Australian Strategy Insight

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Investment Strategy

Comparing the Australian and US housing markets

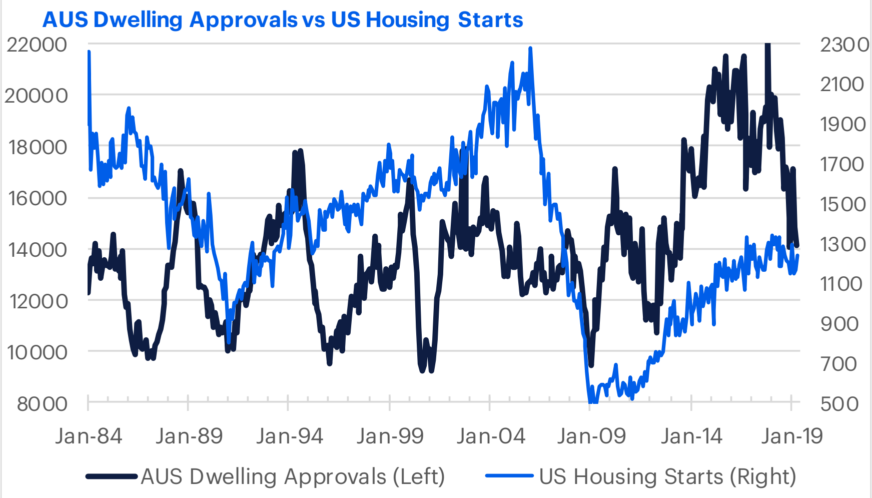
The Australian housing market has been very weak, with approvals down 25.5% and home prices down ~10% from peak levels. However, guidance of near-term rate cuts by the Reserve Bank of Australia (RBA), easing of a lending guideline by the Australian Prudential Regulation Authority (APRA) and the avoidance of Australian Labor Party (ALP) measures targeting negative gearing and capital gains tax, have led to calls for a turn in the property market.

Despite these positives, we see ongoing significant headwinds for the Australian housing market, including building oversupply, record leverage, still elevated valuations, high investor exposure and the RBA's rate cut constraint. Indeed, 30-35bps off mortgage rates in the near-term is much smaller than the 200-385bps seen in driving the last three housing recoveries.

In the US, housing activity has slipped 7-10% over the past year on the back of higher bond yields, which have since reversed. Early indicators point to a recovery. Broader fundamentals are also supportive, including a growing underbuild, low leverage and reasonable valuations. We see a much higher likelihood of upside in the US housing market.

Three ways to play this theme are James Hardie (JHX), Boral (BLD) and Reliance Worldwide (RWC), with US exposures of 67%, 35% and 53% of sales respectively. All three are reducing costs; JHX from lean manufacturing, and BLD and RWC from their recent Headwaters and John Guest acquisitions respectively. All have been materially de-rated and are trading at the low-end of valuation ranges (12-month consensus forward P/E) – JHX on 16x, BLD 12.3x and RWC 16.7x. We have BUY ratings on JHX and RWC.

Fig.1: Comparing two housing markets – Australia down 25.5% from a record peak, and the US down 10% from a level still well below average



Source: Datastream, Baillieu

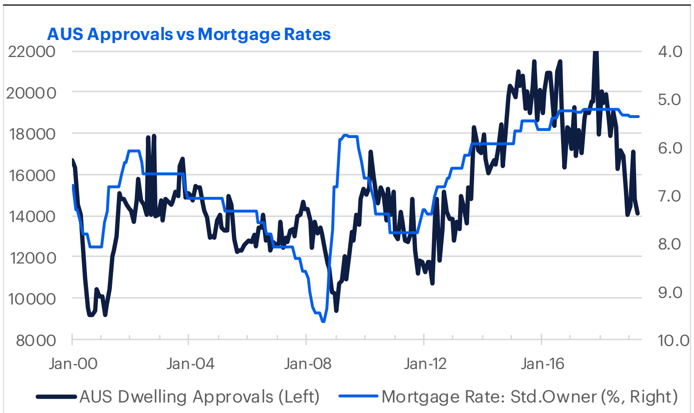
Comparing the Australian and US housing markets

