The Unnecessary Fear

MARCH 2023

IN FEBRUARY 2023, Gryphon CIO Ashley Burtenshaw gave a speech to potential and current investors in GCI regarding market fears around the ability of mortgage borrowers in Australia to weather the current storm of rising interest rates. We believe that the fears being promulgated in the press appear to be unnecessary due to many mitigating factors and that the Australian mortgage market looks like it is in good shape.

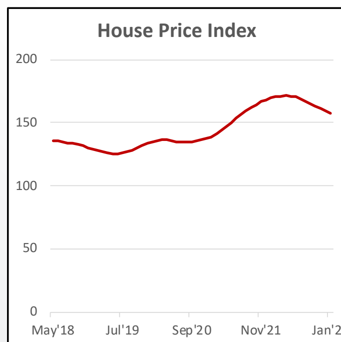
The Perception

In a nutshell, many market commentators are starting to question the ability of mortgage borrowers to make payments on their loans based on higher interest rates and the cost-of-living crisis. On the back of this, we see a lot of fear-mongering about the Australian housing market and mortgage borrowers. We call this the "Unnecessary Fear".

As we see it, there are three main components to this Unnecessary Fear:

1. House Prices — "The Incentive"

The growth in house prices in 2021 was clearly unsustainable and we saw prices begin to decline in 2022. When house prices rise, this gives financial freedom to borrowers and increases consumer confidence due to the wealth effect. Rising house prices also increases the security value backing our RMBS investments.



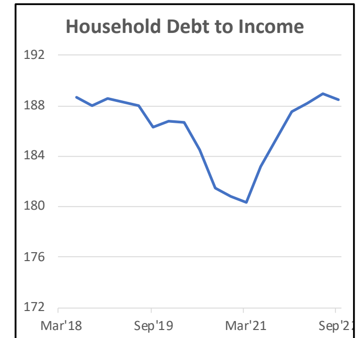
Source: Core Logic, Seasonally adj hedonic home value, 31 Jan 2023

Conversely, when house prices decline the consumer mindset changes as they focus on the recourse nature of mortgage lending. This, in effect, also weakens the security package backing our RMBS investments.

Historically performance in house prices has been very strong making the recent relatively small drop of interest, but does not have a worrying impact on risk. The Incentive is still good.

2. Household Income — "The Obligation"

You may be familiar with the old adage: "Small kids — small problems, big kids — big problems". The same is true for mortgage loans: small loan balance — small problem, large loan balance — large problem. Typically, mortgage loans are designed so that borrowers' monthly repayments represent 30% to 40% of their monthly gross income. As a result, as interest rates increase driving up mortgage repayments and squeezing borrowers, particularly those with large loan balances. Larger loans, therefore, have a higher probability of moving into arrears.



Source: RBA, Australian household finances debt to income, 30 Sep 2022 | Reserve Bank of Australia (rba.gov.au)

It is not possible to fully avoid large loans in a pool of mortgages, but our information advantage driven by proprietary databases allows us to monitor any large loans and to track other risk factors including:

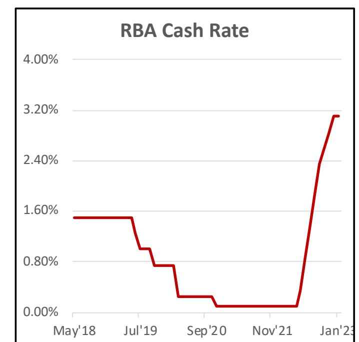
- Leverage — high or low (better) LTV
- Documentation — low or full (better) doc
- Purpose — refinance or purchase (better)
- Valuation — drive-by or full (better)
- Payment history — arrears history or perfect payer (better)
- Postcode — area with high or low (better) volatility in values
- Repayment method — interest-only or fully amortising (better)

Using this analysis driven by our proprietary data systems, we avoid investing in loan pools that have an overabundance of large loans with other poor characteristics, such as high LTVs or drive-by valuations.

Our data analysis highlights that The Obligation is under control.

3. The RBA — "The Influencer"

The RBA increases interest rates to tighten monetary conditions and lowers rates to loosen monetary conditions. During the past 3 years we have witnessed the RBA loosen policy dramatically and, now as they are reversing course at a rate of knots, it is starting to cause concern that they have lost control.



