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Topical Thoughts
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The Driving Forces behind Australia's Housing Market

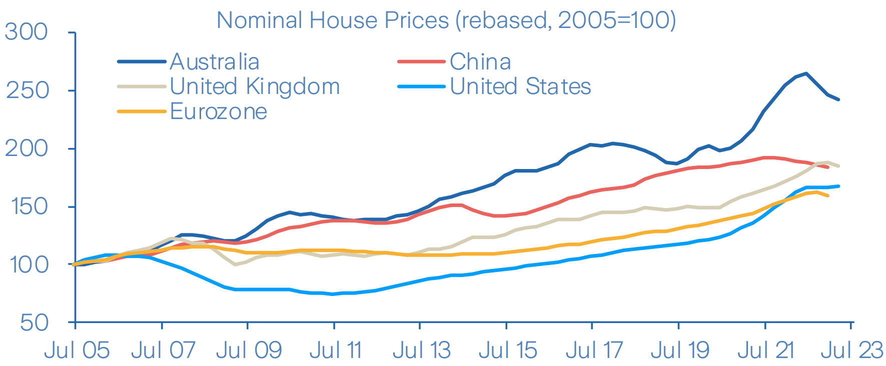
Australia's housing market has experienced a remarkable price appreciation over the last two decades, outpacing major markets on the back of robust demand and persistent supply shortages. The pandemic further fuelled Australia's house prices through unprecedented policy support.

However, the subsequent surge in interest rates raised concerns of a significant housing downturn. Surprisingly, the market has shown resilience, supported by a favourable interplay between demand and supply influenced by Covid distortions. Importantly, a robust labour market has aided households in meeting the challenges posed by rising mortgage rates. However, caution is warranted when interpreting the rebound in house prices given uncertainties surrounding the Reserve Bank of Australia's response to sticky inflation.

The demand-supply gap helps explain Australia's long-running housing boom

Over the past two decades, Australia has experienced one of the most significant appreciations in house prices among major economies. Prices have climbed nearly 2.5 times during this period, surpassing major markets like China, the US, the UK, and the Eurozone.

Australia's housing market has been a long-term outperformer



Source: BIS, ZIG estimates

Housing demand in Australia has continuously faced upward pressure, driven by several factors such as favourable demographics, evolving living preferences and tax incentives. With robust population growth of around 1.5% on average per year over the past two decades and net immigration averaging around 180k people per year, there has also been an ongoing structural decrease in household size over time. Furthermore, Australia's tax system tends to encourage home ownership by allowing households with a secondary property to offset their interest expenses against their total income, known as negative gearing.

In 2008, the Australian government relaxed regulations for foreign buyers, resulting in an initial surge of foreign participation in the housing market. However, the law was amended in 2010 to curb foreign speculation by permitting foreigners to purchase only newly developed dwellings and vacant land. Overall, the proportion of foreign purchases relative to total market turnover has remained stable and relatively low, indicating that foreign buying does not play a dominant role in driving house price fluctuations, according to an analysis by the Reserve Bank of Australia (RBA).

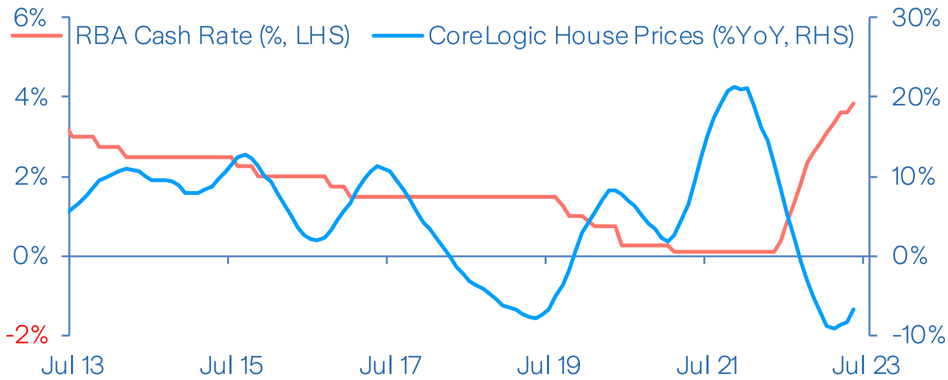
More importantly, the supply of housing has failed to keep up with demand. Despite its vast land size, Australia has one of the world's most urbanised populations, with around 70% of the population concentrated in several coastal cities and nearly 40% of people residing in Sydney and Melbourne. Other factors including planning complexity and duration as well as opposition from local residents to new developments have also contributed to supply constraints.

