Shane Oliver, Head of Investment Strategy
& Chief Economist

AMP CAPITAL

Australian house prices – is the crash upon us?

EDITION 21 – 28 JUNE 2012

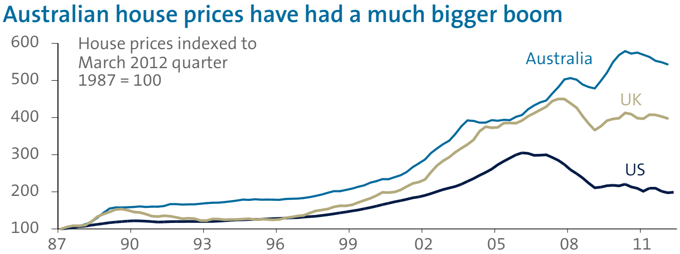
Key points

- Australian housing is still overvalued, leaving it, banks and the broader economy somewhat vulnerable. Undersupply provides some support but the two key threats are a Chinese hard landing and selling by investors.
- The most likely scenario is many years of range bound house prices around a flat trend in real terms.
- Right now house prices may slip a further 3% or so in the short term but lower mortgage rates are likely to lead to a bounce in prices from later this year/early next year.

Introduction

After the surge in Australian house prices from the mid 1990s into last decade, my view was that while the risks of a sharp fall in house prices were high, the most likely scenario was an extended period of range bound house prices (in real terms). If anything, most of the surprise has been on the upside – although not by much in real terms. But despite the fears of many, house prices have not plunged like those in the US and elsewhere, despite a bigger boom.

Australian house prices have had a much bigger boom



Source: Case-Shiller, Nationwide, ABS, AMP Capital

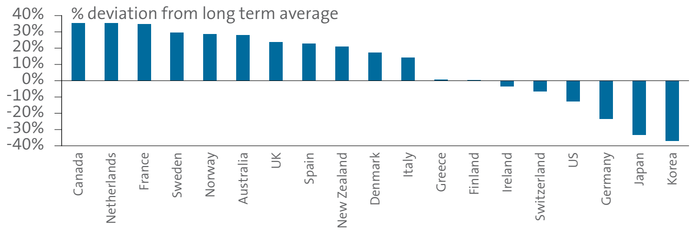
However, the risks are rising again. Prices have slid 6% since their 2010 high and worries that the GFC is about to finally catch up with Australian housing are on the rise again. Excessive house prices and the excessive level of household debt that has come with it are Australia's Achilles heal. **Housing is 60% of household wealth and therefore, movements in house prices have a big impact on household financial wellbeing and spending.** Housing credit also amounts to 59% of total private credit so what happens to house prices is critically important to Australian banks. As we have seen in Ireland and now in Spain, what happens to banks can have a big impact on public debt levels.

Still overvalued, but not by as much

The bad news is Australian housing is still way overvalued. The good news is it is less so, with real house prices going nowhere for the last four years:

- According to the OECD, the ratio of house prices to incomes in Australia is 28% above its long term average, putting it at the top end of OECD countries, although several other countries are more extreme. The US is now below its long term average on this measure.

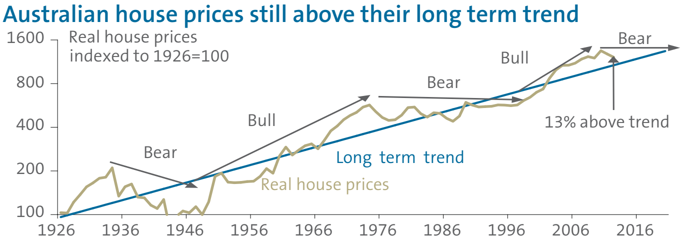
House price to income ratio



Source: OECD, AMP Capital

- According to the 2012 Demographia International Housing Affordability Survey, Australian housing trades on a multiple of median house prices to annual household income which is double that of the US. In Sydney, median house prices are A$637,600 compared to US$324,800 in Los Angeles. In Perth they are A$450,000 compared to US$159,500 in Houston, Texas.
- However, it is apparent in the next chart that while real house prices are still above their long term trend, the divergence has narrowed to 13% from a peak of 33%. Real house prices have now fallen back to 2008 levels.

Australian house prices still above their long term trend



Source: ABS, AMP Capital

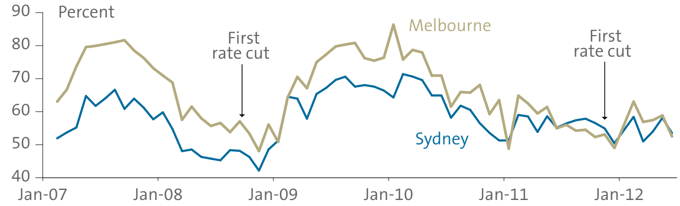
- Another way of looking at property valuations is to look at the ratio of price to rents (sometimes referred to as a PE ratio for housing) and adjust for inflation. On this basis, Australian housing is still overvalued relative to its long term average by 10%, but at least this is down from a peak overvaluation of 38% in 2003.

The bottom line is that while house prices may not be as stretched as was the case a few years ago, Australian housing is still overvalued. This, combined with still high household debt to income ratios leaves Australia vulnerable.