- In Australia, strong guidance of near-term rate cuts by the RBA, easing of a lending guideline by APRA and the avoidance of ALP measures targeting negative gearing and capital gains tax have led to calls for a turn in the property market. In this note, we analyse the likely impact of these positive drivers in a weak housing market. We compare the prospects for the Australian property market with the US, where mortgage rates have fallen ~100bps in an underlying strong housing market. We see a much higher likelihood of upside in the US housing market. James Hardie, Reliance Worldwide and Boral are three ways to play this theme.

The current Australian housing market: unusual weakness

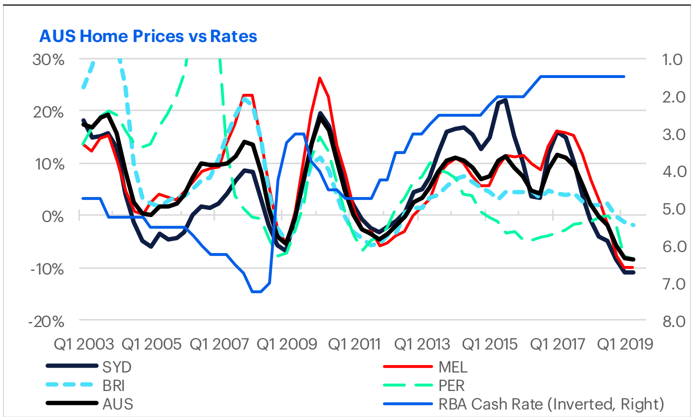
- The Australian housing market peaked in late-2017, after one of its most powerful booms from 2012 to 2017. Dwelling approvals have fallen by 25.5% from peak levels, and are down 20.5% YoY (Figure 2, using 3-month moving averages). Home prices have fallen ~10% from the peak and are down 8.4% YoY (Figure 3). Associated with the downturn, new home sales have fallen 31.6% from the peak, and are down 18.2% YoY, whilst the number of owner-occupiers drawing housing finance has fallen 22.5% from the peak and is down 13.7% YoY.

Fig.2: AUS dwelling approvals – down 20.5% YoY – are down 25.5% from the peak



Source: Datastream, RBA, Baillieu

Fig.3: AUS home prices – down 8.4% YoY – have fallen ~10% from peak levels



Source: Datastream, Baillieu

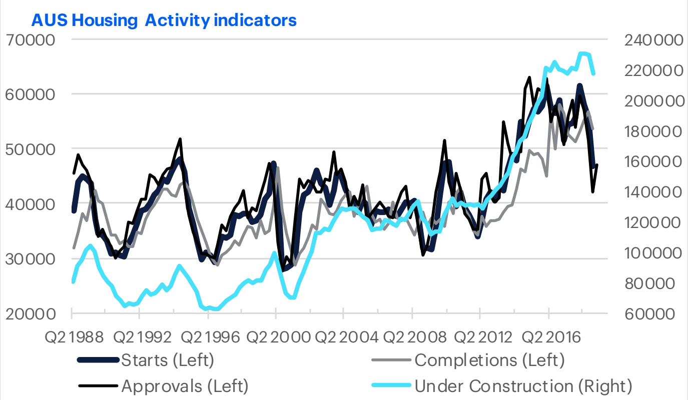
The Australian housing market outlook: Still significant challenges

- The housing market is set to receive support from lower mortgage rates on the back of RBA rate cuts and the easing of a key lending standard. We expect 50bps of RBA near-term rate cuts to drive the banks to cut mortgage rates by ~30-35bps. Increased borrowing capacity driven by APRA, the government's First Homeowner's Deposit Insurance Scheme and the removal of the ALP-inspired risks to negative gearing and capital gains tax rates following the election are all positives for the housing market.
- However, as Figure 2 shows, the housing recoveries of 2001-02, 2009-10 and 2012-17 required mortgage rate cuts of 200bps, 385bps and 260bps respectively – far more than 30-35bps!
- In addition, the Australian housing market continues to be confronted by five significant structural headwinds, including:
  - **Growing oversupply**: While approvals have fallen 25.5% from peak levels, and starts 24%, given the elevated peak, they are still above our estimates of underlying demand. In addition, Australia has yet to work through a near-record pipeline of 217k dwellings under construction. We estimate that oversupply will continue rising until late-2020 (Figure 4).

