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Australian house prices and interest rates

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Key points

- Australian housing remains overvalued. Combined with high debt levels, this leaves households vulnerable should anything threaten their ability to service debt.
- House prices are likely to remain weak as a result of poor affordability. An undersupply of housing provides some support for house prices, but the two key risks to watch are China and domestic interest rates.
- House price softness, along with weak consumer spending and low levels of confidence regarding family finances, suggests households are already struggling and are good reasons for the Reserve Bank of Australia (RBA) to tread cautiously. A June rate rise would be dangerous.

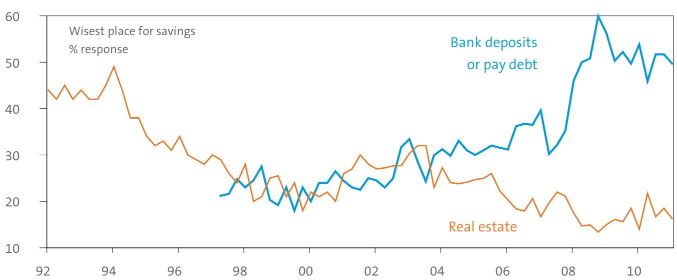
Introduction

So far this year, the Australian residential housing market is off to a poor start. House prices are down approximately 2%, auction clearance rates are well below levels of a year ago and housing finance is weak. Is this the start of the Australian house price crash some have been predicting, or merely a correction after a near 20% gain in prices over the year to the March quarter last year? And what does it mean for interest rates?

Between a rock and a hard place

I don't regard Australian house prices as a bubble. While there was probably a bubble seven or eight years ago, apart from overvaluation there has recently been little sign of the excesses that characterise a bubble: housing credit has been soft, investors have been sidelined, buyers have been restrained and lending standards have not deteriorated. Just as Australians have been sceptical about shares in recent years, they have also been sceptical about real estate, with only 16% of Australians seeing real estate as the wisest place for savings. This is hardly the stuff of bubbles!

Australians are cautious on real estate - no bubble here



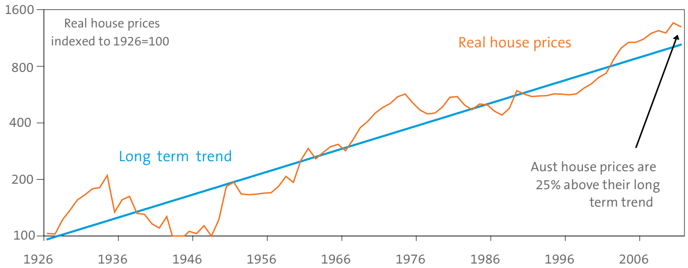
Source: Westpac, Melbourne Institute, AMP Capital Investors

That said, I still regard high house prices as Australia's Achilles' heel. And the reason is simple. Reflecting a huge surge in house prices into 2003/2004 and solid gains since, Australian housing is considerably overvalued. This has gone hand in hand with a massive increase in household debt.

Signs of overvaluation are evident virtually everywhere:

- Despite recent softness, Australian house prices are still running around 25% above their long-term trend.

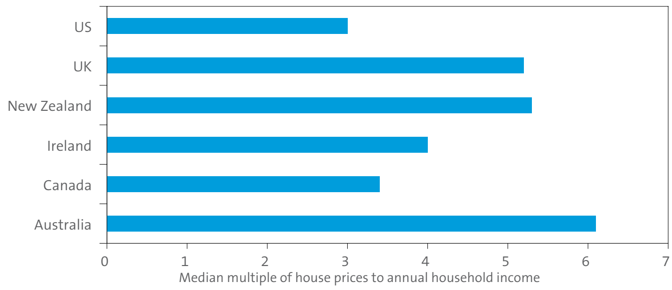
Australian house prices well above their long-term trend



Source: ABS, AMP Capital Investors

- According to the Organisation for Economic Cooperation and Development (OECD), the ratio of house prices to incomes is 34% above its long-term average, and the ratio of house prices to rents is 50% above its long-term average, both being at the top end of OECD countries.
- According to the 2011 Demographia International Housing Affordability Survey, Australian housing trades on a median multiple of house prices to annual household income which is double that of the US.

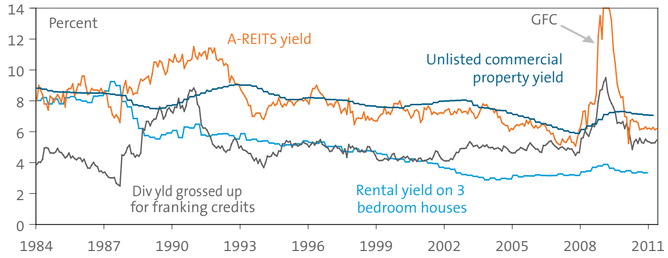
Australian housing is very expensive by global standards



Source: Wendell Cox and Hugh Pavletich, 7th Annual Demographia International Housing Affordability Survey, 2011, AMP Capital Investors

- To give some examples, Los Angeles' median house price is US$345,600, whereas in Sydney it is US$634,300. In Austin, in oil-rich Texas, the median house price is US$189,100, whereas in Perth, in resource-rich Western Australia, the median house price is US$480,000.
- Finally, housing looks expensive relative to other assets. It has been argued the surge in house price to income ratios over the last 20 years reflects the adjustment to lower interest rates, which have made higher debt to income levels possible. This is clearly part of it, but it's worth noting that rental yields on housing have fallen much more than yields on other investments which have also adjusted to low inflation. Right now the gross rental yield on housing is around 3.4%, compared to yields of 7% on unlisted commercial property, 6% for listed property (or A-REITs) and 5% for Australian shares (with franking credits). So for an investor, these other assets represent much better value.

