Sector spotlight

June 2014

Each quarter, Alphinity Investment Management's portfolio managers share their expert views on the trends and themes emerging within their relevant sectors. This quarter, Johan Carlberg shares his thoughts on the housing sector and where he's looking for upside.

Who: Johan Carlberg

Role: Principal and Lead Portfolio Manager

Sector responsibilities: Healthcare and small industrials

Industry experience: 27 years

The housing sector has been one of the recent stars within the domestic economy. What's been driving it?

Australian housing activity tends to be driven by the level and direction of interest rates, and this cycle has been no different. Of course, there are many underlying factors, such as housing affordability, debt serviceability, employment and general economic activity which impact the housing market. However, as there is a mutually dependent relationship between these factors and interest rates, we can focus on interest rates to explain housing market activity. While it took a bit longer than what has historically been the case for the current rate-cutting cycle to start to positively impact the housing market, we have seen the usual pattern where lower rates first lift home loan approvals, which then flow through into buildings approvals - and finally housing starts. What has been a bit unusual in this upswing has been the greater proportion of investors rather than first home buyers and upgraders, and also a higher proportion of apartment buildings vs detached houses. The latter probably being partly structural, as more people opt for townhouses and apartments for lifestyle reasons, and partly explained by the strong investor demand, including that from offshore.

How sustainable is the current level of market activity?

Building approvals are now close to historical peak levels so it's likely that we have seen the best in terms of growth rates. Actual construction activity however, has really only started to pick up noticeably in the last 4-5 months. The lags between approvals and building activity have increased in recent years, driven by a combination of increased complexity in the approvals process and the greater proportion of apartments, which tend to have longer lead times than that for single family homes. This means that we should have at least another 18 months of solid activity ahead of us. There is still a significant deficit in the total Australian housing stock when we compare demand to supply, so we would expect demand to stay strong as long as affordability doesn't become too stretched. While house prices have risen in most capital cities over the last 12 months, real price growth over the last 10 years has only been around 4.5%. Interest rates are thus most likely to have the biggest influence on housing affordability, which currently sits around long-term averages. Recent Reserve Bank of Australia (RBA) minutes highlight what most of us would have noticed; the economy has slowed in recent months, particularly since the federal budget was announced in May. We at Alphinity were already of the view that interest rates would be kept low for some time to deal with the impact of declining capital expenditure in the mining sector but the current slowdown may see the RBA reduce rates even further.

As an equities fund manager, where do you see the opportunities and risks with housing related stocks?

The potential for strong construction activity over the next 12-18 months and a fairly elongated housing cycle make us comfortable with our housing exposure in the portfolios, which from a domestic building materials perspective is concentrated in CSR. The reduction in single family homes as a percentage of total activity means that demand for some traditional building material products is less than previous housing cycles. However, CSR has been working hard to reduce the company's cost base and increase its exposure to lightweight products suitable for both detached housing and apartment buildings. The company has significant leverage to improved volumes and pricing power and this has started to become evident in the last six months or so. Another way to gain exposure to the housing sector is through the Real Estate Investment Trust (REIT) sector. Most REITs are fairly diversified with a substantial proportion of earnings from investments in commercial property assets across retail, industrial and office. In this sector, we like Mirvac and Lend Lease which offer decent leverage to the housing market through their residential development businesses. Finally from a risk perspective, while the Australian stock market's direct exposure to the housing sector is perhaps less than what many would perceive, the housing market is of course an important part of the overall economy. A sharp correction in Australian house prices would, in our view, require a significant increase in unemployment – i.e. a recession, such a scenario may result in vulnerability across many sectors of the Australian market, including the banks.

For more information please contact our Investor Services team on 13 51 53 or visit alphinity.com.au

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