- **Record leverage**: Housing credit growth has slowed to a record low 3.9% YoY, but it is still outpacing disposable income growth. As such, the household debt-to-disposable income ratio has risen to a record 190% (Figure 5). We estimate the shift from interest-only to principal and interest loans over 2017-2021 will lift the debt burden by ~140bps, while the RBA's 50bps of rate cuts will lower the interest burden by ~60bps.
- **Persistent overvaluation**: Home prices have fallen ~10% from their late-2017 peak. Together with some income growth, this has improved the home price-to-disposable income ratio from a peak of 5.52x to just above 5.0x, a similar level to the pre-GFC peak (Figure 6). This is still 9% above the 2004-14 average of 4.6x, and 20% above the long-term average 4.0x.
- **High levels of speculation:** Investor lending has fallen 46.5% from the peak. The investor share of ex-refinance lending has fallen to 26.8%, around a 25-year low (Figure 7).
- **Reserve Bank policy constraints:** With the cash rate already at a record low 1.5%, the RBA is not far from the zero-bound. As such, we see a limit to mortgage rate cuts of about 80bps, well below the 200-385bps of cuts in recent cycles.

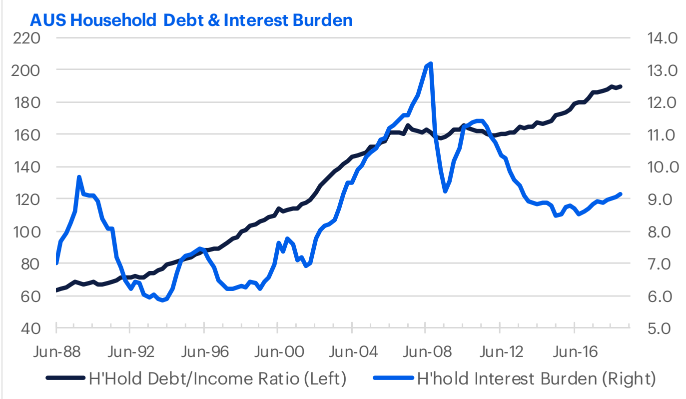
• The Liberal National Party (LNP) election victory reduces downside risks, increasing investor support for the market. Rate cuts, slightly earlier than expected, are also supportive. Nonetheless, the significant challenges facing the housing market lead us to retain our base case scenario of a ~50% decline in approvals and ~15-20% decline in home prices.

Fig.4: AUS dwelling approvals and starts are still relatively high, and the near-record pipeline will add to oversupply



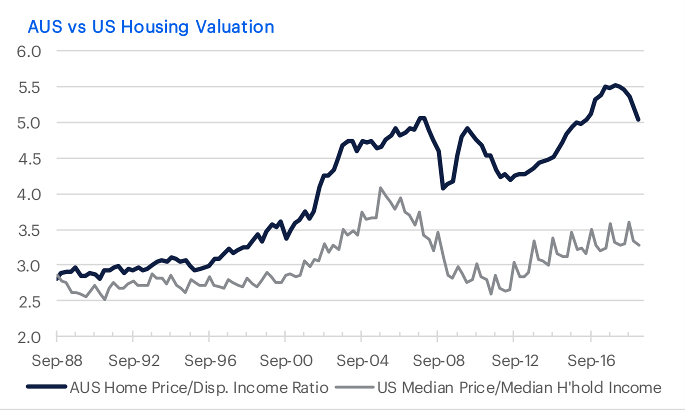
Source: Datastream, Baillieu

Fig.5: AUS household leverage has risen to a record 190% – deleveraging has not even begun



