HOUSING MARKET UPDATE

PETER MUNCKTON – CHIEF ECONOMIST

WEEK ENDING 21ST JANUARY 2022

BOQ GROUP

Key points

- **House prices were up strongly across Australia in 2021;**
- **Very low interest rates, strong labour market, and increasing demand for standalone houses at a time of modest new supply were the main factors;**
- **Price growth will be lower in coming years, with the possibility they may decline for a period;**
- **Brisbane, Adelaide, Perth and Darwin provide the best value across the capital city housing markets.**

Summary

We are in the middle of the biggest global pandemic in a century and house prices have just had their largest annual rise in 30 years (21%).

One factor that is very important for house prices is the level and movement of interest rates. History has shown that most periods of strong house price growth has coincided with a declining cash rate. Right now the discussion about interest rates is very much when they may head higher.

History also suggests a nuanced relationship between rate hikes and house prices. At various times other factors can be more important drivers of the housing market than interest rates. These include household confidence about the jobs market and their own finances, confidence in the outlook for house prices, the availability of finance and the underlying supply and demand conditions.

Actual declines in house prices often coincide around the peak of the cash rate. This makes sense as the peak of the cash rate is when the full bite from higher interest rates is being felt. Financial markets are pricing the peak of the cash rate to be in 2024-5 at around 2-2.25%. I agree with financial markets about the timing of the peak in the cash rate. But as argued last week I think the peak in the cash rate will be above current financial market pricing.

The momentum of house price growth slowed over the final four months of 2021. This makes it likely that growth in 2022 will be comfortably below the pace seen last year. The expectations of slower growth reflects the possibility/likelihood of rising interest rates, weak demand from slow population growth, rising supply of new houses and the potential for some further tightening of bank lending standards. There are risks that house prices may decline sometime for a period around 2024. More generally, past 2022 we are likely to be in for a run of years of less rapid house price growth.

Brisbane led the way in the Big City annual house price growth leader board for 2021. Sydney, Brisbane and Adelaide were all above 20%, with all major cities achieving double-figure growth. Many local government areas (LGA's) experienced big price rises for standalone houses. Fourteen had over 50% price growth in the year, three had over 100%! There was double-digit price growth in three quarters of all LGA's. But 28 LGA's experienced price declines indicating that even during strong periods of nationwide growth house prices can still decline driven by local economics.

Relative to Sydney, the average house price in Hobart is expensive by the standards of the past 40 years. Melbourne and Canberra house prices are about the mid-point of the range they have been relative to Sydney over the past fifty years. Brisbane, Adelaide and Perth appear cheap. Another indicator of affordability is the proportion of income spent on meeting mortgage payments. Sydney is the most expensive by that measure. Melbourne, Hobart and Canberra the next highest. Perth and Darwin the lowest, with Adelaide and Brisbane in between.

Value and affordability both suggest the Brisbane and Adelaide housing prices may rise by more over the next 2-3 years. The same factors suggest that Sydney and Hobart could have the slowest house price growth. Melbourne and Canberra are likely to be somewhere in-between. The Perth and Darwin housing markets currently offer the best value.

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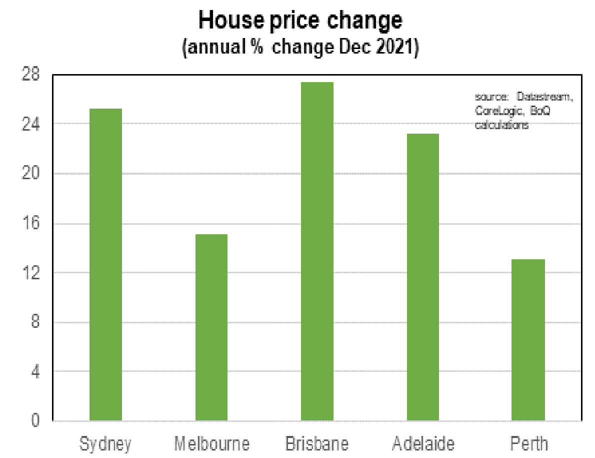
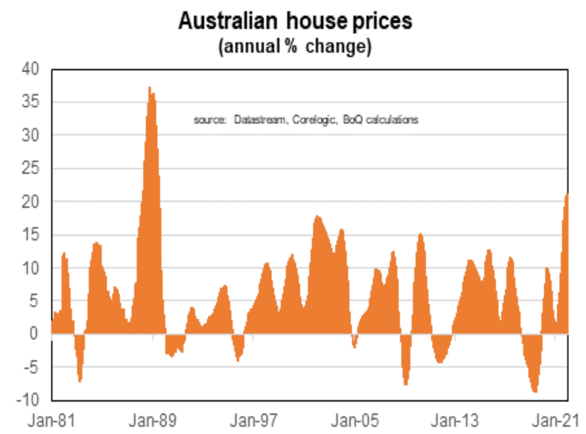
2021 was a big year for house price growth