Source: RBA, Cash Target Rate, 31 Jan 2023 | Reserve Bank of Australia (rba.gov.au)

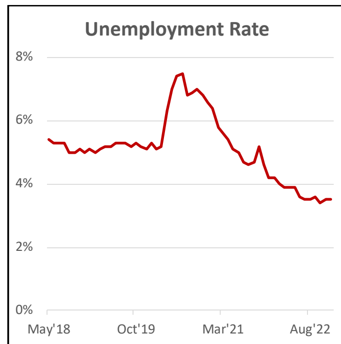
Our view is that the RBA keeps monetary policy either too loose or too tight for too long. So, in an attempt to manage the pandemic period, the RBA was too loose for too long which makes the probability of an overcorrection (too tight) too high to ignore.

continued overleaf...

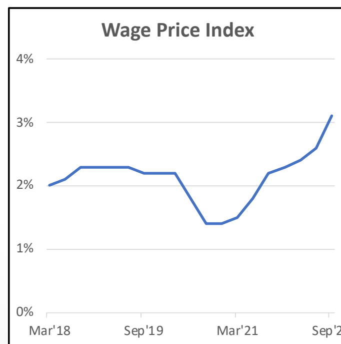
In Mitigation

Now let's focus on the realities of the market and look at the "roadblocks" that challenge and mitigate the above fears.

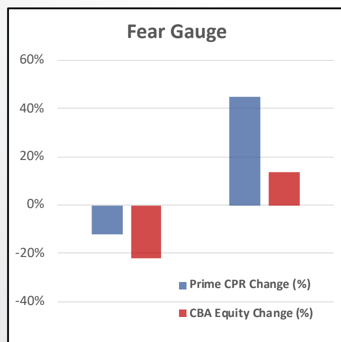
- **Unemployment Rate**
  In some ways this is self-explanatory, but unemployment is one of the biggest drivers of early-stage mortgage arrears. A low unemployment rate as we are seeing in today's tight labour markets allows borrowers to keep making their payments.
- **Wage Inflation**
  Wage inflation builds mortgage power as it lowers the impact of increasing mortgage payments on borrowers. Coincidently, wage inflation is up at 3.1% year on year, virtually in lockstep with interest rate increases.
- **National Savings Rate**
  We saw the national savings rate peak at 23.6%* during the pandemic but it has now dropped back to 6.9%*, in line with rates observed before the pandemic. This is another positive for borrower resilience to interest rate increases. (*Source: ABS – Australian Household savings ratio).
- **Number of Payments Ahead**
  This is a well-known feature of the Australian mortgage market. In the downward trend in interest rates prior to May 2022, borrowers were reluctant to change their mortgage payments to reflect lower interest rates. This meant that borrowers built up a balance of overpayments giving them greater resilience to weather any increases in mortgage payments. Yes, this has been reduced somewhat with rate rises but it remains a significant protection for RMBS investors.



Source: ABS, Labour Force, Australia, December 2022 | Australian Bureau of Statistics (abs.gov.au)



Source: ABS, Wage Price Index, Australia, September 2022 | Australian Bureau of Statistics (abs.gov.au)



Source: S&P Spin report, Australian RMBS Arrears SPIN Statistics November 2022 (Inc. Non-Capital Market Issuance) | S&P Global Ratings (spglobal.com), *Bloomberg* (as at 31 January)

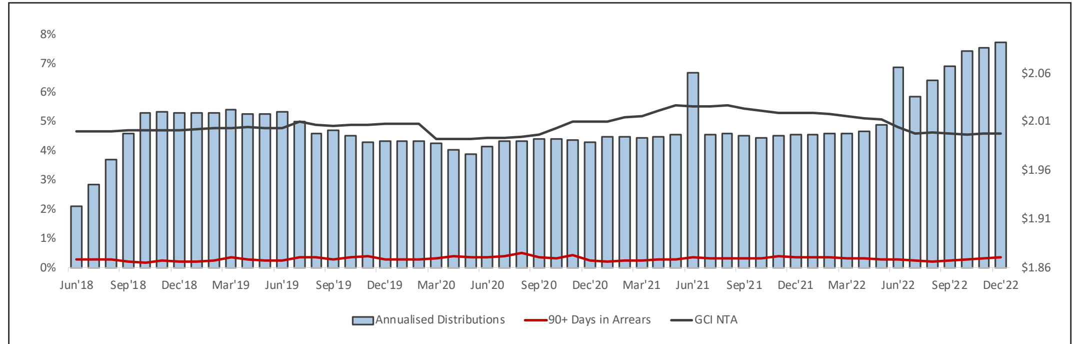
- **Equity Build Up**
  Over time mortgage borrowers build up the equity in their homes as the pay off the capital value of their mortgage. This is further enhanced by house price increases and eroded when house prices decline. With respect to GCI's exposure to RMBS, the average equity is still 35% of the total value of the house and remains a big investor protection. This promotes a couple of avenues for borrowers who struggle with their loan to self-manage their way out of trouble through either refinancing their current mortgage or, as a last resort, a property sale.
- **Strong Financial System**
  The Australian financial system is much stronger than it was prior to the GFC in 2008, allowing lenders to price credit risk fairly. Borrowers with a strong track record and good equity can demand a fair deal on their loans.
- **Mortgage Prepayment Rates**
  This is one of the strongest indicators of market health even if it is a little technical. In a normal market we often see that a significant number of loans in a pool prepay in any given year, largely due to housing turnover or refinancing activity. We measure this using CPRs (Constant Prepayment Rates) where a CPR of 20% means that 20% of the loans in a pool prepay in a given a year.

