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The low down on the upside of Housing

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May 2010

Newspaper headlines continue to focus on comments surrounding a ‘housing bubble’ in Australia. Many commentators are debating whether or not this bubble may burst with opinions divided. More recently, arguments for the affirmative suggest a price correction is imminent. The question remains whether the solid economic fundamentals that have supported recent strong housing price growth will again drive the market over the remainder of the year? When comparisons are drawn between Australian and some overseas markets, key fundamental differences help answer that question.

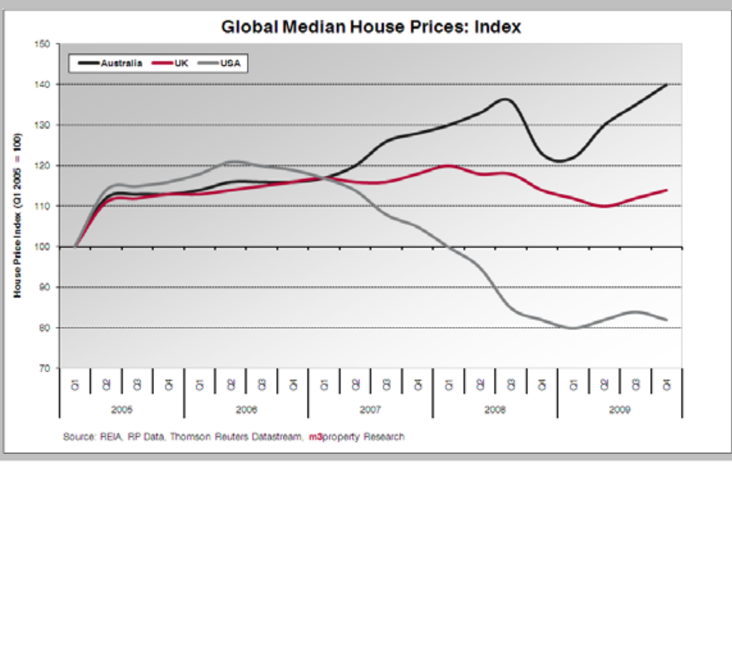
AUSTRALIAN HOUSING IS UNDERPINNED BY A STRONG ECONCOMY & A SOUND FINANCIAL SYSTEM…

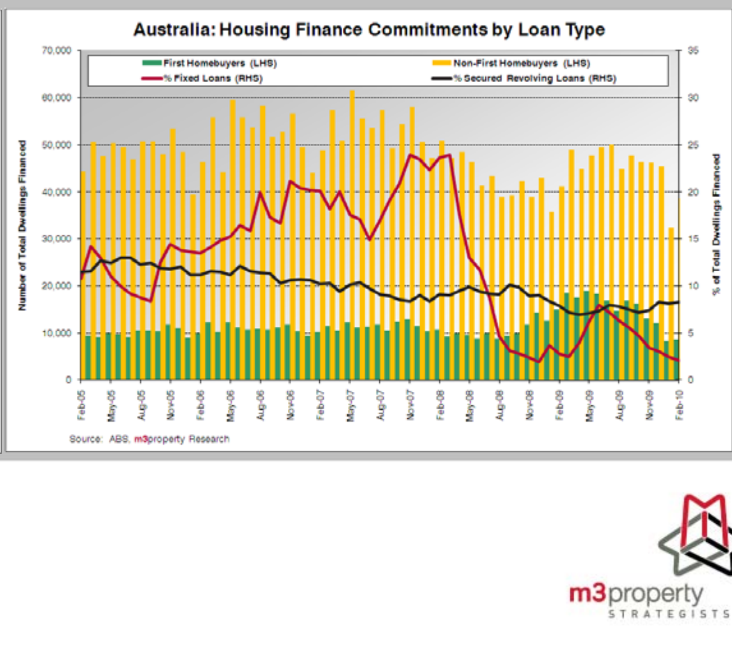
Melbourne has led the domestic housing market with the strongest underlying growth in median prices over the past year. The Real Estate Institute of Victoria (REIV) March quarter 2010 Property Update revealed that Melbourne recorded its strongest March quarter in seven years with the median house price now $524,500 (incidentally it was just $345,000 in March quarter 2005). At the same time, a vacancy survey showed more stress on the housing rental market with a recorded vacancy rate of just 1.5%. Australia’s housing market has defied the rest of the world during the global financial crisis. Conservative lending practises and full recourse loans have supported lower forced selling rates. But it is record population growth and the accompanying housing shortage that is the main precursor to robust price growth. As for non-permanent residents, anecdotal reports suggest a strong increase in the number of Asian buyers since the beginning of 2009 however, debate continues as to whether they have been the cause of stronger price growth in many ‘blue-chip’ suburbs.

