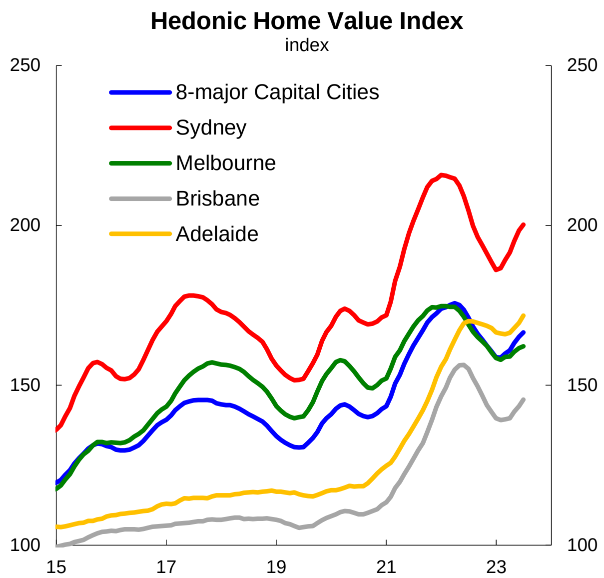
Wednesday, 2 August 2023

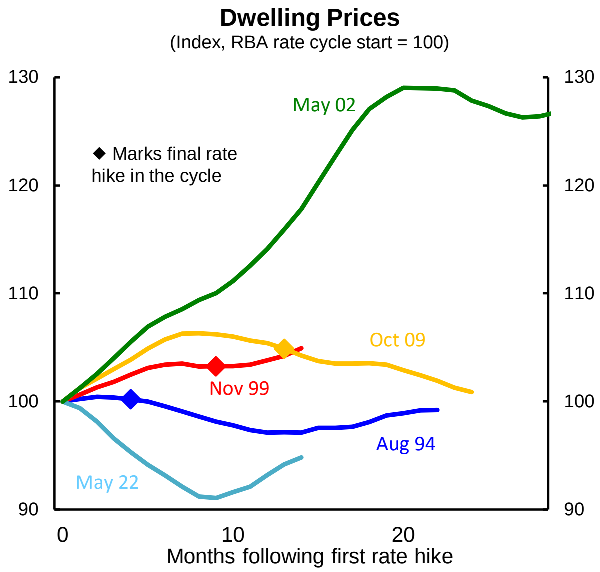
Housing Market

Piecing Together the Housing Puzzle

- **Dwelling values rose 0.7% in July, extending a run of 5 consecutive months of price gains. Since bottoming out in February, dwelling prices have risen by 4.1% nationally. This is even larger in Sydney where dwelling prices have surged by 7.6% since bottoming out in January.**
- **Why are prices increasing when rate hikes are reducing borrowing capacity and squeezing household budgets? Like any market, it comes down to the balance of supply and demand.**
- **A surge in population growth and a decline in the average household size has boosted demand for housing against a backdrop of low advertised supply. These drivers of demand are expected to wane slowly over time, but to largely persist in the near-term.**
- **An expected rise in new listings is likely to take the steam out of the current price rally. However, we are not currently anticipating a sharp enough increase in advertised supply to see a material price downtrend reappear.**
- **Over time, changes in the housing stock and the population will determine the trajectory of dwelling prices. Given limited approvals and disruptions in the construction sector, supply will take longer to respond to the rise in demand. This is expected to put upward pressure on dwelling prices over the medium term.**
- **The housing market is likely to remain in limbo while interest rates are elevated. We do not expect to see the conditions for a strong sustainable rise in dwelling values until we are close to interest rate cuts.**



