The housing debate in numbers

- Fears of a housing bust are never far below the surface.
- These fears touch a communal nerve, are easy to ignite and make a good “headline”.
- The numbers tell a different story.

There is a cycle in house prices. They fall as well as rise. The tendency is to accentuate the size of the moves by looking at trough-to-peak or peak-to-trough moves. Comparing like-with-like gives a better feel for underlying trends.

Australian capital city dwelling prices are up 32% from the last trough in May 2012. But the increase “shrinks” to 22% when compared to the previous peak in October 2010.

So, depending on the starting point, Australian dwelling prices have either grown at 8.7%pa (from the last trough) or 4.2%pa (from the previous peak).

The unwinding of the earlier commodity price and terms-of-trade booms has weighed on household income growth in recent years.

Nevertheless, after-tax household incomes have grown at an average pace of 4%pa in the period since the previous dwelling price peak in late 2010.

So dwelling prices and incomes have grown at a similar pace since the last price peak. Some of the more extreme overvaluation fears look overdone on that basis.

Geography and demographics are important when thinking about dwelling valuations.

Australia is one of the most highly urbanised countries in the world. Most households reside in the capital cities. About 40% of the population live in the two largest cities (Sydney and Melbourne). This share compares with about 5% in the US and 17% in the UK.
The number of house price cycles in Australia since 1972

The dominance of the larger cities means Australia should be more susceptible to housing booms.

In countries with less concentrated urban populations, price booms in one city have less effect on national average prices.

Population concentration also puts upward pressure on capital city dwelling prices.

So house price:income ratios should vary with urban density.

And equilibrium household debt ratios should be higher in Australia than elsewhere.

Incomes are also higher in the capitals. So any average valuation based on capital city prices and Australia-wide incomes will have a natural upward bias.

Current valuations based on capital city prices and Australia-wide incomes shows a price-to-income ratio of 6½. But estimates based on Australia-wide dwelling prices and Australia-wide incomes give a “true” ratio of 4½.

Price:income ratios are still historically high. Our consistent view over the years has been that the rise reflects a shift in household preference for and ability to access credit. And a shift in the type of housing we want to inhabit.
Sustained low inflation from the early 2000's allowed a structural step down in mortgage rates. The standard variable rate has averaged 7% since 2000, some 300 basis points below the 1990’s average.

More households could access credit markets as a result. Housing demand lifted relative to a supply that doesn’t change very quickly. A lift in house prices relative to incomes was inescapable.

The shift in housing preference reflects the desire to build bigger and more elaborate dwellings. The average floor area of a new house, for example, is now 49% larger than in 1985. That house is also likely to be made from more expensive materials.

The “house” part of price:income calculations is higher as a result.

Concerns about an Australian housing bubble and its imminent demise are a long-running feature of the economic debate. We have been fielding questions from clients on this issue since 2003!

The global financial crisis would have been a natural trigger for a price correction if there was a genuine valuation issue. The resilience of house prices through that period provides a solid case against the overvaluation argument.
A suggestion of lax lending standards is part of renewed housing market fears. The reality seems quite different:

- the share of high LVR lending (>80%) has fallen sharply;
- the share of interest only loans has returned to more normal levels as investor interest has cooled; and
- the share of lending via low doc loans, the closest approximation to “sub-prime”, is negligible.

Information from CBA’s half-yearly results illustrates the rising protection for borrowers and lenders against housing market “shocks”:

- the serviceability buffer was increased from 1½% at end 2014 to 2¼ at end 2015;
- 78% of borrowers are ahead in their repayments by an average of 7 payments;
- the buffer extends to 29 payments when mortgage offset accounts are included; and
- the average LVR is 50%.

New entrants are typically most at risk when something goes wrong in the housing market. They are at peak debt and minimum equity. Information from CBA’s half-yearly results, again, shows that most recent borrowers are skewed towards the higher end of the income range and so should be better placed to deal with any shock.
“Bubbles” (and negative gearing strategies) also require a belief that prices will continue to rise at a rapid pace. Surveys do show that over the past few years a significant proportion of households expected house prices to keep rising. But that proportion has slowed sharply since late 2015 and no longer looks threatening.

The slowing in house price expectations has also seen a shift in perceptions about buying conditions. The majority now see it as a “bad time” to buy a dwelling. Falling buyer sentiment is typically followed by a slowdown in residential sales activity.