Front cover image source: iStock

The trajectory of interest rates exerts a significant impact on house prices

The high sensitivity of house prices to interest rates is likely linked to the prevalence of variable mortgage rates in Australia. Although they fluctuate during business cycles, interest rates have generally trended lower over time, underpinning the housing market over last decades.

House prices in Australia are highly sensitive to interest rate cycles



Source: Bloomberg, ZIG estimates

From a business cycle perspective, Australia's housing market is particularly sensitive to cyclical changes due to its close ties with the consumer sector. According to data published by the Australia Bureau of Statistics (ABS), Australian consumers held approximately 55% of their wealth in property, and household debt is primarily made up of mortgages. Notably, Australian households are among the most indebted in the world, with a debt-to-income ratio close to 200% according to RBA latest data. This high ratio makes them susceptible to rate increases, especially considering that the majority of mortgage rates in Australia are variable.

The pandemic has altered the market dynamics

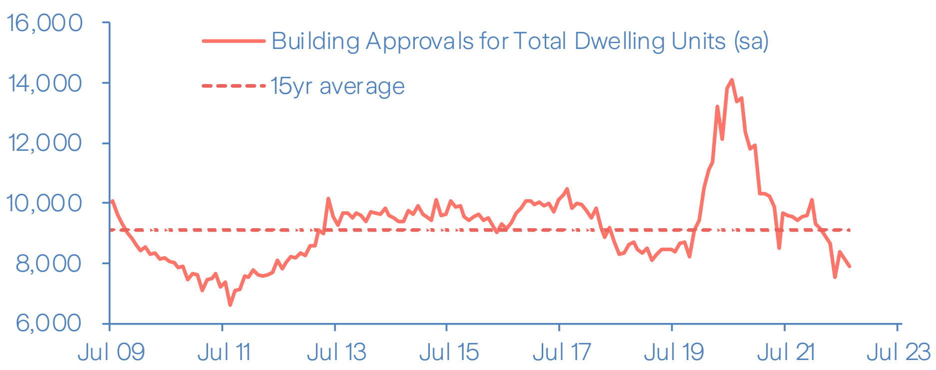
Adjustments in living preferences, substantial fiscal and monetary expansion, and prolonged labour and supply shortages have reshaped the market dynamics.

First, there has been a preference for smaller households on the back of work-from-home and quarantine requirements during Covid, resulting in a sharp drop in household size, creating around 120,000 households additionally over this period, according to the RBA's estimate and kept housing demand buoyant despite a sharp fall in net migration during Covid.

Second, substantial policy support provided households with abundant cash buffers while Covid lockdowns altered household saving behaviours. The savings rate peaked at around 24% of net disposable income in July 2020 and stayed well above the pre-pandemic level until Q1 2022. Much of this liquidity was channelled into the housing market. During this period, the central bank cut its cash rate to a historic low of 0.1%. Numerous households capitalised on the low interest rates to purchase their new homes. This resulted in a surge in home prices of around 25% between Q3 2020 and Q1 2022.

Third, the housing supply was hindered by disruptions in supply chains and labour shortages caused by Covid. At the beginning of the pandemic, housing starts and building approvals experienced a surge due to government initiatives. However, after reaching their peak in the first half of 2021, both housing starts and building approvals swiftly declined, hitting their lowest levels in H2 since 2014. Additionally, although reduced net migration initially resulted in a surplus of housing, resilient domestic demand fuelled by a decrease in household size quickly absorbed the surplus.

Housing supply bottlenecks remain following Covid disruptions



Source: Bloomberg

Finally, the share of fixed mortgage rates doubled during Covid. These fixed mortgages typically have terms of two to three years, which means the majority of them will transition to variable rates between 2023 and 2024.