Source: CoreLogic



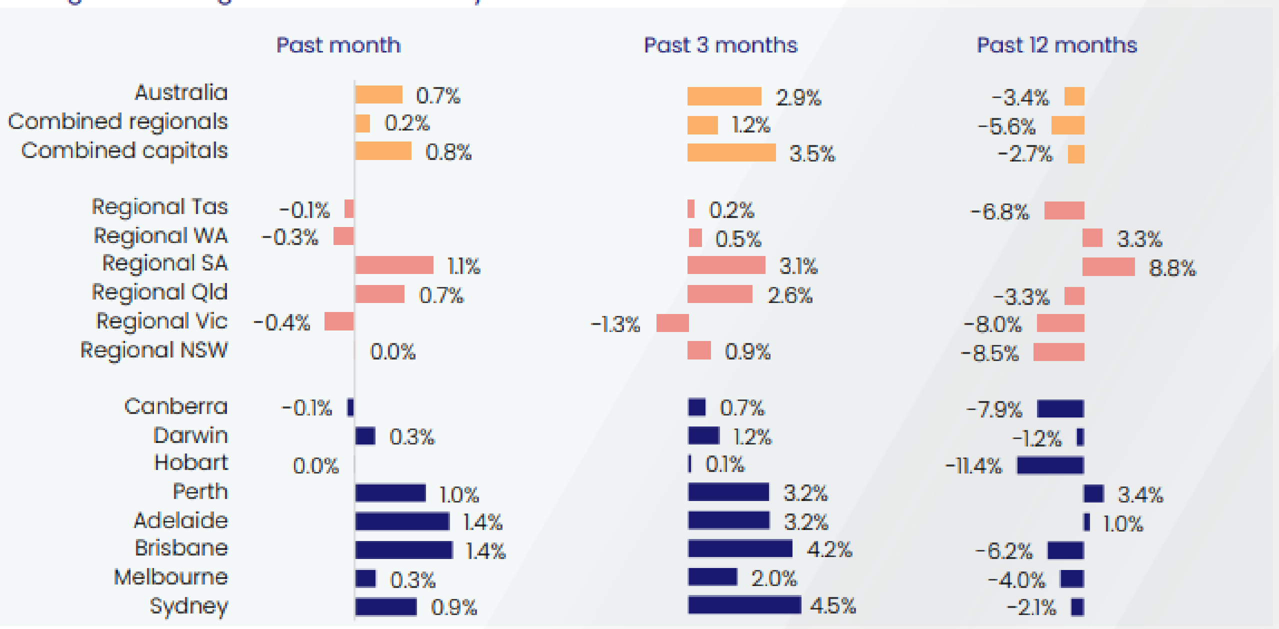
Source: CoreLogic

Dwelling Prices

Dwelling values rose 0.7% in July, extending a run of 5 consecutive months of price gains. The monthly increase was a step down on the 1.1% increase through June but still represents a very strong pace. The run of price increases means dwelling values nationally are just 5.3% below their peak from April last year. Price growth in July was concentrated in Brisbane (1.4%), Adelaide (1.4%), Perth (1.0%) and Sydney (0.9%). Apart from Sydney, growth accelerated in each of these cities.

Since bottoming out in February, dwelling prices have risen by 4.1% nationally. This is even larger in Sydney where dwelling prices have surged by 7.6% since bottoming out in January. What many first thought was a 'dead cat bounce' has since materialised into a more sustained uptick in dwelling prices.

Change in dwelling values to end of July 2023



So, what's going on in the housing market? Why are prices increasing when interest rate hikes are reducing borrowing capacity and squeezing household budgets? Like any market, it comes down to the balance of supply and demand. However, the housing market has some added complexities, including the interaction with the rental market and the important distinction between short-term and long-term determinants of demand and supply.

Breaking Down the Market

The simplest way to consider the housing market holistically is as a pie with two slices. One slice for owner occupiers, and one slice for investors. This is because renters are renting from investors. In other words, renters and investors are different sides of the same coin. In Australia, investors are predominantly mums and dads, unlike in other advanced economies where institutional investors are big players.

This framework is helpful, as there are different forces which determine the size of the pie (housing stock) and the number of people who want a bite (housing demand). But there are also factors which influence how the pie is split (owner-occupiers vs investors/renters). And both the size and the split are important for dwelling values.

