A small step for rates, a giant step for sentiment

MaxCap Group Research – February 2025

A gentle downhill run

Now for the downhill run. After the most aggressive interest rate tightening cycle in modern history, we are finally moving past the peak. More central banks are now easing to stimulate their economies, with Australia finally joining the rate-cutting bandwagon in early 2025.

A small step for rates, a giant step for sentiment. As the economy moves to modestly lower rates, we expect to see a bigger shift in sentiment, with significant implications for the most rate-sensitive sectors, particularly consumer spending and housing construction.

Better construction feasibility. The building sector, long constrained by high material and borrowing costs, is set for a stronger outlook in 2025. Slower cost inflation and lower funding costs ahead should drive a clear turning point and rebound in building activity from here.

Some relief on affordability. For home buyers, higher mortgage rates have been a prominent factor behind the debilitating squeeze on housing affordability. Mortgage rates are falling in 2025, which should provide much-needed relief for financially-strained households.

What are the implications for credit? We see modestly lower rates in 2025 as a better sweet spot for private credit. While floating-rate interest repayments may edge slightly lower, we expect to see some offset from stronger borrower appetite and increased lending volumes.

Strategies for changing rates. For many asset classes, changes to the growth or rate regimes may drive big changes to the returns outlook. For commercial real estate debt, these regime changes are less relevant, given a long historical track record of stable returns.

MaxCap Research Team:

Bruce Wan
Head of Research
bruce.wan@maxcapgroup.com.au

Nicholas Moorman
Research Analyst
nicholas.moorman@maxcapgroup.com.au

Fashionably late

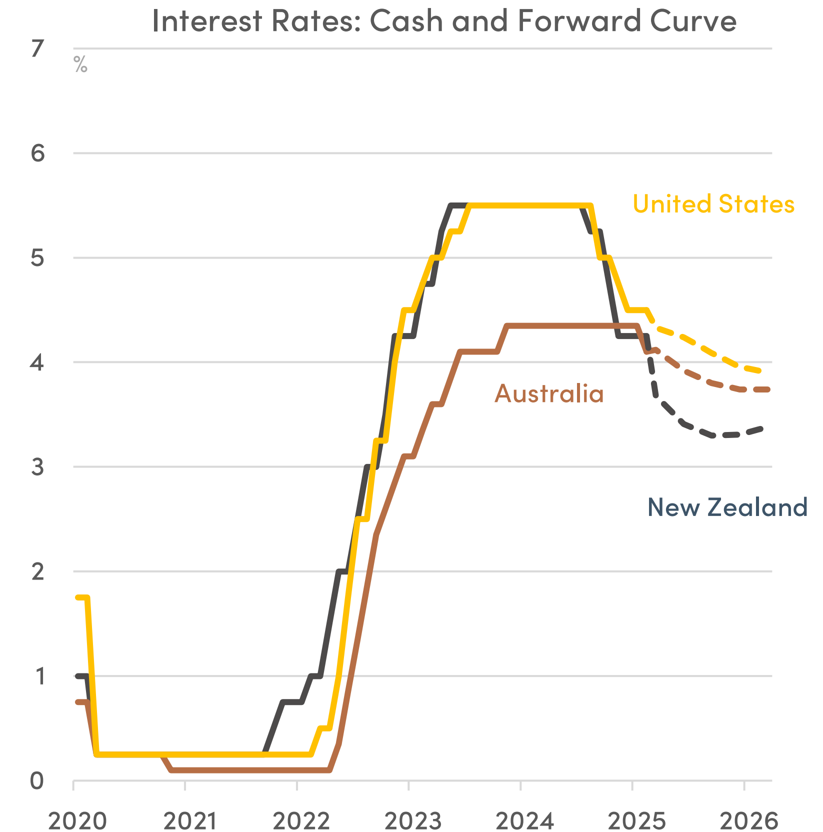
Since 2022, **global interest rates** have risen in a coordinated fashion from near-zero levels to their highest level in more than a decade, as most central banks responded to the breakdown of global supply chains and the biggest run of inflation since the oil price shocks of the 1970s.

- What followed was the **most aggressive monetary tightening phase** in modern history, with deeply adverse impacts on investor portfolio returns. Since then, investors have moved urgently to adapt to this new world order, with big shifts in asset allocations to private credit, in search of better returns and more effective diversification.

In 2024, we were finally **done with the big rate squeeze**. With moderating inflation and sluggish economic growth, many of the biggest central banks in the world are flipping back into stimulus mode, looking to revive a global economy increasingly weighed down by geo-political uncertainty and continuing wars in Europe and the Middle East.

