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Thunder Down Under

"I have a mate of mine who lives around the corner in a nice, A$4 million house," David Martin, a visitor from Melbourne, Australia, was telling Deputy Editor Evan Lorenz the other day. "One of the best in the suburb where I live. I was in there having a chat with him one night, and he said, 'I just got my bank statement.' He said, 'I was in an interest-only loan, and I open the statement up and I have to pay the principal down.' I asked if the bank had contacted him. He said, 'No, it just turned up in the mailbox.' That was a light bulb."

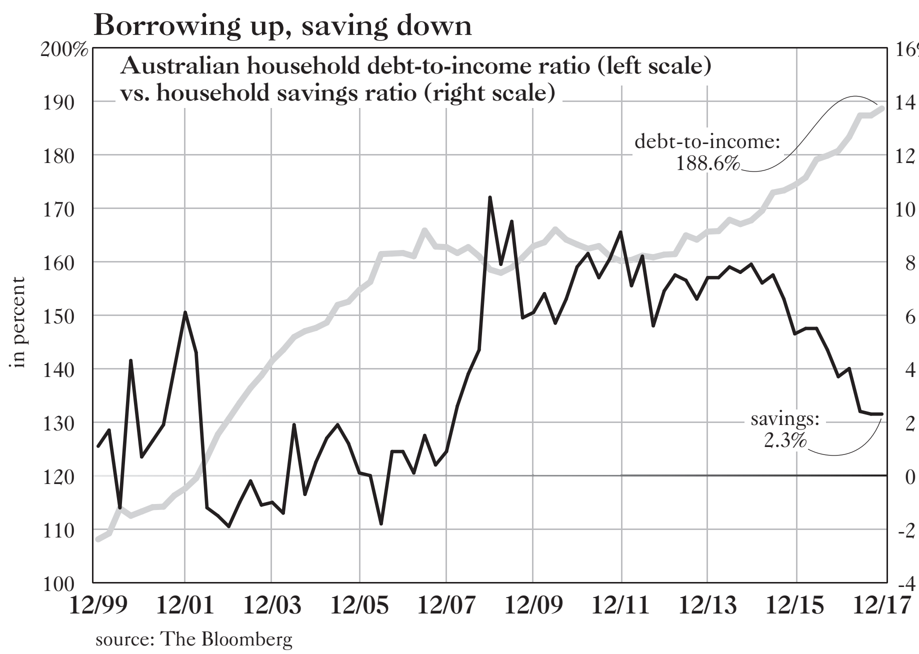
Almost exactly one year ago, this publication proposed that levitating Australian house prices would come fluttering back down to earth (*Grant's*, June 16, 2017). To us Americans, the Lucky Country had a distinct 2005–06 air about it. Liars' loans, robo-signing and interest-only mortgages—all features of a sizzling Australian residential real-estate market—recalled the pre-2007 salad days in America. Our 2017 analysis homed in on the connection between flyaway Australian house prices, on the one hand, and the Chinese debt extravaganza, on the other. "Two hips joined" was the headline. "Look out below" was the essential investment prognosis.

The arrival in New York of Martin and his business partner, Michael Schneider—they had flown to America to raise money for a new hedge fund—is the catalyst for this update. It's a story about the universal perverse effects of ultra-low interest rates, easy credit and unchecked booms that happens to be set in Australia. "Firebell Capital" the two are calling their anticipated partnership. The grand plan is (a) to sell the ears off of housing-sensitive Australian assets and (b) to buy what they had forehandedly sold once prices obediently collapse. Who wouldn't want to do that?

Actually, many have tried, though few—possibly none—have succeeded. Low interest rates, high-yielding bank stocks, immense offshore demand for domestic property, the advent of gimmicky mortgages and a wave of immigration have sustained the Aussie boom. Then, too, the Chinese debt bubble has failed (so far) to find its pin. No more just the Lucky Country, Australia, as today's bulls are wont to cheer, is the Wonder Down Under.

And by some measures, the wonderfulness goes on. Growth in first-quarter GDP weighed in at 3.1%, measured year-over-year, above expectations of 2.8% and up from 2.4% in the fourth quarter. The April unemployment rate came in at 5.6%, down 10 basis points from the reading last year despite a 60 basis-point jump in the labor-force participation rate, to 65.6%. Those data match, if not outshine, the comparable American figures of 3.8% and 62.7%.

There's no such glow in house prices. Since October, they have fallen by 2% on average and by 4.1% in Sydney, the former furnace of the white-hot national market (in the five years through 2017, Sydney prices had advanced at an average annual rate of 10.9%). In Australia, auctions are the preferred sales channel for single-family houses, and the auction clearance rate is a key housing met-



ric. Lately, the number of homes sold under the gavel as a percentage of those offered for sale at auction has declined to 55.3% from 74.6% a year ago. Clearance rates below 50% have historically spelled trouble.

