MARCH QUARTER 2022 HOUSING UPDATE

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Key points

- **House price growth moderated in the March quarter;**
- **The outperformance of houses v units and regions v cities largely continued;**
- **Housing is an imperfect hedge against inflation;**
- **Higher interest rates will see house price growth moderate further this year and next;**
- **I am expecting house prices across Australia to grow on average by 8% this year, and 1% in 2023.**

What happened to house prices in the March quarter

As would be expected (and hoped) house price growth slowed across the country in the March quarter. This was particularly the case in Sydney and Melbourne. Price growth remained strong in Brisbane and Adelaide. Perth was somewhere in between. That price growth was slowest in the two most expensive cities suggests that affordability was an important factor.

Affordability is the main reason why regions continued to outperform cities in most states in the March quarter (particularly in NSW). The exceptions were Brisbane (the South East of Queensland has benefitted most from higher inter-state migration over the past year) and Perth (cheapest of the major cities). Despite affordability concerns houses outperformed units in all major cities (apart from Melbourne). That trend likely reflects the ongoing strong demand for houses in suburbs and regions in the WFH era. But affordability worries means that a stronger run for unit prices relative to standalone housing is probable at some stage in most major cities.

House prices and inflation

Over recent months there has been rising concern about inflation. Strong demand (notably for goods) and problems with supply has resulted in higher prices. In Australia, the Q1 CPI numbers are likely to show that inflation will be over 4%. In the US, CPI inflation is currently running at 8%. In Germany, producer price inflation (the increase in prices paid by many companies) is running at over 30%!

Financial markets and most forecasters believe that we are currently close to the peak of inflation. Falling real wages growth (wage growth after inflation) means households are able to buy less goods. Factories are (slowly) working their way through the mountain of backlog of orders. The hit to commodity prices from the Russia-Ukraine conflict appears to have peaked (although they don't look like falling substantially at least in the near term).

Most likely inflation both domestically and globally will return to the 2-3% band that it has been within for much of the past twenty five years (as financial markets and economists are forecasting). But there must be some risk that inflation stays higher for longer than currently assumed.

It is often said that 'real' assets (assets used by households, firms and governments such as property and infrastructure) do better than financial assets (such as equities) during periods of rising inflation. This is particularly the case if inflation is taking place at the same time as strong economic growth (as it is currently). During these periods the unemployment rate is low, spending is strong and so there is plenty of demand in the economy for places to live and for use of infrastructure. Periods of strong economic growth and rising inflation are often associated with rising interest rates, a negative for financial assets.

Historically house prices do appear to move in line with inflation. Certainly housing appears to do better than equities during periods of high inflation (above 10%). But no-one is forecasting inflation to be sustainably in the double-digits in Australia. The outperformance of housing over equities is less obvious during periods when inflation was rising but still moderate (under 5%). And during those high inflation periods while housing did outperform equities it also underperformed inflation (ie, house prices rose by less than inflation). So historically housing has proved to be a better hedge against high inflation than financial assets but it is still not perfect.

House prices and interest rates

Over time, it is movements in interest rates (and more particularly interest rates after inflation, or 'real' interest rates) that is a key driver of house prices (other important factors include lending standards and population growth). Low real interest rates makes it more affordable to borrow. It is also an environment where investors' are more likely to invest in housing to achieve higher returns.

The ongoing decline of real interest rates over the past decade (as well as strong population growth) were important elements in the house price growth over that time. House price growth was extremely strong in 2021 (around 20%). The average over the past five years has been a more modest (but still decent) 6.7%.

It is very likely that the rise in interest rates that financial markets are projecting over the next 1-2 years will dramatically slow house price growth (and may well lead to a fall). Over the past forty years house prices declined on six out of eight rate hike cycles, for an average peak-to-trough decline of 10-15%. The RBA thinks that if interest rates rise by 2 percentage points this would reduce real house prices (house prices after allowing for inflation) by around 15% over a 2 year period. Financial markets are currently pricing that interest rates may rise by 3-3.5% in this cycle.

But even if financial markets are correct interest rates (particularly after inflation) will still be very low by historical standards. The bigger issue for the housing market would be if there was a substantial weakening of the economy (and therefore rising unemployment) as interest rates were rising. As far as I am aware very few people are forecasting a substantial rise in unemployment for the foreseeable future. But concerns about a global economic slowdown have risen in recent times (notably amongst global investors).

Small annual house price declines (flat to -5%) are not uncommon (they have occurred a bit over 10% of the time in both Sydney and Melbourne since 1900). Larger declines have rarely occurred in Melbourne (and in other cities such as Brisbane and Adelaide since 1970) although they have been more frequent in Sydney. One reason is that Sydney also has larger house price rises than other cities (so does Perth). That might reflect the more limited supply of land in Sydney that make it tougher for housing supply to quickly respond to an increase in demand (in Perth the big swing in property prices has largely reflected mining booms and busts).

