Investment insight

What's the outlook for Australia's housing market?

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'Australian investors should carefully consider the extent to which residential housing dominates their wealth.'

Renewed interest in US housing

The slow economic recovery underway in the US has reignited interest in investment in residential property there. Over the 12 months to April 2013, the US housing market appreciated around 12% according to the S&P/Case Shiller 20-City Composite Home Price Index.

This, combined with the 15% rise in the US share market over the same period, has taken US net household wealth back to its pre-GFC highs.

If there are no further shocks, this boost to wealth bodes well for the continuing recovery of the US economy over the next two to three years. But continuing improvement in the US housing market will be important to maintain the recovery.

So with the US housing market looking more positive, what's the outlook for our housing market?

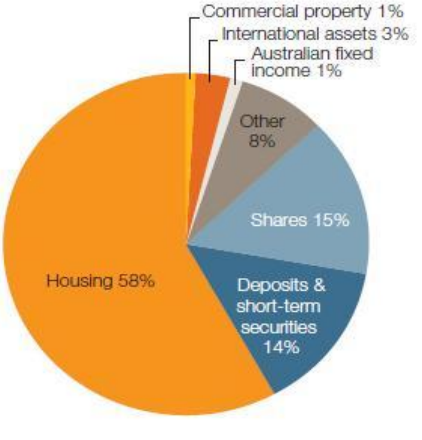
A resilient housing market helped Australia through the GFC

In contrast to the US, and despite showing some recent weakness, Australia came through the GFC relatively unscathed.

The remarkable performance of the local economy during the GFC is often attributed to the role of the mining sector in boosting national income, countering the effects of the global downturn.

However, perhaps more important was the resilience of the local housing market. Chart 1 shows that at September 2012, almost 60% of Australian household wealth was tied up in residential property. This was only slightly lower than two years previously.

Chart 1: Housing continues to dominate Australian household wealth



Source: Reserve Bank of Australia and Australian Bureau of Statistics.
Note: Australian household asset allocation at 30 September 2012.
Excludes non-housing non-financial assets.

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While US household wealth collapsed with the 30-35% decline in house prices following the GFC, the comparative price stability of the Australian housing market protected this large slice of household wealth.

As a result, Australian households have not been forced to undertake the destructive debt reduction seen in other countries.

What has supported house prices here?

Those who argue the Australian housing market is largely immune to global ructions often claim our market has a number of special features. These include:

- the preferential tax treatment for owner-occupied housing in Australia
- the availability of negative gearing and depreciation benefits for investment properties, and
- the apparent shortage of housing.

Certainly these factors help explain why prices for Australian residential property have remained high over the past decade or more.

But house prices don't always increase

We need to be careful not to extend this logic to assume that Australian house prices should always increase in value.

From 2007, the housing markets of the US, Ireland and Spain were battered by a perfect storm of excessive overvaluation funded by an over-leveraged household sector against a backdrop of economic recession. We should be quite concerned that Australia also seems to be afflicted with two of these: overvaluation of house prices and excessive household leverage.

Is Australian housing really so expensive?

On many metrics, Australian house prices seem extremely expensive, by both historical and international standards.

The Economist magazine monitors the cost of buying a house compared with renting as one way of assessing the degree of housing market overvaluation.[1] On this measure, Australia is in the top tier of countries (along with Hong Kong, New Zealand, Singapore and Canada) where the appreciation of house prices has outstripped the growth in rents by an average of at least 50% in the past 10-15 years.

The US experienced a similar over-run of house prices compared with rents up to 2007. There, however, the house price to rent ratio has reverted to the longer term average as house prices fell sharply after 2007. This means that the rental yields available on US investment properties are now dramatically higher than in the Australian housing market.

The Economist also monitors the ratio of house prices to household incomes, a measure of housing affordability.[2] It shows that Australia sits in the top tier of countries in terms of poor affordability. On this measure, Australian house prices are, on average, around 25% overvalued compared with household incomes.

In the US, the ratio of house prices to household incomes was similarly elevated in 2007. This ratio has more than fully corrected, suggesting that US house prices are now on average 20% undervalued relative to US incomes.

1 "Location, location location: interactive guide to the world's housing markets", www.economist.com/blogs/dailychart/2011/11/global-house-prices
2 As above.

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What about our debt levels?

The level of debt in Australia is also of concern. The ratio of household debt to household incomes remains stubbornly high, both by historical standards and compared to other countries. It is currently above the ratio for the US household sector before the GFC (see chart 2).

Does this imply disaster for our housing market?

Expensive housing and a heavily indebted household sector certainly make the housing market vulnerable to shocks. However, these factors alone won't necessarily create a housing bust.

As the experiences of the US, Ireland and Spain showed, the third element generally needed to produce a major housing market correction is an economic recession.

