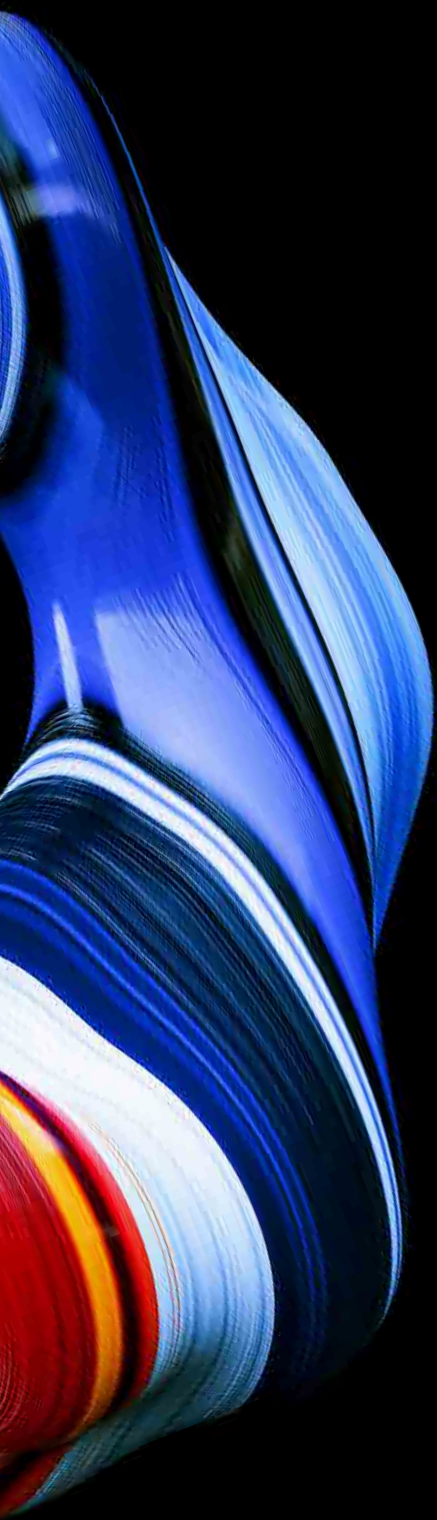
NORTHSTAR
ASSET MANAGEMENT



QUARTER 4, 2022 MARKET REPORT

Closer to the truth

Property – a ticking time bomb?

Adrian Clayton, CEO
Mark Seymour, Director Fixed Income

Property engenders much emotion, we look at whether or not it is potentially over-valued and how endemic this is globally.

The 2020 United States Census Bureau revealed that US households had 64% of their aggregate wealth (after debt) in home equity and retirement accounts. 44% being exposed to pure property both primary and rental.

Between 1940 and 2000, home ownership went through a revolution, which researchers refer to as ‘’the great mortgaging’’. American home ownership rates rose from 45% to 70% and in Britain, from 30% to 70%. This theme became pervasive across the world.