We are in the middle of the biggest global pandemic in a century and house prices have just had their largest annual rise in 30 years (21%). Rock bottom interest rates, a banking system in good shape, strong income support to households and businesses from governments and a strong jobs market were the enablers. Annual house price growth of this magnitude is unusual. Sydney has experienced 20%-plus growth only 14 times since 1880.

Growth was strong across capital cities.

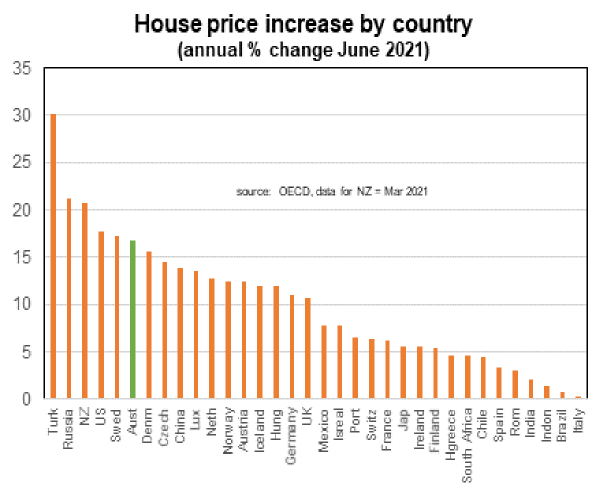


House price growth in 2021 was the strongest in over thirty years.

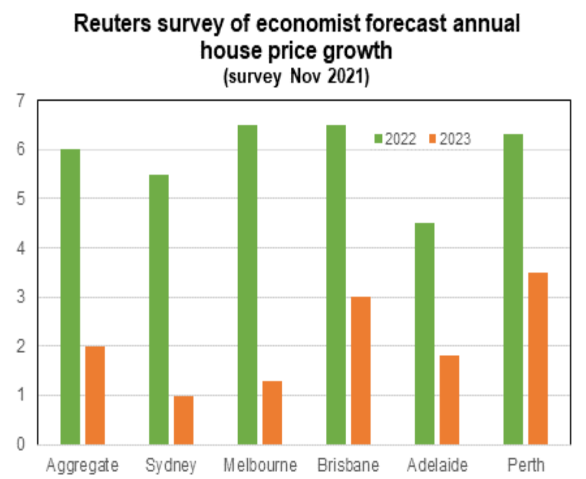


Australia's house price growth has been strong by peer country standards. According to the OECD only the US, Sweden and New Zealand and some emerging markets (Turkey and Russia) had faster growth last year.

House price growth in Australia in 2021 was towards the top end of OECD outcomes



Slowing growth of house prices is expected across Australia over the next couple of years.



Historically big house price rises in one year doesn't necessarily mean a smaller rise (or even a decline) in the following year. In Sydney from 1880-2021 house prices on average grew by 10% the year after double-digit growth. What drives house prices is not what happened in the past year but factors such as interest rate movements, the availability of finance, the underlying demand and supply for houses, affordability and confidence in the outlook for house prices.

