RMBS – Property market update

4 December 2018

Sector
Residential Mortgage Backed Securities

Servicer
Various

Notes
Various

Asmita Kulkarni, CFA

Director, Investment Strategy
+61 2 9697 8768
Asmita.Kulkarni@fiig.com.au

Higher rated notes of RMBS transactions remain attractive investments. Here we look at the relative value of these securities and consider the factors influencing property prices.

This document has been prepared by FIIG Investment Strategy Group. Opinions expressed may differ from those of FIIG Credit Research.

Background

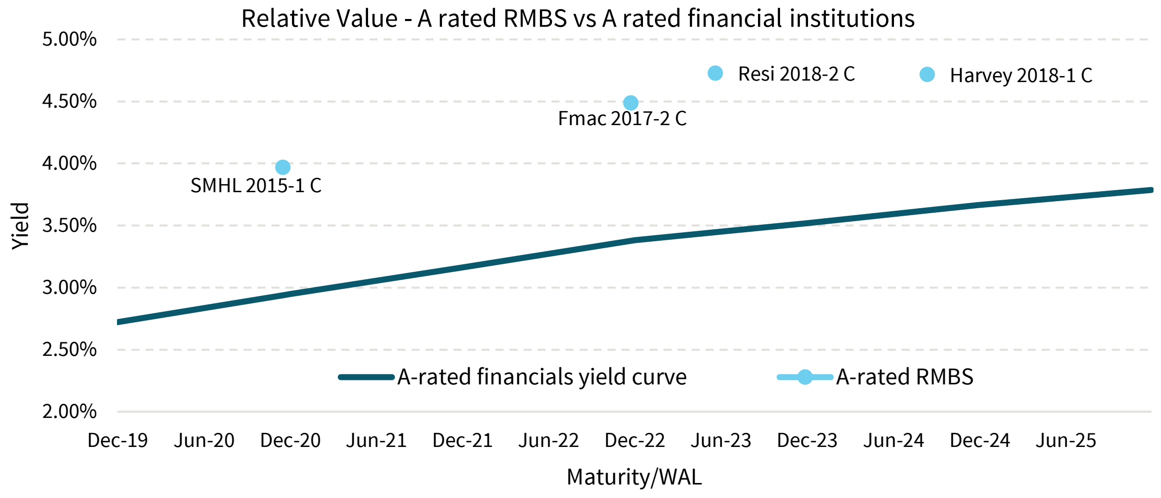
Recently, there has been a large amount of press coverage dedicated to discussing the current state of the Australian property market. This is due to the ongoing correction in prices in Sydney and Melbourne experienced over 2018. While the price decline has somewhat dented confidence, we believe that the correction to date has been orderly and necessary for the overheated property market.

Investment strategy

Investment grade rated tranches of RMBS transactions continue to offer attractive relative value for investors. These notes benefit from a strong rating, a diverse pool of mortgages and, importantly, are secured exposures against first ranking Australian mortgages. Please refer to our earlier note on RMBS to further understand the mechanics of these securities.

Typically, the weighted average loan to value ratio (LVR) of a pool of mortgages underlying RMBS is not higher than 70%. This provides an additional buffer to these securities beyond subordination provided by lower ranking tranches in the capital structure. In simplistic terms, at 70% LVR, a mortgage can withstand a 30% decline in property price before it will suffer a dollar value loss.

The chart below displays the yield offered by select RMBS tranches compared to similarly rated bonds issued by Australian financial institutions. It highlights that RMBS offer strong relative value in comparison to corporate bonds.



Source: FIIG Securities, Bloomberg. Prices accurate as at 03 Dec 2018.

