HOUSING UPDATE

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WEEK ENDING 22 JULY 2022

Key points

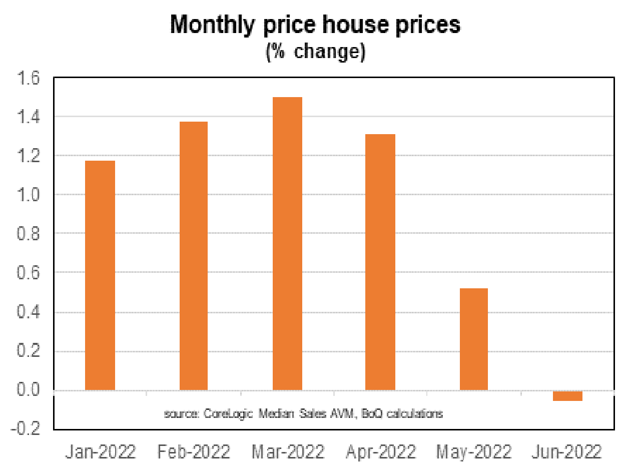
- **The house price decline began in Q2;**
- **Further declines are virtually certain given more rate hikes on the way;**
- **The extent of the fall in house prices will differ between cities;**
- **Sydney and Hobart are most vulnerable;**
- **House prices appear best value in Perth and Darwin.**

The slide has started

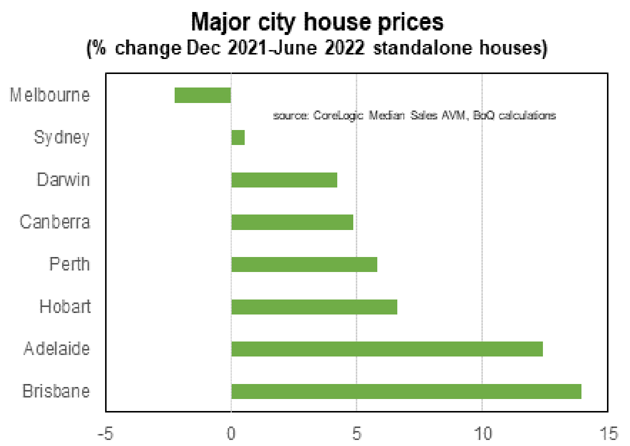
'*We're going to ri-ri-ri-ri-rise til we fall' was the opening line from 'Rise*', a song by Jonas Blue a UK DJ and music producer. The song peaked at number 3 in the top UK singles charts of 2018 (was number one in the Czech Republic) and apparently did very well on the US Dance scene (not that I would know). Whatever its musical merits the reason why the opening line grabbed my attention was that it is a pretty accurate description to what is happening to house prices. In March house prices rose by well over 1%. By June house prices declined on average across Australia.

As is so often the case, averages can deceive. Since the end of last year house prices have declined in Melbourne and were essentially flat in Sydney. Growth remained strong in Brisbane and Adelaide. The other capital cities were in between.

There has been a remarkable change in the direction of house prices.



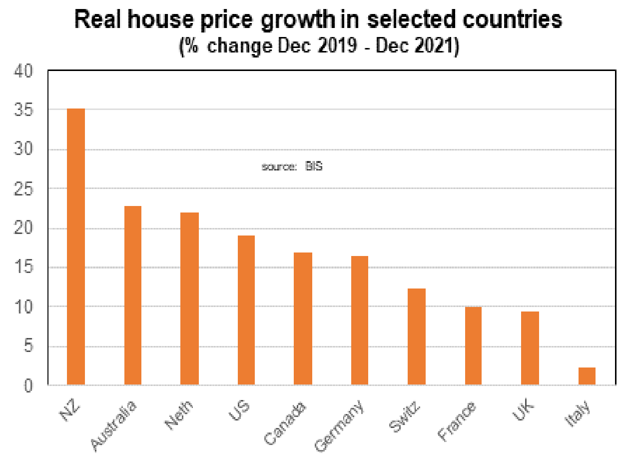
The weakness in house prices has been most visible in the largest cities.