Martin and Schneider represent only one point of view on the market, of course. The bullish case rests on the competence of the Australian monetary and regulatory authorities. It is they who instigated the post-2012 housing boom by chopping a 4.25% policy interest rate down to 1.5%. And it is they who, as long ago as 2014 (and again in 2017), took timely and effective steps to defuse the risks presented by an overabundance of interest-only mortgages, so the argument goes.

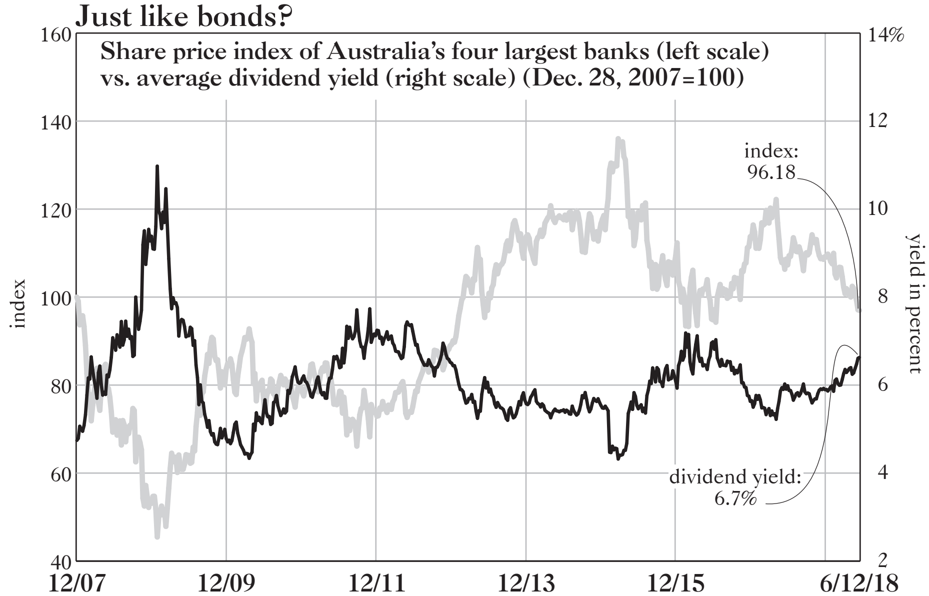
"The reason house prices are falling in Australia is not because the economy is slowing," Christopher Joye, co-CIO of fixed-income manager Coolabah Capital Investments, Pty. Ltd. and a contributing editor to *The Australian Financial Review*, tells Lorenz. "It is not because interest rates have increased because of the RBA [Reserve Bank of Australia, the country's central bank]. It is precisely because the APRA [Australian Prudential Regulation Authority] has engineered a slowdown. It limited loan growth to investors by 10% per annum. It limited interest-only loans to 30% of loan flows." The I.O. loan threat is four-year-old news.

According to Joye, house prices will likely fall by 5% to 10% from the late-2017 peak. Barring an aggressive Reserve Bank tightening drive, this will be the full extent of the non-crisis. Whereupon, the market will rebound as it did after pauses in 2008–09 and 2011–12.

"However," Lorenz observes, "peel back the macro data and you see confirmation of the picture we laid out in these pages one year ago: low-quality job growth, stagnating wages and towering debts. Economic growth has been propelled by a snapback in commodities, notably Chinese-driven demand for iron ore, coal and liquefied natural gas. Yes, between the fourth and first quarters, real output grew at a 4.2% annualized rate, but household consumption rose at a 1.4% rate. While Australia posts a higher employment population ratio than does the United States, more Aussies work part-time (32% of the total workers) than Americans do (17%)."

In the absence of satisfactory wage

Just like bonds?



source: The Bloomberg

growth, Australians have run up their borrowings and run down their savings. At year-end 2017, debt as a percentage of disposable income topped 188.6% (vs. not quite 105% in the United States) as the saving rate fell to 2.3% (vs. 2.4% in America).

How is it arithmetically possible for the Australians to save so much as a dime when their indebtedness as a proportion of their income is rising? The national mandatory retirement program—"superannuation"—explains the mystery. Employers must pay 9.5% of a worker's salary into the superannuation kitty. The government classifies such obligatory contributions as income, though employees can't touch the money except for retirement or in case of hardship. So, a 2.3% savings rate in fact represents a negative pull on disposable income.