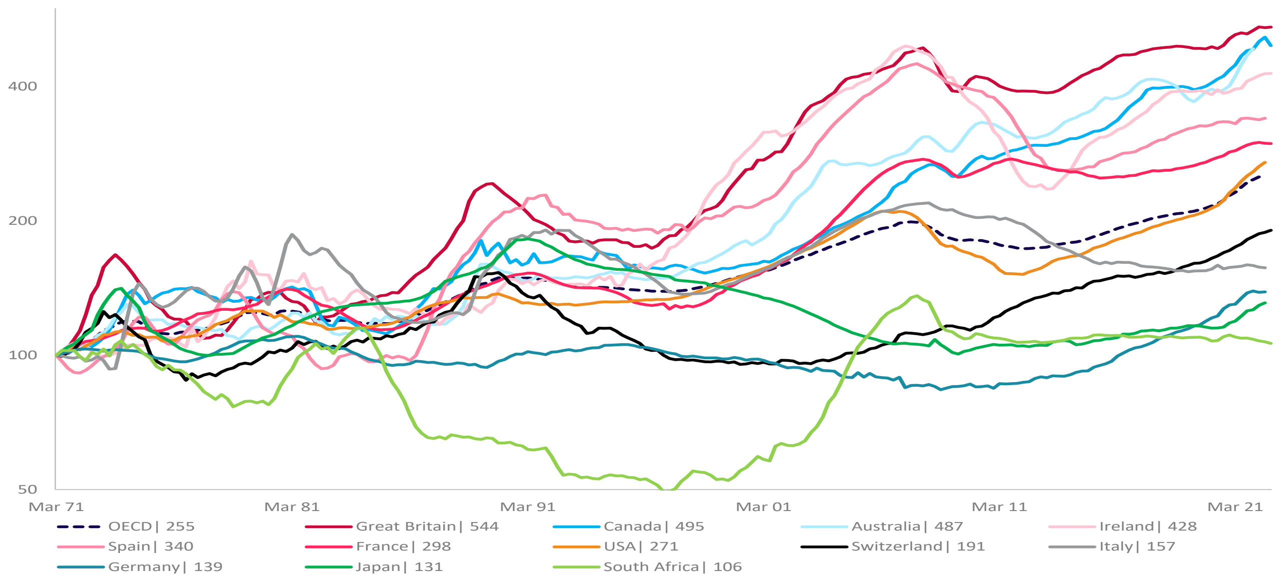
Considering its significance, residential property is key to consumer confidence and thus consumption (OECD - 60% of GDP), which in turn is key to economic growth. Bear in mind that the globe has entered a new era of elevated inflation and subdued growth.

We briefly highlight the pending risks to the global residential property market, and compare these versus the 2008 bust. What should we be worried about?

Excessive price gains

Not all residential markets have grown equally due to idiosyncratic factors including property stock levels post 2008, unique central bank interest rate policies, and emigration trends. With that said, most markets have experienced rapid home prices growth since the GFC, and price gains further accelerated through Covid. The attached graph shows how real house prices have moved across various markets over the decades.

Chart 1: OECD Real House Price Indices



Source: OECD Website (https://data.oecd.org) (as at 30 September 2022)

Rising interest rates – two concerns here

The first is the extent to which mortgage rates have risen in the past 6 months. A US 30-year fixed term mortgage in early 2021 would have cost a mortgage holder under 3%, and this is now closer to 7%. Rates were last at these levels in the early 2000's.

Chart 2: Freddie Mac – US 30 Year Fixed Rate

Source: Bloomberg (as at 30 November 2022)

To appreciate the impact on a US household's cash flows, we modelled this change and monthly payments would have increased significantly by 44%. More concerning is that mortgage originators allow mortgage payments to be as much as 45% of total income. At 3%, this homeowner's original monthly mortgage payment accounted for 45% of her income, assuming static income, at 6.7%, the mortgage is 65% of her income.

Table 1: A typical American household's mortgage repayment

		3% (2021) 30-year fixed mortgage rate	6.7% current 30-year fixed mortgage rate
House price	$400 000	$1632 monthly	$2342 monthly
Down payment	$80 000		
Period	30 years		
Monthly payment		$1632	$2342