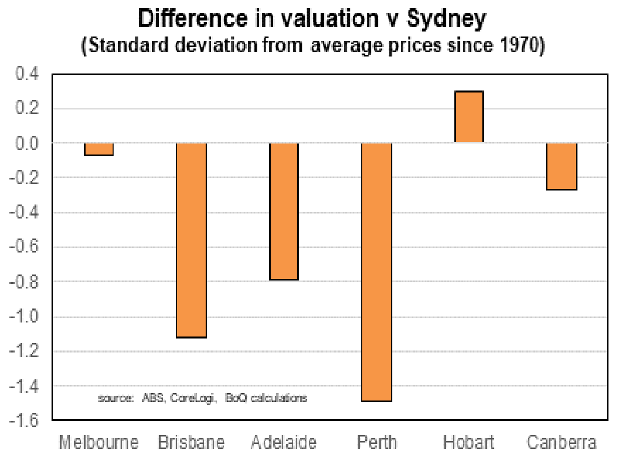
The impact of the first cash rate rise in May appears clear. But price growth had already begun to moderate in Sydney and Melbourne reflecting affordability concerns and the big rise in the supply of homes available for sale. Prices are starting to decline in the cities (Hobart and Canberra) that do not appear cheap (relative to their historical average price compared with Sydney). The cities that are still experiencing growth (Brisbane, Adelaide, Perth and Darwin) are the ones that are cheap (again relative to Sydney).

Extremely low interest rates, strong fiscal support and rapidly rebounding economic growth meant that house prices rose strongly across many countries over the course of the pandemic. The rise of Australian house prices has been higher than most peer countries.

House prices have risen strongly across many countries over the Pandemic.



Valuations differ across cities.



Previous episodes

This is not the only time that house prices have fallen over recent decades. Over the past forty years house prices have fallen on six occasions (excluding the very brief decline that happened at the beginning of the pandemic). The peak-to-trough declines have been relatively modest (-3 to -11%). On the first four occasions the declines lasted for just over one year although in the past two occasions the falls have taken longer.

Most people look at the actual movement in house prices. Economists' also focus on the after inflation (or 'real') moves. The reason why is if the price of a good goes up by more than the inflation rate it is a sign that demand is a lot stronger than available supply. The higher price reduces demand and drags in more supply (that then leads to a lower price). In 'real' terms house prices across the episodes have typically fallen by 10-20%.

Historically the impact of the state of the economy on house prices has been mixed. House prices declined during the two big recessions in the 1980s and 1990s (when both economic and national income growth were both very weak) as well as around the GFC. In the other episodes the rise in the unemployment rate rise was modest.

Historically house price growth has not started to slow until well into the monetary policy tightening cycle. One reason is that the first few rate hikes have typically taken place when momentum in house price growth was strong and the economy was performing well. In earlier episodes house prices and debt levels (relative to household incomes) were a lot lower so the initial rate hikes had less impact although they eventually rose to a level that led to declining growth. The one exception was 2017-19 when the bigger issue was not so much the cost of finance (interest rates) but its reduced availability reflecting a tightening of credit standards.

Experience of past house price declines

Episode	Actual peak-to-trough decline	Real house price fall	Unemployment rate rise from cyclical low	Mortgage rate rise
Apr 82 – Feb 83	-9	-22	4.3	4.4
Apr 90 – Feb 91	-3	-8	2.7	3.5
Oct 94 – Aug 95	-4	-9	0.1	1.75
Feb 08 – Jan 09	-8	-11	2.4	0.9
June 10 – Jan 12	-6	-10	0.3	2.0
Sept 17 – June 19	-11	-14	-	0.25

Note: House prices are the CoreLogic measure of property values in the five major capital cities