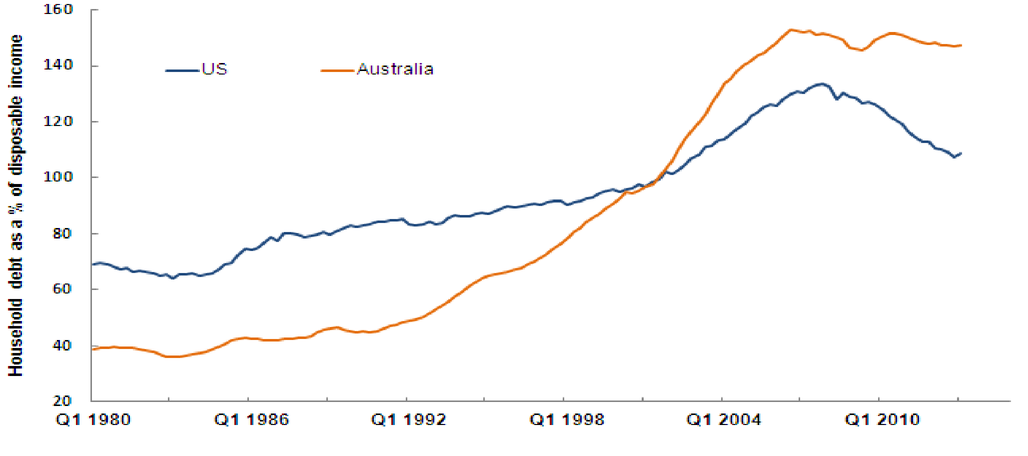
This is why the current slowing of the mining sector and the potential negative income shock it may bring could be a risk for housing markets in many parts of regional Australia. The aggressive cuts to interest rates by the Reserve Bank of Australia (RBA) in the last two years indicate its concern that this shock could flow into urban areas through a broader income impact.

However, with the backdrop of poor affordability and high household debt in Australia, it is hard to see broad-based and dramatic rises in house prices occurring without a coincident acceleration in employment and wages growth.

There are some segments of the housing market, for instance the lower to middle price bracket in Sydney, where prices have seemingly jumped in recent months. Historically low interest rates have undoubtedly assisted this move.

The real concern here is what happens to this segment of the housing market and the many highly indebted buyers when, at some future time, interest rates start to normalise. The RBA may not ultimately be doing any favours to the more marginal house buyers if they aren't able to manage future rises in interest rates.

Chart 2: Australian household debt remains high, while US households have paid down debt



Source: Datastream, Reserve Bank of Australia

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The outlook for the market

Balancing these factors, the outlook for the Australian housing market as a whole for the next few years could be, on average, one of extended price stagnation, with prices barely keeping pace with inflation.

The upturn in house prices seen across the nation over recent months (see chart 3) remains quite muted compared with previous cycles, reflecting an environment in which many households are increasingly concerned about uncertainty and reducing debt. This more cautious environment could last a few years.

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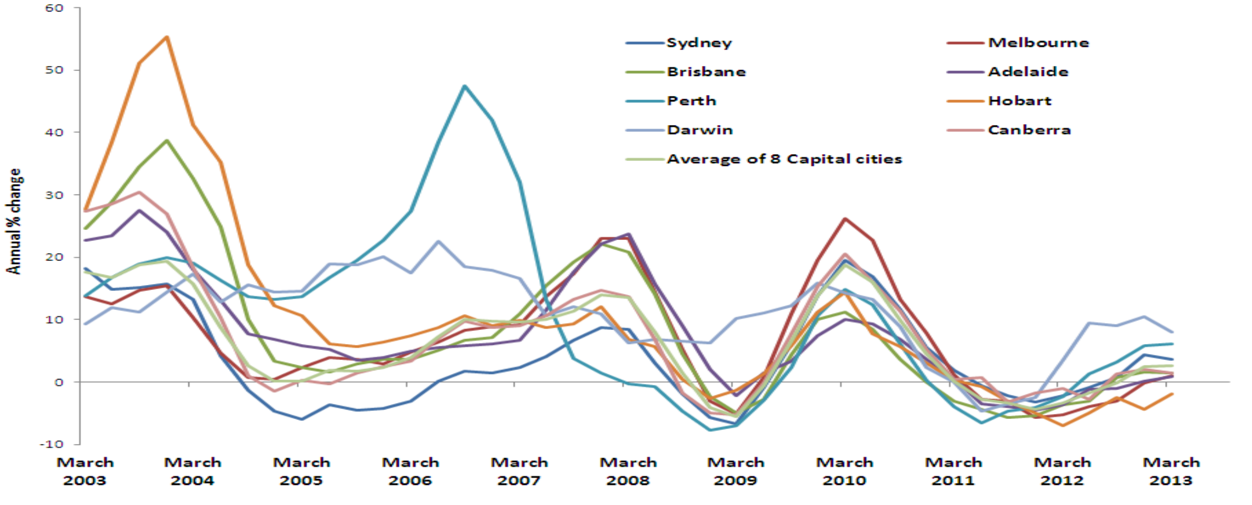
What implications are there for investors?

In such an uncertain economic environment, many Australians should carefully consider the extent to which housing dominates their wealth. The current low interest rates make investing in residential property seem appealing, but people in or approaching retirement need stable income flows from their investments. Australian residential property isn't likely to produce the same returns in future as it has in the last few years and is certainly not likely to produce particularly attractive rental yields. As a result, it may be worthwhile considering a more diversified wealth strategy.

Chart 3 - Australian house prices are levelling off



Source: Australian Bureau of Statistics