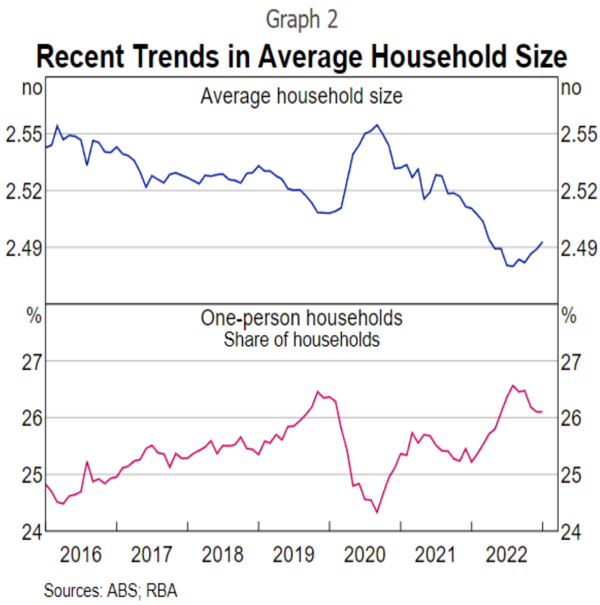
The overall supply and demand for housing are key determinants of dwelling prices in the long run with a big part of this connection flowing through activity in the rental market. Policy settings such as interest rates and the availability of credit impact the price and flow of borrowing for housing (i.e. the supply and demand for credit) and are another important factor for the trajectory of dwelling prices.

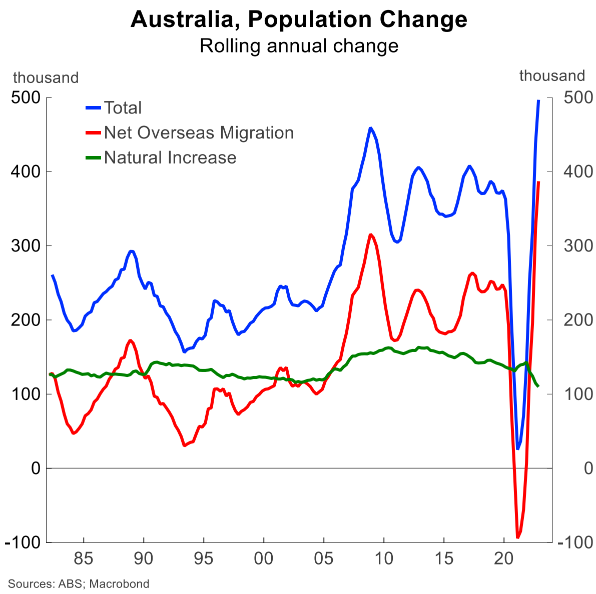
The total supply of housing is simply the number and size of existing dwellings. The construction of new dwellings adds to the total supply of housing, as do renovations that increase the potential occupancy of an existing dwelling. The total housing stock can only shrink when existing housing is demolished and not redeveloped, for example housing that is rezoned for a large infrastructure project. The stock of housing is a slow-moving beast, it cannot change overnight and takes time to react to underlying market forces. That is because the approvals process can be drawn out and buildings cannot just be thrown up in a matter of days or weeks. We will circle back to the drivers of the total housing supply at the end.

Population Surge and Changing Preferences

Interest rates are often thought of as the key driver of aggregate housing demand, but this is not entirely accurate. Housing is an essential service and the demand for housing in an economy is determined by just two factors, the size of the population and the average number of people living in each dwelling. And these have moved in opposite directions recently.

It started during the pandemic; households shrunk as our preferences changed. Location became secondary with the need for an extra space, a home office or a backyard taking priority. Smaller households mean the housing stock will need to be larger for a given population. The Reserve Bank (RBA) estimates that the change in behaviour increased housing demand by around 120k dwellings – that's a sizeable chunk given we have historically built an average of 150K dwellings per year. While this fall in the average household size will continue to gradually unwind as preferences revert, they are unlikely to fully revert to how they were before the pandemic. This means the impact on housing demand is likely to persist.