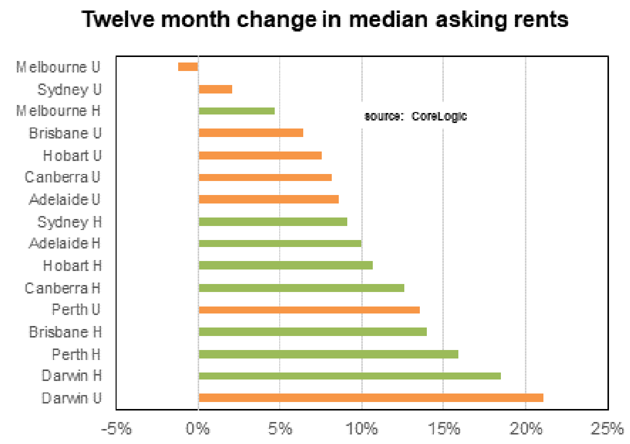
With further cash rate rises to come house prices are almost certain to decline further in coming months. The RBA recently suggested that historically a 2 percentage point rise in the mortgage rate had led to a 15% decline in real house prices over the following two years. With financial markets suggesting that the cash rate could rise by almost 3.5 percentage points from its low in this cycle if that relationship continues to hold it would be consistent with real house prices falling by 25-30%. With inflation likely be rising by close to 10% over the next 2 years the RBA rule of thumb is suggestive of a decline in house prices by around 15-20% if current financial market pricing is correct.

There are mitigating factors. Rents can be thought of as the earnings generated from housing (similar to the way that profits drive equity prices). Movements in rents provide a snapshot of the demand-supply conditions in the housing market. Just as rising earnings don't necessarily mean a rising stock market, rising rents doesn't necessarily stop house prices declining. But if rents continue to rise for a long enough period they provide strong fundamental support to house prices. Asking rents have been rising strongly, particularly for houses in all cities.

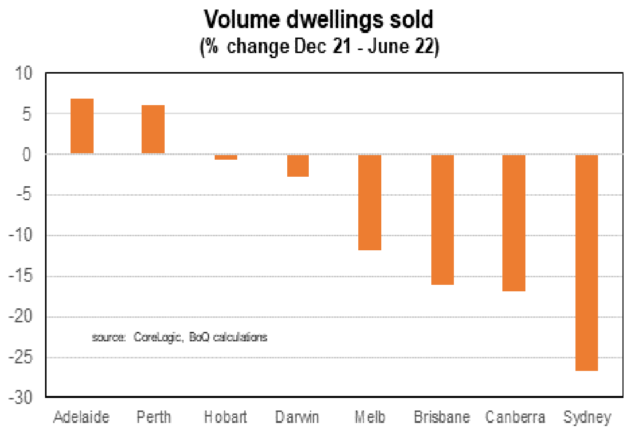
Another factor that will start to support the housing market is a reduction in the number of houses available for sale. Just as high prices lured many sellers onto the market declining prices will lead to less stock for sale. In the year to date there has been a big reduction in the number of places sold in Sydney, Melbourne and Canberra although that has largely reflected an increase in unsuccessful sales. Another plus is that immigration growth is again on the rise.

Offsetting a reduction of existing homes for sale is that there will be a large number of new homes that are due for completion over the next year. It is also possible that the large amount of alterations and additions work has led to some households renting a place, temporarily reducing available supply for rent. That will unwind as the alterations are finished. There has been also a reduction in the number of group houses in recent years, likely encouraged by the lower rents through the pandemic (particularly in Sydney and Melbourne). Rising rents might make group houses attractive again.

Rents have risen strongly over the past year, particularly for standalone houses.