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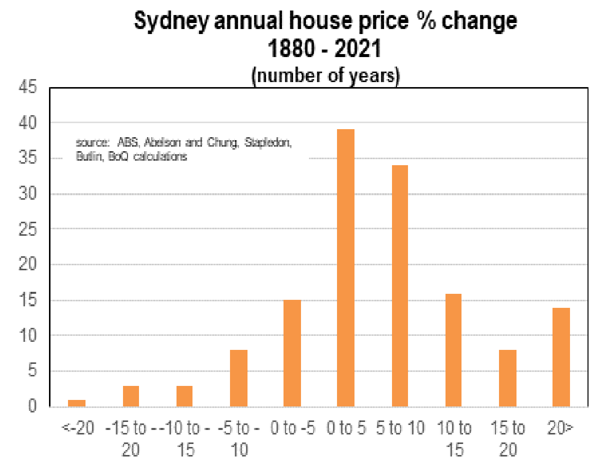
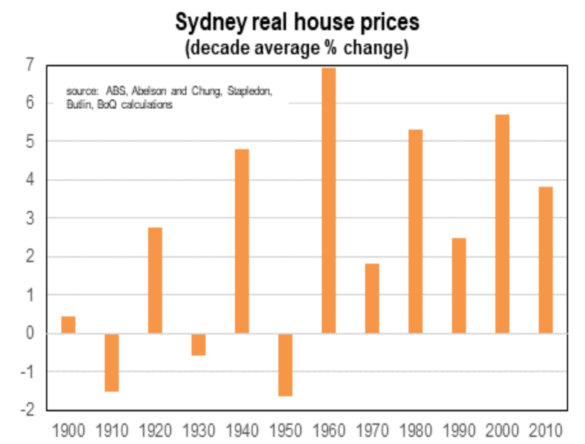
House price growth of over 20% are unusual.



Real house price growth has been more stable since 1960.



House prices and rate hikes

One factor that is very important for house prices is the level and movement of interest rates. History has shown that most periods of strong house price growth has coincided with a declining cash rate. Right now the discussion about interest rates is very much when they may head higher. The possibility of further reductions in the cash rate is very much last years' story.

Higher interest rates can hit the housing market in three ways. A higher cost of borrowing reduces the number of new home buyers able to enter the market. Increasing mortgage payments for existing borrowers raises the chances they might not be able to meet their obligations forcing them to sell. Higher interest rates also increases the attractiveness of other assets, reducing the number of investors that might want to enter the housing market.

At the time of writing financial markets are pricing in the first rate hike by mid-year and a full percentage point of rate rises by the start of the following year. The current consensus of economists (and my view) is that the first rate rise will happen sometime between the fourth quarter of this year and mid next year (although that consensus appears to be changing). Whether the rate hikes occur will depend upon domestic inflation and wages outcomes, as well as what happens to global interest rates (particularly in the US).

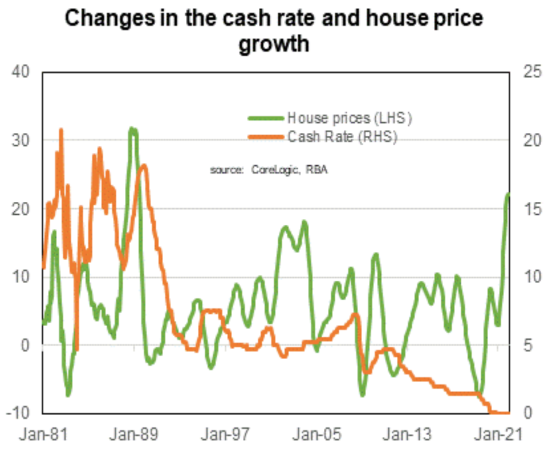
History suggests a nuanced relationship between rate hikes and house prices. In the early 1990's and around the turn of this century the peak in house price coincided with the beginning of tightening of monetary policy. Other times (such as the period just prior to the GFC) house price growth both rose and fell as the cash rate was increasing. This indicates that at various times other factors can be more important drivers of the housing market than interest rates. These include household confidence about the jobs market and their own finances, confidence in the outlook for house prices, the availability of finance and the underlying supply and demand conditions in the housing market.

Declines in house prices and the cash rate

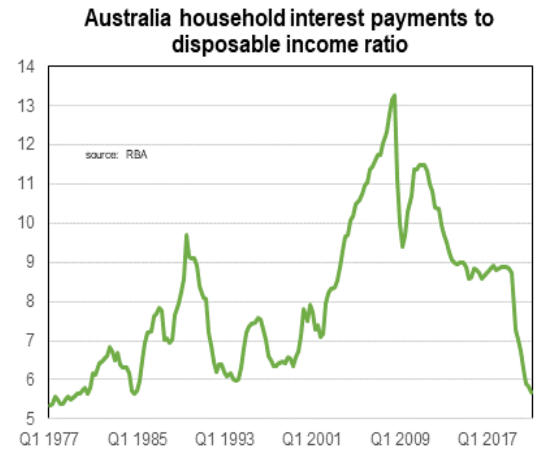
Actual declines in house prices though often coincide around the peak of the cash rate. This makes sense as the peak of the cash rate is when the full bite from higher interest rates is being felt. There has been seven times that price growth has been negative over the past forty years, with peak-to-trough declines ranging between 5-10% over those episodes.

