Shane Oliver, Head of Investment Strategy
& Chief Economist

Australian house prices – a bit too hot in parts

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Key points

> The Australian housing sector is doing its part in helping the economy rebalance as mining investment slows.

> Thanks largely to a persistent undersupply of new homes, Australian housing remains overvalued. Negative gearing, foreign and SMSF buying are just a sideshow to the supply shortage.

> The home buyer market is still not seeing the bubble conditions of a decade ago, but the market is too hot in parts and the risks have grown. Expect increasing jawboning from the RBA with a rising likelihood of credit growth restrictions for investors if it doesn't slow soon.

> The medium term return outlook for residential property is likely to be very constrained.

Introduction

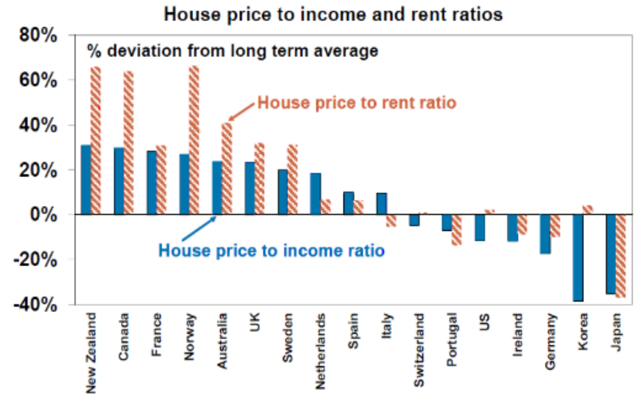
As the mining investment boom deflates, in order for Australia to rebalance its economy, a pick-up in demand for homes and house prices in response to lower interest rates, sending a signal to home builders to build more homes was essential. Fortunately, it's occurred. The RBA (belatedly in my view) got rates down, home buyers returned, home prices rose and we are now in the midst of a dwelling construction boom. The housing sector is doing its part!

But it seems that there is nothing that gets Australians going more than what's happening with house prices. Are they in a bubble? Is negative gearing to blame? Or is it foreign buying? Will it burst? Should the Reserve Bank slow it down? Is housing a good investment? This note looks at the current state of play in the Australian residential property market.

Australian housing remains overvalued

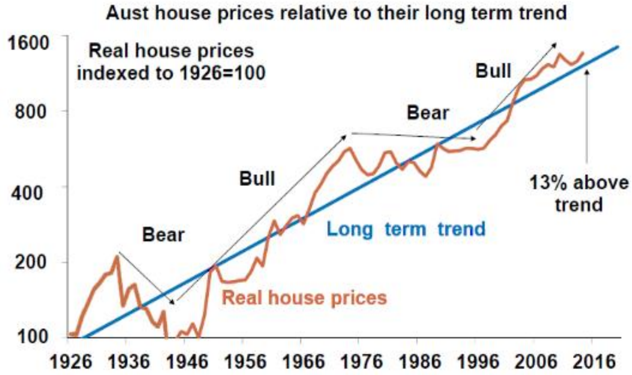
Australian housing remains overvalued on most measures. But then again this has been an issue for more than a decade. For example, while a bit more extreme than my own view at the time, the OECD estimated that Australian house prices in 2004 were 51.8% overvalued. This compared to just 1.8% for US housing and 32.8% for the UK. While real house price weakness through 2010 to 2012 saw the degree of overvaluation diminish, the problem is returning with a vengeance:

- According to the 2014 Demographia Housing Affordability Survey the median multiple of house prices to household income in Australia is 5.5 times versus 3.4 in the US.
- On the basis of the ratio of house prices to rents adjusted for inflation relative to its long term average, Australian houses are 30% overvalued and units 17% overvalued.
- The ratios of house prices to incomes and rents in Australia are 23.5% and 40.9% above their long term averages respectively, which is at the higher end of OECD countries. This contrasts with the US, which is near the lower end in the OECD.