  Higher CPRs imply that credit is flowing and borrowers can get access to it. Credit is to financial markets as oxygen is to humans. On the contrary, lower CPRs imply credit is more restricted and like humans a withdrawal of oxygen makes it difficult to breathe therefore making it harder for financial markets to function. Unsurprisingly, CPRs are increasing, as highlighted in the Fear Gauge chart, which illustrates how increasing CPRs are correlated with optimism in the banking sector from 2019–2022 compared to the GFC period when CPRs slowed and the banking sector was under pressure. Even when the banking sector was at its weakest during the period between 2006–2009, there were NO RMBS principal bond losses in Australia.

continued overleaf...

Conclusion

In short, we believe that fear over the mortgage market in Australia highlighted in the press is in fact unnecessary. Early-stage arrears are not showing signs of stress (see chart right) and the mitigating factors described above are working to offset the rise in the mortgage obligations. What can you expect from the Gryphon team? More of the same — a sustainable monthly income stream derived off a portfolio of reliable investments as has been the case over the past four and a half years.



Source: Gryphon

Disclaimer

Investment involves risks. Past performance is not a guide to future performance. Investors should not only base on this document alone to make investment decision. This document has been prepared without taking account of the reader's investment objectives, financial situation or needs. Any person reading this document should, before deciding to invest in or continue to hold the investment in GCI, seek professional advice. The ratings are only one factor to be taken into account when deciding whether to invest in GCI.

One Managed Investment Funds Limited (ABN 47 117 400 987) (AFSL 297042) (OMIFL) is the responsible entity of the Gryphon Capital Income Trust (ARSN 623 308 850 ("Fund"). Information contained in this document was prepared by Gryphon Capital Investments Pty Ltd (ACN 167 850 535) (Gryphon). While neither OMIFL nor Gryphon has any reason to believe the information is inaccurate, the truth or accuracy of the information cannot be warranted or guaranteed. Before making any decision regarding the Fund, investors and potential investors should consider the Product Disclosure Statement (PDS), the Target Market Determination (TMD) and other continuous disclosures available on the Australian Securities Exchange ("ASX") website (Disclosure Material). The Disclosure Material contains important information about investing in the Fund and it is important investors obtain and read the Disclosure Material before making a decision about whether to acquire, continue to hold or dispose of units in the Fund. This document contains general information only and is not intended to be financial product advice. It does not take into account any person's (or class of persons') investment objectives, financial situation or particular needs, and should not be used as the basis for making investment, financial or other decisions. Investors should also consult a licensed financial adviser before making an investment decision in relation to the Fund. This document may contain forward-looking statements based on current expectations, estimates, and projections about the Fund's business and the industry in which the Fund invests. Readers are cautioned not to place undue reliance on these forward-looking statements. Neither OMIFL nor Gryphon undertakes any obligation to revise any such forward-looking statements to reflect events and circumstances after the date of this publication. Past performance is not indicative of future performance. Neither OMIFL or Gryphon nor any other person associated with the Fund guarantees or warrants the future performance of the Fund, the return on an investment in the Fund, the repayment of capital or the payment of distributions from the Fund. To the extent permitted by law, no liability is accepted by OMIFL, Gryphon or their respective directors for any loss or damage as a result of any reliance on this information. Information in this document is current as at 19 April 2023.