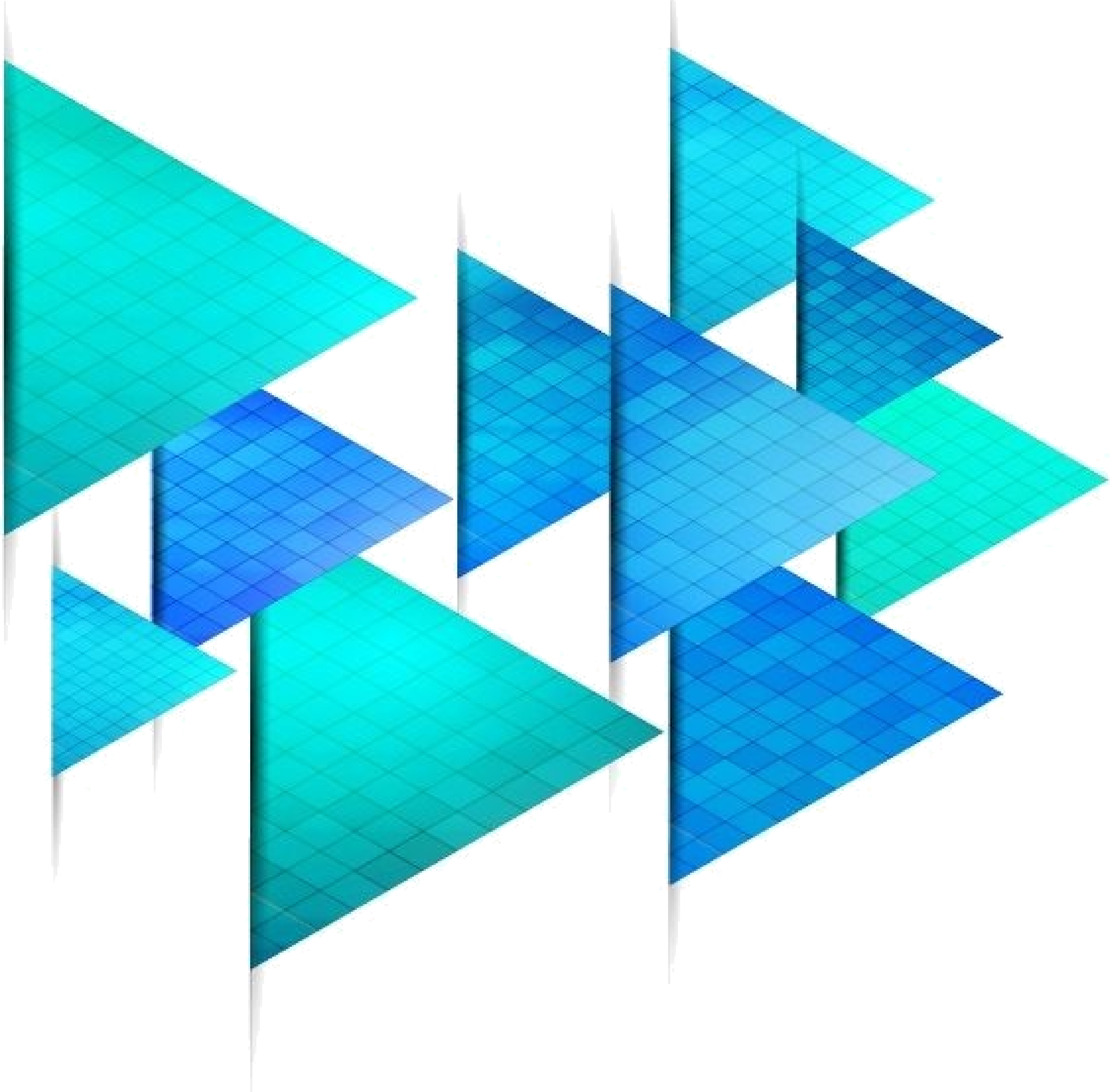

NEWSLETTER

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FINANCIAL SERVICES

Introduction

Australia's residential property market is really hotting up. Some analysts predict a 20% rise in prices over the 2021 and 2022 years. If February is anything to go by, this may well happen. Meanwhile, the share market tracked sideways during February. Read on to find out more.

