House prices: just the facts

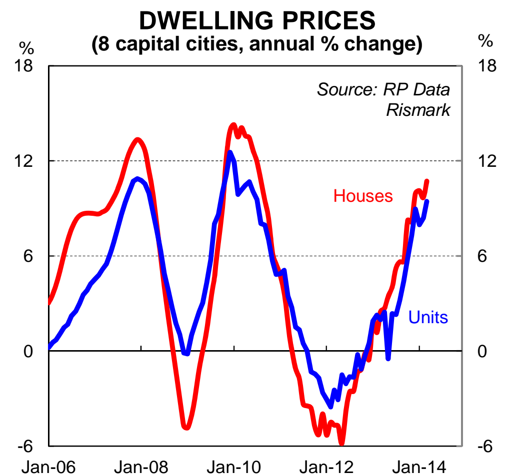
- Even the proverbial pet shop galah is talking about house prices.
- This piece outlines the facts behind house prices.

What are the latest house price trends?

Dwelling price growth has stepped up significantly over the past year:

- *House* prices rose by 10.7% over the year to March.
- *Unit* prices rose by 9.6% over the same period.

Both measures are running at the upper end of the range of the past decade.

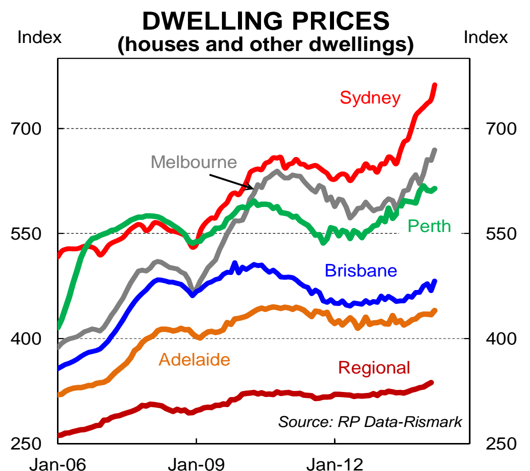


Are price trends uniform across the country?

Dwelling prices are rising everywhere but growth rates vary significantly.

Table 1: Dwelling Prices (%pa as at March 2014)

Sydney	15.6
Melbourne	11.6
Brisbane	4.8
Adelaide	4.6
Perth	4.7
Hobart	0.9
Canberra	1.7
Darwin	3.8
Regional	4.5

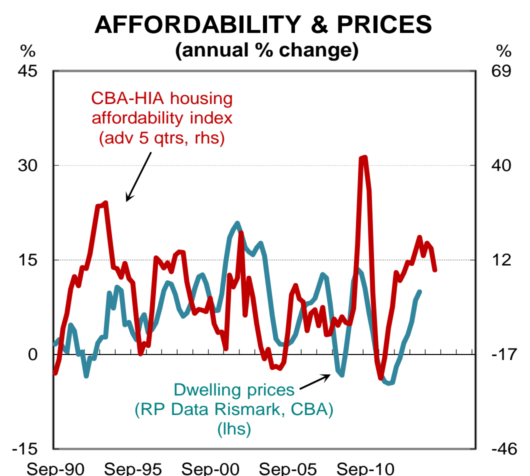


Why are prices rising?

Like any market, price reflects the interaction of supply and demand.

But the housing market is also different. Enter a supermarket and everything on the shelf is for sale. In housing, however, the "liquid" part of the market is quite small. About 4-6% of the dwelling stock is turned over each year and new construction adds 1½-2½% to the stock. The rest is locked up. The limited amount of stock in play magnifies the price effect of changes in the supply-demand fundamentals.

Housing is a big ticket item. So affordability also matters in price outcomes. Exceptionally low mortgage rates have boosted housing affordability and are helping to turn underlying demand for housing into real demand.



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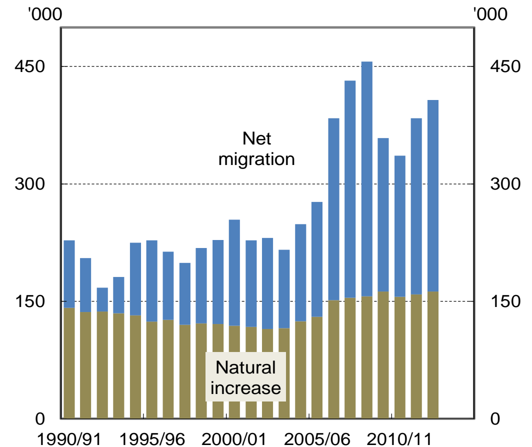
What is driving demand?