Source: OECD, AMP Capital

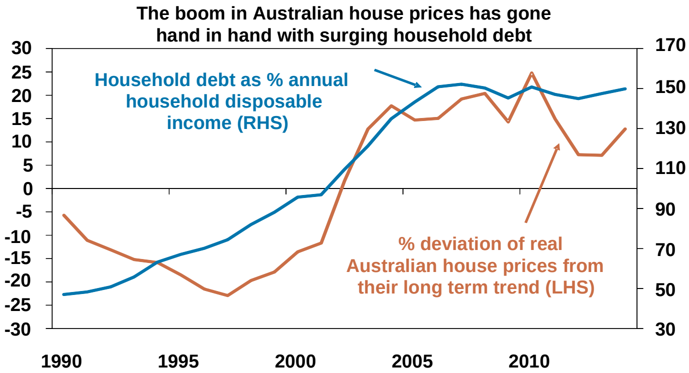
- And on my favourite measure, real house prices have been running above trend since 2003.



Source: ABS, AMP Capital

What's to blame for high house prices?

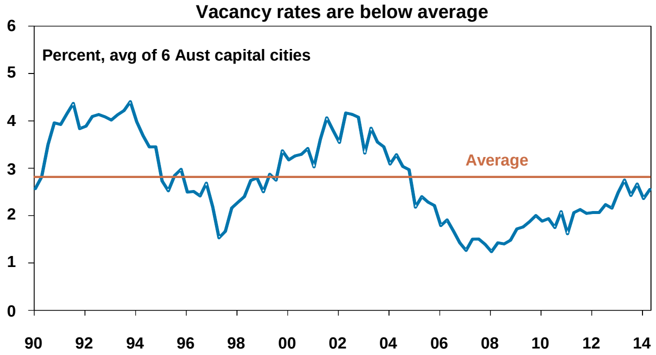
There are two main drivers of the surge in house prices over the last two decades. The first was the shift to low interest rates. Lower rates enabled Australian's to borrow more for a given level of income and so pay each other more for homes. As can be seen the shift in house prices from below trend to above (as derived from the last chart) has gone hand in hand with an increase in the ratio of household debt to income.



Source: ABS, RBA, AMP Capital

The trouble is that the shift to low interest rates occurred in many other countries and most did not have anywhere near the surge in house prices or household debt Australia had, implying a heavy speculative element in driving prices higher as well. I have long thought this surge in household debt and relative house prices represents Australia's Achilles' heal. Should anything go wrong with the ability of households to service their debt Australia would be at risk. Fortunately it's hard to see the trigger for this in anything but a small way.

The second reason is a lack of supply. While the US saw a property price surge into 2006 matched by a supply surge, supply in Australia has been subdued due to restrictive land supply policies and high stamp duty and infrastructure charges. The National Housing Supply Council estimated a few years ago that since 2001 Australia had a cumulative net shortfall of over 200,000 dwellings. Reflecting this, residential vacancy rates remain relatively low.



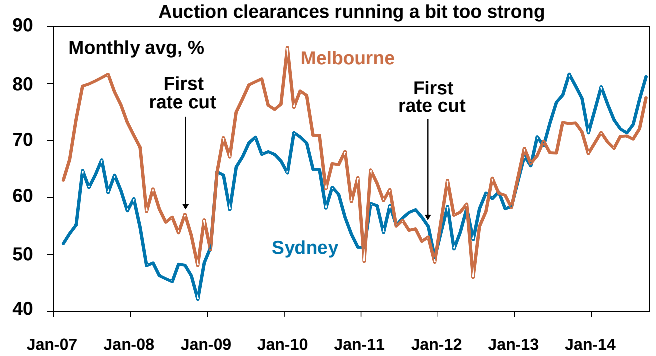
Source: REIA, AMP Capital

Given the supply shortfall, most of the scapegoats that various commentators have come up with to explain high home prices are a sideshow. Foreign and SMSF buying is no doubt playing a role in some areas but looks to be small. Negative gearing is more contentious, but it's likely that curtailing access to it when stamp duty remains very high will have a negative impact on the supply of property to the extent that it will have the effect of reducing the after tax return to property investment. Restricting negative gearing for property would also distort the investment market as it would still be available for other investments.