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The Property Market

As we wrote last month, Australia's residential property markets defied expectations during 2020. Since the end of January, we have seen various predictions of substantial gains ahead in 2021. The largest prediction we have seen has been Westpac's, with the bank predicting average rises of 20% across the two year 2021-2022 period.

The predictions started to get interesting on the first day of February, when the ABC reported that the Australian national average dwelling price had reached it's highest level ever. The previous high was in 2017, and prices at the end of January were 0.7% higher than back in 2017. They were a full 1% higher than they were immediately before the pandemic. The price rises were all down to houses, as units are not enjoying anything like the same levels of growth.

Well, the data for February certainly makes those predictions look likely. Earlier this week, market observer Corelogic reported a national average increase of 2.1% for residential property prices. This is the highest single month growth for the last 18 years – and it was the shortest month of the year. The extraordinary national average growth was underpinned by rises of more than 2% in each of the Melbourne and Sydney markets. Hobart was the only other market whose monthly growth started with a 2.

Here is how Corelogic reported the data:

Index results as at February 28, 2021

	Change in dwelling values				
	Month	Quarter	Annual	Total return	Median value
Sydney	2.5%	3.6%	2.8%	5.3%	$895,933
Melbourne	2.1%	3.5%	-1.3%	1.8%	$717,767
Brisbane	1.5%	3.5%	5.0%	9.3%	$535,618
Adelaide	0.8%	2.7%	7.3%	11.8%	$478,587
Perth	1.5%	4.2%	4.6%	9.3%	$491,795
Hobart	2.5%	4.8%	8.7%	14.0%	$535,994
Darwin	0.7%	5.5%	13.8%	19.4%	$438,645
Canberra	1.9%	3.7%	9.7%	14.6%	$706,454
Combined capitals	2.0%	3.6%	2.6%	5.9%	$675,014
Combined regional	2.1%	5.4%	9.4%	14.4%	$438,185
National	2.1%	4.0%	4.0%	7.6%	$598,884

The national average figure of 4% for the 12 months to February 28 means (of course) that prices have not dropped at all as a result of the pandemic. As we have said before, as the country went into various lockdowns almost 12 months ago, no one would have expected this result.

The main rise has been in the prices being paid for houses rather than units. For the three months to February 28, Corelogic report that house prices rose by 4.4% compared to just 1.4% for units.

It is tempting here perhaps to brag about the great job that Australia has done in managing the pandemic, and assert that our residential property markets are performing so well because we got the virus under control. Unfortunately, this is not really the case. As an example, in February the UK Office of National Statistics reported that house prices in the UK had risen by 8.5% over the 2020 calendar year – a rate of growth that is quite astounding given the impact Covid has had in the UK.

The US also observed that house prices in that country were rising by more than 1% per month in the second half of the 2020 calendar year. And, of course, neither of those countries can claim any success at all really in managing the pandemic.

The strong price performance for residential property is undoubtedly almost wholly a function of the very low interest rates being seen not just in Australia but around the world. The RBA has already stated its intention to keep interest rates low for several more years, so the bullish predictions for the Australian market are looking more and more likely.

The Share Market

While it was a great month for people who own residential property, February may as well not have happened for people who own shares. For the 4 weeks to Tuesday March 2, the market (as measured by the ASX 200) rose by just 0.4%. Here is how it looked, thanks to Google and the ASX:

As you can see, the market moved in relatively small increments backwards and forwards across the month. Indeed, the market did not maintain momentum in either direction for more than two days across the entire month. It was a boring old time.

February is known as the 'half-yearly reporting season.' As that name suggests, companies typically report their half year results to the end of December (remembering that the financial year ends in June for most companies. That said, there are a handful of companies who use the calendar year. In February, those companies report their full-year results). So, a lot of information about recent performance hit the market – 191 of the largest 200 companies gave a report to the market in February.

According to brokerage firm CMC markets, the average performance of companies was generally down. Sales fell by an average of 2% and profits fell by an average of 8.5%.

Why, you might then be wondering, did prices not generally fall? The reason is that prices only change in the market when the market's *expectations* about the future change. This basically means that if the results reported were consistent with what the market expected, then prices will already reflect the expectations and will not need to change. The market expected lower profits, and that is what happened. So, no impact on (general) prices.