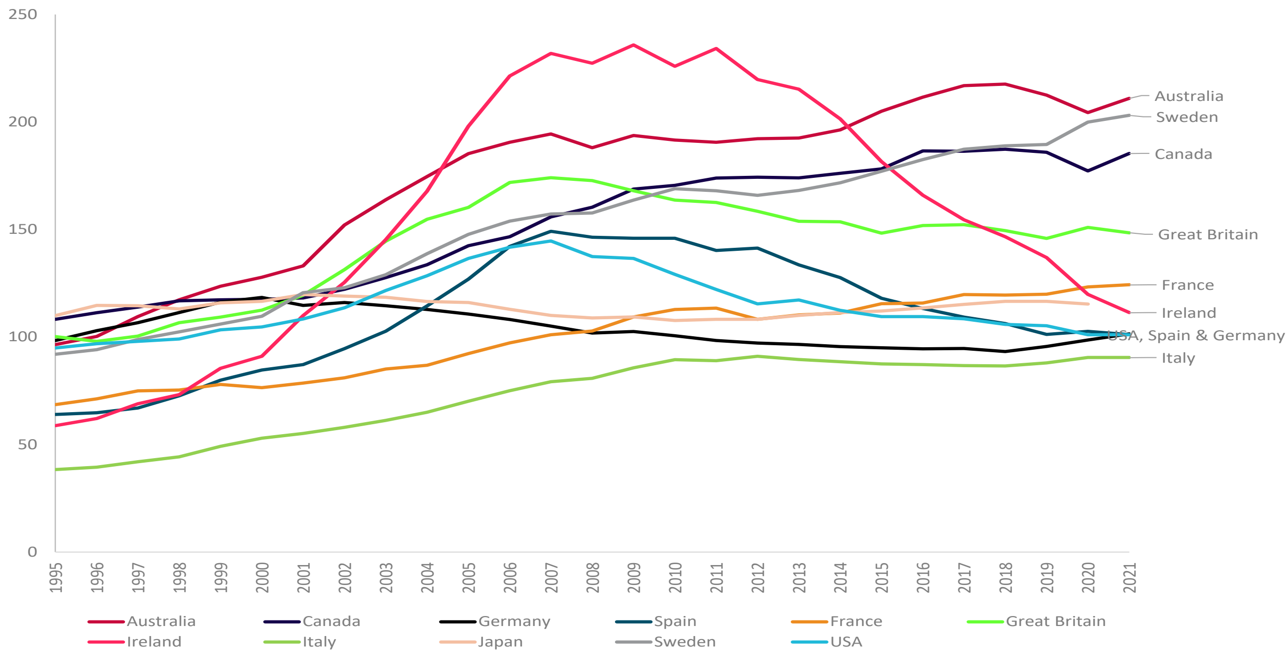
Source: US online mortgage calculator

Secondly, in many markets, a decade of very low and declining interest rates lured home buyers into variable interest rate schemes. In those markets more inclined for fixed rates, a significant percentage of these are due to reset within the next few years. In the UK for example, according to The Economist, 50% of fixed mortgages taken-out in 2021, will reset in 2023/2024. This makes mortgage holders highly susceptible to higher interest rates.

Household debt

Since the GFC, households in Northern Europe, Canada and Australia have grown their debt levels to the point that they are currently double their net disposable incomes. Fortunately, and this is the silver lining for the global property market, household debt levels are much lower in the US, Spain, Italy and Ireland. Consumers here clearly learnt past lessons, as these markets were at the epicentre of the previous housing market crash in 2008.