…BUT THE KEY DRIVER OF PRICE GROWTH IS THE GROWING DEMAND & SUPPLY IMBALANCE

The difference between domestic and overseas housing markets is that Australia does not have a physical excess of dwellings that can support this population growth. Over the 2009 financial year, *ABS* data showed Australia recorded 2.1% population increase (or 443,000 people), the strongest growth in the developed world. With underlying housing demand estimated to have doubled over the past year, the gap between supply and demand has continued to widen.

The following charts identify the change in global median house prices as an index (left) and the proportion of housing finance commitments by purchaser type (right) over the last five years. When countries are compared, Australian house prices have been remarkably resilient while the level of forced sales due to sub-prime in the USA have underpinned its substantial fall in market value. In Australia, rising interest rates and the removal of the First Home Owner Boost has led to a fall in housing finance commitments from first homebuyers. The proportion of first homebuyers seeking approvals (in original terms) decreased further in February 2010 to 18.1%, which was the lowest approval rate since October 2008.





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SO WILL A RAPID INCREASE IN MONETARY POLICY COOL THE HOUSING MARKET?

The short answer is yes but it is clear that Australia is moving into a new economic cycle with forecast population growth; historically low vacancy rates; and the cost of construction materials increasing. Basic economics suggests that housing values are more likely to rise, rather than fall. However interest rates will take some of the heat out of the market. With the *RBA* cash rate increasing 100 basis points since October 2009, rising interest rates mean housing affordability is deteriorating and will limit median price growth (and hence buyers) in the middle and outer ring suburbs. Higher borrowing rates have so far had little impact on the inner city suburbs between the buying range of $600,000 and $1 million.

Leading economists forecast that the cash rate may increase another 100 basis points by this time next year, taking standard variable lending rates to above 9%. The *REIV* confirmed that the March quarter 2010 median price in Melbourne fell around 2% over the previous quarter, so interest rates are holding off some buying decisions. Or at least the *RBA* thinks.

There's no conclusive evidence to suggest that the continued increasing of interest rates correlates with a fall in house prices. For instance, the cash rate in March 2007 was 300 basis points higher than where it is right now yet for much of the 2007 year, house prices kept appreciating. Indeed, the rate of home price growth throughout 2007-08 kept growing, irrespective of the changes to monetary policy. It was only after the onset of the global financial crisis that began to cool the residential market. Analysis of *REIV* median price data shows interest rates have only a minor effect on prices historically.

A MODERATION, FOLLOWED BY SUSTAINED GROWTH IN HOUSE PRICES, APPEARS MOST LIKELY

Forget the doomsayers. There is no bubble to 'burst'. Australia's longer term economic prosperity and strong population growth will underpin a softer landing for the domestic housing market. While it is evident that unsustainable median price growth will abate this year (and has already begun to), it is more likely to be short lived, with the growing housing shortage applying long term pressure to housing values once inflation is under control and interest rates stabilise.

Changes in foreign investment policy will cool demand from many Asian investors. A temporary reduction in immigration and Foreign Investment Review Board (FIRB) rules governing purchases by non-permanent residents has been a contentious issue. The relaxation of investment rules in early 2009 allowed temporary residents to buy existing homes as their primary place of residence without *FIRB* approval. As no official data is kept on those purchases following the rule change, it is difficult to measure the true impact on house prices. The Government was obviously somewhat concerned by all the media hype and has now enforced that temporary residents must sell their property when they leave Australia.

Higher levels of mortgagee in possession sales are a prerequisite for downward adjustments to housing prices. The economy will grow and unemployment has peaked. Mortgage defaults are associated with job losses and at present rising job vacancies suggest employment and wages growth are improving. A fall in house prices can only occur if the housing shortage issue is reversed, or if Australia enters a recession with a consequential large rise in unemployment. Current forecast strong economic conditions are unlikely to result in any of these situations occurring.

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