



ECONOMICS & MARKETS RESEARCH AUSTRALIAN HOUSING UPDATE

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ARE AUSTRALIAN HOUSE PRICES OVERVALUED?

The remarkable resilience of Australian house prices during the GFC and subsequent strong price gains have led widespread talk of a housing price 'bubble'. However, there are solid underlying reasons for the strength of Australian house prices and we do not believe a 'bursting of the bubble' is imminent¹.

House prices underpinned by solid fundamentals

Widespread forecasts of a looming collapse in Australian house prices ignore the stark fundamental differences between Australia and most of the rest of the developed world. Conservative (on-balance sheet) lending, minimal sub-prime, full recourse loans, minimal CDS exposure, record population gains, significant pre-emptive policy action and a severe housing shortage all saw Australian house prices remain well supported through the global financial crisis. An acceleration of immigration in 2008-09 to over 300,000 combined with a mini-baby boom, lifted Australia's population by 460,000 or 2.1% (the strongest population growth in the developed world). These people need to be housed and underlying housing demand last year is estimated to have risen well above 200,000 for the first time on record. This combined with a cyclical trough in home building (starts of just 131,000) saw the housing market tighten dramatically as reflected in near-record low rental vacancy rates.

We believe the fundamental shortage of housing and a buoyant economy are responsible for the ongoing strength of house prices despite the removal of the First Home Owner Boost and sharply rising mortgage rates. Skilled labour shortages in several sectors suggest an ongoing requirement for high levels of international migration which combined with insufficient home building (excessive developer charges, inadequate land release, rising interest rates, restrictive credit conditions and capacity constraints), mean it is very hard to see the housing shortage being resolved any time soon. With new supply expected to remain below housing demand, an ever tightening housing shortage will be a feature of the market for many years to come and will continue to place upward pressure on house prices and rents.

Contrary to popular belief, for the past seven years, house price gains have been broadly matched by growth in average household incomes, maintaining the house price to income ratio at just over 4 times². Nonetheless, rising interest rates mean housing affordability (purchase and rental) will deteriorate further and *will eventually cap price growth*. However, prices are expected to decelerate rather than fall, *as long as the economy remains supportive*.

¹ Or whether the term 'bubble' is even appropriate when talking about Australian house prices.

² Source: RP Data-Rismark

ECONOMIC UPDATE

Forced selling is usually a prerequisite for house price falls and with the economy in the early stages of what appears to be a solid cyclical upswing, the labour market continuing to strengthen and unemployment falling, a significant rise in forced selling appears unlikely.

Australian households well placed

Many commentators have raised concerns about the level of household debt and suggested that 'excessive' leverage and rising interest rates could trigger a 'collapse' in house prices. Household debt servicing burdens will continue to rise, however, bank lending criteria generally apply an interest rate buffer of up to 2%³ and there is no evidence that we are on the cusp of a major de-leveraging of household balance sheets. In fact, most evidence suggests the Australian household sector remains well placed. Economy wide debt to income ratios, gearing ratios and even debt service ratios tell us little about the underlying sustainability of household debt. The distribution of debt across the household sector, lending criteria applied and the strength of the labour markets are far more telling for debt sustainability. Relative to offshore experience, lending into the Australian household sector has remained very conservative. This is reflected in the virtual absence of a sub-prime mortgage market and extremely low delinquency and default rates.

The application of tight lending criteria (loan to valuation ratios and individual debt service measures) means that debt is generally held by households that are well placed to repay their loans. This is a stark contrast to the US where the National Home Ownership Strategy eventually drove a disastrous lowering of lending standards that culminated in the sub-prime mortgage crisis and the GFC. Two-thirds of Australian households had little or no debt prior to the recent debt accumulation and recent RBA analysis suggests the proportion of households whose loans are vulnerable remains at very low levels. This contention is supported by relatively low non-performing mortgage loans.

The household sector's debt burden has risen by \$1.2 trillion in the past 20 years, however, this has been more than offset by an additional \$5.4 trillion in gross assets. Moreover, low interest rates during the GFC have allowed a vast majority of borrowers to get ahead of their scheduled repayments providing a further buffer as debt service costs rise once more.

'It's the economy, stupid!'

Ultimately, debt serviceability depends on the strength of the economy, in particular employment and income growth. Substantial interest rate buffers built into bank lending criteria mean few households are driven to default by rising interest rates alone. Mortgage default is usually associated with the loss of income due to job loss. At present the labour market appears robust and rising job vacancies and skilled labour shortages suggest employment and wages growth will remain solid in the year ahead.

Key structural imbalances will continue to restrict growth in the major developed economies, however, the growth surge in China and developing Asia appears likely to be sustained. The renewed commodity price boom is driving a new wave of major resource developments in Australia which will

³ Meaning mortgage rates can rise by over 2% without causing debt servicing difficulties

ECONOMIC UPDATE

underpin growth in investment, profits, tax receipts and exports for many years to come.

In the near term, Australia's growth prospects are bright and much will depend on the RBA and government's ability to effectively manage the expansion. *Higher household debt means the RBA has considerable leverage over the household sector and their actions during the GFC should instil confidence that the present upswing in growth will be handled well.*

The potential for a temporary reduction in immigration and a reversal/change to the Foreign Investment Review Board rules on foreign purchases of Australia property present some near-term risks. However, we believe the broad outlook for house prices remains solid underpinned by a housing shortage that could approach critical levels and a buoyant Australian economy. Realistically, significant falls in house prices can only occur if we experience a significant over-supply of housing and/or a serious recession and sharp rise in unemployment. *Neither of these seems very likely at the present time.*

Note: See associated chart pack for more detailed analysis

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