The *demand* fundamentals are strong courtesy of rapid population growth. A lift in the birth rate and net migration inflow means that population growth is at the high end of the range of the past forty years. The skew in the intake towards skilled migrants is accentuating the impact on the housing market. Skilled migrants are typically cashed up when they arrive and quickly add to housing demand.

There are also temporary skilled migrants (457 visas). And a strong education-related inflow as well. These groups are not necessarily permanent settlers. But they do need to live somewhere while they are here.

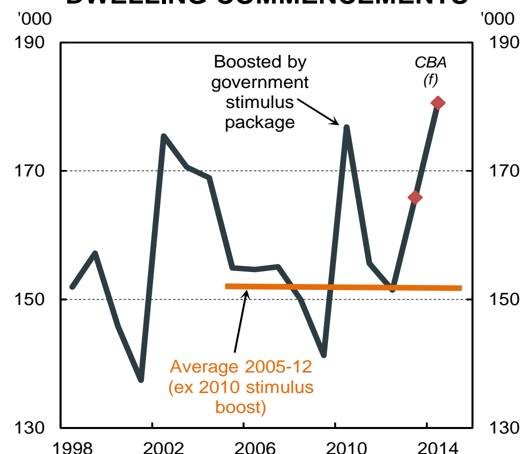


What is driving supply?

New dwelling supply has run at a little over 150,000 dwellings per annum in recent years. Competition for skilled labour and materials with the mining and infrastructure booms has limited *supply*.

With "demand" running ahead of "supply", there is an excess demand for dwellings. This excess demand has been in place for a number of years. So a pent-up or accumulated demand exists as well.

Dwelling prices are responding to this demand-supply imbalance.

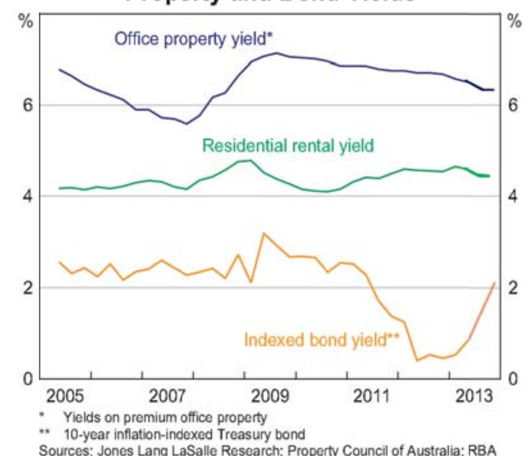


Are investors distorting the market?

The investor segment is accounting for an unusually large part of housing activity at present.

This investor interest is a rational response to the environment created by central banks. Central banks responded to the financial crisis by boosting liquidity and pushing interest rates to "emergency" levels. This approach encouraged a search for yield, lifted risk appetite and boosted asset prices.

The rising exposure of self-managed super funds (SMSF) to property is another outcome. This exposure is small in dollar terms but the RBA notes that SMSF's represent a "potentially speculative demand for property that did not exist in the past".



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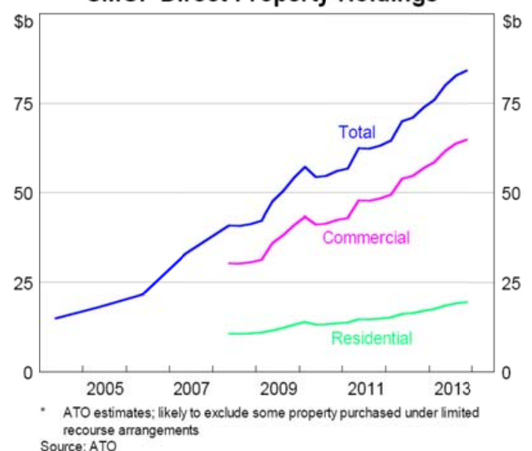
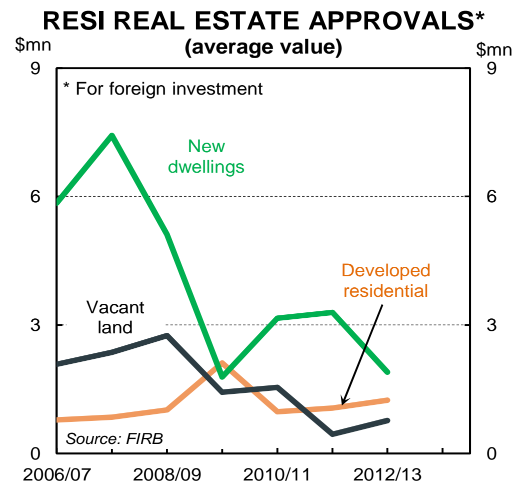


