Weakening House Prices — potential investment opportunity for GCI

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Much has been made in the press of recent house price forecasts which indicate an expectation of slowing house price growth in Australia and even declines in house prices in 2023. If these forecasts play out, what does it mean for investors in GCI? Below, we discuss our thoughts on this in detail, concluding that this is not a threat given the defensive nature of GCI. Indeed, it may produce further buying opportunities for the trust, much as we saw at the time COVID broke out back in March 2020.

Housing price growth may slow after a strong year, but borrowers remain resilient

Let's remind ourselves of recent house price performance. We have seen significant increases in house prices in Australia over the past 12 months and the major banks currently forecast housing price growth of 22% in 2021, 5% to 8% in 2022, before a decline of 4% to 10% in 2023. Taken together, there is a total forecasted increase of 17% to 25% from 2020 to 2023. A recent S&P article in November looked at the impact of COVID on the Australian RMBS market and determined that underlying borrowers have significantly increased their resilience during the pandemic, concluding:

Key takeaways

- Australia's RMBS sector has been mostly resilient to the economic effects of COVID-19.
- Low interest rates, strong property price growth, and competitive refinancing conditions are supporting debt serviceability.
- A buildup in savings, repayment buffers, and low interest rates have supported households' financial resilience.

This increased resilience to further shocks means that RMBS are better protected now from falls in house prices than they were prior to the pandemic. The current indexed weighted average LTV of all the mortgage loans underlying the GCI portfolio is only 60.8%

which, in and of itself, provides more investor protection than needed for the forecast rise and falls of the housing market (which still have them circa 20% above 2020's values after the forecasts for 2021, 22 and 23).

Borrower ability to repay limits losses

As described in a recent RBA research paper it is important to remember that triggering a default on a mortgage loan that results in a loss requires the borrower to BOTH be in negative equity AND to lose their ability to make required repayments. An inflationary environment that leads the RBA to increase interest rates (thereby reducing mortgage affordability and consequently house prices) is usually driven by an overheating economy in which we typically see robust employment rates. So, while house prices might see small declines in that scenario, the chances of borrowers being unable to pay their loans goes down, offsetting the increase in potential losses due to declining house prices. Importantly, across the GCI portfolio, as of November 2021 the average homeowner has built up 2.1 years in repayment buffer, further decreasing the likelihood of payment defaults.

RMBS have strong protections

RMBS are secured bonds and are the most senior ranking securities issued by banks and non-bank mortgage lenders. Of the four protections for RMBS investors, which we have previously described in section 4.9 of the most recent PDS, only the homeowner's equity is negatively impacted by falling house prices — the other three protections remaining just as strong. Crucially, issuers must pay their RMBS obligations in full prior to being able to allocate cash (profits) to pay anything else such as senior unsecured bank debt, hybrids, or dividends. As a result, RMBS are the least sensitive to house price declines of all the different securities issued by banks and will therefore be the least impacted by house price declines.

GCI investments are rigorously stress tested

Before GCI invests in any RMBS transaction, the Gryphon team conduct substantial due diligence on the position and, in particular, run an APRA specified 1-in-200-year stress event. This equates to a house price decline across the board of circa 40%. The Gryphon team take the issue of house price declines very seriously, but our ability to run these stresses at the individual loan level and then forecast bond performance accurately, gives us comfort that even a 10% house price decline would be immaterial in its impact on GCI's ability to pay its target monthly income while preserving capital.

GCI remains in a strong position

We believe that RMBS remains a strongly defensive asset class and will continue to provide income generation with strong capital preservation. The current concern regarding potential future house price declines is not a reason to exit from the RMBS market. On the contrary, as we have seen in previous periods of concern, the partial and temporary departure of generalist investors (who lack the detailed analytical capability to fully evaluate stressed market impacts on RMBS credit risk) from RMBS, creates profitable buying opportunities for GCI.

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