Australian Property market – Bubble or Bubble like?

Realm Investment House

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A debate has been running, for at least a decade about whether Australia's house prices are too high, and indeed whether there is a house price 'bubble'? Housing is the key piece of collateral that underpins the Residential Mortgage Backed Securities (RMBS) market, the banking sector and household wealth in Australia. Globally house price corrections have occurred, in line with economic weakness and more specifically employment. The magnitude and length of this adjustment is directly linked to differing loan market infrastructure, local legal environments and mobility of borrowers to name a few. Australia's loan market has demonstrated characteristics, which can be considered superior to their peers; this has allowed this sector to weather one of the most testing financial crises of our era. However, the question everyone is still trying to answer is what will cause a sharp and/or large house price decline in Australian house prices?

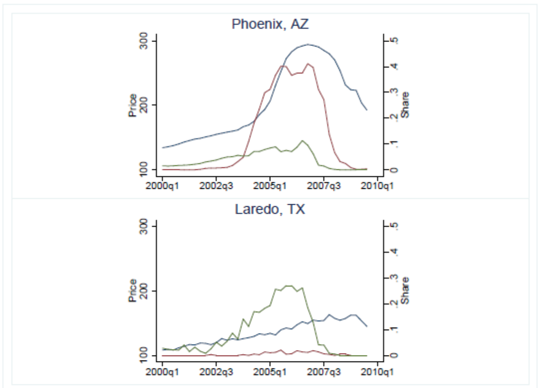
What is a bubble?

What is a bubble and what causes it to burst? A common misconception is that cheap credit is the single reason for housing bubbles; in fact the price response in this environment is a normal equilibrium response, assuming borrowers can access the cheap credit. What makes this adjustment process transform into a bubble is the simultaneous increase in the supply of housing, which in most definitions is the "over-inflated" argument. Demand in this setting is transformed into speculation i.e. exaggerated expectations of future price appreciation.

In analysing periods of speculation vs. equilibrium adjustment many fall into a trap looking at the amount of subprime, securitisation and leverage in the housing market as a predictor. Even though relevant, these factors are not definite. Analysis of the amount and growth of Interest Only ("IO") loans being written, not because of high house prices to address affordability or servicing, but that IOs anticipate future price appreciation.

IO loans are attractive to borrowers who want to back-load principal payments, given their intention not to hold the asset for a long period of time. Following periods of high IO origination, IOs pre-paid and foreclosed at higher rates than mortgages without back-loaded payments.

Figure 1: House Prices and Mortgage Use in Two Cities

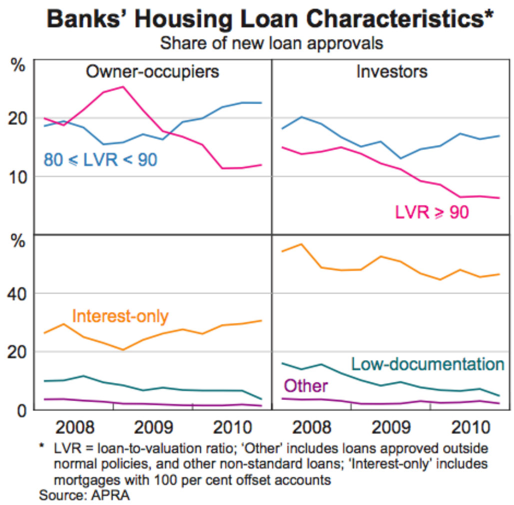


Note: Blue lines – Real Price, Red lines – IO Share, Green lines – Sub-prime Share.

Source: Barlevy, G and Fisher, J (2010), Mortgage Choices and Housing Speculation, Federal Reserve Bank of Chicago

In Australia, when comparing the same period as Figure One, there was only a small increase in IO loans, to around 60 per cent of new investor housing loans and a little over 15 per cent of new owner-occupier loans were IO loans. As compared to the 2003 in Australia, they were approximately 50 per cent of new investor housing loans and a little over 10 per cent owner-occupier IO loans. In 2005, interest-only loans accounted for around 30 per cent of all new housing loans.

When analysing the post 2006 IO stats, the increase in the first part of the decade do not appear to be representative of rampant speculation, with IO loan approvals trending in a range.



