House prices to fall but not bank profits?

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There's another entrant in the unending debate about the outlook for the Australian house prices: Merrill Lynch is forecasting that they'll fall 10 per cent from their peak in June last year, while another broker, JP Morgan, reckons there's a particular bad debt problem building for loans made in 2009.

But Merrills also forecasts that total bank profits will continue to rise nicely – up from $22 billion last year to $24.6 billion this year, $26.2 billion next and $27.7 billion in 2013 - and Morgan says the housing market is just where the Reserve Bank wants it.

“If the tinder is there, RBA officials stand ready to snuff out any nascent recovery,” says Morgan's latest research report. Go figure.

Meanwhile Goldman Sachs is saying there's no reason for the RBA to consider a rate hike until November – reflecting money market betting that has turned soft on harder monetary policy.

The Goldman view is that residential construction will contract through most of this year but “it will be a relatively mild downcycle by historical standards”.

It's not just the comments made by readers on *BusinessDay* articles that are often conflicting.

The Merrill Lynch view is the most surprising. While various parts of the Australian housing market are capable of a good bubble and bust – Gold Coast units, anyone? - a 10 per cent across-the-board decline would be serious business indeed with major implications for consumer sentiment and the broader economy.

But before having any implications, such a forecast would first have to be correct.

Contradictions

By way of comparison, it's worth remembering that during the 1990-91 recession, one that started with sky-high interest rates to choke a housing bubble and featured double-digit unemployment, the price of the average Australian home actually ticked up a fraction.

Yes, current house prices represent a bigger multiple of average income, but unemployment is just 4.9 per cent, household income is growing strongly, home building has not been keeping pace with population growth, the outlook for a leap in supply isn't flash and the commodities and capex booms are just taking off.

Knock 10 per cent off the value of the average home and the present softness in consumer spending would soon be considered the good old days.

Throw in the JP Morgan view that the cohort of loans made in 2009 are running into trouble and it's hard to see how such a bleak housing market view is consistent with solid growth in bank profits. Merrill Lynch has "buy" recommendations on NAB and Westpac and rates ANZ and CBA as "neutral".

JP Morgan analysts meanwhile prefer ANZ and NAB over CBA and Westpac because the latter two made a bigger proportion of housing loans in 2009.

Lengthy Morgan analysis released to clients at the end of last week boils down to the idea that when rates were slashed during the GFC, the banks were lending with an unspoken safety margin of the ability of borrowers to repay at a 7.25 per cent. That's effectively what most borrowers are now paying – with any further hike in rates by the RBA likely to get more of them into trouble. Or, as the Morgan report phrases it:

“We note that any further increase in interest rates would see 2009 vintage loans (about 20 per cent of portfolios) exceed affordability tests set at the time of loan origination.”

Well, that's the theory. Goldman Sachs notes that house prices have drifted lower and are now around 2 per cent below their peak but isn't particularly bearish:

“While we do not expect this deterioration to progress to broad-based precipitous falls, the underlying trends in this data set and low auction clearance rates (on low volumes) imply further house price softness in the near term.”

And for all Australian's alleged fear of further interest rate rises, we don't seem to be doing much about it – the proportion of fixed-rate loans being taken out is just 5.6 per cent of the total, back where it was in September before the last RBA rate hike.

It looks like we don't take forecasters too seriously.

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Read more: http://www.smh.com.au/business/house-prices-to-fall-but-not-bank-profits-20110614-1g10n.html#ixzz1PDSP2hVT