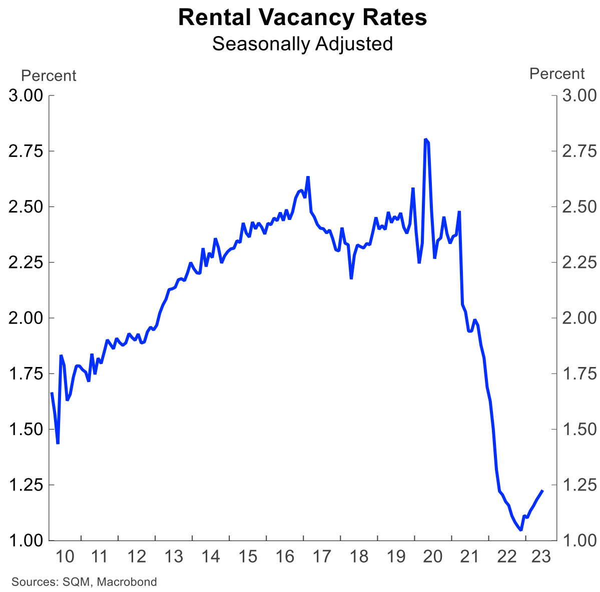


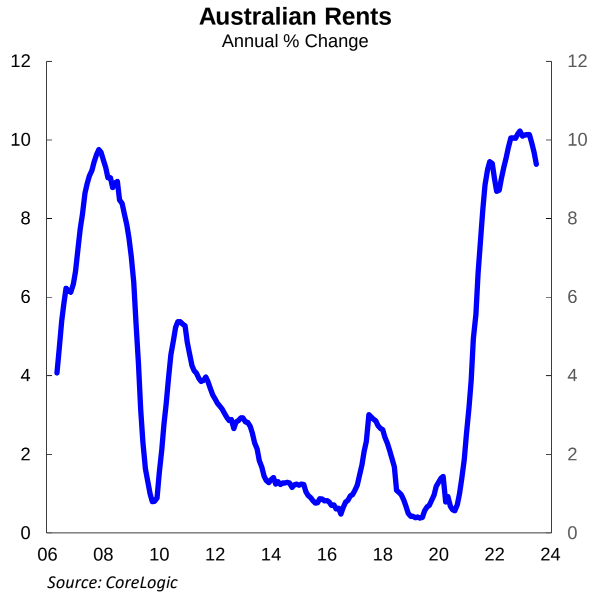
Since international borders have reopened, the population has surged at a record pace jumping almost 500k in 2022 alone. Taking the most recent estimate for the average household size, population growth in 2022 increased housing demand by around 200k dwellings. And, consistent with the government's forecasts, we expect population growth to remain strong in 2023 and 2024.

The upshot is that housing demand has surged and is pushing up against inelastic supply. This puts upwards pressure on both dwelling prices and rents as more and more people vie for the limited supply of housing.

Rental Market

The upward pressure from demand is usually felt in the rental market first. We have seen vacancy rates fall sharply across the country as the existing supply of rental properties has been snapped up by the increase in demand. Nationally, the vacancy rate is currently sitting at just 1.3%, well below the 10-year average of 2.2%. And late last year, the vacancy rate hit a low of 1.0% - its lowest level since 2006. Such low vacancy rates have made it difficult to find a rental property in some markets, with rental listings being filled rapidly and an intense battle for housing unfolding.





The natural response to these conditions is a rise in rents as potential tenants leverage their only bargaining chip, price. This has seen advertised rents surge 9.4% nationally over the year to July. Growth has moderated in recent months after annual growth hit a record high of 10.2% in December. Rents are growing even faster for apartments, where growth in advertised rents topped out at 14.8% in May.

Additionally, low vacancy rates and intense competition in the rental market give landlords better pricing power making it much easier to pass through cost increases (such as interest rates) or improve their existing returns. This adds to the upward pressure on rents.

The surge in rents has prompted a partial unwind in the shift in housing preferences from the pandemic as the rising cost of a second bedroom, or a home office becomes less palatable. This has likely driven the recent moderation in rental growth from extremely elevated levels. A continued unwind in these preferences will help to ease conditions over time.