Are foreign investors distorting the market?

Only limited and dated information is available on foreign investor activity. This data comes via the approval process for such investment run by the Foreign Investment Review Board (FIRB). The data shows foreign investor activity in 2012/13 was equivalent to 0.1% of the dwelling stock or 2.8% of transfers (ie sales). Foreign investor activity is also skewed by the legislation towards new construction. So *demand* is bringing forth some additional *supply* and more residential construction is a policy objective.

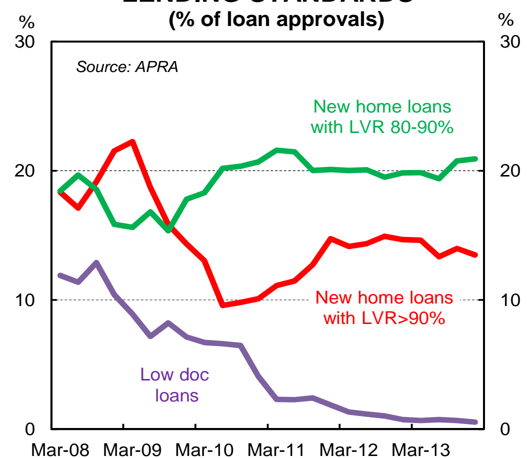
The FIRB data implies that the average value of a foreign approval is $1.5m. So most of the activity is at the top end of the market and is unlikely to be unduly influencing affordability.



Are lenders distorting the market?

The regulators regularly warn lenders and borrowers of the need for caution. The recent RBA *Financial Stability Review*, for example, argues that "it will be important for financial stability that banks do not respond by unduly increasing their risk appetite or relaxing their lending standards".

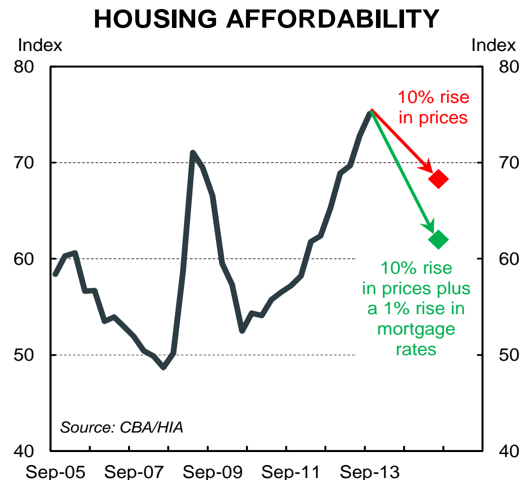
But there few signs of a significant easing in lending standards. Low doc loans account for a negligible share of new housing lending. And the share of lending accounted for by loans with a high loan-to-valuation ratio (LVR) has not shifted appreciably.



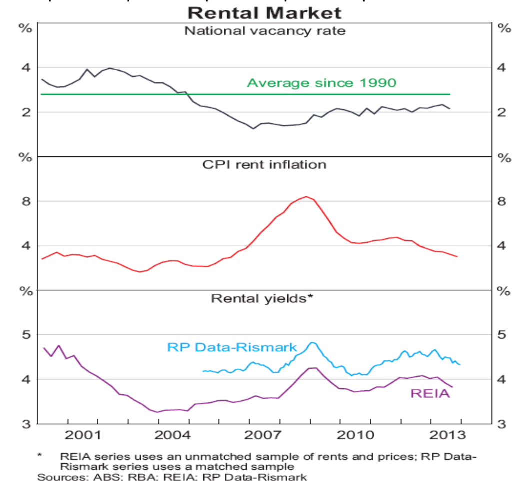
Will dwelling prices keep rising?