Financial markets are pricing the peak of the cash rate to be in 2024-5 at around 2-2.25%. I agree with financial markets about the timing of the peak in the cash rate. But as argued last week I think the peak in the cash rate will be above current financial market pricing. The proportion of households' disposable income going to meet interest payments is at its lowest level ever. Households have run up a huge level of saving over the past couple of years (although these aren't necessarily the households that have the biggest debts). In the US and Europe inflation is hitting levels not seen for decades. This follows the decision by global central banks and governments to actively boost economic growth and higher inflation in this economic cycle.

Falling house prices often coincide with near the peak in the cash rate.



Interest payment are not taking a big slice of disposable incomes.



Lending standards

The other factor the can have nation-wide impact on house prices is the availability of credit (bank lending standards). Regulators are more likely to change lending standards if they are worried about developments in the housing market than they were in the 1990s and 2000's. The slowing (and decline) of house price growth 2017-19 took place during a low and stable cash rate. One factor impacting house prices at that time was tighter lending standards.

Regulators nudged lending standards tighter last year. Whether they make any further moves will reflect a number of factors, including the pace of credit growth, the proportion of risky loans (such as high loan-to-value ratio) and the proportion of lending going to investors.

Outlook

The momentum of house price growth slowed over the final four months of 2021. This makes it likely that growth in 2022 will be comfortably below the pace seen last year. According to a Reuters' survey analysts are looking for growth to slow to around 6% this year and 2% in 2023 (with 2% growth also expected in 2024). The expectations of slower growth reflects the possibility/likelihood of rising interest rates, weak demand from slow population growth, rising supply of new houses and the potential for some further tightening of bank lending standards.

I expect house prices to be a little stronger than the consensus over the next couple of years. The labour market will be very strong, disposable incomes rising, interest rates will still be relatively low and supply bottlenecks means new supply of housing will take time to hit the market.

As noted, history indicates that the peak in the cash rate often coincides with a fall in house prices. This suggests there are risks that house prices may decline sometime around 2024. The growth rate decline could bottom out around 5%, with a total peak to bottom decline of house prices of 10%. More generally, past 2022 we are likely to be in for a run of years of less rapid house price growth.

The scenario for stronger house price growth is if economic growth was robust for an extended period with low interest rates. One such possibility is if export prices rose strongly as a result of strong demand at a time of under investment in mining. This would substantially boost national income enabling households to take on more debt. This scenario is possible although the terms of trade (export prices divided by import prices) is already near a record high.

The scenario for weaker house prices is if real interest rates (interest rates after adjusting for inflation) need to rise a lot more than expected due to the CPI remaining too high for too long for the RBA's comfort level.

Aggregate house price forecasts

2021 (a)	2022 (f)	2023 (f)	2024 (f)
21%	8%	3%	-5%

The price rises of last year were widespread

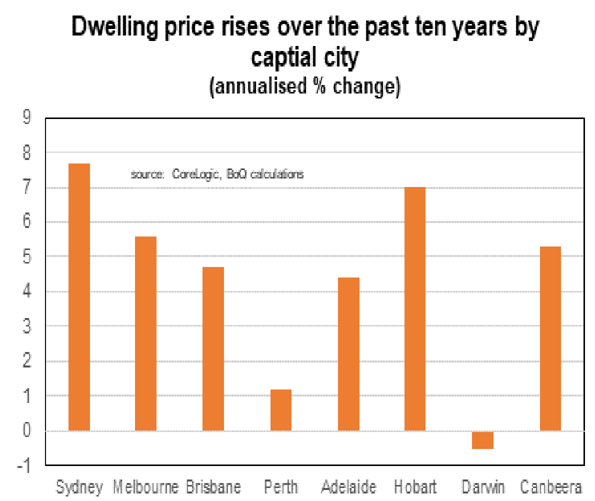
The discussion has so far focussed upon has been about the average movement of house prices across Australia. But house price growth differs by state, city and local government area. Brisbane led the way in the Big City annual house price growth leader board for 2021, the fifth time it has topped that chart since 1993. Sydney, Brisbane and Adelaide were all above 20%, with all major cities achieving double-figure growth.

