AMP CAPITAL

Australian house prices getting closer to the bottom, but don't expect a return to boom time conditions

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Key points

> The combination of the removal of the threat to property tax concessions, earlier interest rate cuts, financial help for first home buyers and APRA relaxing its 7% interest rate test points to house prices bottoming earlier and higher than we have been expecting.

> As a result, we now expect capital city average house prices to have a top to bottom fall of 12% (of which they have already done 10%) rather than 15% and to bottom later this year.

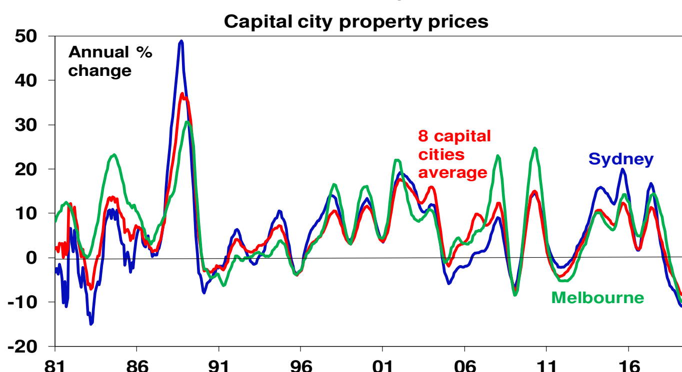
> However, given still high house prices and poor affordability, still very high debt levels, tighter lending standards and rising unemployment a quick return to boom time conditions is most unlikely.

Introduction

The negatives weighing on Australian residential property prices remain significant but the past few weeks have seen a number of developments that suggest that prices could bottom earlier and higher than we have been expecting. The election outcome removed a key threat, but several other factors also help. This note looks at the key issues.

The biggest home price fall in the last 40 years

According to CoreLogic data, capital city dwelling prices are down 9.7% from their September 2017 high, which is their worst decline in the last 40 years. Of course, there is a huge range here with prices down from their top by 15% in Sydney, 11% in Melbourne, 28% in Darwin, 18% in Perth, 2% in Brisbane, less than 1% in Adelaide and at record highs in Canberra & Hobart.



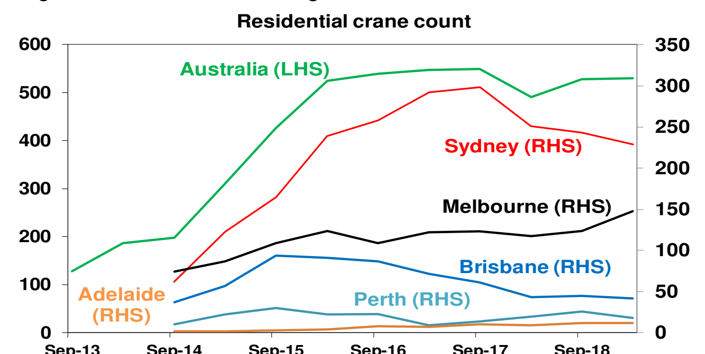
Source: CoreLogic, AMP Capital

Drags on house prices remain significant…

The decline in prices reflects a range of factors, most notably:

- A "correction" to the huge surge in prices into 2017 in Sydney and Melbourne that left prices very overvalued relative to income, rents and their long-term trend and affordability very poor and household debt very high.
- The end of the mining investment boom impacting prices in Perth and Darwin since their peak in 2014.
- A tightening in lending standards that initially cracked down on lending to investors but since 2017 moved on to interest only loans and then a more fundamental focus around credit quality which made it harder to get loans.
- A surge in the supply of units to record levels which has led to rising rental vacancy rates in Sydney.
- An 80% collapse in foreign demand.
- A big pool of interest only borrowers switching to principal and interest loans driving higher debt servicing costs.
- Price falls feeding on themselves – just as the boom in prices was accentuated by a fear of missing out (FOMO), falling prices are driving falling price expectations & leading to reduced demand and FONGO (fear of not getting out).
- Investors started to factor in some probability that Labor would win the election which would have meant that negative gearing would be restricted and the capital gains tax discount halved – with estimates that this could have knocked another 5-10% from property prices.

The negatives weighing on the housing market remain significant. In particular, credit conditions are still tight with housing finance still falling with a brief bounce in February giving rise to further falls in March and the start-up of Comprehensive Credit Reporting which will see banks crack down on borrowers with multiple undeclared loans. And the pipeline of units to hit the Sydney and Melbourne markets is still huge as reflected in a still high crane count.



Source: Rider, Levett, Bucknall Crane Index, AMP Capital

Meanwhile, auction clearance rates in Sydney and Melbourne have risen from their December lows but this looks largely seasonal with clearances still weak at pre-boom levels just above 50% as are sales volumes. What's more the number of capital cities seeing monthly price falls has gone from three out

of eight a year ago to now seven out of eight. Given all these considerations we have been reluctant to read too much into the slowing in downwards momentum in monthly property price falls in recent months, particularly given that Perth and Darwin have seen several phases where price declines slowed then sped up again during their five-year slump.

And Australian housing still remains expensive. Real house prices have fallen from 27% above their long-term trend to 7% above now, but housing is still expensive compared to incomes and rents. Sydney home prices may have fallen 15% from their 2017 high but this was after a 75% gain since 2012 when wages rose just 14%. And household debt remains very high.

…but some positives are starting to creep in

However, while the drags remain significant several positives have become apparent over the last few weeks.