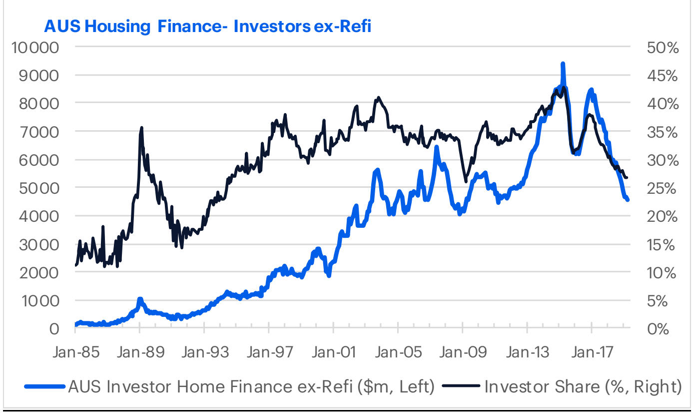
Source: Datastream, Baillieu

Fig.6: AUS home valuation ratios are back to the 2007 peak



Source: Datastream, RBA, Baillieu

Fig.7: Investor lending has fallen 47%

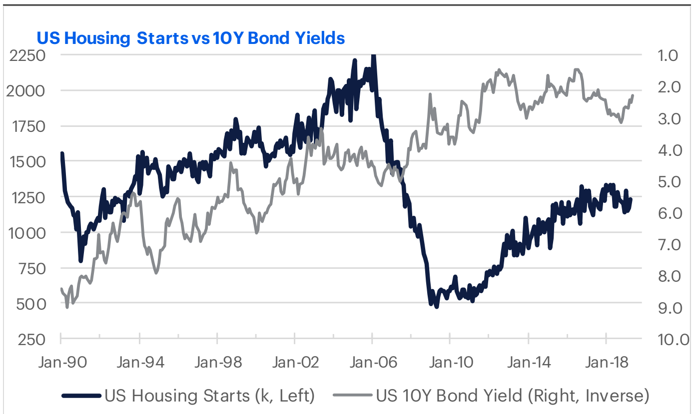


Source: Datastream, ABS, Baillieu

The current US housing market: Setback in post-GFC recovery

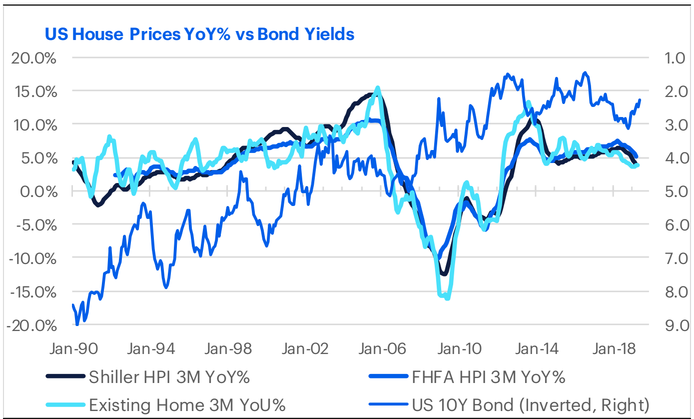
- The US housing market is still recovering from the global financial crisis (GFC). Whilst starts in 2018 were the highest since the GFC (1.25 million), they are still 40% below the peak year of 2005 (Figure 8)! Starts in 2018 were just 5.6 times Australia, despite the US population being 13 times larger! Within 2018, rising bond yields (since reversed) pushed starts down ~10%, and they are currently down 8.8% YoY.
- After falling more than 30% in the GFC, the median existing home price has recovered to ~15% above the 2006 peak. Along with the broader housing slowdown, price growth has decelerated to 3.8% (Figure 9).
- By contrast, new home sales are rebounding, up 7.2% YoY. Even so, they are 48% below the 2005 peak! Similarly, housing finance, proxied by the MBA New Purchases index, is up 4% YoY to a post-GFC high, but still well below the pre-GFC peak (Figure 11).