In trying to understand why a breakout in IO lending did not occur in Australia, can be simply explained by the fact that the majority of lenders assess debt serviceability on the basis of principal and interest payments, not just interest payments. In addition to this, the ability to fund large pools of IO loans, via securitisation is extremely difficult in large volumes, given the limited self-amortisation and refinancing limitations the Australian capital markets place of this type of financing. In effect these are a kin to underwriting buffers.

What causes a bubble to burst?

When speculation, risk-taking and exuberance become pervasive throughout the housing market, the bubble that has certainly been created, will burst. This will happen while the supply of housing stocks is still increasing i.e. demand decreases while supply increases, resulting in a fall in prices. The falling prices will lead to losses suffered by homeowners, mortgage lenders, mortgage investors and property investors. Those losses could be triggered by a number of things, including, an increase in interest rates reducing serviceability and puts homeownership out of reach for some buyers. This could make the home a person currently owns unaffordable, leading to default and foreclosure, which eventually adds to supply.

Coupled with increased interest rates, is generally a downturn in general economic activity. Less disposable income and job loss are generally the result, which decreases the demand for housing.

Demand slows or is exhausted, bringing supply and demand into equilibrium. When rapid price appreciation stagnates, property owners who rely on it to afford their homes long term might lose their homes, bringing more supply to the market.

In summary, when losses mount, credit standards begin to be tightened and easy credit is no longer available. This leads to decreased demand, supply increases, speculators leave the market and prices fall.

The process above, assumes that all homeowners are leveraged and will be motivated sellers. In fact the evidence around home ownership in Australia is quite to the contrary.

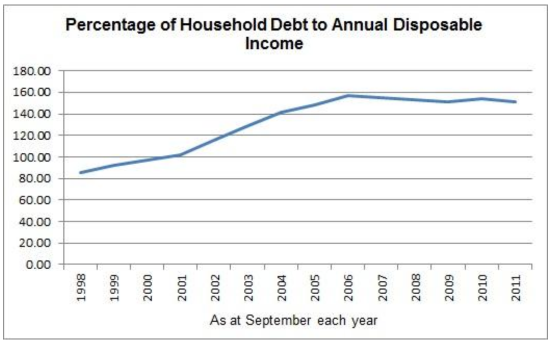
Australian borrowers in aggregate have positive housing equity, and will sell only if they need to move. A substantial portion of home ownership is not incumbent with debt. A substantial amount of borrowers have choice, i.e. the likelihood of sellers lowering prices substantially and/or sharply to encourage potential buyers

The ABS Survey in 2011 states that, of the households with some home loan debt (2.8 ml), the average loan amount was $206k. The next largest household debt category, loans used for property other than the family home (investment debt), was 12% of all households. For this type of liability, the average amount owing was $312k.

The same ABS survey stated, that one third of Australian households owned their home and are debt free (without a mortgage). The survey also states that 36% of Australian households owned their home with a mortgage. The average value of these households is $531k[1]. (In capital cities this average is higher, over 600k.)

The survey suggests that net equity on average is 61% for owner occupied homes. Even though household debt is high in Australia, it has the capacity to be even higher based on these facts.

Australian households were indebted at around 150% of their disposable income. This trend has be slowing and in fact falling since about 2006.



Source: RBA

In addition to this deleveraging taking place in the household sector, is consideration that the 36% that have a mortgage on their own home, the buffer or the "V" in LVR, is significant and provides for a great degree of headroom in an environment where prices could come under pressure in an economic downturn.

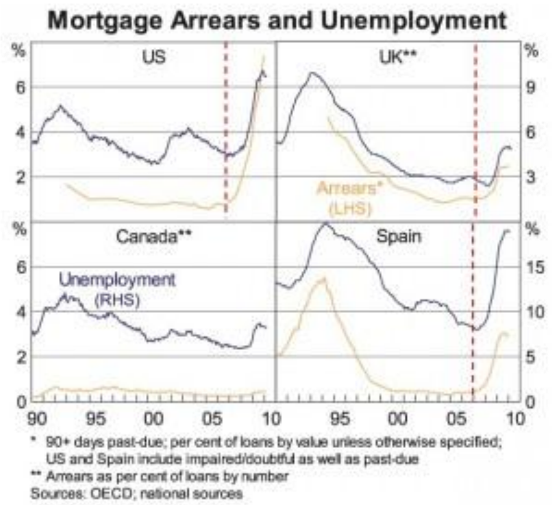
For investment properties or a second property like a holiday home, the conservative assumption for this analysis is that all properties in this bucket are debt incumbent as the survey does not break this out. The average value of investment property is around 660k with debt of 312k, representing a net equity position of 52%. This also has capacity, but more importantly headroom.