Our Aussie visitors—Schneider is the CIO and co-founder of macro fund Brookline Partners Ltd., and Martin is a senior partner at Ceres Capital, Pty. Ltd.—cite two principal reasons for a coming spill in Aussie residential real estate. First are the looming unhappy surprises in store for the many who hold interest-only mortgages. As in the example of the man with the A$4 million house, many such loans will shortly migrate to the principal-amortizing kind, with commensurate rises in monthly payments. Second are the revelations emerging from a government inquest into abusive and deceptive lending practices. Anticipating a public shaming, banks are tightening their lending standards before the scheduled release of the government's interim report in September.

By 2015, almost 40% of the stock of outstanding mortgages was interest-only—typically, for the first five years of the loan, the borrower pays down no principal. Last year, the previously cited regulator, APRA, ordered that such loans must constitute no more than 30% of new mortgage originations. As his loan matures, an interest-only borrower has been free to apply for a new mortgage of the same type, but he is confronting a new era of official disapproval, higher interest rates and tighter underwriting scrutiny.

Speaking in Sydney in April, Christopher Kent, assistant governor of the RBA, ventured that A$120 billion of interest-only loans will become principal-and-interest loans each year for the next three years. "Consider," said Kent, "a 'representative' interest-only borrower with an A$400,000, 30-year mortgage with a five-year, interest-only period.... At the expiry of the interest-only period, required payments will increase by around 30% to 40%." Not that the central banker would quit his day job to join a short-selling hedge fund. While the step-up in required payments for the individual borrower could be daunting, he said, the cash-flow effect for the household sector as a whole is "likely to be moderate." As for the probable effect on household consumption, it will likely prove inconsequential.

Martin and Schneider, of course, have another idea. "We have a guy who does a lot of mortgage analysis," says the first-named bear. "He surveys 60,000 people. One of the first comments he makes to us is that most of these people don't realize they are on interest-only loans." To which Schneider adds: "We've been told this would be illegal in America. It didn't occur to us."

It has occurred to the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, as the aforementioned government investigatory body is formally known. The Royal Commission has not only held public hearings on sensitive subjects, but also posted once confidential business papers procured in the course of its investigations into bankerly dereliction and wrong-doing.

One such document, a report privately circulated last year among the directors of Westpac Banking Corp. (WBC on the Australian Stock Exchange), among Australia's big four banks, summarized the findings of a survey of the bank's own lending practices in residential mortgages. PricewaterhouseCoopers, which conducted the canvass, found that WBC flunked eight out of 10 control objectives, including this one: "Mortgage borrower financial information is entered completely and accurately in to the Bank's system for assessing loan serviceability."

Westpac, No. 3 in asset size among the big four, has an A$400 billion mortgage book, representing 70% of its loans. If it's almost a mortgage bank, you would not call it an especially proficient one based on PwC's analysis of a sample of 420 WBC portfolio mortgages. Jonathan Mott, analyst at UBS in Sydney, summarized the results in the course of issuing an April sell recommendation on WBC shares:

> From our analysis of this data, we estimate (1) All minimum income verifications (e.g., payslip check) were not completed for 29% of the sample; (2) 86% of the sample had assessed living expenses equal to the Household Expenditure Measure benchmark [rather than checking actual data]; (3) 66% had no itemized living expenses collected; (4) The median assessed household living expenses represented just 23% of household income; (5) In 30% of the sample, the borrower's financial position was suggested to have been misrepresented; (6) In 9% of the sample the loan would not have been approved if the "true financial information" was used in serviceability assessment.

The WBC's highly leveraged borrowers showed a median ratio of debt (total debt) to income of 5.4:1, with 35% of the sample reporting more than 7:1. Reviewing these figures, the chairman of APRA, Wayne Byres, called WBC a "significant outlier," though American experience in 2001–06 would suggest that WBC is not alone in pushing the envelope. Angels are scarce in a bubble.

Tighter underwriting standards are already apparent in lending data. In April, seasonally adjusted mortgage originations fell by 1.4% from March, the fifth straight monthly decline, the longest such streak since Black September 2008, the month Lehman Brothers, Inc. passed away.

According to a seven-month-old national survey posted on the website of Domain Group, an Australian real-estate marketing company, 54% of encumbered homeowners would find it inconvenient to bear a rise in mortgage-service payments of as little as A$23 a week. "Households are incredibly stretched," Schneider says. "Real incomes have gone sideways for 20 years. You've had massive increases in housing prices, but the ability to service these mortgages in real terms has gone nowhere in 20 years."