Still undersupplied, but maybe not as much

One of the big supports for the Australian housing market is thought to be a shortage of housing. The National Housing Supply Council estimates a cumulative shortfall of more than 200,000 dwellings. However, the recently released 2011 ABS census wiped almost 300,000 off previous population estimates, suggesting that the undersupply may not be as chronic as thought and along with slowing population growth, has potentially reduced a support for house prices. Our assessment though is that while the undersupply of housing may not be as severe as thought, low vacancy rates still attest to some undersupply. And Australia has not had anything like the residential property construction boom that the US had in the past decade, which accentuated the downward pressure on house prices. In Australia, housing starts and approvals are at cycle lows.

Residential auction clearance rates remain soft

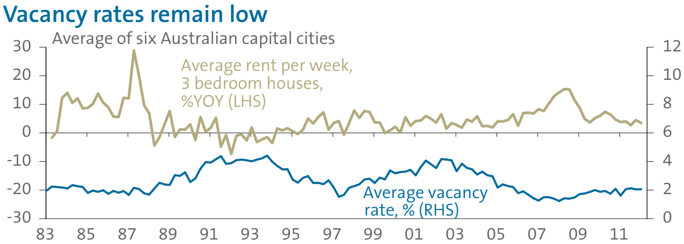


Source: REIA, AMP Capital

Where to from here?

Right now the Australian residential property market is chronically weak. Finance approvals and new home sales are depressed, first home buyer activity is subdued, prices are down, listings are up and auction clearance rates have been weak for 18 months. In fact, the failure of timely data like auction clearances to spring back into life despite mortgage rates starting to fall 8 months ago, is a sign of how weak things are. Since the GFC, Australians have become fearful of taking on more debt and the once strongly held belief that house prices can only go up has long been ditched.

Vacancy rates remain low



Source: Australian Property Monitors, AMP Capital

However, while fears are growing of a deep house price slump ahead, the most likely scenario remains a lengthy period of range bound house prices around a flat trend in real terms just as we have seen nationally over the last few years and in Sydney since 2003. Essentially, poor affordability, overvaluation and high household debt levels have put a cap on house prices, whereas undersupply should limit their downside which will likely see prices cycle up and down with a lagged response to falls and rises in mortgage rates.

Australia did not experience the same deterioration in lending standards that occurred in other countries over the past decade. Home ownership rates didn't increase. Most of the increase in mortgage debt went to older and wealthier Australians better able to service loans. This has all been reflected in still low arrears rates of around 0.6%, and something like 50% of borrowers being ahead on repayments.

Nevertheless, there are two key threats. First, a hard landing in China resulting in a collapse in export earnings, which could drive unemployment sharply higher and threaten a sharp rise in delinquencies and forced sales. However, while this risk has increased given the threat from Europe, a sustained hard landing in China seems unlikely given China's low tolerance for social unrest and a trend of easing inflation.

Second, property investors, which account for a third of national housing debt, may loose patience with the lack of capital growth and sell, leading to sharp falls in house prices. However, while it's hard to see investors piling into residential property now, why would those who are already invested suddenly sell now? Real estate investors are usually there for the long term, made necessary by large transaction costs.

A third threat has been from interest rates, but with rates falling since last November, this has turned into a positive for the housing market. Affordability is still poor, but at least it's improving and our assessment is that a further improvement in affordability lies ahead as interest rates are likely to fall by another 0.75% by year end.

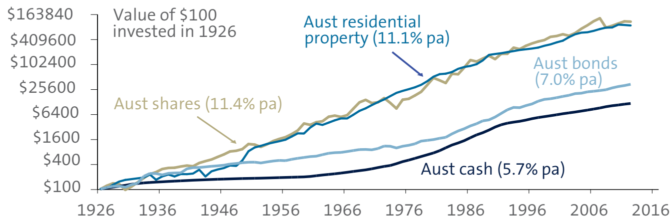
Bottom line – in the very short term house prices could fall a bit further as economic uncertainty continues to impact, but providing Europe doesn't plunge China and the world into a renewed recession, falling mortgage rates are likely to drive a cyclical recovery in the housing market from later this year/early next year. However, the most likely profile over the next 5 to ten years is for house prices to be stuck in a trading range of 10% or so around a broadly flat trend in real house prices.

This is consistent with the 10-20 year pattern of alternating long term bull and bear phases seen in real Australian house prices since the 1920s (see third chart on page 1). The long term bull phase of Australian house prices that started in the mid 1990s is now giving way to a long term bear phase.

Housing as an investment

After allowing for costs, residential property has historically provided a similar return over the long term to shares. This can be seen in the next chart, which shows an estimate of the long term return from housing, shares, bonds and cash

Total return from housing versus other assets



Source: ABS, REIA, Global Financial Data, AMP Capital

Since the 1920s, housing has returned 11.1% p.a. after allowing for capital growth and rents and shares have returned 11.4% p.a. after allowing for capital growth and dividends. While housing is less volatile than shares and seems safer for many investors, it offers a lower level of liquidity and diversification. Considering the similar returns of housing and shares, there is a case for including both assets in a portfolio over the long term. Right now though, housing looks somewhat less attractive as it continues to offer much lower yields. The gross rental yield on housing is around 3.7%, compared to yields of 7% on unlisted commercial property, 6% for listed property (or A-REITs) and 6.5% for Australian shares (with franking credits). So for an investor, these other assets represent much better value.

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

Contact us

If you would like to know more about how AMP Capital can help you, please visit ampcapital.com.au, or contact one of the following:

Financial Advisers	**Your Business Development Manager or call 1300 139 267**
Personal Investors	**Your Financial Adviser or call us on 1800 188 013**
Wholesale Investors	**AMP Capital's Client Services Team on 1800 658 404**

280612