Earlier rises in house prices dented affordability for owner-occupiers. Affordability levels are down 19% from the early 2013 peak. Falling affordability is typically followed by a slowdown in residential sales activity.

The affordability measure is based on HIA methodology that relates actual income to the qualifying income needed to service the typical home loan.

The net % of households who expect house prices to rise over the next year

The net % of households who see now as a “good time” to buy a dwelling

The decline in home loan affordability since the early 2013 peak
The current house price story is characterised by an unusually high level of investor activity. This investor interest is a rational response to the environment created by central banks. Central banks responded to the financial crisis by boosting liquidity and pushing interest rates to “emergency” levels. This approach encouraged a search for yield, lifted risk appetite and boosted asset prices. From an investor perspective, term deposit rates are below rental yields.

The counterpart to unusually high investor interest is unusually low first-home-buyer activity. It may be that some “investors” would be first-home-buyers in normal circumstances. But affordability constraints mean they entered the market as investors to take advantage of the rental income and tax offsets. The emergence of a two-tier mortgage rate structure where investors pay a higher rate has exposed this distortion. The RBA reports that $35bn worth of investor loans were re-classified as owner-occupier loans from July 2015 to January 2016.

In the end, housing market developments will reflect supply and demand. But the housing market is different. Enter a supermarket and everything on the shelf is for sale. In housing, however, the “liquid” part of the market is quite small. About 4-6% of the dwelling stock is turned over each year and new construction adds 1½-2½% to the stock. The rest is locked up.

The limited amount of dwelling stock in play magnifies the price effect of any changes in the supply-demand fundamentals.
Population growth is the main fundamental driver of housing demand. Australian population growth is rapid by advanced economy standards. But it has slowed. Based on current trends, we put the underlying demand for new dwellings at 185,000 per annum.

The migrant component of population growth is biased towards cashed-up skilled migrants, accentuating the impact on the housing market.

The demand impact of the population story is accentuated by a number of factors. The migration component is dominated by cashed-up skilled migrants who add immediately to housing demand. Education-related flows also add to housing demand. As does safe-haven flows from foreign investors.

Population trends are also important in explaining regional variations. The slowdown in population growth (and housing demand) is concentrated in the mining States of WA and Qld. Housing markets in these States should underperform.
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The % increase in Sydney dwelling prices since the last peak in 2010

The divergence in population trends is reflected in the divergence in dwelling prices. Price trends are noticeably different across the capital cities. As expected, the weaker capitals are those with less favourable demographics.

23

The % of Australian population growth accounted for by Sydney

The Sydney market has the strongest demand (population) and the lowest supply (land availability). Housing markets in Sydney should outperform.

220k

The estimated number of new dwelling commencements in 2015

A major residential construction boom is underway. So the supply of new dwellings is lifting. We put the number of new dwelling starts in 2015 at 220k. And we expect a further 211k starts in 2016.
The lift in construction activity means that the construction:population ratio is back around average levels.

The flow through of building approvals into dwelling commencements has been slower than in previous cycles. The delay reflects the larger share of medium-high density developments (40% of starts vs 30% in previous cycles). So the pipeline of new construction activity is “fuller” than usual.

The peak in activity will occur well after the peak in leading indicators like construction lending and building approvals.

The lift in construction followed a period of relatively constrained activity (commencements running around 150k pa). Competition with mining and infrastructure during the mining boom limited the ability to lift new dwelling supply.

The accumulated or pent-up demand for new dwellings that built up during the mining boom is now being run down. But the stockpile remains substantial.

Demand and supply are moving in a way that favours a slowdown in house price growth. The momentum behind dwelling price rises has stalled over the past year.

2.8
The residential vacancy rate

70k
The estimated stock of pent-up demand for new dwellings left over from the earlier period of underbuild

7.6
The % growth in capital city house prices over the year to February
1.2

The % growth rate of dwelling rents at the end of 2015

Demand and supply are also moving in a way that favours rising residential vacancy rates and a slowdown in rental growth. Dwelling rents were growing at 1.2%pa at the end of 2015, the slowest pace in twenty-one years.

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The % probability of a “crisis” in 2016 based on IMF early warning indicators

The IMF has developed a model that uses credit and house price growth as early warning indicators of the probability of a banking crisis two years ahead. The related heatmap shows the probability of a banking crisis for various combinations of credit and house price growth. Where Australia sits on that heatmap is consistent with a low probability of crisis in 2016.