

Australian Housing Review

November 2018



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The script gaining popularity this year is that Australia's housing bust is finally coming. From 2013 to 2017 foreign buyers and local investors pushed up prices to levels that were unaffordable for local owner occupiers but very profitable for developers, spurring on supply which only now is hitting the market. Government policy meanwhile has put the screws on foreigners and investors meaning there is a long way to fall before new buyers step up. Throw in a Labor government ban on negative gearing outside of new developments (see discussion in the next section) and we will be back to 2015 prices soon, sending new investors into negative equity. Of more concern though, price falls will make some new building unprofitable, causing a sharp fall in developments.

This script has a lot going for it. Mind you many people, particularly offshore funds, have been calling the death of Australian property since 2009. So we need to look at the structure of housing and the data.

Housing as a consumption good

There are two ways to look at housing. Firstly, housing as a consumption good - you need somewhere to live whether you rent or own. In this regard property yields should be treated much like any other fixed income asset. In Sydney the average unit price is \$720,000 and the average unit rent is \$530. Once costs are factored of around \$130 a week (strata, rates, fees etc), current yields on property are around 2.8%, so about the same as a term deposit. However this is below the cost of borrowing. With little change in rents likely and new supply now largely meeting new demand, there is little reason to see this change for a while. With interest rates near all-time lows house price movements are unlikely to be driven from the income side. That is, property yields are unlikely to rise because of increased cash flow. Therefore if a yield rise is needed it must come via lower prices.

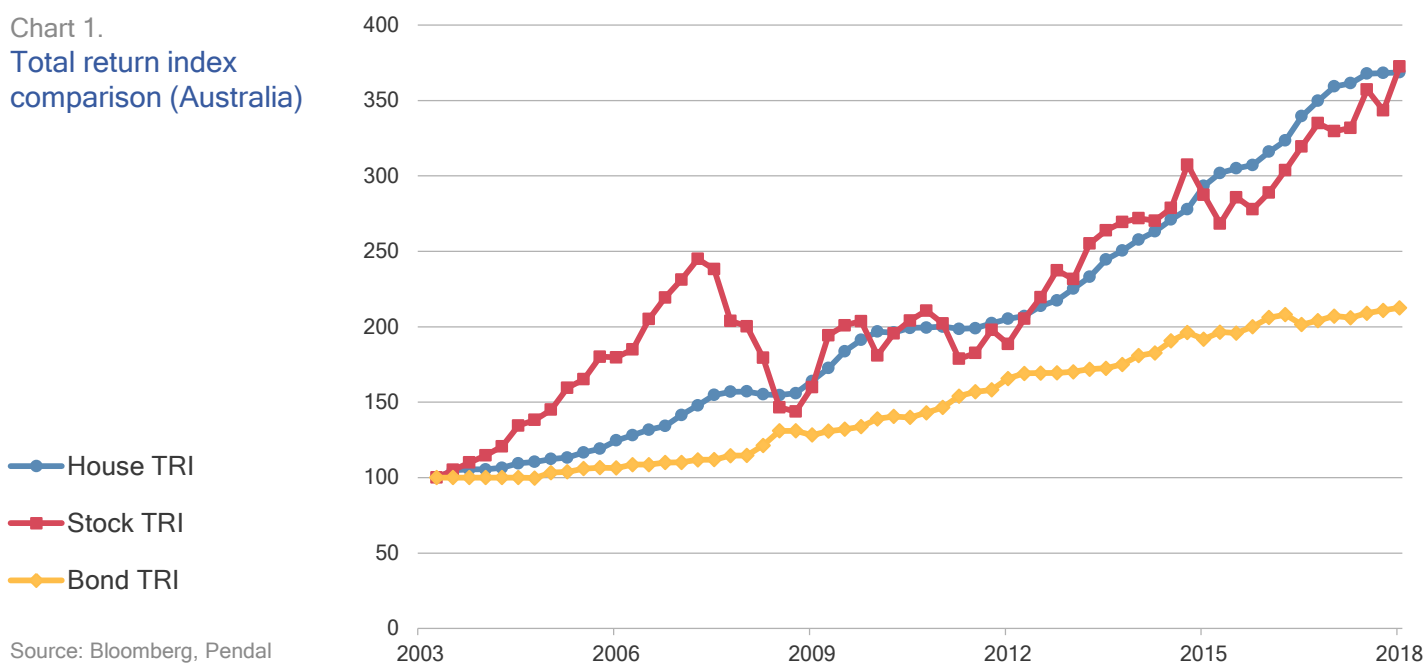
Housing as an investment good

Most Australians will aspire to become owner occupiers because of the need for somewhere to live. Throw in housing as a tax free store of wealth it is considered 'as safe as houses'. For owner occupiers housing is therefore a consumption good and an investment good. However once you become a property investor you are buying it solely as an investment good. Australia has around 2 million individuals who own around 2.6 million investment properties (27% of all housing stock). Significantly over half of all units are owned by investors, with almost 60% in Victoria.