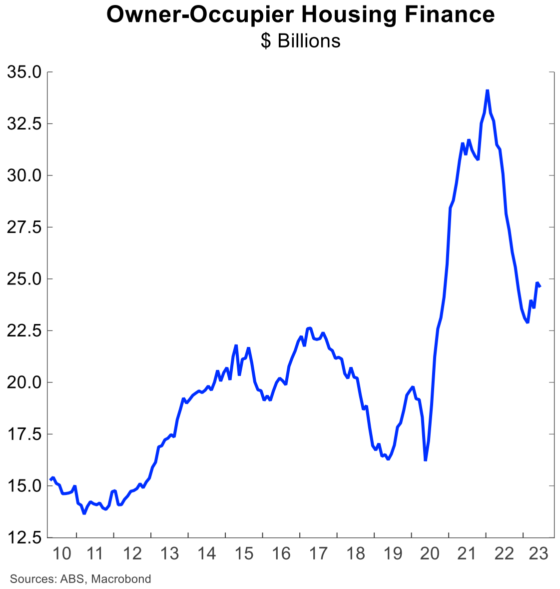
So Where Do Interest Rates Come In?

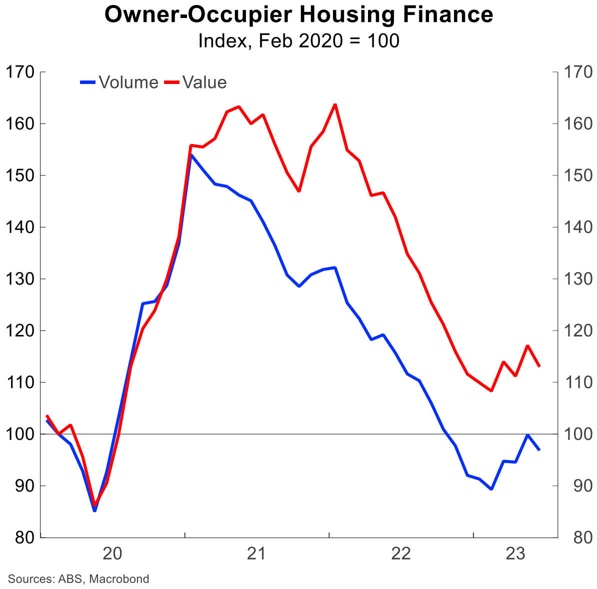
Remember the distinction between the size of the pie and how it is split? Well interest rates largely impact how the pie is split. Households generally have a choice between renting and purchasing (owner-occupiers). This decision generally boils down to the relative cost of each option, as well as other factors such as personal preferences. The cost of renting is straight forward, asking rents, while the cost of purchasing is largely dependent on household borrowing capacity, with underlying dwelling prices also playing a role.

The biggest implication of rising interest rates for this dynamic is a reduction in the borrowing capacity of prospective purchasers. This means for a given household income, the amount you can borrow, and thus the value of the house that can be purchased is smaller. And for marginal buyers a fall in borrowing capacity could mean a purchase is no longer possible. It is estimated that the average borrower has seen their borrowing capacity decline by around a third so far this interest rate cycle. This would ordinarily be expected to reduce demand for purchasing and increase demand for renting.

However, rents have also surged and up until March dwelling prices were falling. This has meant that while borrowing capacity has been squeezed, some of the other forces driving the purchasing decision have been flowing in the opposite direction. Additionally, many borrowers do not borrow at their maximum giving them scope to offset some of the fall in borrowing capacity by stretching themselves a bit further. This has prompted a stabilisation in purchasing demand which has contributed to the recent increase in dwelling prices.

Another important driver of this stabilisation in purchasing demand comes from the behaviour of migrants settling in Australia. The tightness of the rental market may have prompted many migrants who would initially rent (say, to find the right neighbourhood to settle) to move straight to purchasing as they simply cannot secure a rental property.