Chart 3: Debt to disposable income

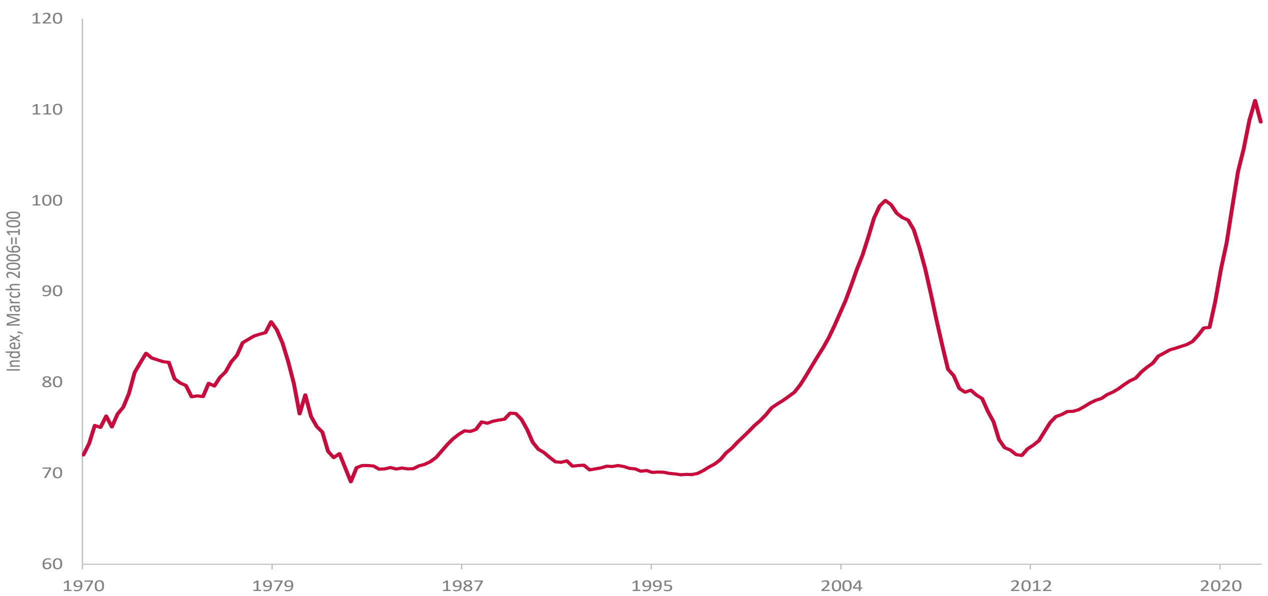


Source: OECD Website | https://data.oecd.org/hha/household-debt.htm (as at 31 December 2021)

Affordability – renting versus buying?

A natural tension exists between the cost of owning versus renting, these forces should, over time, keep property prices in check. But distortions are apparent and presently, the affordability index (see attached, the USA market as a global proxy), clearly indicates that prices relative to rentals are at all-time highs, in fact, at levels which last precipitated a housing collapse.

Chart 4: Index of the OECD U.S. House Price-to-Rent Ratio



Source: Bloomberg (as at 30 September 2022)

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At the end of 2021, our Northstar Market Report was dedicated to explaining our concerns around developed market equity valuations – they were too high. Unfortunately, we end 2022 with another warning – bubble-like property markets in Northern Europe, Australia, and Canada.

How important is SA growth to local equity's investment case?