Over the past ten years annual house prices rises has averaged a more modest 5%. Sydney and Hobart led the way at over 7%. Perth (1%) suffered the fallout from the end of the largest mining boom on record.

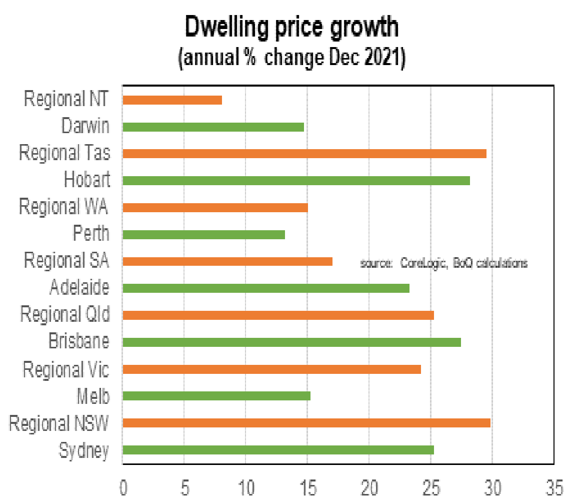
There was talk that 2021 was the year of the outperformance of the regions relative to the capital cities. That was certainly true in Victoria and NSW. Regional outperformance was more marginal in WA and Tasmania. The capital cities did better in the other states. Outside of Hobart and Darwin, houses did better than units. Students and long-term holiday makers left the country reducing demand for units, while WFH (working from home) increased demand for standalone houses.

Many local government areas (LGA's) experienced big price rises for standalone houses. Fourteen had over 50% price growth in the year, three had over 100%! There was double-digit price growth in three quarters of all LGA's. But 28 local Government areas experienced price declines indicating that even during strong periods of nationwide growth house prices can still decline driven by local economics.

House price growth has been strongest in Sydney and Hobart over the past ten years.



The regions outperformed cities in some but not all states and territories.

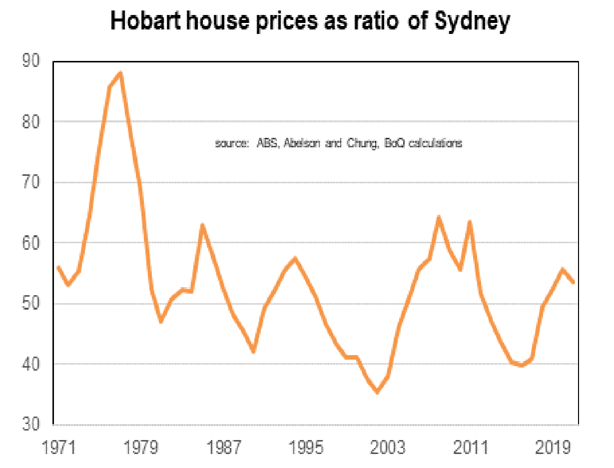


The outlook by city

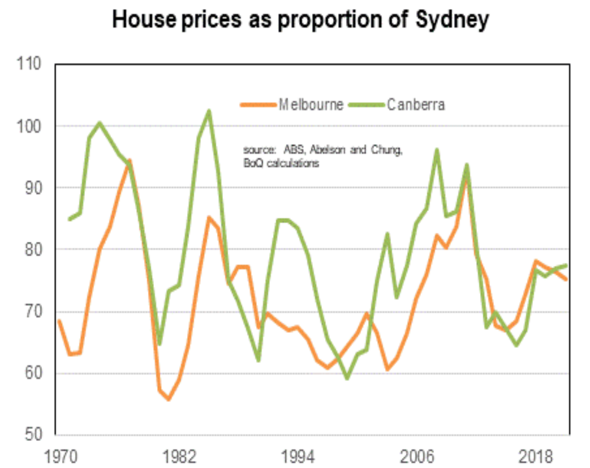
Currently Western Australia is topping the state economic growth charts (it has the lowest unemployment rate). But the economies of all states and territories are doing pretty well (although all are going through a tougher patch with the current Omicron wave). So the difference in the performance of state economies is unlikely to play a big role in the performance of house prices.