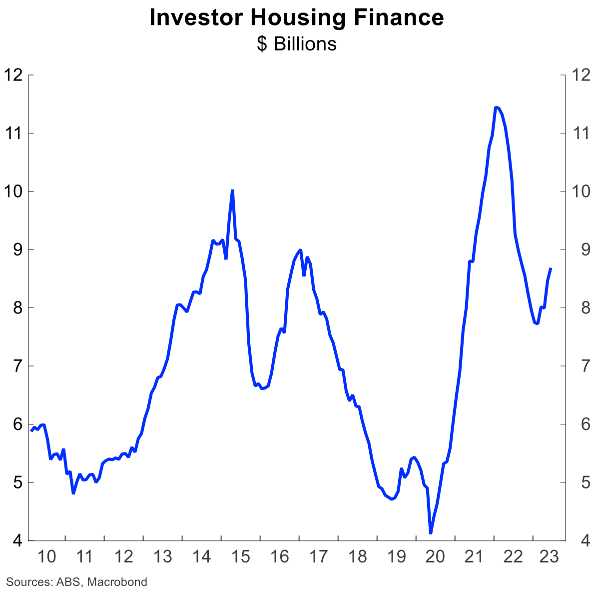
The stabilisation in demand has been evident in housing finance activity, which is an important leading indicator of dwelling price growth. The value of new finance for owner-occupiers has fallen sharply from elevated levels alongside aggressive rate hikes. However, the value of financing has more recently ticked up reflecting the stabilisation in purchasing demand. Interestingly, the volume of lending has fallen by the more than the value over this period, pointing to an increase in the average loan size. This is evidence that households may be stretching their borrowing closer to their maximum capacity.

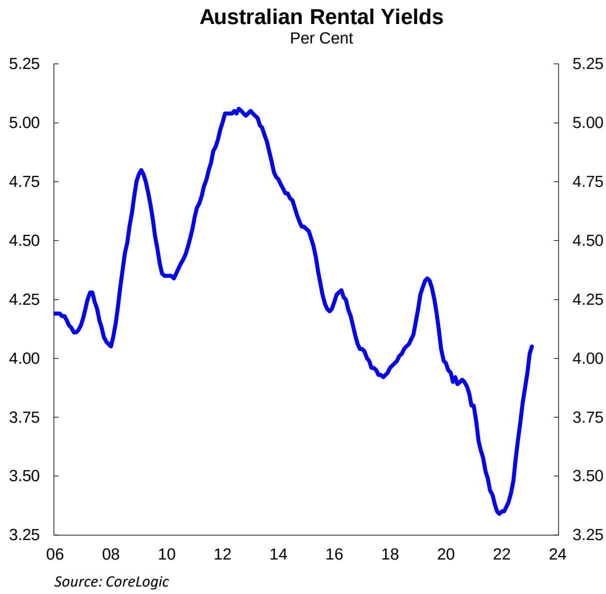
Investor Demand

Housing investors are the important conduit between rental demand and a claim on the housing stock. They provide another important link between the rental market and dwelling prices. When returns (or yields) become more attractive, more investors want to purchase existing dwellings to capitalise on the opportunity, and vice versa. This adds to purchasing demand and puts upward pressure on dwelling prices.

All else equal, an increase in rents will improve the potential expected return for investors, while higher dwelling prices have the opposite effect. Higher interest rates increase the cost of earning this return and therefore make housing investment less favourable. In the last 12 months these factors have all been flowing largely in opposite directions making it difficult to consider the overall impact on investor purchasing demand. An important feature of Australia's housing investment market which adds to this complexity is the reliance on capital gains for returns by many investors, to take advantage of the capital gains discount in the tax system.

Overall, investor demand appears to have followed a similar trajectory to owner occupiers. Initially unwinding alongside higher interest rates but stabilising more recently as rents have surged and dwelling prices have shown signs of rising, supporting speculation of future price gains. Since troughing in February, investor lending has jumped a massive 12.5% - pointing to a more material lift in purchasing demand from housing investors as opposed to just a stabilisation.





The lift in investor purchasing demand is also a likely contributor to the recent growth in dwelling prices. However, if interest rates remain elevated for longer, this could put pressure on purchasing demand from investors and could prompt investor sales as the affordability for existing borrowers deteriorates.