- The Australian central bank is **fashionably late to the party**, with no interest rate cuts until early 2025. This relatively restrained, hawkish stance reflects several factors, namely the relatively lower level of local cash rates, and the slower moderation in local price inflation, especially compared to other developed markets.
- Nevertheless, **the direction of the tide is clear**, and Australia is finally embarking on rate cuts in early 2025. Otherwise, growth could slow further with an appreciating Aussie dollar and diminished export competitiveness. Indeed, money markets are pricing further rate cuts in 2025, to bring about comparable rate settings by late 2026.
- As we have already seen in other markets, the move towards more accommodative policy settings signals **a significant turning point** in the market cycle. While the expected movements in rates are set to be modest, there is likely to be a more substantial shift in consumer, business and investor sentiment to come in 2025, unleashed by lower borrowing costs.

Australian cash rates are falling in 2025, following the lead from other developed markets in 2024. The rate cut profile ahead for Australia is a little slower and a little less substantial, compared to peers abroad.



Source: Bloomberg, MaxCap Group (February 2025).

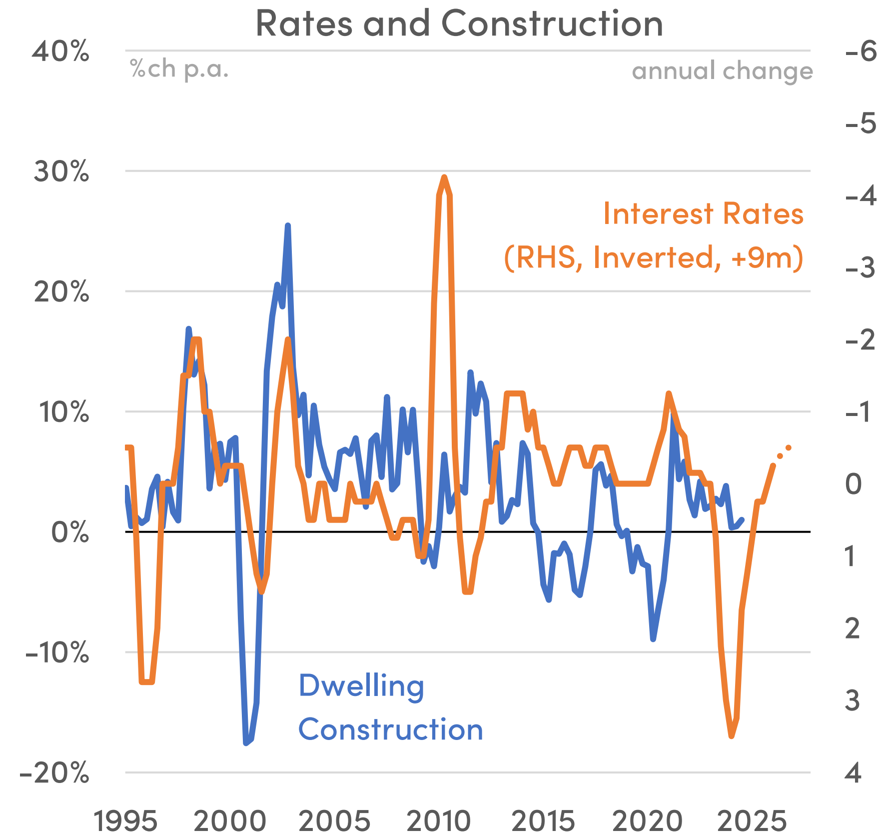
Building momentum

With **modestly lower interest rates** in 2025 and beyond, forward-looking investors need to determine where we could see the most substantial uplifts in economic activity.

- In Australia, the most **rate-sensitive economic sectors** have traditionally been related to discretionary consumer spending (with household budgets deeply impacted by variable mortgage rates) and housing construction (with both buyers and builders being highly responsive to even small movements in funding costs).
- Indeed, **housing construction** has been notably subdued for several years running since 2020, hampered by the collective headwinds from disrupted supply chains, shortage of construction labour and sharply higher building costs. Moreover, the marked uplift in interest rates has been the dominant cyclical factor behind the weaker pace of housing construction activity growth.
- For builders, the **outlook for housing construction** has been shaping for a cyclical rebound for some time now, particularly as supply chains freed up and building cost inflation subsided. In 2025, the easing in borrowing costs is likely to be the final catalyst needed to support a more convincing rebound in building activity.
- On top of these cyclical drivers, there are still **strong fundamental drivers** at work as well. Specifically, the robust pace of population growth (even with some moderation in 2025) is still outrunning housing supply additions by a considerable margin. The mismatch between surging housing demand and inadequate building supply is resulting in this dramatic pattern of undersupply – a situation that is likely to persist for several years to come.

