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Australian housing – economic saviour or just another bubble?

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Key points

> Australian house prices have turned up at a time when they are still overvalued. However, there is no sign of a new property bubble.

> The cyclical bounce in house prices likely has more to go, but the broad trend is likely to stay flat in real terms.

> There are tentative signs of an acceleration in dwelling construction activity, which should help rebalance Australian economic growth over the year ahead.

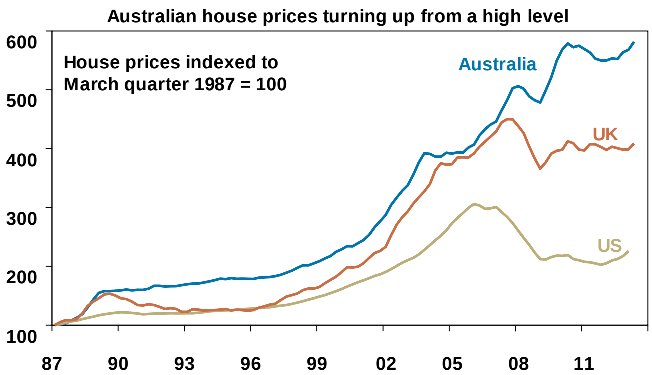
Introduction

An uptick in the interest sensitive housing sector is critical if Australia is to successfully rebalance economic growth away from the fading mining investment boom. As part of this, house prices need to rise to help boost household wealth and support consumer spending, but more importantly to encourage an upturn in the housing construction cycle. Of course the fear is that we end up with another imbalanced housing cycle where prices surge and languishes.

The past year has seen a huge swing in sentiment towards house prices. A year ago fears were rising that Australian house prices might be on the brink of a sharp fall – house prices were sliding, interest rate cuts were not getting much traction and it was becoming apparent that the mining investment boom was starting to fade. Now it seems most of the chatter is about whether we are back into another housing bubble. This note looks at these issues.

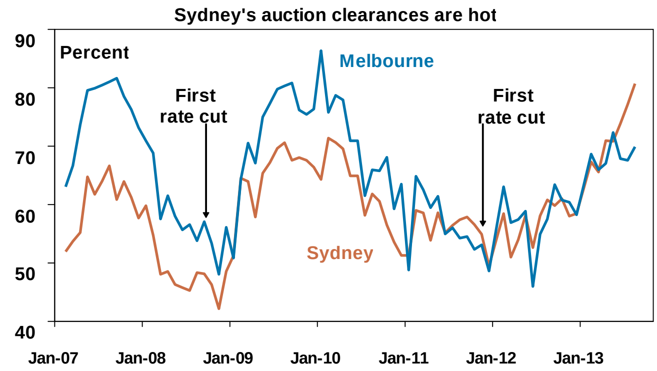
House prices on the up

After initially failing to respond to rate cuts its clear house prices have turned back up with annual capital city average house price growth running around 5%. This is coming at a time when house prices in the UK and the US have also started to head up. The only difference is that prices in these countries are turning up from much lower levels, whereas Australian house prices are turning up from a high level.



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

Fears of a renewed bubble have also been heightened by a surge in Sydney's auction clearance rate above the 80% level, well above its normal cyclical high of around 70%.

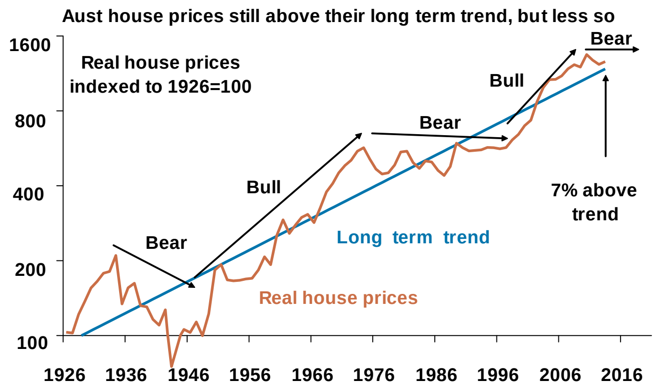


Source: Australian Property Monitors, AMP Capital

Still overvalued

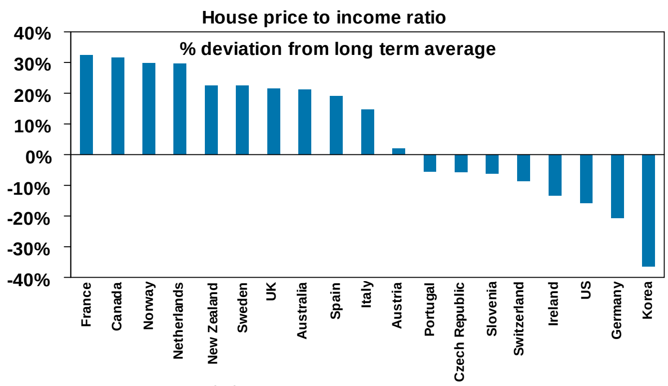
While Australian house prices have worked off some of their overvaluation, they nevertheless remain overvalued. This can be seen in a range of indicators:

- While real house prices have fallen from an extreme of 25% above their long term trend in 2010, they are nevertheless still above it by around 7%.



Source: ABS, AMP Capital

- The ratio of house prices to incomes in Australia is 21% above its long term average, leaving it toward the higher end of OECD countries, albeit less extreme than it was. This contrasts with the US. It's a similar picture when it comes to the ratio of house prices to rents.



Source: OECD, AMP Capital

- According to the 2013 Demographia Housing Affordability Survey the median multiple of house prices to household income is still around double that in the US.

...but not a bubble

However, apart from overvaluation and hot Sydney auctions there is little evidence of a housing bubble at present.