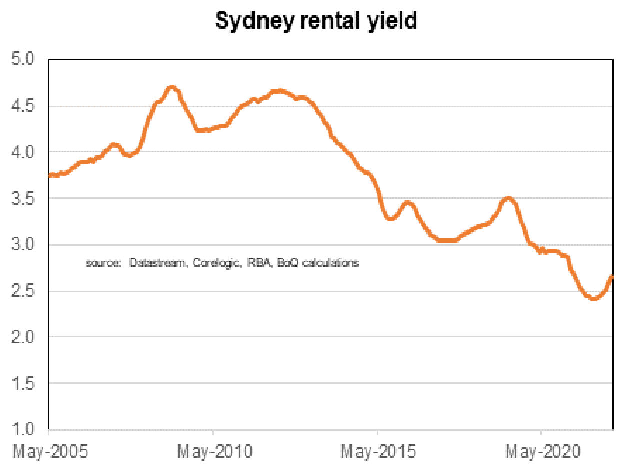


The number of houses sold declined in most cities in the first half of the year.

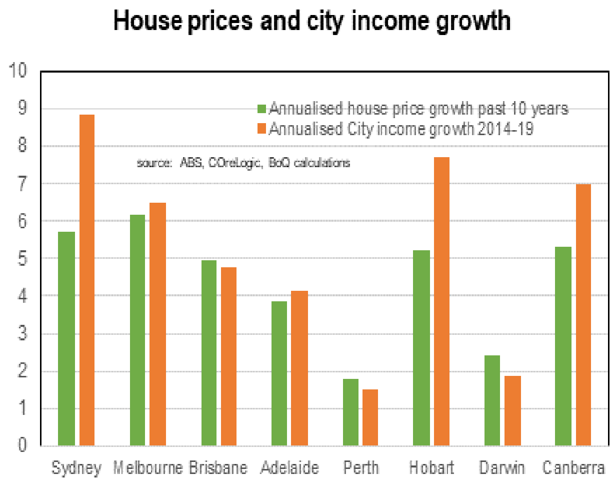


For most cities house price growth has broadly grown in line with city income growth over recent years. The exceptions are in Sydney, Hobart and Canberra where house price growth has been clearly stronger. In the case of both Canberra and Hobart strong house price growth has coincided with an extended period of strong rental growth suggesting that the stock of housing in both capitals has not been strong enough to keep up with population growth.

Sydney rental yield declined over the past year reflecting falling interest rates.



House price growth has broadly grown in line with income in most capital cities.



Different valuation methods

Different valuation metrics suggest that Sydney may suffer the biggest house price peak-to-trough decline (not surprising for the least affordable city). House prices in Melbourne might remain under pressure, at least until it is clear that immigration numbers are returning back to be closer to their pre-pandemic levels.

On a number of metrics Hobart and Canberra also appear over-valued. Rental growth has been strong in both markets. Affordability is an issue (particularly in Hobart) and I expect to see a reasonable fall in house prices in both markets.

Both Brisbane and Adelaide benefit from better affordability (both relative to Sydney and relative to the history of mortgage payments for each city). The one knock against Brisbane is that the rental market has been softer.

Brisbane (and the wider South East) benefit from very strong inter-state migration. Queensland also currently has the strongest housing sentiment across the states.

Perth and Darwin are cheap on all metrics. Both economies are strong (particularly WA). Given the rise of interest rates it is unlikely that prices will rise in either city. But strong valuation support should mean that house prices should not decline substantially in either city.

House price valuation metrics

	BoQ Economics Expected peak-to-trough decline standalone houses	Decline from peak to June 2022	Repayment to income (relative to city average 1996-2022)	Average house price relative to Sydney (1970-2022, Darwin since 1999)	House rental yield spread (current house rental yield v average spread over long-term rates 1982-2002)
Sydney	-15	-1.5	+7	-	+11
Melbourne	-11	-1.0	+3	-1	+22
Brisbane	-8	-	+6	-15	+2
Perth	-3	-	-27	-35	-15
Adelaide	-6	-	+5	-15	+1
Hobart	-12	-0.3	+21	+7	+12
Canberra	-10	-1.0	+15	-4	+8
Darwin	-4	-	-32	-40	-27

We live in interesting times.

Regards

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