Looking ahead, the housing construction downturn of the last several years is expected to turn in 2025, as more drivers – housing demand, building costs and interest rates – all align to support **increasing momentum in housing construction**.

For the most rate-sensitive sectors of the economy, lower interest rates are usually the main trigger for a cyclical upswing. Indeed, lower rates have historically been a strong leading signal for a turnaround.



Source: ABS, RBA, MaxCap Group (February 2025)

A pivotal moment

For home buyers, a move to lower mortgage rates in 2025 is likely to mark **a clear turning point** in the housing market cycle as well.

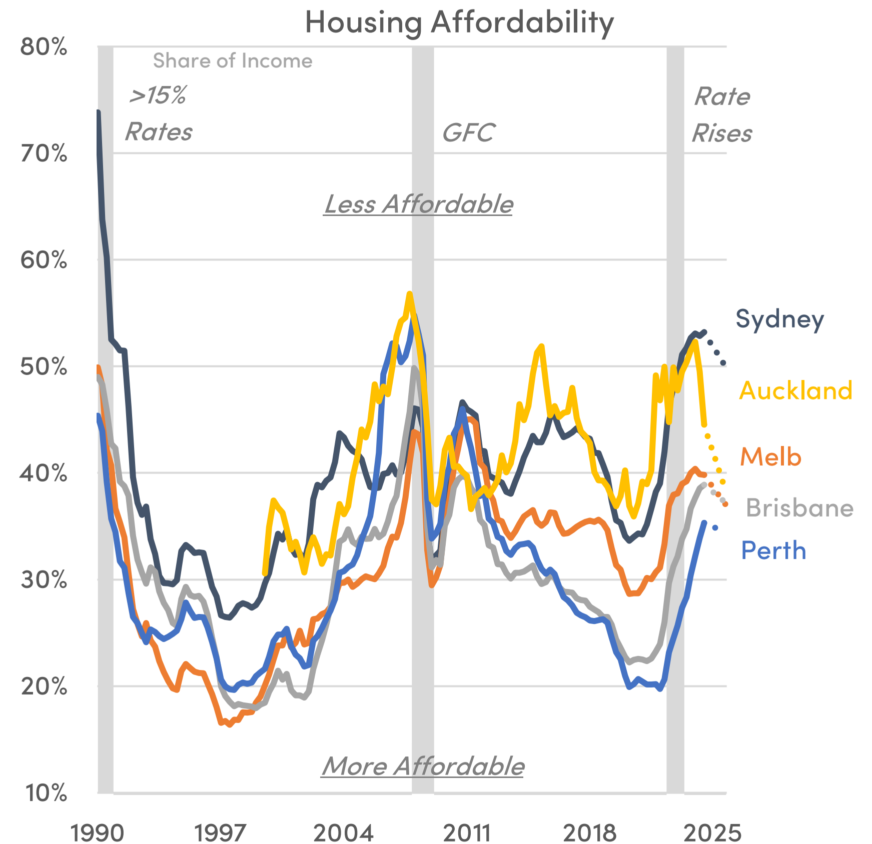
- Historically, movements in **mortgage interest rates** have been the dominant factor behind the direction of housing price growth in Australia. Indeed, the price corrections of 1995, 2008 and 2011 all came on the back of higher mortgage rates. Conversely, lower mortgage rates were consistently the clear cyclical triggers behind the subsequent pricing rebounds.
- In this context, the **pricing resilience** of 2022 and 2023 – alongside aggressive rate rises – was highly unusual. In any event, prices were only down slightly for a very short period (-2% over 7 months), when a -10% price correction would have been expected. In this cycle, the marked undersupply of housing continued to support rents and prices, despite the adverse drag from increased mortgage repayments.

Meanwhile, **housing affordability** has deteriorated markedly in recent years, reflecting the combination of subdued household income growth, rising house prices and markedly higher mortgage rates.

- The move to lower mortgage rates in 2025 will be a pivotal factor behind the **turning point in housing affordability**. Certainly, this will not 3–5-year affordability to the levels we have seen over the past decade, but it will provide welcome relief for stretched household budgets challenged by sharply elevated cost-of-living pressures.
- Moreover, we are not anticipating any substantial changes in **affordability rankings** across different cities. Indeed, Sydney is likely to remain the most unaffordable, which should drive some degree of emigration to other cities or regions over a 3–5-year horizon.

Altogether, we are looking at **a better alignment of tailwinds** for the housing market in 2025, all unleashed to some degree by the move towards lower mortgage interest rates and modestly better affordability.