Has Australia Property got a floor?

When property prices become distressed it will still require the borrower to default, sell the asset and not repay the loan fully. In Australia, our resource laws and cultural environment will create a question of equity and serviceability. If a home owner is not in default, but negative equity exists in the home, a default decision will involve weighing up the payments on the mortgage against the income that accrues from retaining ownership of the house and the legal ramifications of the decision to default.

What will drive this default decision? When does the equity draw down impact the 20% investment debt and the 30% with homeowner debt?

This definitely will be driven by employment and the ability to carry and service debt. Globally it is well observed that this relationship has had a direct impact on arrears, defaults and ultimately loan losses.

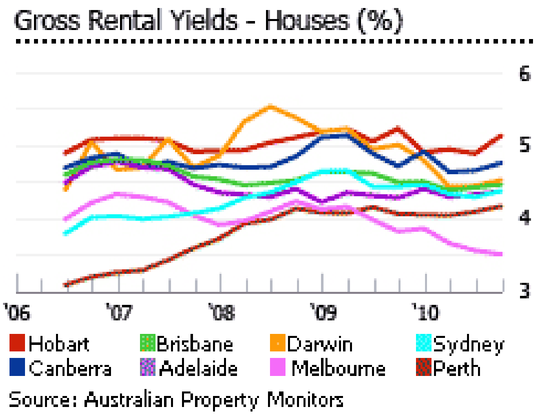


I would expect that the Australian experience will be no different expect for a floor in the price decline. In Australia the housing sector is

1 This is up 15% on the CPI adjusted average in 2005-06, and up 26% on the value in 2003-04

the largest asset class and culturally an investment asset. Property is should be viewed like a 30-year bond, as it trades on a yield. As prices fall, the yield will increase attracting capital and buffering these price declines.

For the most part, Australian property has traded in a 4 to 5% yield range for the good part of a decade or more.

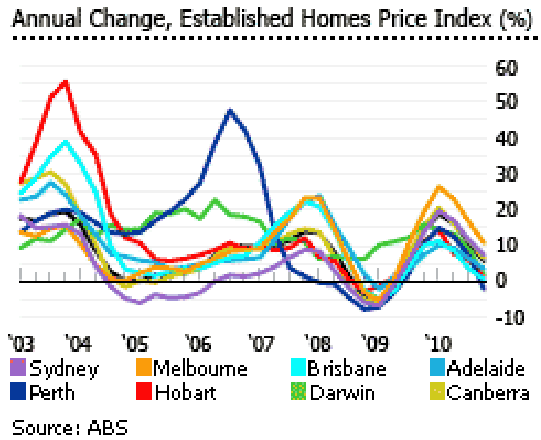


One scenario, which has the potential to provide a buffer, is the 36% of households without debt, gearing up, if need be, and buying these assets, as yields increase. I would expect that a drawdown of equity in the household sector under this scenario to be orderly.

Conclusion

We do not see a sharp or large house price decline in Australia occurring. Clearly the economic environment will be a key catalyst driving serviceability and equity considerations for borrowers. Even in an environment that gets to test this premise, the demographics of the home ownership market support a significant buffer and headroom to absorb price declines.

When overlaying the considerations of how property as an investment asset is also perceived to be in Australia, one cannot help begin to see the merits of a natural buffer in property prices. This means that mortgage markets and banks have a strong supporter, in the name of the un-incumbent homeowner to help manage a period of price declines in Australia.



Signs of speculation and the formation of a "bubble like environment" where in existence during the early part of the last decade, particularly the period prior to 2007. This was kept in check by a series of underwriting buffers. In observing price movement since this time, that the bubble like environment, if one existed, did not burst, but has experienced a deflation in Australia, and in fact is some way is historical.