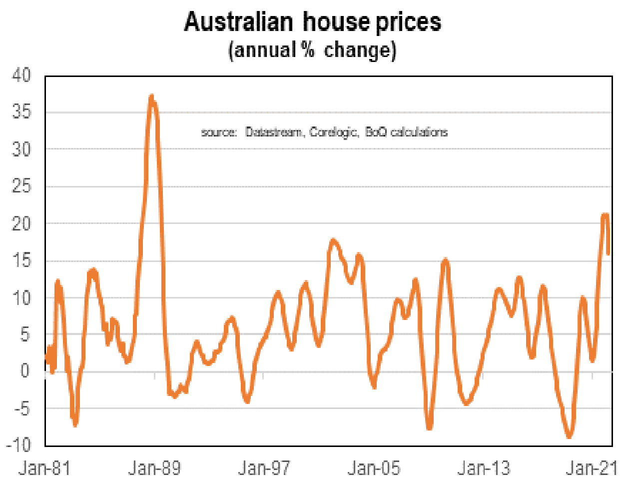
Outlook for house prices

The outlook is for further house price moderation over the remainder of this year. House prices are high relative to incomes. And interest rates will almost certainly rise in the second half of this year. One support for house prices this year is that labour and material shortages will reduce the supply of new housing hitting the market.

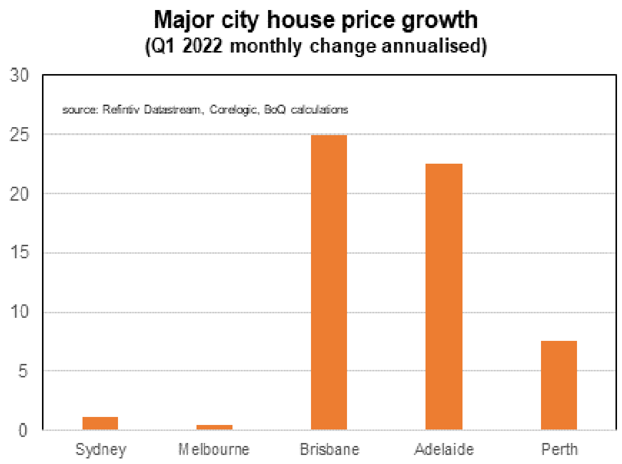
Low population growth will at some stage weigh upon housing demand. Treasury is forecasting that immigration numbers will rise strongly over the next 12-18 months. The opening of the borders has seen a pickup of immigration. In January and February long-term and permanent immigration looked to have returned to their monthly pre-pandemic level. It will be interesting to see whether that immigration level can be maintained given that many other countries are also facing a severe shortage of workers. But demand for housing is also driven by other immigration categories (such as students and tourism) that are currently well below pre-pandemic levels

I expect house price growth of 8% this year, followed by a 1% rise in 2023 and an 8% decline in 2024. These forecasts assume the economy still performs well and the cash rate ends this year at 1-1.25% and next year at 2%. If interest rates rises end up being more aggressive along the path that financial markets are currently projecting then house prices are likely to decline next year.

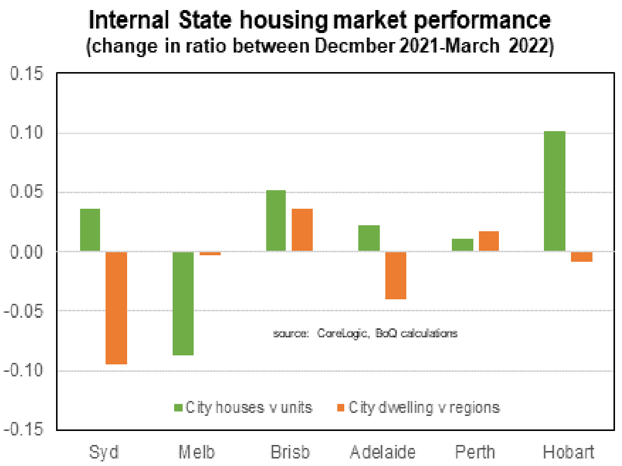
House price growth moderated in the March quarter.