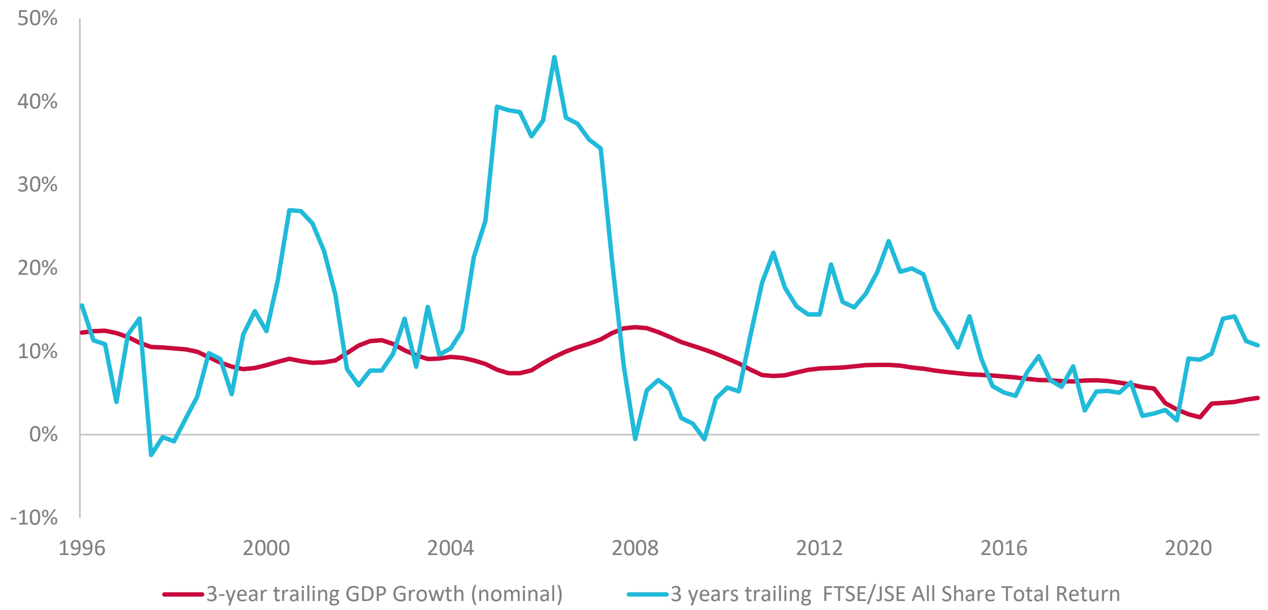
Marco Barbieri, Director of SA Equities

As tighter monetary conditions continue to have a significant impact on global equity prices and valuations, it has become common occurrence to read investment articles discussing how cheap SA equities are and the opportunity they present to investors. While this argument tends to receive a fair amount of support, particularly from local bottom-up investment managers, it is often met with a high level of skepticism by various capital allocators across the industry. They struggle to reconcile this asset class's potential, in light of South Africa's grim medium-term outlook. In this article we try to make sense of these polarised views, provide some historical context and present an outlook for SA equities.

Historical perspective

The positive relationship between stock performance, corporate earnings growth and nominal GDP growth over the long term is well documented. Over the short term, however, this relationship tends to breakdown as earnings growth is driven by business cycle conditions rather than longer term economic cycles. The local market is further complicated by the fact that a large component of it, is not materially impacted by local growth dynamics but rather by global developments and currency effects. Based on our calculations, more than 60% of the local equity index is exposed to global return drivers hence the significant underperformance over the past decade of SA-sensitive sectors against ZAR hedges and resources.

Chart 5: Local equity returns vs SA Nominal GDP growth



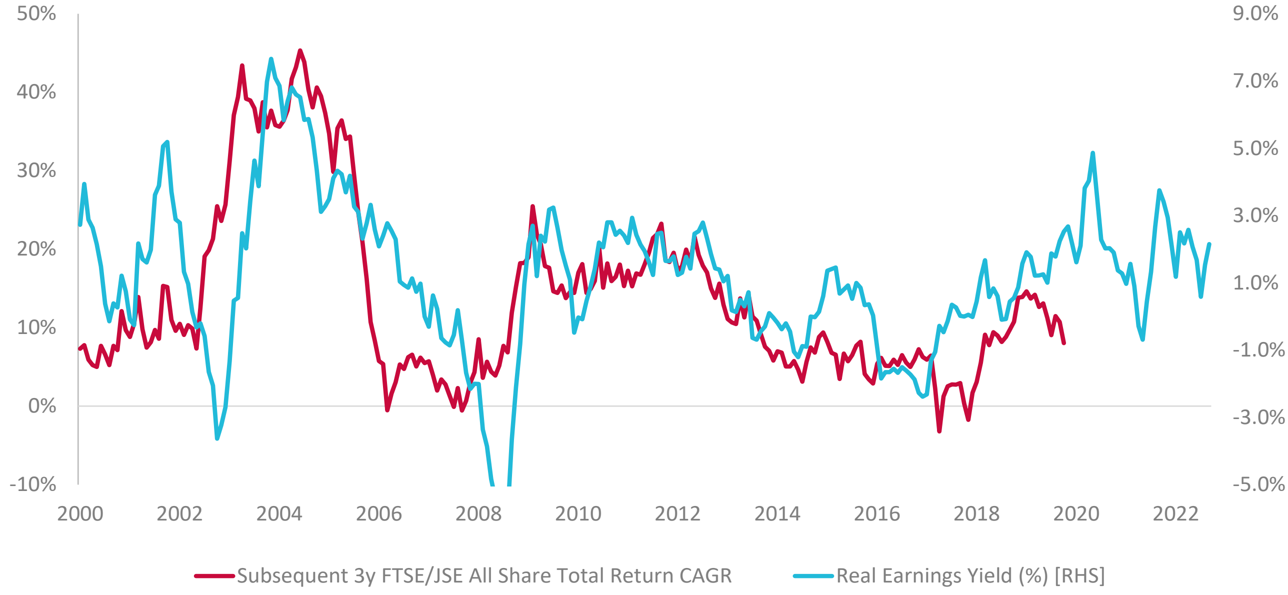
Source: Bloomberg; Iress; Northstar Asset Management (as at 30 June 2022)

When we consider the 3-year return an investor would have generated by holding SA equities over time and compare it to 3-year average nominal SA GDP growth (chart 5), two important points become apparent. Firstly, in the short term, there is a fairly low correlation between local equity returns and nominal GDP growth. Secondly, even over the long term, it appears that SA equity returns are loosely explained by local growth conditions. An analysis using other SA macro variables such as PMI tends to reveal similar outcomes. This is ascribable to market structure as aluded to above.