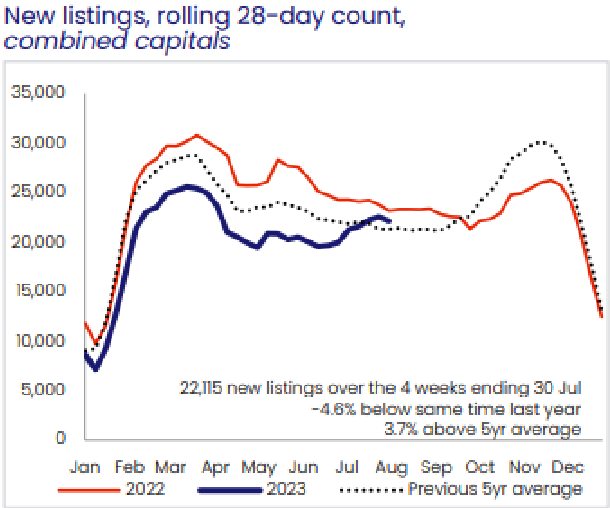
Available Supply

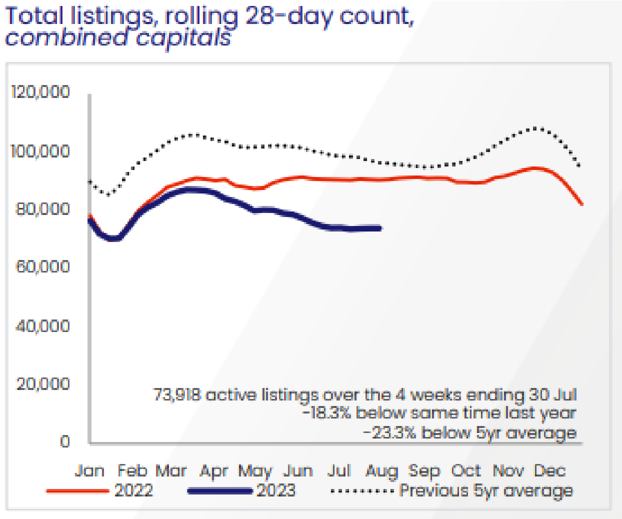
While the rise in total housing demand has been a key contributor to the increase in dwelling prices, the lack of available supply has been doing the heavy lifting. When considering dwelling prices, it's the advertised supply rather than the stock of dwellings that is important. That is, the supply on the market which is available for purchase. After all, in markets, it is the trading between participants that sets the price.

As purchasing demand initially fell in the face of rate hikes, advertised supply also slowed as households who did not need to sell opted to hold onto their properties and wait for better conditions. Purchasing demand has since stabilised but advertised supply remains incredibly low prompting the rise in prices experienced over the past five months.

The importance of supply in the recent dwelling price rally means an increase in advertised supply is currently the biggest risk for dwelling prices in the near-term. A large uptick in listings could prompt prices to take a leg lower given the depth of demand appears thin.

Over the four weeks to July 30, new capital city listings lifted 3.9%. This is an out-of-season rise in listings which usually fall through winter. This could be a potential early sign of some motivated selling as household budgets remain under increasing pressure. We have also heard anecdotes of a recent lift in investor sales which could be driving the increase. However, the lift in listings could equally be explained by sellers who stayed on the sidelines returning to the market as conditions have improved. Despite the unseasonal lift in new listings, the total stock of listings remains unusually low, meaning a more sustained rise in new listings will be necessary to put material downward pressure on prices.