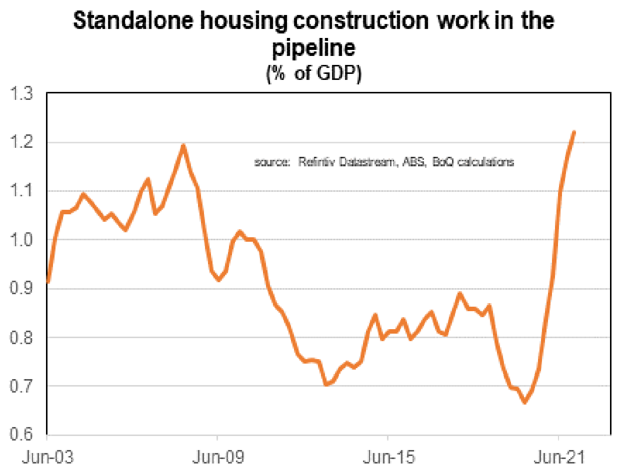
Slower house price growth was most notable in Sydney and Melbourne.



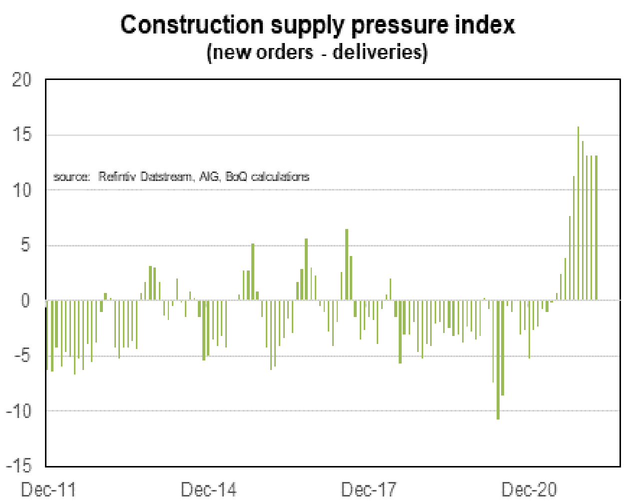
Mostly, house price growth continued to favour houses over units and regions over capital cities.



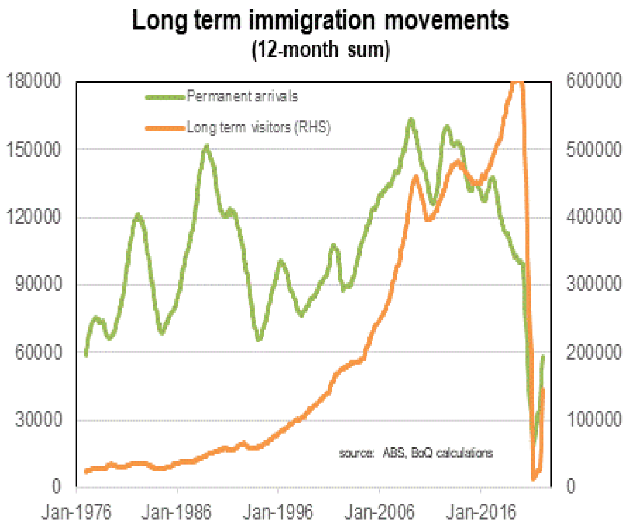
There is plenty of new homes to be built.



But worker and material shortages means it is taking longer to complete projects.



Longer-term immigration is starting to rise again.



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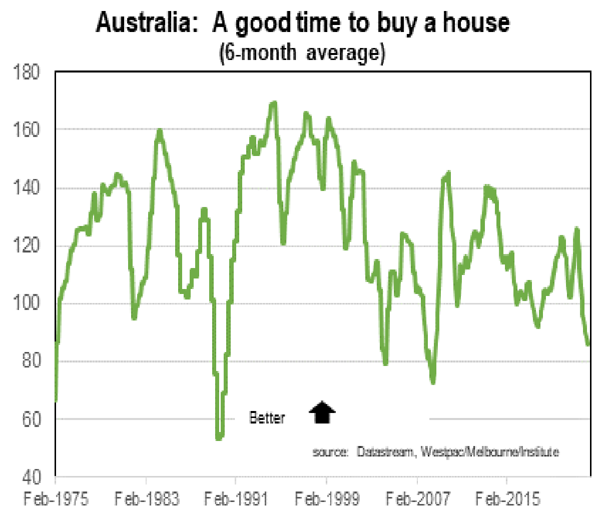
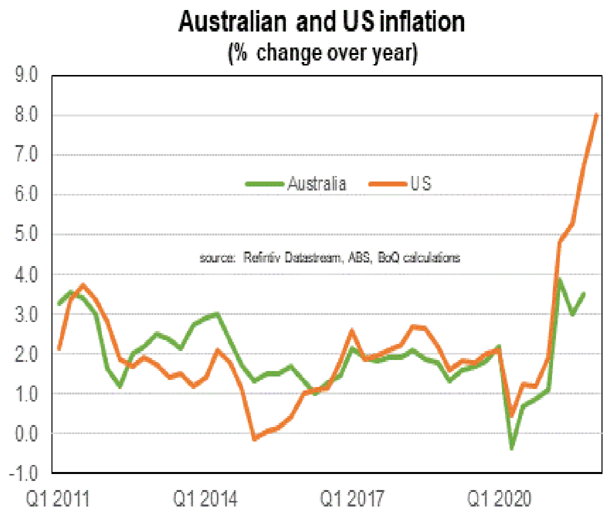
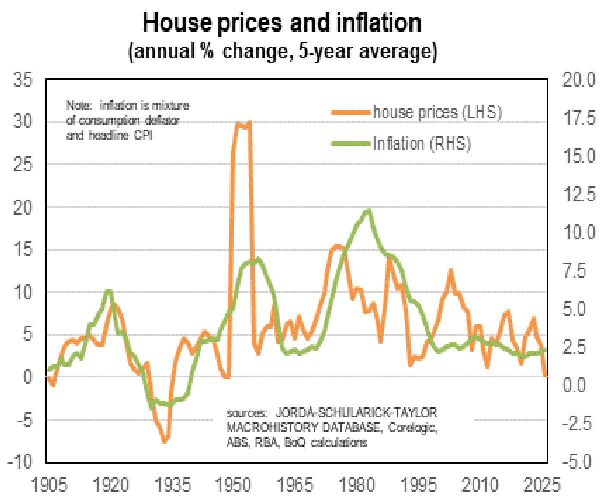
Sentiment towards housing is at its lowest level in around 15 years.