Like any investment good the after tax returns need to reflect the cost of capital plus a risk premium. Chart 1 shows the total return index of bonds, equities and housing. They all assume no leverage and reinvestment of all net income, more difficult to achieve in housing than bonds or equities. With housing we look at Australia-wide prices and rents.

Property advocates will argue their asset is less volatile and therefore more attractive, while equity advocates will highlight liquidity, low transaction costs and no maintenance. For simplicity we will ignore these issues.

Chart 1.
Total return index
comparison (Australia)



Starting points always have an impact, but importantly since the GFC housing and equities have moved largely in lockstep. Low interest rates benefitted all asset classes (except cash) but the combination of low interest rates, solid growth and a rising population has been a massive boon for risk assets, with both equity and property having an average total return over the last decade of around 10% pa. The risk free asset, government bonds, returned around 5% over the same period, meaning a risk premium for property and equity of around 5%.

Assuming no change to the current tax code and no change to the risk premium, financial theory would suggest the total return on equity and property in the decade ahead would continue at the risk free rate plus 5%. Using current 10 year government bonds, the risk free rate is now closer to 3%, so property total returns should be more like 8% (or 5% price growth and net 3% rental yield).

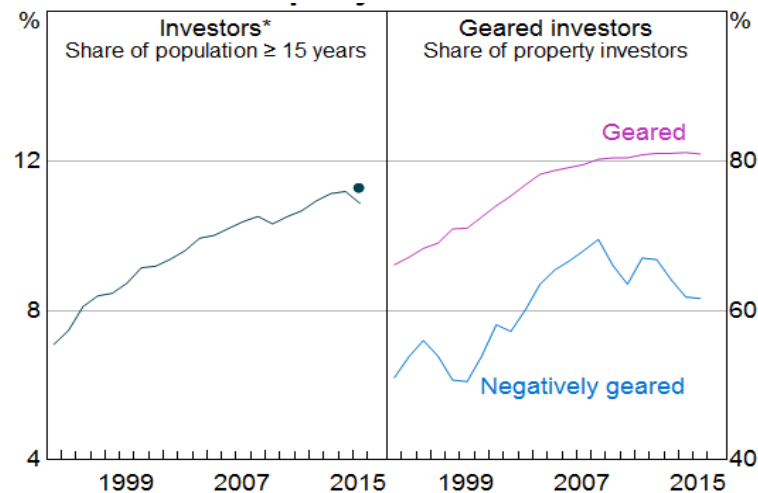
Tax changes

Over 60% of property investors are negatively geared, claiming a total of \$3 billion in tax losses in recent years. This has fallen over the past decade as interest rates have come down, after peaking at \$8.4 billion in total losses in 2011/12. As Chart 2 (borrowed from the RBA) shows, the proportion of negatively geared investors has declined in recent years after pushing up through the last decade. In fact if interest rates fell much further, negative gearing could almost disappear without any policy change.

Chart 2.
Property investor
breakdown

*Dot indicates estimate from the 2013/14 data accounting for likely revisions

Source: RBA, ATO



However, we do need to factor in the impact of the Labor party's proposed tax changes - a lower CGT discount and no negative gearing against wage income. These apply to all investments, including both property and shares, but it is property where there is the most leverage and current use of negative gearing. Of course existing investors will be grandfathered, but importantly it is new buyers who set the prices on property. Also, whilst new builds will still be able to negative gear against wages, buyers will have to factor in that when they eventually sell, the new purchasers will not be able to negative gear and hence should pay less.

To examine the potential impact, let's look at the average two bedroom Sydney apartment. Again we ignore transaction costs as this is a long term analysis, but we will also ignore depreciation benefits. Also we assume an investment loan of 80% LVR and interest only. On average after recent APRA changes less than 60% of new investor loans are interest only. Finally, we ignore the opportunity cost of the 20% equity (deposit). We are largely concerned with changes to returns.