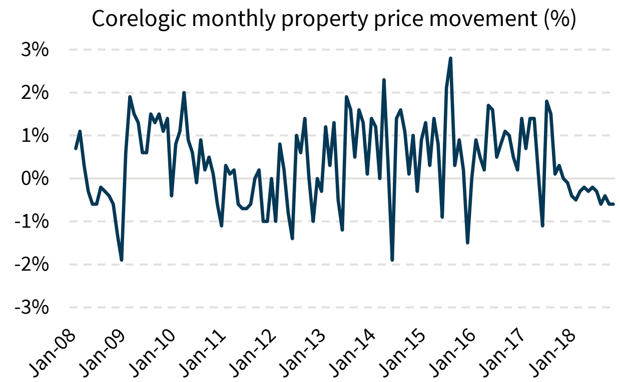
RMBS – Property market update

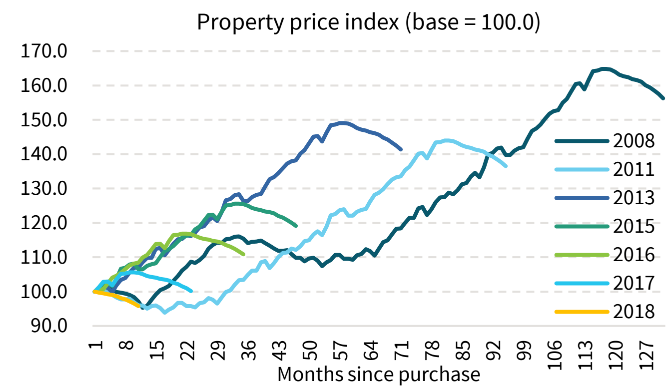
Property market performance

The recent property market correction in Australia has been observed around the world following a strong, and at times overheated, growth in the market. A culmination of a number of factors resulted in this slowdown. These factors included a reduced quantity of offshore money (China) investing in Australia, prudential regulation resulting in a slowdown in the supply of credit and loans, and the recent Royal Commission into Misconduct in Banking. .

While the property market correction has seen flat to negative changes in property prices since the beginning of 2018, we believe the correction to date has been orderly. The first chart below show the monthly change in residential property (houses and apartments) prices for the five largest Australian capital cities (Sydney, Melbourne, Brisbane incl. Gold Coast, Adelaide and Perth). This clearly shows the slowdown in property prices in 2018. However, this charts fails to capture the capital gains experienced by dwellers and investors prior to 2018.

In order to illustrate the compounding effect of this capital gain, we have put together a second chart that shows the indexed value of a property assuming it was purchased at 100.00 in January of each of the following years – 2008 (11 years ago), 2011 (9 years), 2013 (6 years), 2015 (4 years), 2016 (3 years), 2017 (2 years), and 2018 (year to date). As the chart illustrates, the price movements for 2018 are closely tracking the experience from 2008 and 2011.





Source: FIIG Securities, Bloomberg, CoreLogic

It is very difficult to predict how property prices will behave going forward, although we continue to be optimistic in the longer-term. A correction in property is often driven by adverse economic conditions or changes to interest rates, however, the decline in prices this time around has occurred without either of these catalysts being present.

Below we outline factors that could influence prices going forward.

- Regulators, including APRA and RBA, remain supportive of the residential property sector and are likely to stimulate the market with loosening of prudential standards or with interest rate cuts, if needed.
- Fundamental economic factors remain robust in Australia. The economy, as a whole, is performing well with strong employment and growth. Employment is a key leading indicator of property market performance, strong employment usually correlates with low defaults.
- Given we are currently in an election cycle, the economy is likely to benefit from additional spending, especially in infrastructure, which should create further jobs.
- Ongoing low wages growth somewhat offsets the economic factors above. Lower wages affect the serviceability of a mortgage.
- Population growth is expected to continue in Australia, specifically in Sydney and Melbourne, through net positive migration. Population growth drives demand for housing.

FIIG | The fixed income experts

RMBS – Property market update

- The recent property price decline has seen many potential purchasers, both owner occupiers and investors, stay on the sidelines waiting for some stability before entering the market. This has driven the demand for housing credit lower. This is offset, however, by those potential purchasers who were 'priced out' of the market during the rapid price appreciation who should now be able to enter the market again.
- Reduced supply of credit has heavily affected the final demand for certain types of loans such as investment and interest only. This reduced demand has in turn affected prices.
- Strong supply of stock, especially with strong construction in Brisbane, Melbourne and Sydney, could result in a lot of stale housing stock on the market.
- Performance of RMBS to date has been strong, arrears are low, though WAL is extending due to lower CPR. Default rates have remained low through previous property market corrections and this trend is expected to continue this time around.

Conclusion

How all the factors noted above will impact property prices is not easy to forecast. Fundamentally, property markets should see some stability in 2019, however, behaviours of lenders and borrowers will ultimately drive price movement. If we continue to see further declines, the magnitude of price falls will need to be assessed in conjunction with economic conditions to understand the impact on RMBS.

In the medium term, we believe investment grade rated tranches of RMBS should continue to perform well. These secured exposures offer good relative value when compared to similarly rated unsecured exposure to financial institutions.

Please contact your Relationship Manager for current availability of RMBS in the secondary market or contact me at asmita.kulkarni@fiig.com.au with any specific questions about RMBS.

Links

RMBS - A beginner's guide

RMBS – Property market update