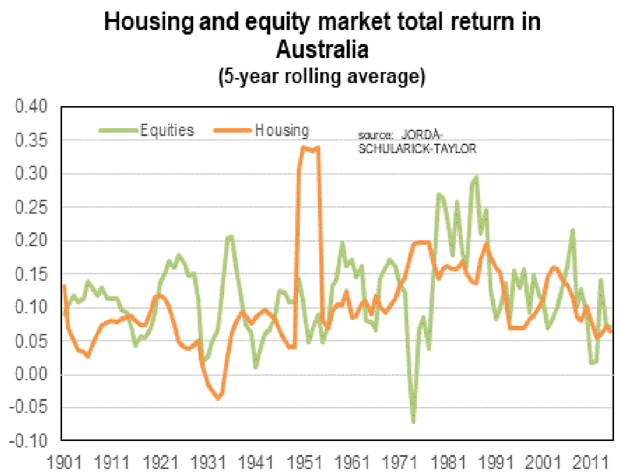
Inflation is currently a far bigger problem in the US than Australia.



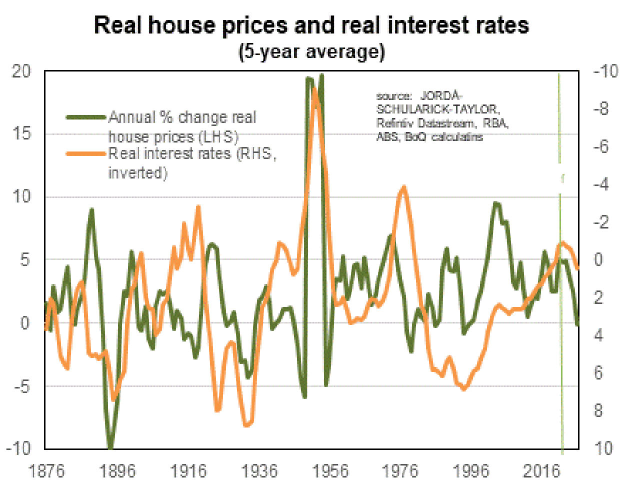
Historically house prices have followed inflation.



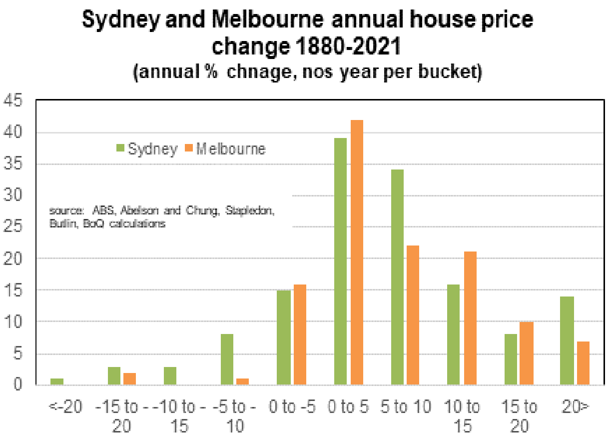
Housing has historically done better than equities during periods of high inflation.



Interest rates are an important driver of house prices.



Historically big swings in house prices have been more common in Sydney than Melbourne.



We live in interesting times.

Regards

Peter Munckton
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Bank of Queensland