Price:	\$720,000
Loan (80% LVR)	\$576,000
Rent:	\$530
After costs:	\$400
Mortgage rate (I/O):	5%
Interest costs:	\$553
Annual Loss	-\$7,956
Tax benefit (45% marginal)	\$3,581
After tax loss	-\$4,375

Let's assume the \$4,375 after tax loss is considered as acceptable to new investors (or as an economist might say, markets are efficient). Therefore if negative gearing is abolished, to maintain a \$4,375 loss (or recoup the \$3,581 tax benefit that disappears) one of three things must happen:

1. The rent goes up by \$70 a week
2. The mortgage rate falls to 4.38% (or \$70 a week)
3. The purchase price falls to \$630,000

New apartment supply means rents are unlikely to have any significant rises for some time and certainly not a 13.2% rise any time soon. Mortgage rates could fall by 62bp, but APRA and the RBA at this point in time have shown a reluctance to make investor interest only finance cheaper. Option 3, a 12.5% fall in apartment values, would therefore need to happen.

Of course in reality property is not a simple investment yield game, with sentiment, supply/demand and owner occupiers all hugely important. Labor's policy changes are effectively like a 62bp rate hike for investors and prices generally do not move by 12.5% when that happens. The main factor that would soften house price falls is that owner occupiers are not affected by the policy change so lower prices would see their share of purchases rise, particularly amongst first home buyers. However, under Labor if the negative gearing changes were to pass through parliament (the Senate may prove recalcitrant) it would definitely escalate the current softening in house prices. Our estimate is it will be worth around 5% and will impact apartments more than houses. When this policy was taken to the 2016 election lower prices were seen as good policy, as they were rising steeply at the time. 2019 will be a very different backdrop, but Labor seems determined to introduce the changes.

As a sanity check we looked at the RBA paper "Negative Gearing and Welfare: A Quantitative Study for the Australian Housing Market" November 2017. In a far more detailed and mathematically elegant model they concluded removing negative gearing was worth around 2% to home values as 9% of homes move from investors to owner occupiers, which would also slightly push up rents. Also the supply response would limit falls which would be around our figure of 5% otherwise. Importantly they showed an overall increase in welfare of 1.5% for the Australian economy and 76% of households were better off. So Labor should have the backing of the majority but this is politics 2018 style and the worse off minority, particularly the property industry, has the money and noise to drown out the majority.

The RBA and housing

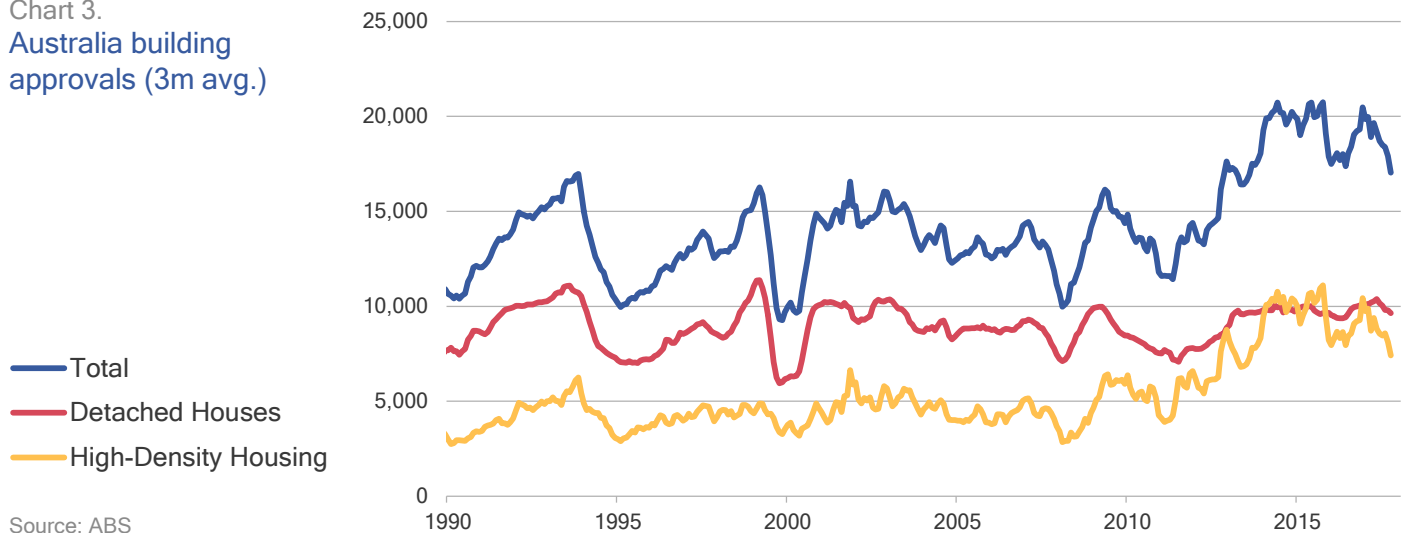
The RBA faces two issues around falling house prices - the wealth effect on consumption and confidence, and the more direct impact on construction activity. The first issue is difficult to quantify but so far the signs are good. Despite the concerns of many, consumption growth remains around 3% despite house price falls nationally of 3% over the last year. Perhaps consumers are encouraged by incomes finally showing growth above 2%. Also household net wealth has increased by almost 7% annually since 2012 so there is a large buffer.

