House Prices

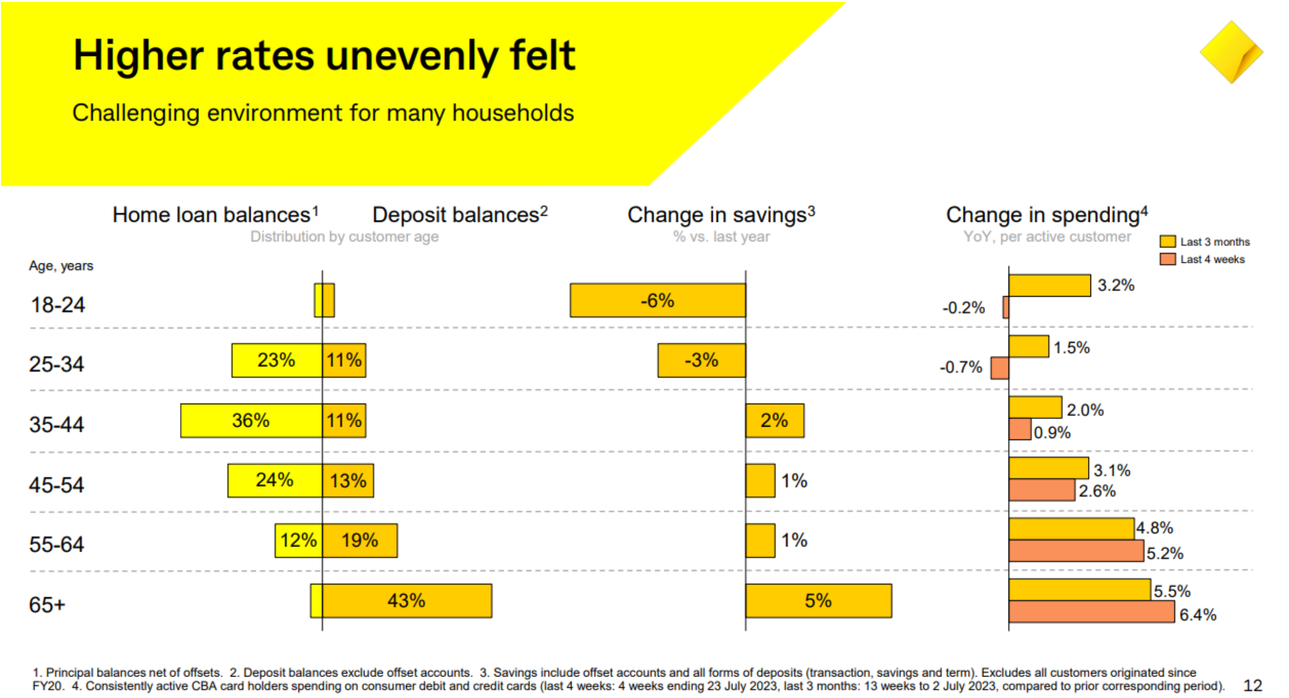
Both here and overseas, the rate of interest rate increases from record low levels has been startling. Nothing new here. Despite the ‘double pause’ decision last week by the RBA, we’ve still endured 12 rate rises in the space of 15 months, from 0.1% to 4.1%.

The number of home loans rolling over from an extremely low fixed rate to market rates has accelerated, noting 35% of all fixed loans will have rolled over in the 9 months from April to December.

I reported last week that household goods retailing had cratered yet cafes, restaurants and takeaway expenditure had risen. This illustrates the different levels of spending in the economy and ultimately, very roughly, compares those without a debt burden living it up to those saddled with a rapidly increasing percentage of their pay packet going to home loan repayments.

In the CBA result, where they managed to eke out a $10.2bn profit, they estimated that with official interest rates at 4.1%, only 3.4% of owner-occupier home loans written in the past five years are in negative cash flow. That is fairly specific grouping, noting data on all owner occupiers would be better received, regardless, still low numbers. Even this low figure is further minimised by the accumulated savings home owners possess and/or a reduction in spending by a mere 10%.

And in reference to my comments last week about those *“people with money are spending it, those without aren’t”,* CBA referred to this division also. The oldies are spending, the youngsters are saving- finally.



This story is repeated around the Western world. So, why haven't property prices collapsed? Just as rising interest rates have seen an expanded equity risk premium demanded to invest in equites, logically another risk asset, property should be demanding a higher 'risk premium' versus cash as well.