Rising risks

Our assessment is that the Australian property market is not at the bubble extreme it was at a decade ago: the overvaluation is a bit more modest; annual housing credit growth for owner occupiers and investors is running at around one third the pace seen in 2003; Australians don't seem to be using their houses as ATMs against which debt can be drawn suggesting they are less comfortable regarding the outlook and debt; and the home price gains now have been over a shorter period and are concentrated in just Sydney & Melbourne. However, danger signs are emerging:

- After a cooler period during the first half of the year the property market seems to be hotting up again. National average home prices rose at an annualised 16.8% pace over the 3 months to August according to RP Data and auction clearance rates are at or above last year's highs.



Source: Australian Property Monitors, AMP Capital

- The proportion of housing finance commitments going to investors is now back to around the 50% high seen a decade ago, suggesting that the market is becoming more speculative. And there are signs that home buyers are starting to extrapolate recent strong price gains into the future which is very dangerous.
- Finally, The Block is back on top as the most watched show on TV highlighting a return to very strong community interest in the property market.

Taken together these indicators warn that the housing market is getting a bit too hot.

Policy implications

The heat in the home buyer market is clearly starting to concern the Reserve Bank with its Financial Stability Review indicating that it's becoming concerned about speculative activity in the property market and the risks this poses to the broader economy when the property cycle eventually turns down. Normally with the property market hotting up the RBA would start to think about raising interest rates but right now it's loath to do this given uncertainty regarding the rest of the economy and the risk a rate hike would put upwards pressure on the still too high $A.

As a result APRA is more closely monitoring the banks and the RBA and APRA are now discussing steps that could be taken to ensure sound lending practices are maintained with a focus on investors. The latter would involve the use of macro-prudential controls to slow the housing market – which is really just a fancy term for the old fashioned credit rationing that used to be applied prior to the 1980s. This could involve limits on loan to valuation ratios, forcing banks to put aside more capital or forcing banks to impose tougher tests when granting loans. Such approaches all have problems: they tend to work against first home buyers; if they target investors as looks likely they work against a group of lower risk borrowers; people can start to find their way around them; and their impact is hard to gauge.

The best approach is for the RBA to first ramp up its efforts to warn home buyers of the need to be cautious. But if that fails in quickly cooling the property market, expect an announcement from APRA and the RBA on lending restrictions likely targeting investors in the next few months.

Housing as an investment

Notwithstanding the rising risk of macro prudential controls, in the short term further gains in house prices are likely until the RBA starts to raise interest rates probably around mid-next year, soon after which another 5 to 10% property price down cycle is likely to start.

Beyond the short term it's worth noting residential property has provided a similar long term return as Australian shares, with both returning around 11 to 11.5% pa since the 1920s. They are also complimentary to each in terms of risk and liquidity and are lowly correlated. All of which means there is a case for investors to have exposure to both.

At present though, housing looks somewhat less attractive as a medium term investment. The gross rental yield on housing is around 3.2% and for units is around 4.4% giving an average of just 3.8%. After costs this is just below 2%. Shares & commercial property both offer much higher yields.

Medium term capital growth is also likely to be limited, with the overvaluation likely to see real house prices stuck in a 10% or so range around a broadly flat trend. This is consistent with the 10-20 year pattern of alternating secular bull and bear phases evident in the second chart in this note.

Taken together this suggests that a realistic expectation for total returns from residential property over the medium term is just around 4 to 5% pa.

Dr Shane Oliver
Head of Investment Strategy and Chief Economist
AMP Capital