Tighter monetary policy poses notable downside risks to the market

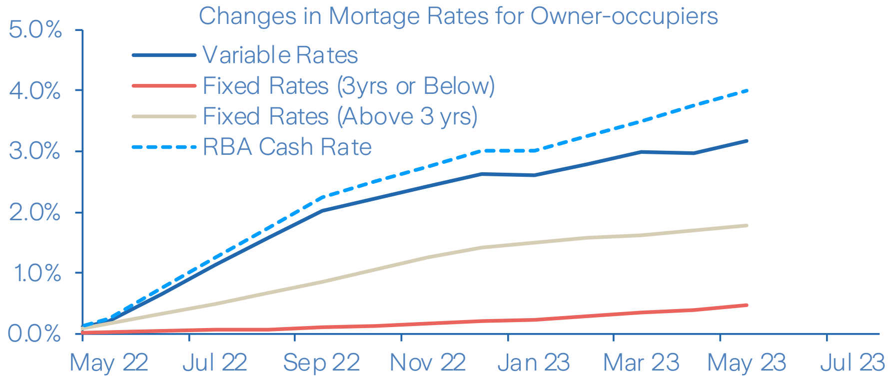
2022 marked the end of an ultra-low interest rate period. In response to multi-decade high inflation, the RBA hiked its cash rate aggressively, bringing it from 0.1% to 4.1% within less than one and a half years, the fastest pace of rate hikes on record. With that, came a striking drop of 20% year-on-year in home loans as of May 2023 and new loan approvals contracted even more drastically. Following the significant boom during the pandemic, Australia's housing market is now highly vulnerable to price corrections.

In the April Financial Stability Review 2022, the RBA estimated that a 200bp rate hike could result in a 15% decrease in home prices over a two-year period, assuming other factors remained constant. Given past experiences, such a downturn could indeed be plausible. To provide context, house prices fell by over 10% between 2017-2019 due to tighter credit conditions and stricter lending standards, even though the cash rate hovered around just 1.5% at that time.

Not all rate hikes have been passed on to home owners yet

There is evidence that the policy rate hikes have a lagged effect on mortgage rates. Lending data published by the ABS show that the rise in variable mortgage rates has lagged the cash rate by about 100bps. It is likely that mortgage lenders are trying to keep their interest rates competitive. However, if the RBA were to maintain elevated cash rates for an extended period, mortgage rates should eventually play catch up.

Housing supply bottlenecks remain following Covid disruptions



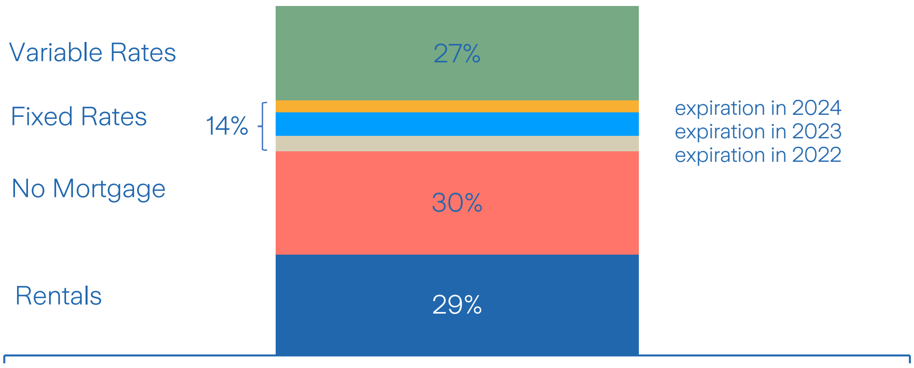
Source: Bloomberg

The higher proportion of fixed-rate mortgages during this cycle, as mentioned earlier, has delayed the impact of previous rate hikes further. Around one-third of the outstanding fixed-rate mortgages expired in 2022, and half are set to expire in 2023, with the rest due in 2024. The peak of fixed rate mortgage repricing, often referred to as the 'mortgage cliff' is estimated to occur around mid-2023. Fixed rates, initially around 2.25% in 2022, are now being adjusted to near 6%, effectively doubling monthly mortgage payments for fixed-rate cohorts. Consequently, these households are likely to experience increased financial strain.

Will the mortgage cliff pose risks of financial instability?