Firstly let me explain the concept behind the 'equity risk premium'.

The equity risk premium (ERP) represents the excess return that investors expect to earn from holding equities over a risk-free investment, compensating them for taking on the higher risk associated with owning stocks.

Therefore when the risk free rate on Government Bonds is 0.5% and the expected return on equities is say 5%, then the equity risk premium is 4.5%. When the risk-free rate moves to 4.1%, as it has done here in Australia on the 10 Year bond, then the expected return will also increase and might rise to say 10% meaning the ERP is 5.9%.

So if we were to take the same perspective of the ERP but with property instead of equities, this alone should result in a decline in property prices. Listed REITS have fallen, unlisted REITS should have but given the lack of volume and liquidity, they're curiously holding up in retail and Industry funds across the land. But the humble residential home, where there is good liquidity, hasn't declined in value the way I would have expected.

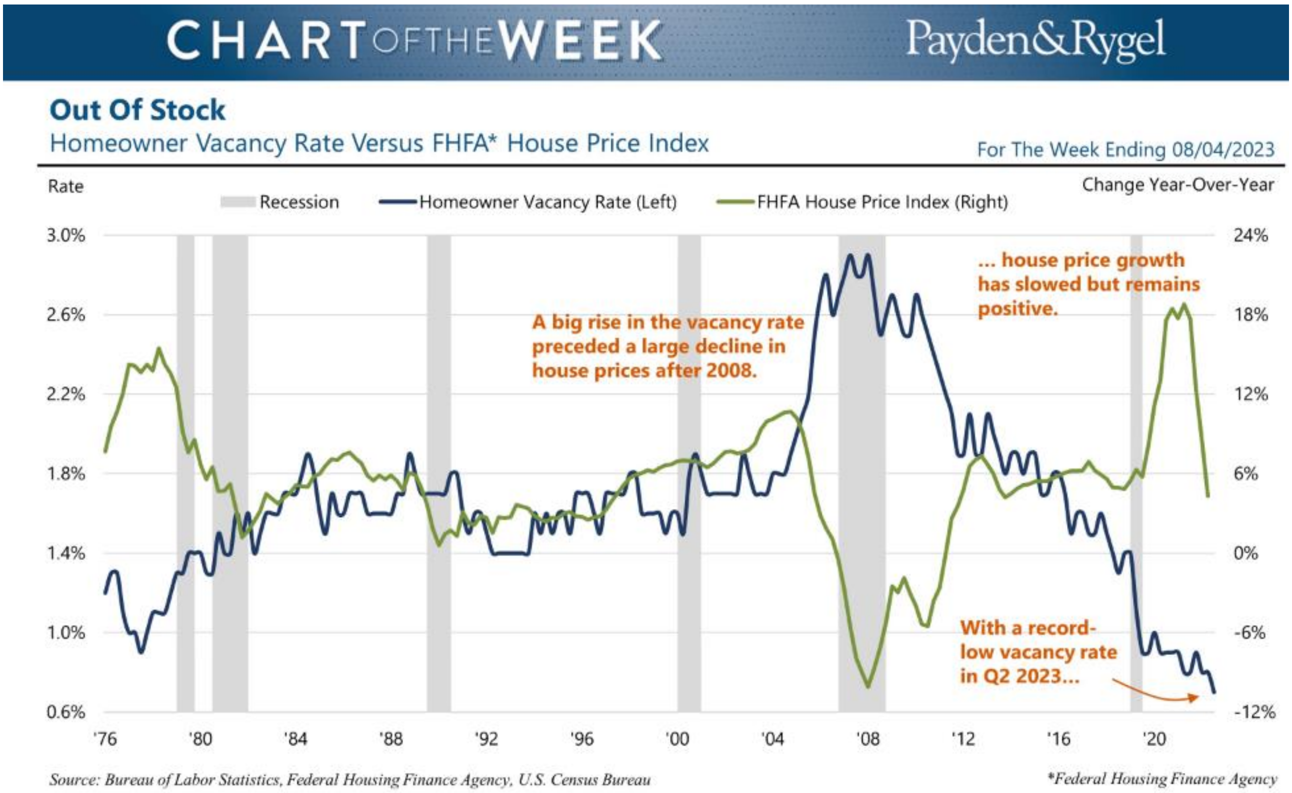
This next chart, which was produced by Payden and Rygel, a massive US based investment advisory, shows the Homeowners' Vacancy Rate versus house prices since 1976. It also highlights where and when recessions occurred. I should note this is a US based study, but the dynamics and stimuli are much the same.