There is some undoubted momentum behind house prices at present. But there are also some natural corrective mechanisms at work:

- Rising prices are now denting housing affordability. There have been no offsetting rate cuts since August 2013 and the debate is turning towards the possibility of *rising* interest rates. Deteriorating affordability will dampen interest from potential owner-occupiers.



- Rising prices are reducing rental yields. Some renters have transitioned to owner-occupiers. More supply will come on-stream as residential construction lifts. Vacancy rates are rising and rental growth is slowing. Lower rates of return will dampen interest from potential investors.

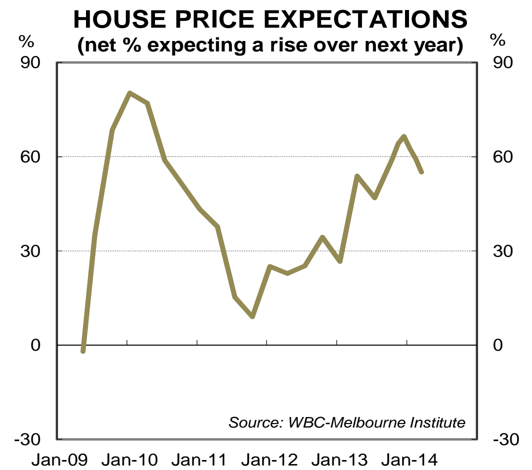


Is it a bubble?

Some perspective on recent price trends is needed. Higher prices today follow a period of falling prices. Dwelling prices are up by 16% from the mid 2012 trough but are only 7% above the previous (late 2010) peak.

For a true bubble, rising prices need to be backed up by: an acceleration in housing credit growth over a relatively short period; an easing in lending standards; and an expectation that dwelling prices keep rising.

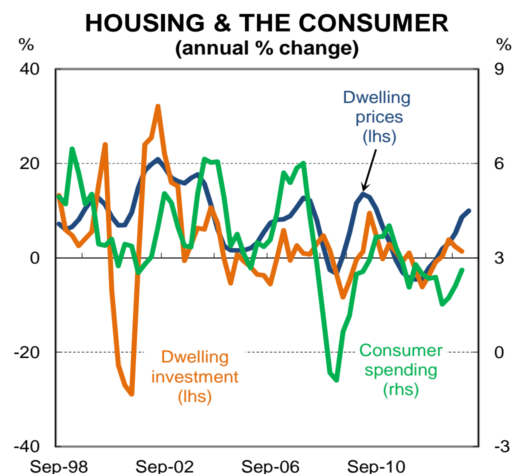
Housing credit growth has picked up but remains at the low end of the range of the past three decades. As noted, there are few signs of a significant easing in lending standards. House price expectations have lifted however. The limited data available makes assessing these expectations difficult. But it is a trend to monitor.



Is the RBA surprised?

The RBA is not surprised by rising house prices. You do not embark on a mission to stimulate housing activity without expecting some sort of price impact! Rising dwelling prices are indeed part of the transmission mechanism.

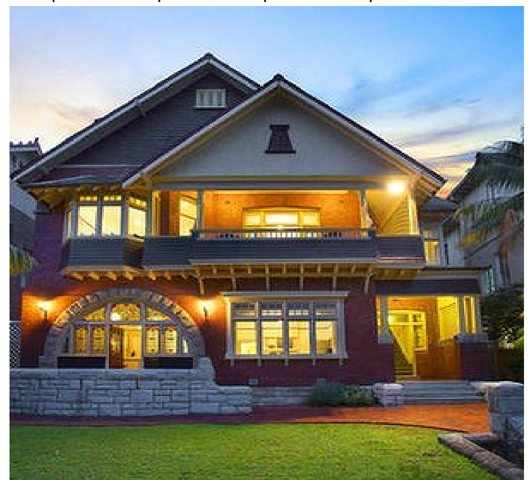
Rising prices boost household wealth and generally lift sentiment. Consumer spending benefits. Rising prices make new construction more attractive (one reason why rates were cut in the first place) and they encourage renovations activity as well.



Is the RBA worried?