For construction activity, 2019 will still see healthy levels as the pipeline from strong higher-density approvals the last few years are worked through. However the RBA will watch approvals closely in 2019. While residential investment is only around 5% of GDP, construction overall is 9% of GDP and employment, although this includes the booming

public and non-residential construction sectors. Housing also feeds into a wider range of sectors with links to housing activity, such as retail and wholesale.

Chart 3 shows that the boom of the last decade has been solely in high density, doubling from 5,000 a month to 10,000. This is the sector that is taking the largest hit at the moment. In fact, detached home approvals have been remarkably steady around 10,000 a month for the last 5 years.

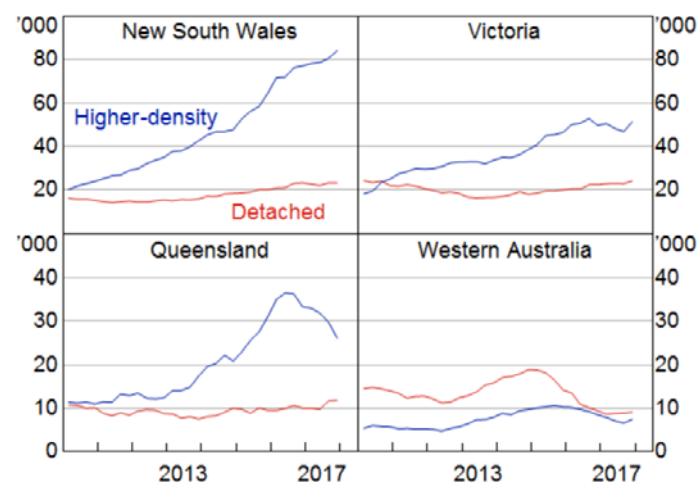
Chart 3.
Australia building
approvals (3m avg.)



Annual approvals are falling towards 200,000 from above 250,000 at the peak as Sydney and Melbourne see sharp falls in higher density, similar to what happened in Brisbane. This will be negative for growth beyond 2019 but approvals of 15,000 are still at reasonable levels on a long term basis. Remember the population has increased on average by just under 400,000 a year this decade. At 2.5 people per household that means 160,000 new houses a year are needed. Once rebuilds are included we need over 200,000 approvals each year. Of course too many years of underbuilding as the population keeps growing by 1.5% every year will see the cycle begin all over again.

Chart 4, also borrowed from the RBA, shows that in Sydney and to a lesser extent Melbourne, high density will become the focus next year. Perth has already been through their major correction and Brisbane has seen most of its adjustment, although it may fall a little further. Importantly, given high building costs and falling prices, developers will be reluctant to begin large developments given the background of uncertainty.

Chart 4.
Residential
dwelling pipeline



*includes dwellings approved but not yet commenced and private dwellings under construction

Source: RBA, ABS

Conclusion

Overall we believe there is too much complacency over the impact of housing in 2019, but that the weakness will be offset elsewhere by better wage outcomes and unemployment dipping below 5%. Housing is likely to be off 10% from the peak by mid-2019, 5% is already happening and the other 5% is likely if Labor wins government and gets its changes through. Sydney and Melbourne will see higher falls as other capital cities stabilise, having already seen these falls. While aggressive investors may be impacted, overall housing will be a step back in the Australian economy's 'one step forward, one step back' experience of recent times. Unemployment falling through 5% will catch the RBA's attention, but Governor Lowe should be able to rest easy for another year.

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