First, financial support for first home buyers is now on the way with the Government's First Home Loan Deposit (underwriting) Scheme. On its own it's not a game changer particularly given that it's capped in terms of numbers, the borrowers will be taking on big mortgages, which will come with a higher risk of negative equity, borrowers will still have to meet the tougher credit standards of recent times and it won't kick in until next year. That said, with the Federal budget looking even healthier and probably already in surplus thanks to the surging iron ore price, I suspect that the deposit scheme will morph into a far more attractive home buyer grant at some point.

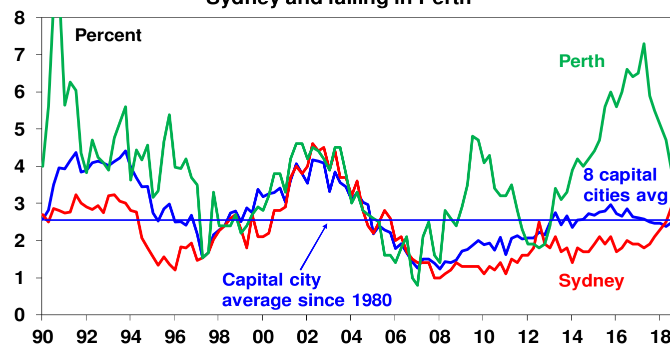
Second, APRA is looking to relax the 7% mortgage rate serviceability buffer. This was inevitable given APRA's move to focus on more fundamental credit standards and 7% is way out of whack with current interest rates. Again, on its own it's not a game changer - it wasn't the main driver of the property downturn and borrowers still have to meet tougher credit standards. And don't forget that relaxation of the 10% cap on growth in investor loans and the 30% limit on interest only loans last year had little impact. But it may help at the margin.

Third, RBA Governor Lowe has all but confirmed that rate cuts are on the way with his comment that "at our meeting in two weeks' time, we will consider the case for lower interest rates" after observing that it needs lower unemployment to get inflation back to target. We expect 0.25% rate cuts in June and August and that the bulk of these will be passed on to borrowers given the recent reduction in bank funding costs. This would be a bit earlier than the August and November rate cuts we were assuming back in January when we last reviewed our house price forecasts. House prices bottomed around three months after the first cuts in 2008 and 2011. It may take longer this time as debt is now much higher, rates are already very low and lending standards are tougher. But they will still help.

Finally, the threat of changes to negative gearing and CGT is gone with Labor's defeat. So a big negative for property is gone. Given the difficulty in predicting the election our house price forecasts had allowed for a 50% probability (ie 50/50 Labor would win) of an 8% additional drag on prices in Sydney and Melbourne from this, ie 4%. In other cities it was a bit less. Now it's zero and we need to remove this from our forecasts.

It's also worth noting that we have not seen much evidence of panic selling or forced selling by the banks despite rising (but still low) levels of negative equity. Mortgage delinquency rates remain relatively low – even in Perth where prices have fallen 18% and unemployment has spiked.

Meanwhile, strong population growth of around 1.6% pa is still driving strong underlying demand for housing at a time when supply is likely to start slowing again next year (given falling building approvals). And vacancy rates while very high in Darwin and above trend and rising in Sydney are actually benign to low in most capital cities and have collapsed in Perth.



Source: REIA, AMP Capital

So taking all these things together – some of which are minor but are still positive – it's likely that we are going to see house prices bottom out a bit earlier and higher than we had expected.

What about the risk of higher unemployment?

The main risk is that Australia slides into a downwards spiral as the housing downturn - maybe in concert with a global slump - triggers a surge in unemployment which triggers rising defaults and a further plunge in house prices ultimately causing 30% plus falls in national property prices. This is still a risk, but we remain of the view that it will be avoided.

The housing cycle downturn will lead to the loss of around 60,000 jobs on our estimates. But there are a number of other things that will keep growth going – albeit at a slower pace than the RBA and Government are assuming – but which should be enough to stop unemployment surging beyond 6% and feeding back to become a bigger threat to house prices. Infrastructure spending is strong, resources investment is close to the bottom, non-mining investment is looking healthier, tax cuts for low and middle income earners next quarter (whether paid upfront or backdated a few weeks later when passed by Parliament) will provide some help, fiscal stimulus is likely to be increased helped by the windfall from the surging iron ore price and rate cuts will provide some help fo households with a mortgage.

Yes, the trade war could spiral out of control – but this probably means more stimulus from China which provides an offset for global growth and explains why the iron ore price keeps rising.

The other big risk is that investors decide to exit in the face of low net rental yields & diminished capital growth expectations.

Revised house price forecasts

Our forecasts for national average prices have been for a price fall of 15% top to bottom (of which we have done 10% so far) and for Sydney and Melbourne it's been for a price fall of 25% top to bottom (of which Sydney has already done 15% and Melbourne 11%) and for prices to bottom in 2020. Reflecting the considerations discussed above – notably the removal of the threat of changes to negative gearing and capital gains tax, imminent rate cuts, assistance for first home buyers and APRA's relaxation of the 7% serviceability test - we are revising the estimate for Sydney home prices to a 19% top to bottom fall, Melbourne to 15% top to bottom (partly because it has been holding up much better likely reflecting stronger population growth) and the national average to 12% top to bottom with prices likely to bottom by year end.

However, given still poor affordability, still very high debt debt levels, tighter lending standards and rising unemployment a quick return to boom time conditions is most unlikely. More likely is a lengthy period of constrained range bound house prices after they bottom later this year (although I thought the same around 2011-12 – but things are different now!)

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