Chinese investors made their contribution to those massive price gains, but China's capital controls and Australia's taxes on non-resident investment in domestic real estate have staunched the inbound flow of renminbi. Thus, it's no surprise that noncitizens' purchase of Australian houses fell by A$47.2 billion to A$25.2 billion in the 12 months ended last June. According to UBS, Chinese home buyers are taking their business to the more welcoming precincts of Japan and Southeast Asia.

"Although house prices are falling just a little bit at the margin, there has been a drop-off in housing-related turnover for the last two to three years," Gerard Minack, the eponym and principal of Minack Advisors, Pty. Ltd., tells Lorenz. "What is interesting to me is that housing in Australia is like most financial markets—which is that volumes go up in a bull market, volumes dry up in a bear market—but what is noticeable in the Australian housing market is that volumes have been much weaker than you would have otherwise expected given the strength in prices. So this is a market that in a sense has been thinning out. But, of course, with no forced sellers because no one is losing their job, the thinness hasn't been tested."

As noted, the RBA presented the housing market with the gift of rate reductions in the sum of 275 basis points between 2012 and 2016. At the current intervention rate of 1.5%, the scope for a new round of interest-rate stimulus is of course materially reduced. Besides, just over one-fifth of Australian bank funding occurs offshore, most of it in U.S. dollars.

Popular discontent presents another risk to the Australian status quo. Elevated house prices have enriched homeowners but condemned a younger generation to rent; homeownership rates among Australians between 25 and 34 years of age have tanked to 44% from 61% in the early 1980s. Election season Down Under could begin as soon as August, and the Laborites, leading in the polls, are banging away on housing inequity. They promise to disallow deduction of negative-carry losses on investment property from taxable income and to end favorable capital-gains treatment of house sales.

Such changes are not exactly what the real-estate doctor would order. Small operators, as distinct from professional real-estate companies, own 83% of all investment properties, and loans to investors, rather than owner-occupiers, make up 34% of all mortgages outstanding. According to the Australia Taxation Office, just over 60% of investors avail themselves of that Labor-threatened deduction of property-related losses from taxable income ("negative gearing," as it's locally known).

"Beyond the potential impacts of a housing-led recession," Lorenz observes, "there are feedback loops that are unique to Australia. Financials constitute 32.3% of the S&P/ASX 200 Index. The big four banks pay an average 6.7% fully 'franked' dividend, meaning that Australian residents pay no tax on distributions received. These are towering yields, more than double the 2.8% offered on the 10-year Australian government note, which is not tax-advantaged.

Domestic ownership of banks, both directly and through superannuation funds, is therefore just as high as you'd expect it to be: Last summer, Commonwealth Bank of Australia estimated that 80% of its shareholder roster, including 800,000 retail investors, hold Australian passports."

If house prices take their expected pratfall, banks will need to retain earnings; the average payout ratio for the big four banks is 79%. Australian Accounting Standards follow International Financial Reporting Standards (IFRS), so that, come July 1, Aussie banks will have to start reserving for expected losses, rather for the ones in front of their eyes (i.e., the local equivalent of rule IFRS 9). Whatever the macroprudential merits of that policy might be, it will win no friends among the retail-investor cohort who treat bank stocks as bond proxies. Indeed, the big Australian bank stocks have been better than bonds, returning an average of 211% over the past dozen years, with dividends reinvested (vs. 146% for the S&P/ASX 200, also with dividends reinvested). Not since 2016 has one of the big four cut its payout.

"We think it starts on the periphery of the consumer sector and works its way into the banks, given that the house is the last thing to go," says Schneider. One year ago, *Grant's* picked JB Hi-Fi, Ltd., the local version of Best Buy, as one retailer likely to disappoint in the face of an increasingly stressed consumer and the entry of Amazon.com, Inc. into the Australian market. During the Macquarie Australia Conference on May 2, JB Hi-Fi buried a 3% profit downgrade on page four of its presentation. The warning sent shares down 9% for the day. Since we highlighted JBH, the stock has gone up 7.9% in local terms vs. an 11% rise in the S&P/ASX 200, both including reinvested dividends.

"In terms of the cadence, we think it is going to be a scenario that will happen slowly and then it will happen quickly," Schneider continued. "We think that banks are massively undercapitalized. We think that there has to be some form of recapitalization of banks. There is going to be more regulatory oversight coming out of the Royal Commission. There is going to be a massive need for provisioning to increase.

"Our economy is a very concentrated bet. It is not a very diverse economy," Schneider concluded. "The place that someone can 'hide' from a housing malaise is almost negligible. If the currency depreciates by a large amount, the mining sector will benefit, but that is a West Coast phenomenon and that won't help East Coast housing prices. Without wanting to sound alarmist, we don't think this is a recessionary outcome but a depressionary outcome."

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