Fig.8: US housing starts are down 8.8% YoY, and still 44% below peak levels



Source: Datastream, Baillieu

Fig.9: US home prices have moderated, but are up 3-5% YoY, whilst bond yields have rallied almost 100bps

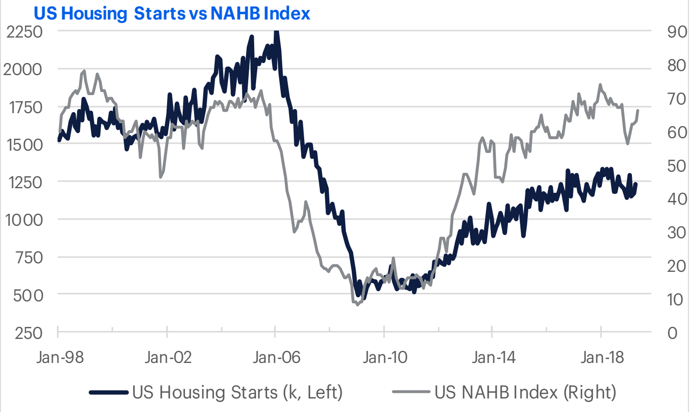


Source: Datastream, Baillieu

The US housing outlook: Recovery on lower mortgage rates

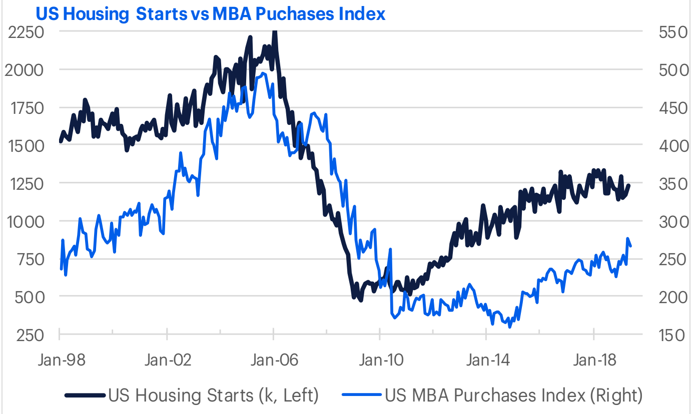
- In our view, a strong case can be made for a rebound in US housing activity after a pullback of ~10% in starts and 7% in existing sales between 1Q and 4Q 2018, driven by a combination of an ~100bps fall in bond yields – driving lower mortgage rates – and robust 1.7% YoY employment and ~3% wages growth. This combination has improved housing affordability and encouraged household formation. Lead indicators of activity point to a rebound, with the NAHB homebuilders index up 18% and the MBA mortgage purchases index up 19% from recent lows (Figures 10 and 11).

Fig.10: A stronger NAHB Homebuilders index should drive a rebound in US housing starts



Source: Datastream, Baillieu

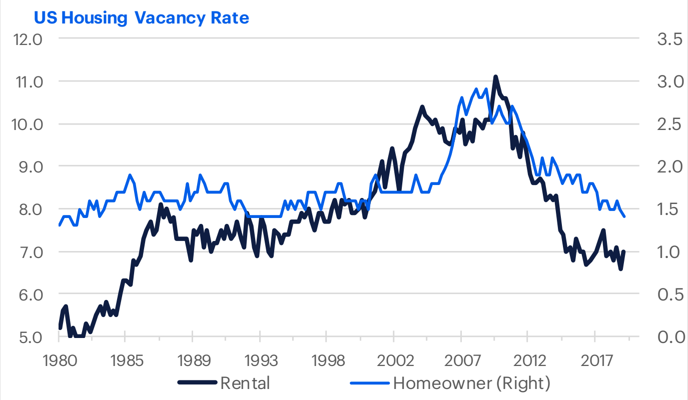
Fig.11: The MBA Purchases index has bounced 19% to a post-GFC high