The homeowners' vacancy rate is at record lows, despite the breakneck pace of interest rate hikes. House prices are no longer growing at a ridiculous 18% as they were during Covid, but they're still growing. Shouldn't we be seeing a 'risk premium' being applied to houses, which would mean a price fall along with rate rises?

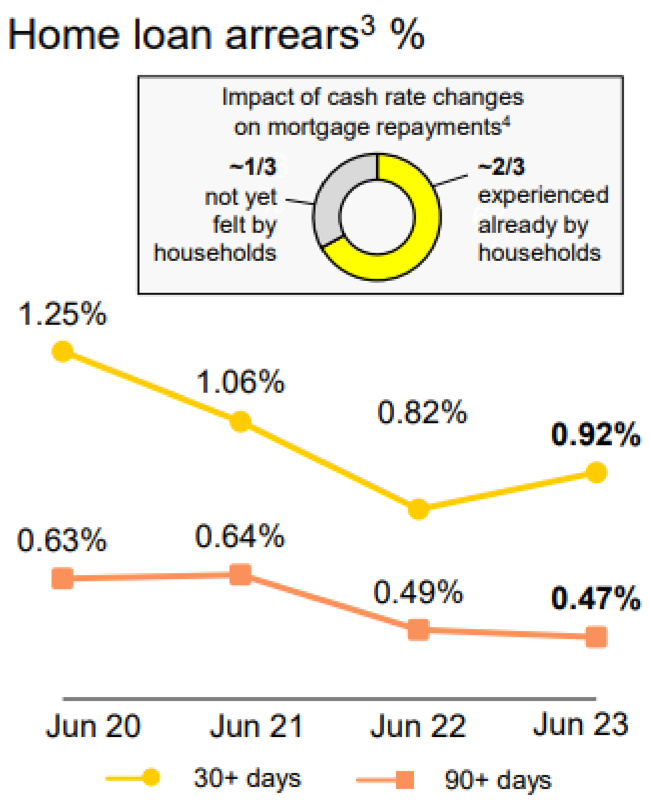
According to Payden and Rygel, *"Interestingly, while house price growth slowed, house prices remain near all time highs. Inventory, or the lack thereof, explains why."* And they go on, *"Out of stock housing keeps a floor under prices, even with affordability stretched. What's next? We expect home-building to rebound, but the process takes time. If the unemployment rate stays low, house prices may have found a bottom."*

The only difference is here in Oz we have a different lending structure, where the majority of home loans are variable rates and far less fixed rate mortgages than the US.

I confess, I expected a much nastier environment for house prices. Either the rate rises haven't inflicted sufficient pain and worked their way sufficiently through the economy yet- noting this chart was as at 8.4.23- or the reasons above are conspiring to keep prices above what would seem economically prudent.



Ultimately, as the CBA results proudly boasted, delinquency rates are practically non-existent across their $500bn home loan book. Home loans that are 90 days behind on repayments represented just 0.47 per cent of the book in June, down from 0.49 per cent a year earlier.



Commonwealth Bank of Australia (CBA)

Speaking of CBA, a clean result, but why on earth are investors taking on equity risk for an extremely fully priced business, paying 2.3x book value for a 4.1% yield (admittedly fully franked) when you can get 4.7% government guaranteed term deposit?

- Pre-Provision Operating Profit (PPOP) $7.6B
- Cash NPAT from continuing operations $5.0B
- Cash Diluted EPS continuing 588cps, comfortably beating consensus 562cps;
- Interim dividend 240cps

RESULT HIGHLIGHTS

- Net Interest Income down 2% to $11.4B, with Net Interest Margin down 5bps to 2.05%
- Non-Interest Income up 14% to $2.2B (5.5% ahead of consensus);
- Total revenue was ahead at $13.6B (1.1% above cons $13.5B);
- Costs grew ~5% to $6.1B (3% worse than cons $5.9B);
- Credit Impairment Charge (BDD) -13bp or $597M (cons -12bp), implying a 4Q charge of 16bp; (7) CET1 12.2% in-line.
- Better-than-expected dividend and $1B buy-back a positive surprise.
- Pro forma CET1 of 12.0%. CBA will continue to target a full year payout ratio of 70-80% of Cash NPAT. FY23 payout ratio of 74%.

