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US Housing Crisis....Can it happen here? 25th May 2018

Investors are still spooked by the mere suggestion of investing in mortgage pools, because of the memory of the 2008 US Housing crisis. This caution is a natural defensive response; however, one needs to fully understand the facts around the ingredients or circumstances for the Australian Housing and Mortgage markets to experience the same event. Understanding this will enable insight to where value in this sector lies.

Research has shown, that for a better part, the US crisis is characterised as an out of Macro cycle downturn (a "Cliff Effect") in house prices, driven by three key factors. Australia did not experience the same extreme downturn during this period and many analysts point to the high quality of underwriting as a major reason to the performance differences, but it goes deeper than that. The US suffered a Cliff Effect during the GFC and in effect can be described as a build-up of clustered risk, where system buffers are overwhelmed. The large quantity of sub-prime loans written in the US experienced a fast deterioration and acceleration of defaults and foreclosures. Had Australia experienced a Cliff Effect as well, our market may have also followed a similar path.

Let us consider why the US market experienced the Cliff Effect, why Australia survived and if it could end up in the same place in 2018 and beyond? Macro cycles in housing exist in every economy, Australia included. You can measure the increase and decrease in house prices, due to a range of macro-economic factors, i.e. the level of interest rates, access to credit, migration patterns and supply of housing. Delinquencies and defaults for the better part eb and flow in a macro cycle and will become pronounced when serviceability is affected in large numbers, mainly driven by unemployment.
Three factors drove the US crash out of cycle:

1. the US housing construction boom
2. the easing in US lending standards
3. mortgage arrears rates which rose before the traditional triggers of a macroeconomic downturn

The US housing construction boom itself helped create this vulnerability. In contrast, to some other countries, strong housing demand in the US was met with additional supply that exceeded underlying needs. When the boom stopped, the United States was left with an overhang of excess supply that other countries had not built up. The easing in US lending standards seems to have gone further than elsewhere on the globe, across several dimensions such as documentation standards, loan-to-valuation ratios (including second mortgages) and loans where principal was not paid down in the initial stages of their lives.

One consequence of this seems to have been that an unusually large fraction of long-standing homeowners ended up with no or negative equity in their properties. Instead of assessing borrowers' abilities to service their loans, lenders ended up focusing on collateral values, in effect betting on rising housing prices. Speculative activity was peaking in many parts of the economy and a good measure of this was Interest Only ("IO") lending as a percentage of new loans. (See our research paper Bubble or Bubble like) For example, in the parts of the US housing market that suffered the greatest house price declines, i.e. 70% or more, IO lending had increased from 30% to 90% of all lending. In the parts of the US housing market than fell by, what can be describe, as a normal macro cycle downturn i.e. around 10%, IO lending increased from 30% to 40% of total loans. Finally, delinquencies and defaults leading a downturn, where an increase in unemployment would normally lead this, the opposite occurred, mainly driven by the inability to refinance or roll over debt.

So, can Australia experience the same housing downturn? The short answer is yes. However, the economy would need to have the same Cliff Effect ingredients to drive it to an out of cycle macroeconomic downturn. Let's examine these one by one.

1. Speculation and easy credit condition.

Allot of commentators talk about the Australian housing market, household leverage and the characterisation of the market being in a bubble. What drives a bubble? In simple terms, lots of speculative activity in a short period of time. If we agree IO lending is a key financing tool that can measure speculation, during the lead up to 2008, IO lending went for 25% to 35% of total loans in the Australian economy. Even in recent times, with the increase focused by the regulator, IO lending within the banking sector, IO's have peaked at 40% and in the Residential Mortgage Backed Securities markets at 25%.

2. Has there been a construction boom?

In parts of the Australian economy there has been, however these are localised in parts of the country still dealing with the fall out of the resources and commodities boom 10 years ago. House prices in these areas are down significantly from their peaks. For a better part, the balance of the mass affluent housing market is still in structural shortage of supply.

3. Can borrowers service their debt?

Arrears are tracking at decade lows, at around 1%. Even if you segregate IO arrears, they are only marginally higher and lower than the peak in 2009 for all loans.

Given these conditions, Australia is not approaching a Cliff Effect and it is hard to see how the housing market gets there. An additional fact to be mindful of, is that house prices are already 15% to 20% off their peaks across the whole nation on average, but yet again there are outliers, meaning prices have not fallen and may have actually maintained or increased in a more local setting.

Yet again, to see arrears meaningfully increase, a severe economic downturn would be needed, driving unemployment higher and yet again this would only characterise the housing market within a normal macro-economic cycle. These financing structures are arranged in such a way to withstand such a downturn.

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