debt instruments, a critical question to ask is: "What is the strength of the security, particularly if a default was to occur?"

[17]

Msquared Capital is situated on the more conservative end of the debt spectrum by ensuring that loans are secured by one or more high-quality properties. Our two pooled funds are the:

Conservative Pooled Fund: A first mortgage fund with no exposure to construction, specialised security, or land, which as of September 2023, was paying 7.73% p.a., with the Weighted LVR of the Fund being 51.39% and with interest paid monthly.

High Yield Pooled Fund: The fund has a diverse combination of first and second mortgages, along with some construction exposure. As of September 2023, the fund was paying 10.30% p.a., with the Weighted LVR of the Fund being 62.09% and with interest paid monthly.

Single-asset investments: Investors can choose direct investment opportunities secured by individual properties which have different terms, security, and gearing.

Ultimately, the evolving interest rate environment and central bank policies necessitate a proactive and flexible approach to private credit investments. We encourage investors to 'look under the bonnet' to get a full understanding of what private credit funds are investing in and how their loans are secured.

At Msquared Capital, we remain dedicated to navigating this complex landscape on behalf of our clients, carefully considering the implications for our portfolios and investment offerings, as well as adapting our strategies to seize opportunities, all while managing risks effectively.

Msquared Capital is a private credit provider with investment opportunities backed by quality property located primarily along Australia's Eastern Seaboard; we ensure that all investment opportunities are based on risk-to-reward as our core offering, coupled with strong performance. Mortgage funds perform well during volatile times, and capital preservation is regular, with a reliable monthly income that gives our investors peace of mind.

If you would like more information, please feel free to contact myself or our dedicated team of professionals at our office with the following details:

Phone: (02) 9157 8608

Email: info@msqcapital.com.au

Address: Level 12, 88 Pitt Street, Sydney NSW 2000

[17] https://www.lordlaw.com.au/dispute-and-litigation/secured-creditors-vs-unsecured-creditors-the-differences/.