Source: Datastream, Baillieu

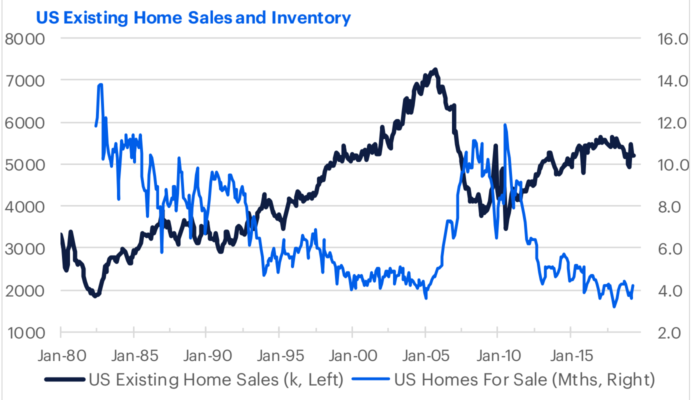
- The bigger picture also appears constructive for US housing:
  - **Growing undersupply:** Whilst population growth has slowed since the GFC, if underlying demand has fallen to 1.3-1.4 million range, 8-14% below pre-GFC average levels, US undersupply is reaching extreme levels of 2-3 million units. Consistent with that, vacancy rates are at multi-decade lows and the stock of homes for sale is close to record lows (Figures 12 and 13).
  - **Low leverage**: Household leverage has not recovered since the GFC. At 99%, it is well below the pre-GFC peak of 133% (Figure 14). With low mortgage rates the debt burden is around a record low 9.9%.
  - **Reasonable valuation**: Home price-to-income ratio has recovered to 3.3x, but remains well below the pre-GFC peak of ~4.1x (Figure 6). It is far below Australian levels! Affordability, whilst below peak levels, should move back into the post-GFC range (with lower mortgage rates) and is still far more attractive than pre-GFC levels (Figure 15).
  - **Speculation is moderate:** Investors tend to represent 14-18% of existing home sales, well below the levels in Australia where investors represented 37% of housing finance during the boom.
- Overall, we expect a solid recovery in US housing activity, supported by lower mortgage rates and the structural tailwinds of undersupply, low leverage and attractive affordability.

Fig.12: US Housing vacancy rates are around 30-35 year lows



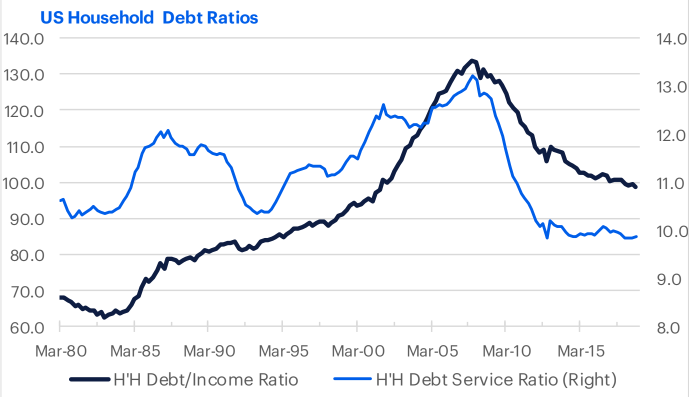
Source: Datastream, Baillieu

Fig.13: US existing home inventory for sale is around record low levels



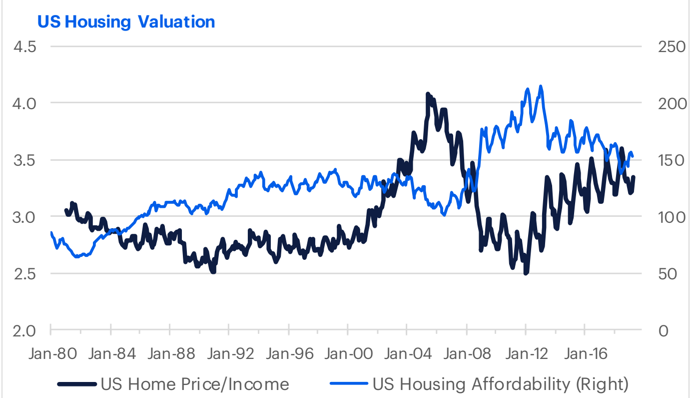
Source: Datastream, Baillieu

Fig.14: US household leverage is at an 18-year low 99%, down 34ppts from the peak