While the repricing of fixed rates is a notable challenge to households, there is limited evidence that the mortgage cliff would result in systemic financial instability. Overall, only around 30% of households are mortgage holders, with the rest being either renters or homeowners without mortgages. Moreover, among the mortgagors, variable rate holders account for around 70% of the total mortgages outstanding and have demonstrated resilience in the face of the sharp rise in rates. RBA analysis shows that homeowners with fixed rates have similar income and saving patterns to variable rate holders, which suggests that these borrowers could potentially manage interest rate repricing.

Only one-third of total households are mortgage holders



Source: ABS, RBA, ZIG estimates

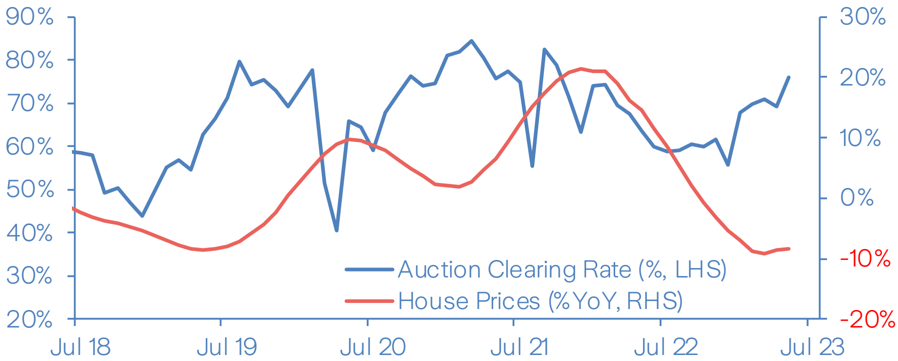
Besides, fixed rate borrowers have had time to prepare for the rate increase while still benefiting from stable income due to the robust labour market. Banks have been cautious about passing on the full rate increases and may offer temporary measures like converting to interest-only payments to reduce the risk of defaults.

Nevertheless, vulnerability remains, particularly for low-income, heavily-indebted households and first-time home buyers who entered the housing market when prices peaked in early 2022.

Despite rising mortgage rates, house prices picked up earlier than anticipated

After falling 9% from the peak, median house prices across major cities have unexpectedly rebounded in the last few months while other indicators such as sales-to-new-listings ratio and auction rates also confirm the positive momentum.

Home prices have picked up recently



Source: Bloomberg

The negative impact of rising interest rates on the housing market seems to have been overridden by the supply-demand gap, which has worsened post-Covid. Net migration is rebounding sharply and expected to expand considerably in the next two years before normalising, according to the latest forecasts in the May 2023 Budget. Rental markets are now exceptionally tight, evident in the multi-decade low vacancy rate and notable rent increase.

Meanwhile, new home listings are currently 20% below the five-year average, and total listings are at their lowest level since 2010, according to a report by ANZ Bank. As mentioned, Covid-induced supply disruptions have delayed building activity while construction companies have faced a significant squeeze in profit margins and insolvency has picked up markedly. While a recent decline in input costs has eased margin pressures, developers now face further challenges posed by elevated interest rates and tighter credit conditions.

Will the rebound be sustainable?

While the favourable dynamic between demand and supply could continue lifting house prices further, the market outlook will largely hinge on how the broader economy and the labour market cope with increasingly tighter monetary policy. Ultimately, what has insulated the housing market from a more significant downturn is the resilience of household income thanks to the strong labour market. However, an exceptionally tight job market presents a dilemma for the RBA as it raises concerns about persistent inflation.

The RBA has consistently emphasised the challenge of navigating the delicate balance between managing inflation and ensuring full employment, a path that has now become even narrower, according to recent RBA statements. In response to sticky inflation, the RBA has delivered two surprise rate hikes in the past few months, while shifting its narrative towards a more hawkish tone. We expect one to two more hikes in H2 2023.

With the prospect of impending rate increases coupled with the lagged effects of previous rate hikes, there are risks that tighter monetary policy could lead to significant economic weakness and higher unemployment rates. Rising interest rates, sluggish growth, and increased unemployment can be a toxic mix for the housing market given its intricate connection to the mortgage rate cycle and the overall consumer sector. Until these factors are addressed and resolved, caution is warranted.

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