That is at the general level. We can see the impact of expectations more easily at the individual company level. For example, Qantas reported a loss on the 25th of February that was much larger than expected. The result was released at 11am, and had an immediate impact on Qantas' share price, as you can see in this graph (again, source is Google and the ASX):

By the close of business, the stock had fallen $0.27 from the $5.25 that it was trading at just before the market announcement. This is a fall of 5.1%. Since then the price has stayed low, trading at $4.91 in the afternoon of March 2. Within three business days, then, the price had fallen 6.5%. This was the market re-setting its expectations downwards for the future of Qantas.

The same happens the other way, of course. On the same day as Qantas made it's announcement, Woolworths also announced it's results. Woolworths had enjoyed an 11% increase in revenue and a subsequent 28% lift in profits. The market really liked that news and the price rose by around 2.5% on the day. Here is how the day looked on Google:

The key thing to remember is that the market is driven by expectations, moreso than actual results. We perhaps saw this most easily in the market-price performance of Afterpay, a company which has still not ever reported a profit. It too announced it's half year results on February 25. As it happens, Afterpay's shares were in suspense that day as the company was negotiating to raise more finance. One of the reasons Afterpay needs to do this is that it is still yet to report a profit, and is thus burning through the cash it already has. The market was not expecting further losses, and the reported loss of $77 million wiped 10% off the value of the company when the market opened on the morning of the 26th:

Since the 'low' of $120 per share, the company has bounced back to trade at $124 by mid-afternoon on March the 2nd. This gives the company a market capitalisation of just under $35 billion. To put that in perspective, the market capitalisation before the financial report was just under $38 billion. So, failing to meet the market's expectations saw almost a $3 billion reduction in the perceived value of the company.

To put *that* in perspective, a market capitalisation of $38 billion means that the market thinks that Afterpay is worth more than Telstra, worth almost twice as much as the Coles Group, and worth three times the ASX itself. That is a large valuation for a company that has never made a profit – and which actually reported a loss that was more than twice the loss for the same time last year, rather offsetting the good news that it's revenue was also up by almost 100%.

Looked at another way, if the average investor had a minimum required rate of income return of 4%, then the company would need to be paying dividends of $1.52 billion to provide that rate of return. Dividends can only be paid from profits, so the profit would need to also be at least $1.52 billion. Afterpay's total *revenue* for the half-year just ended was $417 million. Double that to get an annual figure of $834 million and we see that the market is arguably pricing Afterpay as if it was earning profit that is twice its actual revenue. Remember, profit is what you get when you deduct expenses from revenue: profit is only ever a fraction of overall revenue. To provide that average 4% return, Afterpay needs to double its revenue many more times over yet.

Thus, the market is pricing Afterpay as if it has (i) much greater revenues, leading to (ii) substantial profits. This can only be expectation and underlines the point of this article: market sentiment drives market prices as much as actual company performance.

Afterpay is an Australian company that trades internationally and we would love to see such a company generate (and presumably repatriate) the revenues and profits that the market is expecting it to make. But we urge caution. And perhaps the most useful cautionary tale comes from the US giant Amazon, which has actually been having a very good pandemic. Amazon first listed on the NASDAQ in May 1997, with shares trading at $US1.97. Amazon too enjoyed a period of extreme optimism, as reflected in a share price that rose to $US86 by the end of 1999. But there were lean times ahead, with the company's shares falling below $US7 in November 2001, as part of the 'tech wreck.' Optimism again took hold and by January 2004 shares had risen to $US55. Three years later, however, and the shares were back down to $US35. Things have been mostly positive since then. 12 months ago shares were trading at $US1,785, from where prices have 'taken off' again. On Monday of this week, shares closed at $US3,146.

Between 1997 and now, Amazon's shares have risen from $US1.97 to now be worth more than $US3,400 each. That is phenomenal growth, and Amazon these days is a very profitable company. But between now and then, things have been decidedly rocky. Clearly, Afterpay's investors expect that it too will become very profitable. Hopefully it will. But the Amazon journey informs us that market expectations can take a long time to come to fruition.

The Legal Stuff

General Advice Warning

The above information is general in nature and does not take into account your personal situation. You should consider whether the information is appropriate to your needs, and where necessary, seek professional advice from a financial adviser.

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