Highlights (A$m)	06/20	06/21	06/22	06/23E	06/24E	06/25E	06/26E	06/27E
Revenues	23,761	24,156	24,896	26,877	27,919	27,911	28,216	28,633
Pre-tax profit	10,247	12,243	13,727	14,204	14,387	14,409	14,641	14,978
Net earnings (reported)	9,592	10,181	10,880	10,108	10,215	10,375	10,542	10,784
Net earnings (UBS)	7,407	8,801	9,817	10,108	10,215	10,375	10,542	10,784
Tier 1 ratio %	13.9	15.7	13.6	14.0	14.5	14.5	14.6	14.7
EPS (UBS, diluted) (A$)	4.06	4.69	5.49	5.58	5.63	5.72	5.80	5.93
Profitability/valuation	06/20	06/21	06/22	06/23E	06/24E	06/25E	06/26E	06/27E
ROE (UBS) %	10.5	11.7	13.0	13.8	13.1	12.5	12.2	12.0
P/PPOP (diluted) x	11.2	12.3	13.8	12.1	11.2	11.5	11.6	11.6
P/BV x	1.9	1.8	2.4	2.3	2.1	2.0	2.0	1.9
P/BV (UBS) x	2.1	2.0	2.6	2.6	2.3	2.2	2.2	2.1
P/E (UBS, diluted) x	18.6	17.3	18.4	18.3	18.1	17.9	17.6	17.2
Dividend yield (net) %	3.9	4.3	3.8	4.1	4.1	4.2	4.2	4.3

Source: Company accounts, Thomson Reuters, UBS estimates. Metrics marked as (UBS) have had analyst adjustments applied. Valuations: based on an average share price that year, (E): based on a share price of A$ 102.21 on 08-Aug-2023

QBE Insurance (QBE)

1H23 Result misses on both EPS and DPS due to high tax rate. New accounting may confuse consensus. This is QBE's maiden result under IFRS17 and so consensus expectations are unclear on a like-for-like basis. Guidance unchanged should foster confidence in operating outlook.

KEY NUMBERS

- NPAT $404m vs consensus $500m.
- Cash NPAT $405m.
- EPS 27.2c vs 33.0c.
- Interim DPS (A$) 14c vs cons 24c

RESULT HIGHLIGHTS

- Gross Written Premium (GWP) +11% pcp to $12.8bn
- GWP by division: Australia Pac $2.8bn, +18%, International $5.1bn, +18%, North America $5bn, +6%
- Cost of Risk (COR) of 98.8%; weak.
- Insurance margin 6%.
- WP growth of ~10% on constant currency. Group combined operating ratio (COR) ~94.5%. Consistent low-to-mid 90s COR through-cycle. 1H23 exit running yield of 4.9%.
- NPAT and DPS are both well below consensus.
- FY23 guidance items are unchanged, which ought to foster confidence in the near-term operating outlook.

Highlights (US$m)	12/20	12/21	12/22	12/23E	12/24E	12/25E	12/26E	12/27E
Net earnings (reported)	(1,517)	750	770	1,323	1,738	1,853	1,941	2,030
EPS (reported, diluted) (US$)	(1.07)	0.47	0.48	0.85	1.12	1.20	1.26	1.32
EPS (UBS, diluted) (US$)	(0.61)	0.50	0.53	0.87	1.14	1.22	1.28	1.34
DPS (net) (A$)	0.04	0.30	0.39	0.67	0.88	0.94	0.98	1.02
BVPS (UBS, tangible) (US$)	3.95	4.36	4.87	5.26	5.86	6.52	7.21	7.92

Profitability/valuation	12/20	12/21	12/22	12/23E	12/24E	12/25E	12/26E	12/27E
P/E (reported, diluted) x	NM	17.0	17.3	12.3	9.1	8.5	8.1	7.8
P/E (UBS, diluted) x	NM	15.9	15.7	12.0	8.9	8.4	8.0	7.6
ROE (UBS, tangible) %	(11.0)	10.3	10.5	15.9	18.9	18.4	17.6	16.9
P/BV x	1.4	1.3	1.3	1.6	1.4	1.3	1.2	1.1
Dividend yield (net) %	0.4	2.8	3.2	4.3	5.6	6.0	6.3	6.5

Source: Company accounts, Thomson Reuters, UBS estimates. Metrics marked as (UBS) have had analyst adjustments applied. Valuations: based on an average share price that year, (E): based on a share price of A$ 15.60 on 10-Aug-2023 09:13:52 AEST

9th August 2023

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Ben and the team.

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