The expected reductions in mortgage rates ahead are expected to be quite pivotal in addressing the most pressing issue today, which is the supremely unaffordable state of the local housing market.



Source: ABS, Proptrack, RBA, MaxCap Group (February 2025)

Credit resilience

For credit investors, the world of elevated interest rates has been **a boon for investment returns**, partly due to the explicit interest rate hedge offered by issuers of floating-rate loans, and partly by the relative outperformance of private credit strategies compared to the public and private equity strategies that have struggled with higher interest rates.

With the expected peak and decline in interest rates, investors are rightly asking the questions. What happens with lower interest rates? More importantly, **where do private credit returns go from here**?

- For starters, the modest rate cuts priced into the money markets into 2026 do not constitute a clear regime change. This part of the world is still contending with **a higher-for-longer rate regime**, although market forecasters are expecting a slightly better outlook for economic growth in 2025.
- In understanding the implications of growth and interest rates on asset class returns and potential allocation decisions, we can readily segment historical investment returns into **different growth and rate regimes**, to compare or rank returns across various asset classes.
- It is interesting to note that – across all the permutations for growth and rates – private commercial real estate debt has historically **delivered consistent returns** across different regimes, through strong and weak growth phases and high- and low-rate environments.
- The **mechanics of this resiliency** are pretty simple, as private credit managers pivoted from fixed- to floating-rate loans with rising interest rates from 2022. Already, commercial real estate lenders are pre-emptively installing interest rate floors in the event that policy interest rates fall by more than local money market expectations.

While many asset classes will see returns shift markedly with growth, inflation and interest rates, the historical profile for commercial real estate debt is **demonstrably more resilient** across different economic regimes.

Over the past 10 years, commercial real estate debt has delivered consistent returns across different economic growth and interest rate regimes, in stark contrast to other regime-sensitive asset classes

Historical returns for each regime	Lower GDP Growth (<2% y/y)	Mid GDP Growth (2-2½% y/y)	Higher GDP Growth (>2½% y/y)
Higher Cash Rates (>3%)	**2024** REITs 26 Shares 15 CRED FM 14 Bonds 2 CRE -2	**2025** CRED FM 14 Shares 8 CRE 2 REITs 2 Bonds -1	CRED FM 13 Shares 7 CRE 2 REITs -17 Bonds -20
Mid Cash Rates (1-3%)	REITs 18 Bonds 15 CRED FM 14 Shares 11 CRE 9	CRED FM 16 REITs 15 Shares 11 CRE 11 Bonds 9 **Scenario: More Cuts**	CRED FM 15 CRE 12 REITs 9 Shares 5 Bonds 3
Lower Cash Rates (<1%)	CRED FM 13 CRE 6 REITs 2 Shares -9 Bonds -20	REITs 33 Shares 29 CRED FM 13 CRE 5 Bonds 2	Shares 17 REITs 17 CRED FM 12 CRE 10 Bonds -7

Source: Bloomberg, MSCI, MaxCap Group (February 2025). Historical performance is no guarantee of future returns. CRED FM = First Mortgage Commercial Real Estate Debt, REIT = Listed Real Estate Investment Trusts, CRE = Unlisted Commercial Real Estate, Shares = Australian MSCI Index, Bonds = JP Morgan 7-10 Bond Benchmark. Gross annual returns over 10 years to Q3 2024, pre fees.

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Key Contacts

Wayne Lasky
Executive Chairman
wayne.lasky@maxcapgroup.com.au

Rob Hattersley
Group Head of Capital
robert.hattersley@maxcapgroup.com.au

Bruce Wan
Head of Research
bruce.wan@maxcapgroup.com.au

MaxCap Capital Team Contacts

Name	Role	Email
Ben Klein	Head of Private Capital	ben.klein@maxcapgroup.com.au
Haley Devine	Director – Capital	haley.devine@maxcapgroup.com.au
Romy Grace	Director – Capital	romy.grace@maxcapgroup.com.au
Leyla Sacks	Director – Capital	leyla.sacks@maxcapgroup.com.au
Penny Tao	Director – Capital	penny.tao@maxcapgroup.com.au
Hugh Thomson	Director – Capital	hugh.thomson@maxcapgroup.com.au
Domenic Demaria	Associate Director – Capital	domenic.demaria@maxcapgroup.com.au
Ashley Feldman	Associate Director – Capital	ashley.feldman@maxcapgroup.com.au
Ben Woolley	Associate Director – Capital	ben.woolley@maxcapgroup.com.au

MaxCap Group

HEAD OFFICE

Level 34, 376-390 Collins Street
Melbourne, VIC 3000 Australia

maxcapgroup.com.au

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