- House price growth averaging around 5% pa is tame by past standards. At a similar stage following interest rate easing cycles commencing in July 1996, February 2001 and September 2008 capital city house prices were showing annual growth of 8%, 19% & 19% respectively.
- Secondly, house price strength is not broad based. Prices in Melbourne, Brisbane and Adelaide are running between 1% and 4% pa. Perth is very strong but it's hard to see this being sustained as the mining investment slowdown leads to slower economic growth in WA. And while Sydney is strong its worth noting that Sydney property prices have had no real growth since 2004 – over the last 8 years Sydney property prices have increased by an average 2.7% pa, which is identical to the average 2.7% inflation rate over the same period.
- Third, growth in housing credit is around a record low of just 4.6% compared to 20% plus gains into 2004 when national house prices were last in a bubble and double digit gains through most of last decade.
- Finally, there is no sign of the irrational exuberance that normally goes with bubbles – auction volumes are lowish, there is no media frenzy around property sales and investing, there is little sign of buyers rushing in for fear of missing out, there is no sign of buyers extrapolating past price gains as a reason to buy and investor interest is modest with 5.7% growth in investor housing credit over the last year compared to 25% to 30% growth a decade ago. In large part this reflects a more cautious approach on the part of home buyers since the GFC - Australians have become fearful of taking on more debt not helped by relatively high job insecurity and the realisation that house prices can go down as well as up.

This is not to say that it won't turn into a house price bubble but at this stage the property market is a long way from that. And with the pick up relying on improved affordability with house price to income ratios remaining high it wouldn't take much in the way of price increases for the improvement in affordability to be undermined. Rising unemployment may also act as a dampener on house price appreciation.

The cyclical upswing in house prices likely has further to run with gains likely to be around 5% to 10% over the year ahead. However, the overvaluation of Australian housing will likely see real house prices stuck in a 10% range around the broadly flat trend that has been evident nationally since 2010. 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 the third chart in this note. The long term bull phase of Australian house prices that started in the mid 1990s likely gave way to a long term bear phase commencing in 2010 that in the absence of an unexpected economic collapse is likely to be characterised by a flat trend in real house prices until the excesses of the 1996 to 2010 period are worked off.

What hope a pick up in dwelling construction?

Australian economic recoveries invariably start with a housing upswing. This boosts economic activity via increased construction but also as new house completions boost demand for household retail items and rising house prices boost wealth (housing is 60% of household wealth).

While the initial response to interest rate cuts for most housing related indicators has been lacklustre there are some encouraging signs on the dwelling construction front.

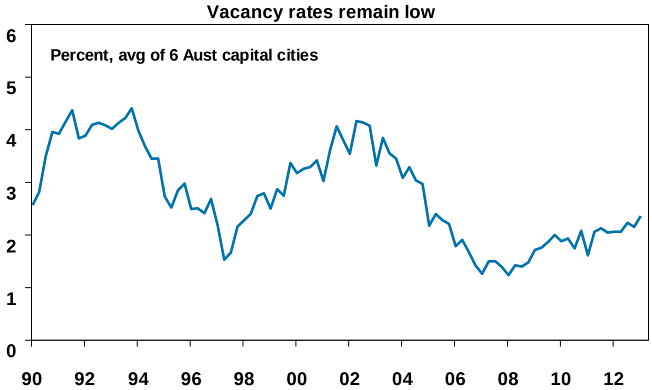
First, as already discussed, house prices have picked up over the last year. This is necessary to encourage developers to boost the supply of dwellings.

Secondly, new dwelling sales are up by around 25% after bottoming in September last year according to the Housing Industry Association. This is consistent with a reported 24% rise in Stockland's residential sales contracts.

Thirdly, while first home buyer (FHB) activity is low, not helped by a tightening in government FHB assistance schemes and job insecurity, there are some signs that it may finally be starting to increase. More broadly housing finance commitments for the construction of new dwellings is trending up. And while first home buyer activity is low the rising trend in investor interest in the property market suggests that they may play a bigger role in driving new housing construction this cycle.

Fourthly, there is still a shortage of housing. Vacancy rates remain relatively low and the National Housing Supply Council's most recent report estimated a cumulative shortfall since 2001 of 228,000 dwellings.

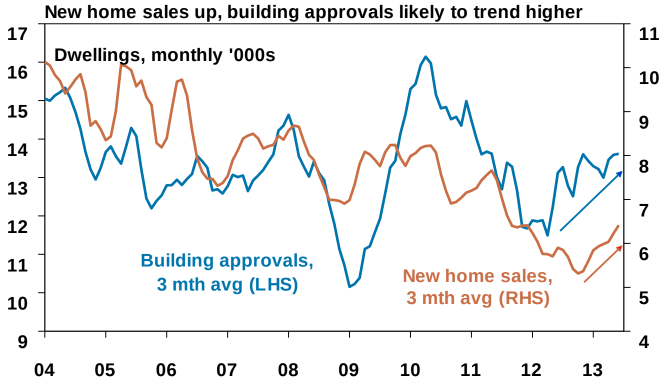
Vacancy rates remain low



Source: REIA, AMP Capital

Finally, taken together this suggests that the (so far modest) rise in building approvals has further to go which in turn augurs well for dwelling construction over the year ahead.

New home sales up, building approvals likely to trend higher



Source: Bloomberg, AMP Capital

Concluding comments

A new housing bubble is the last thing Australia needs as it would limit the RBA's ability to keep interest rates down to boost the broad economy. However, while the cyclical recovery in house prices likely has further to go its unlikely to become a bubble given more cautious attitudes on the part of home buyers and job insecurity. And if house prices do rise too quickly it will probably be because the economy is much stronger, in which case interest rates can start to rise anyway. More broadly there are signs that dwelling construction activity is likely to rise over the year ahead.

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