Source: Datastream, RBA, Baillieu

Fig.15: US home valuation is still very attractive, with affordability back into the post-GFC band



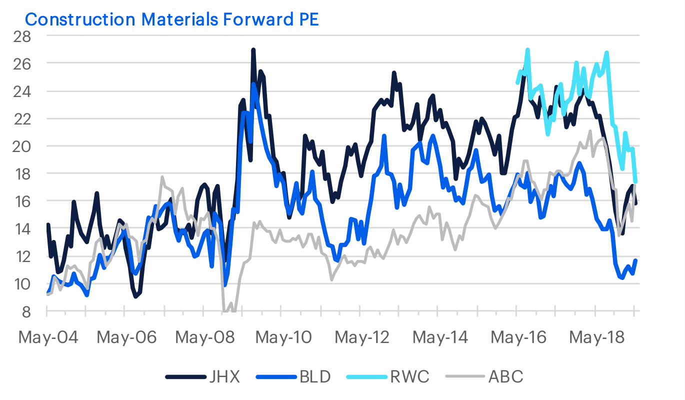
Source: Datastream, ABS, Baillieu

Three stocks to play a US housing rebound

- James Hardie (JHX) provides substantial exposure to the US housing market: US housing represents ~67% of its sales and ~75% of operating profit. In addition, the company is pursuing US$100 million of cost-outs from a move to lean manufacturing over FY20-22. Even so, the company has de-rated to its lowest forward P/E of ~16x (outside of early this year) since the GFC. We have a Buy rating on JHX with a $23.00 price target.
- Reliance Worldwide (RWC) offers substantial exposure to US housing, particularly repair and remodel (R&R), at ~53% of sales and 43% of adjusted EBITDA. The company recently issued a profit warning, impacted by US weather, US customer inventory adjustments, product shifts and delays and weakness in Australian construction. Our analyst particularly likes the: 1) continued penetration of PTC fittings and associated accessories; 2) exposure to the more defensive R&R market in the US; and 3) acquisitive growth through the John Guest acquisition. Following the profit warning, the stock has de-rated to ~16.7x forward earnings. We have a Buy rating on RWC with a $4.40 price target.
- Boral (BLD) offers 35% exposure to North America, with 17% exposure to US new housing and 9% to US repair & remodel. It is also targeting US$115 million in synergies from its Headwaters acquisition, of which a cumulative US$53 million had been delivered as of 1H FY19. On the other hand, it has a 15% exposure to Australian new housing and 7% to Australian R&R. BLD also issued

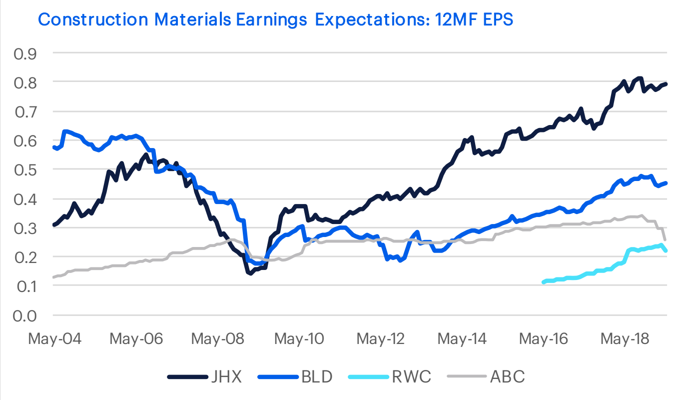
a profit warning earlier in the year, driven by poor weather in Australia and the US. At ~12.3x forward earnings, BLD is just above the valuation lows of the GFC. We have Hold rating on BLD with a $4.80 price target.

Fig.16: Construction materials stocks have significantly de-rated on housing market concerns



Source: Datastream, Baillieu

Fig.17: Profit warnings, particularly from Boral, Reliance and Adelaide Brighton, have hurt earnings estimates



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