The RBA may not be surprised that prices are rising but it does look like we are approaching a comfort threshold. Recent speeches by RBA Governor Stevens, the Governor's recent Parliamentary appearances, comments by Deputy Governor Lowe and the RBA's *Financial Stability Review* all warn borrowers that house prices can go *down* as well as up (perhaps this is why the RBA is selling some property in Kirribilli!). Governor Stevens described 10%pa house price growth on an ongoing basis as "unwelcome".

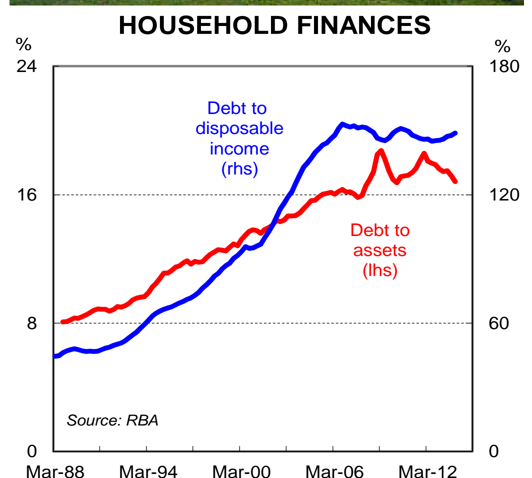
If nothing else, house prices have reached the point where further interest rate cuts are unnecessary and unlikely. Double digit price growth adds, at the margin, to the arguments for the next rate move being up.



What would satisfy the RBA?

The RBA has a long-running concern about household leverage. They have made it clear that they do not want to see current policy settings drive a shift in household behaviour that results in a return to rising leverage. Weak income growth means household debt:income ratios are rising again after a period of relative stability. The less remarked flipside is that debt:asset ratios are *falling*.

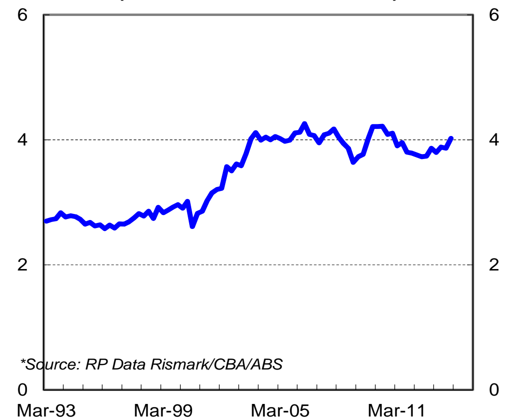
We suspect that the RBA would be happy if house prices grew at around the same rate as income over time (say 5-6%pa). In that scenario price:income ratios remain unchanged. And debt:income ratios would track sideways as a result.



Do valuations matter?

House price:income ratios are also rising again. And fears about overvalued housing are rising in tandem. Our consistent view has been that a significant part of the rise in price:income ratios reflects a shift in household preference for and ability to access credit. And a shift in the type of housing we want to inhabit.

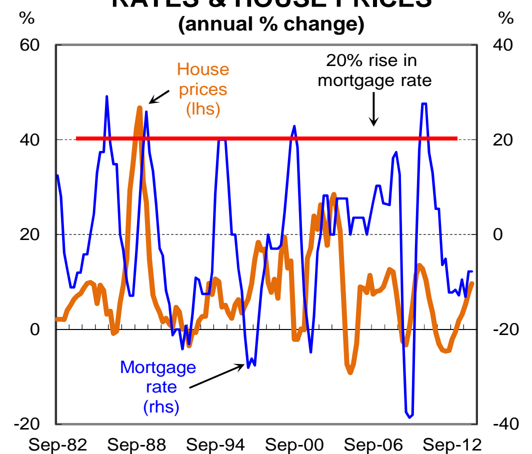
Sustained low inflation allowed lower interest rates. More households can access credit markets as a result. Housing demand lifted relative to a supply that doesn't change very quickly. A lift in house prices relative to incomes was inescapable. The shift in housing preference reflects the desire to build bigger and more elaborate dwellings. The "house" part of valuation calculations is higher as a result.



What would it take to kill the boom?

A "black box" rule we have followed over the years is based on the connection between mortgage rates and house prices. This "rule" is that a 20% rise in the mortgage rate is typically sufficient to choke off whatever house price boom is underway at the time.

A 20% rise would take the mortgage rate to around 7%pa. To get there would require them RBA to lift the cash rate by 100bpts to 3½%.



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