A more important factor is likely to be housing affordability, a growing issue across Australia. Now that interstate borders are re-opening cheaper housing may again be an important reason why people move regions. Relative to Sydney, the average house price in Hobart is expensive by the standards of the past 40 years (although Hobart prices were only just lower than Sydney in the 1970's). Melbourne and Canberra house prices are about the mid-point of the range they have been relative to Sydney over the past fifty years. Brisbane, Adelaide and Perth appear cheap.

On historical grounds Hobart house prices are relatively high compared with Sydney.

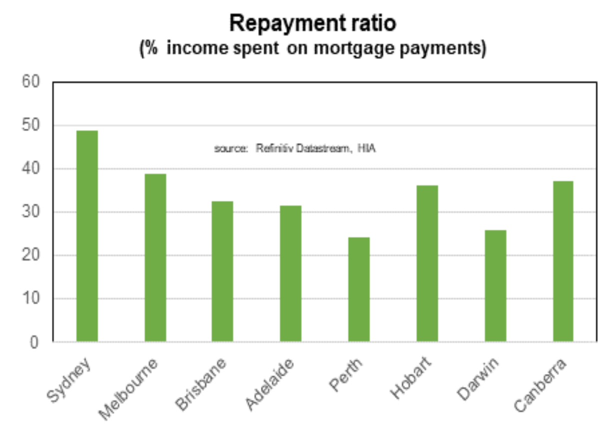


Melbourne and Canberra are providing about average value compared with Sydney.

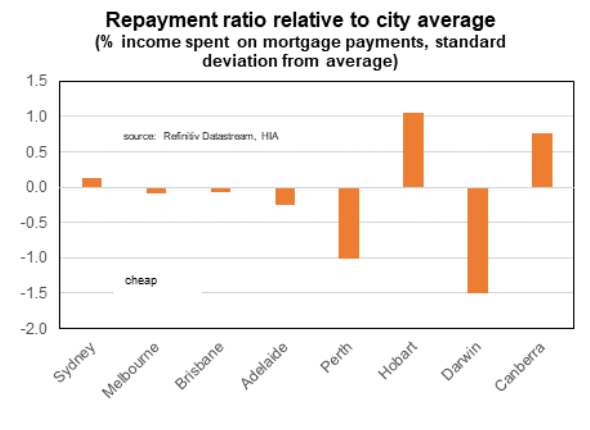


Another indicator of affordability is the proportion of income spent on meeting mortgage payments. Sydney is the most expensive. Melbourne, Hobart and Canberra the next highest. Perth and Darwin the lowest, with Adelaide and Brisbane in between. It would be expected that the bigger cities such as Sydney and Melbourne would be less affordable (higher population wanting to live on the same land). When comparing this affordability measure with a city's' historical average, Perth and Darwin are cheap and Canberra and Hobart expensive.

Housing prices have outperformed units in the major capital cities over the recent years.

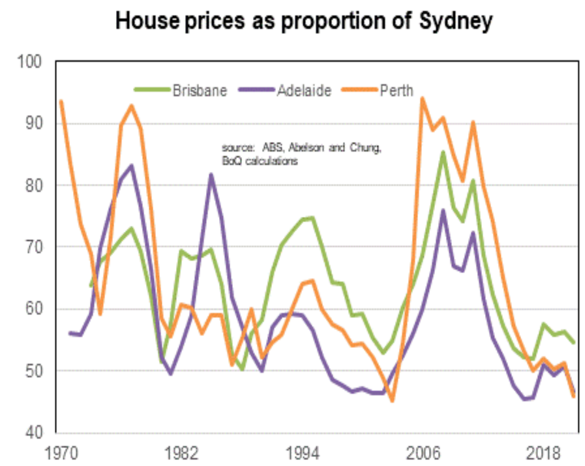


Rising concerns about affordability is weighing on consumer sentiment about housing.