Valuation metrics have proved more reliable indicators than GDP growth

While GDP growth and other local macro conditions have not been particularly good explanatory variables of stock performance, they have occupied an increasing proportion of investors' worries. Ultimately, we view stock returns to be valuation-driven and over the short to medium term, mispricing occurs and creates opportunities. Importantly, valuation metrics have proved to be more reliable than macro indicators in forecasting returns. In this regard, we find a good fit between the local market's real earnings yield and the JSE All Share Index's subsequent 3-year returns, particularly for the period following the Global Financial Crisis ("GFC").

Chart 6: Local equity returns vs Real Earnings Yield



Source: Bloomberg; Iress; Northstar Asset Management (as at 30 September 2022)

While we acknowledge that certain areas of the markets are exhibiting "value trap-like" characteristics, due to a lack of self-help levers and medium term growth tail-winds, we find that the broader market opportunity-set, is extremely compelling. From a valuation perspective, local equities are now trading in real terms at levels last seen during extreme past events such as Nene-gate and the GFC.

Outlook – Various drivers shape returns not just SA growth

We are not advocating that buying cheap stocks without accounting for growth is the best investment strategy, we are merely highlighting that local market returns are shaped by a myriad of drivers and ultimately, by valuations. From a risk-adjusted return perspective we see good opportunities in both SA and non-SA sensitive areas of the market. Among SA focused companies we like resilient businesses which have demonstrated an ability to navigate downturns. This includes South African banks, various retailers (particularly those exposed to the value segment) and quality industrials. The opportunity among SA-listed ZAR hedges is also attractive and we are becoming constructive on resources which have significantly corrected over the past year.

Meet the team

Meron Sletzion
Analyst

When did your interest in financial markets start?
I grew up in five different countries and travelled extensively over the period. During this time, I was exposed to different economies and learnt to appreciate the extent of globalisation, and interconnectedness of markets from a young age. Over the years, this combined with my analytical mindset fostered an interest in financial markets. I decided to advance this interest in my undergraduate and honors degrees.

What did you study and why?
I majored in Finance and Economics in my undergrad at the University of Cape Town. This provided me with the building blocks to understanding businesses from a micro and macro level, further understanding the accounting of operations and how to derive a business' value. I subsequently completed an Honors in Financial Analysis and Portfolio Management, which allowed me to specialise in the investment industry particularly exploring the theories of active and passive management. At this stage, I plan to further expand my investment knowledge and skills through pursuing the CFA charter, which I am currently in the process of doing.

What do you think equips you to do this job properly?
My natural tendency to be investigative, detail-oriented and to actively seek as much perspective/insight as possible from industry professionals, allows me to extrapolate data and information in a manner that adds value to Northstar's investment process. My growth-oriented mindset and ability to apply a process consistently, yields objective and standardised inputs.

What do you love about investing?
I love the complexity of markets, understanding the different drivers of asset classes, individual companies, their competitive positioning within an industry and the evolution of performance through business cycles. These factors keep me constantly engaged and allow me to apply my mind in different ways. The fact that no two days are the same is truly exciting!

What do you find the most challenging part of your role to be?
Being flooded with information and having to filter through market noise can at times be challenging. It is a critical skill to be able to identify, condense and analyse key drivers to a company's investment case, doing this efficiently and timeously. I find myself having more questions than answers, at times, as data limitations in the local equity space can lead to inefficient methods of rectifying information gaps.

Why do you think clients will do well at Northstar?
Northstar truly has their clients' best interests at heart, which is a core value carried right through from the operations team to the research team. The rigor and dedication that each team has towards the common goal of providing quality service and returns to clients sets us apart from the ordinary firm. Through Northstar's consistent investment process and team driven decision making, we are able to deliver the appropriate risk-adjusted returns for our clients.

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