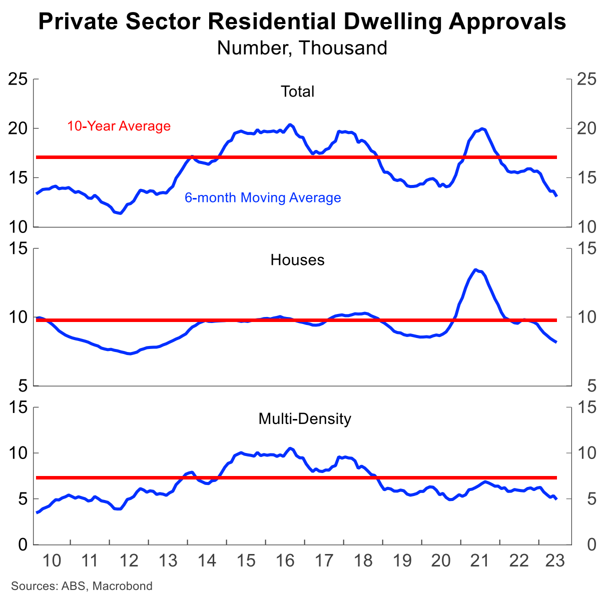


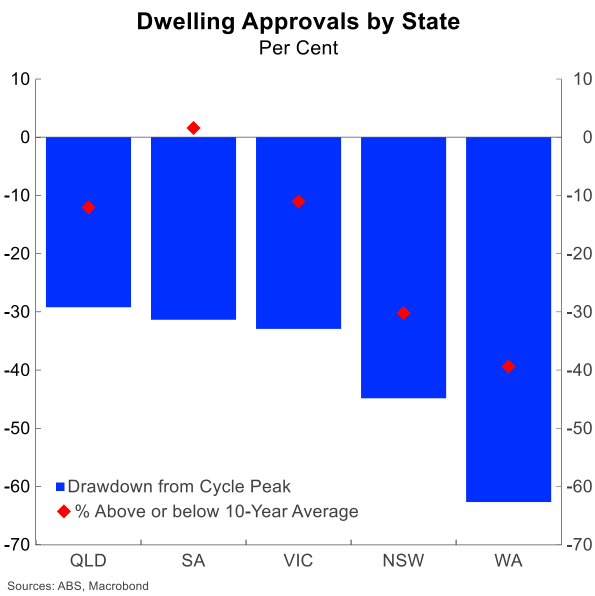
New Housing Stock

This silver bullet for easing pressure in the housing market comes from growing the stock of housing. But as we have said, this does not happen overnight. Instead, new dwelling construction is an important determinant of dwelling prices and rents over the long run.

Unfortunately, Australia is amid a sharp housing construction downturn. Part of this downturn reflects an unwind from the large run-up in activity during the pandemic supported by the HomeBuilder program and other state-based subsidies. However, the pull-back has now gone well beyond just an unwind of stimulus.

Dwelling approvals are a good leading indicator of new housing supply as they represent new construction projects which have been approved by governments. Private sector dwelling approvals have fallen 40.1% since peaking in March 2021 and are now 22.4% below the 10-year average. The collapse in new approvals has been driven by both freestanding houses and multi-density approvals, such as townhouses, terraces and apartments. The sharpest pull-pack in new approvals has been felt in WA, NSW and Victoria.





The slowdown in approvals has largely been driven by disruptions in the construction industry caused by severe materials and labour shortages. The disruptions pushed the average build time of a residential property from around 8 months to over 12 months. This has meant that while approvals have tumbled sharply, the pipeline of construction activity remains robust as it has not yet been worked through. The risk for new housing supply is that this pipeline is likely to dry up over time as lacklustre approvals will be insufficient to replenish completed projects.

A related side-effect of the disruptions in the property sector has been a surge in the cost of new dwelling construction, which has been one of the largest contributors to the spike in inflation. The rapid increase in costs hamstrung many developers and builders locked into fixed-price contracts, leading to an increase in insolvency activity, ultimately amplifying the disruption in the industry. This has been another key driver of the fall in new dwelling approvals as projects have been delayed or pulled given the uncertainty.

While the stock of housing is slow to respond to market conditions, there is still a response. Rental yields have risen from 3.3% in December 2021 to 4.1% in June while the recent increase in dwelling prices also provides an incentive to undertake new dwelling construction. However, rising interest rates and the ructions in the construction industry are likely to mean that this response will come with a larger delay than usual.

Outlook

Unique conditions in the housing market have underpinned the recent rise in dwelling prices in the face of a sharp increase in interest rates. The question for the outlook is whether these conditions will persist.

Many of the demand factors, such as a surging population and changes in household behaviour are likely to persist but will wane over time. However, these factors have driven a stabilisation in purchasing demand in the housing market rather than outright strength. This means the upswing in prices remains fragile as it has not been accompanied by a rise in volumes.

The wildcard remains advertised supply. While we expect a tick-up in listings to take some of the steam out of the current price rally, we believe that continued resilience in the labour market will keep listings under wraps and prevent prices from taking a material leg lower.

In the longer term, the delayed response in the housing stock amid strong population growth will continue to put upward pressure on both rents and dwelling prices. However, we do not expect to see the conditions for a strong sustainable rise in dwelling values until we are close to interest rate cuts.

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