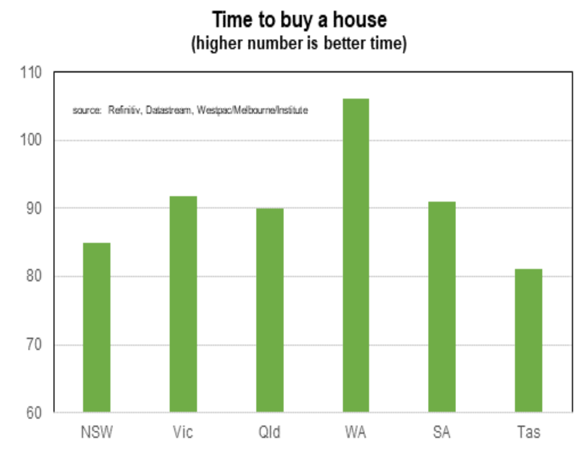


There is also a survey that asks households their view on whether now is the right time to buy a house, a customer sentiment view about affordability. WA is currently considered best value, Tasmania and NSW the least. The other states rank in between.

Brisbane, Adelaide and Perth house prices offer best value relative to Sydney.



Consumer sentiment about buying a house is currently strongest in WA.

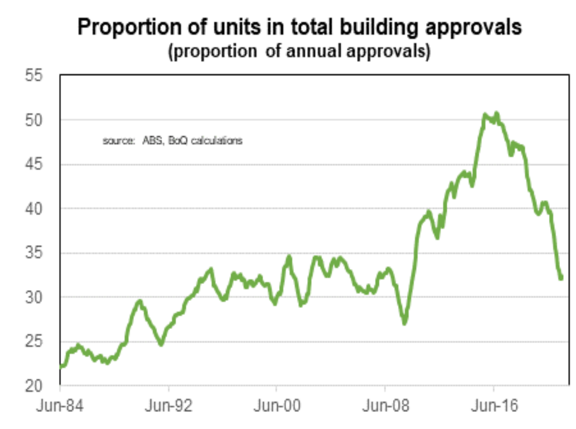


Affordability and jobs is all about the demand side of housing. House prices will also be impacted by differences in the supply of new housing between states. One indicator that takes into account both demand and supply is the ratio of the annual change in state population relative to the 12-month sum of building approvals. Prior to COVID that ratio was at a cyclical high for all states (except NSW) suggesting that not enough housing was being built for the growth of the population. Since then approvals have gone up and population growth has slowed sharply. The result is that ratio is now at or close to record lows for most states.

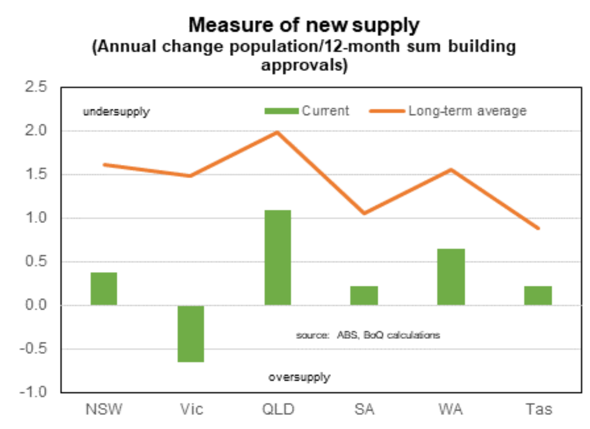
That suggests that supply will weigh on house prices across all states at some stage over the next couple of years. Victoria (particularly Melbourne) could be the most affected. The ratio is at its highest in Qld suggesting it might be less impacted by supply than the other states.

At some stage that ratio will rise again. Building approvals have already declined from their peak reflecting the end of (some) government subsidies. And the opening up of the borders means population growth will begin rising again from 2022.

A larger proportion of that extra building has been of standalone housing.



There has been plenty of new houses built across all states relative to population growth.



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Forecast for city house prices

Value and affordability both suggest the Brisbane and Adelaide housing prices may rise by more over the next 2-3 years. The same factors suggest that Sydney and Hobart could have the slowest house price growth. Melbourne and Canberra are likely to be somewhere in-between.

The Perth and Darwin housing markets currently offer the best value. And WA currently has the strongest economy. The history of the past fifty years has been that the Perth market outperforms strongly during mining booms (and underperforms substantially during the busts). During other periods movements in Perth house prices relative to Sydney swing by less than in other cities.

Major city house price forecasts

City	2021 (a)	2022 (f)	2023 (f)
Sydney	25	6	1
Melbourne	15	6	2.5
Brisbane	27	10	4
Adelaide	23	10	4
Perth	13	7	4

We live in interesting times.

Regards

Peter Munckton
Chief Economist
Bank of Queensland