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The Aussie dream exposed

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With a recent study from The Economist estimating that our residential property prices are currently around 55 per cent overvalued, Zurich Investment Specialist Elliot Bullock takes a closer look at the driving forces behind the price rises and whether current prices are sustainable.

The majority of the developed world experienced sharp drops in the value of residential property during the depths of the GFC, but the Australian residential market experienced only a brief plateau in prices before soaring again. So it begs the question: what makes us so different to the rest of the world?

The Hollywood Hills argument

A number of studies have looked at the phenomenal difference in price tags between property in Australia's major capital cities and the likes of Detroit in the US. Most informed observers accept that housing supply in Australia is relatively tight, employment is strong and incomes are generally high – a great recipe for a strong housing market. Detroit, on the other hand, is the opposite on all accounts, which makes this comparison not particularly informative.

While looking at US real estate websites, I found what I believe to be far more compelling evidence for Australian property prices being overheated. It's what I call the Hollywood Hills argument.

Living in the exclusive neighbourhoods of the Hollywood Hills district in Los Angeles truly exemplifies the American dream. It is a highly sought after area in a city with a population roughly the size of Australia's entire population and yet with a very limited housing supply. A number of five bedroom houses on sizeable blocks of land are advertised for anywhere between AUD$800,000 and AUD$1,500,000. A five bedroom house in any of Sydney's Northern Beaches or Eastern suburbs would attract a price tag at least double or triple those figures. Add to this the fact that a 30-year fixed mortgage rate in the US is around 5 per cent per annum and that non-recourse loans essentially eliminate personal downside risk and you may begin to question the fundamentals behind Australian property valuations. However there are other factors at play.

The visible hand of government

Government policy has been a major reason for the rapid asset price appreciation we have seen. Prior to the introduction of the First Home Owners' Act in 1983, there was little noticeable trend to Australian house prices. Not only have various iterations of the programs allowed more and more people to purchase homes at prices they could not otherwise afford, the scheme has also provided prospective buyers with upfront capital. Having a higher amount of upfront capital then allows people to borrow more money from the bank, bidding prices up even further. The most recent boost in the first home owners' grant resulted in a significant increase in mortgage demand and undoubtedly contributed to the 18.8 per cent year-on-year house price growth we saw in the first quarter of 2010.

Supply or the ability to borrow more?

According to the National Supply Council, the shortfall between supply and demand for housing currently stands at around 220,000 dwellings and is expected to swell to more than 600,000 by 2030 as strong population growth is forecast to continue.

I believe, however, that the structural decline of interest rates is a far bigger culprit in rising prices than supply and demand dynamics. With interest rates starting the 1990s at more than 17 per cent and declining to a low of three per cent in mid 2009, the level of debt that prospective home owners could service dramatically increased. This meant that households took on a lot more debt without paying more interest. Investors often took comfort in the old adage that house prices always trend up and this meant the cycle became self-perpetuating. Australians continued to borrow larger and larger amounts to purchase homes at higher and higher prices. As the situation in the US has shown, this works fantastically well; until it doesn't.

Is the bubble going to burst?

Residential property prices in Australia are certainly overvalued, but I would put a relatively low probability on a major housing crash.

Why? The missing link in Australia for a sharp pullback is a catalyst. In Australia, unemployment is low, excess supply is not an issue and interest rates are not overly restrictive. In other words, it is unlikely that a large number of people would be forced to sell simultaneously (the likely cause of a crash), given the current environment. I believe the largest risk to this scenario would be if inflation was to rise sharply, forcing the RBA to hike rates more aggressively than expected.

Given that somewhere around 60 per cent of Australians' wealth is tied up in residential property[2], the government will continue to support the market simply because it is too politically unpalatable not to. However the US illustrates a shining example of how market forces can be stronger than the will of the government if the bubble finally pops. With these factors in mind, the most likely scenario for house prices is a fairly extended period of flat to low single digit returns, however risks certainly remain to the downside. A blind belief that house prices are a one way bet is a dangerous game.

Sources: [1] Demographia, [2] Morrelandkoren.com, Rismark International, Bloomberg