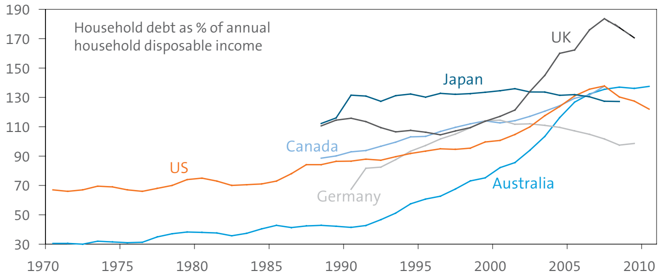
Australian residential property yields are low compared to alternative investments



Source: Thomson Reuters, AMP Capital Investors

Additionally, the debt to income ratio has gone up much more in Australia than in other comparable OECD countries which also went through an adjustment from high inflation to low inflation over the last two decades.

Australian household debt levels are high

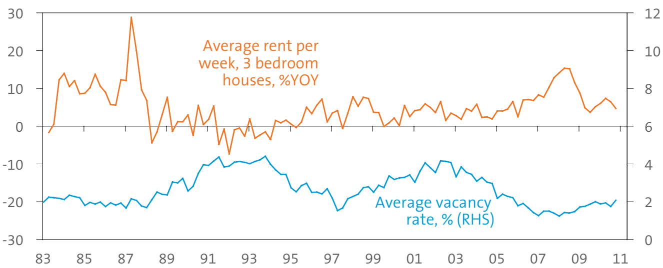


Source: OECD, RBA, AMP Capital Investors

Hard to see trigger for collapse but storm clouds ahead

The overvaluation in Australian housing leaves it vulnerable to anything that leads to an increase in dwelling supply or threatens the ability of homeowners to service their mortgages. At present there is no threat on the supply side. Australia chronically needs faster land release to speed up dwelling supply. According to the National Housing Supply Council, Australia has a cumulative net shortfall of 200,000 dwellings. While underlying demand has slowed with the decline in population growth over the last two years to around 160,000 dwellings per annum, the recent slump in building approvals suggests supply is now likely to run well below this over the year ahead, with little sign of any recovery. The undersupply is evident in chronically low rental vacancy rates and rising rents.

Average of six Australian capital cities

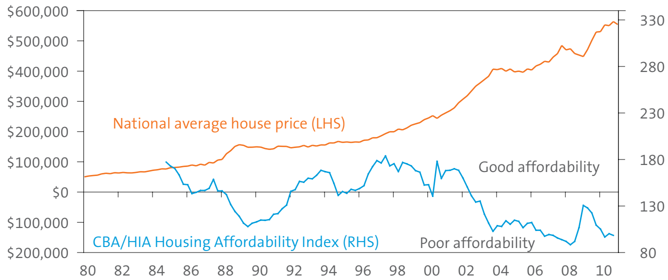


Source: REIA, AMP Capital Investors

The two threats to watch out for are China and interest rates. A sharp collapse in Chinese growth could trigger reduced export income and higher unemployment for Australia. China has been battling an inflation problem, and there is a risk it could over tighten in response. While this seems unlikely given its track record of wanting to avoid the social unrest that goes with a hard landing, it's worth keeping an eye on.

The interest rate threat is more worrying. The RBA has indicated interest rates are likely to rise "at some point" if the economy unfolds as expected. In other words, if the global recovery carries on and the mining boom continues to heat up, it's likely rates will need to rise again to make room for the mining boom without causing the economy to overheat. Four interest rate hikes, as some are suggesting, would knock affordability to a new record low.

Poor affordability is likely to weigh on house prices



Source: Commonwealth Bank/HIA. REIA, AMP Capital Investors

The problem is that the combination of poor retail sales, low levels of confidence regarding household finances and falling house prices suggests households are struggling with current interest rates. Australian banks are now indicating that while overall mortgage arrears remain low, they are rising, with older home borrowers rapidly reducing their debt while newer borrowers are starting to fall behind in their payments. Further interest rate hikes, particularly before the economy has recovered from the current soft patch, risk knocking households over the edge and with them house prices. It would be best for the RBA to wait a while and then assess.

For house prices, the most likely outcome is an extended period of constrained range-bound prices while income levels catch up, but the risks are on the downside, particularly if interest rates rise much further.

Concluding comments

Thanks to massive overvaluation and poor affordability, Australian house prices remain vulnerable to further weakness. A Chinese hard landing and excessive RBA interest rate hikes are the key risks to watch.

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