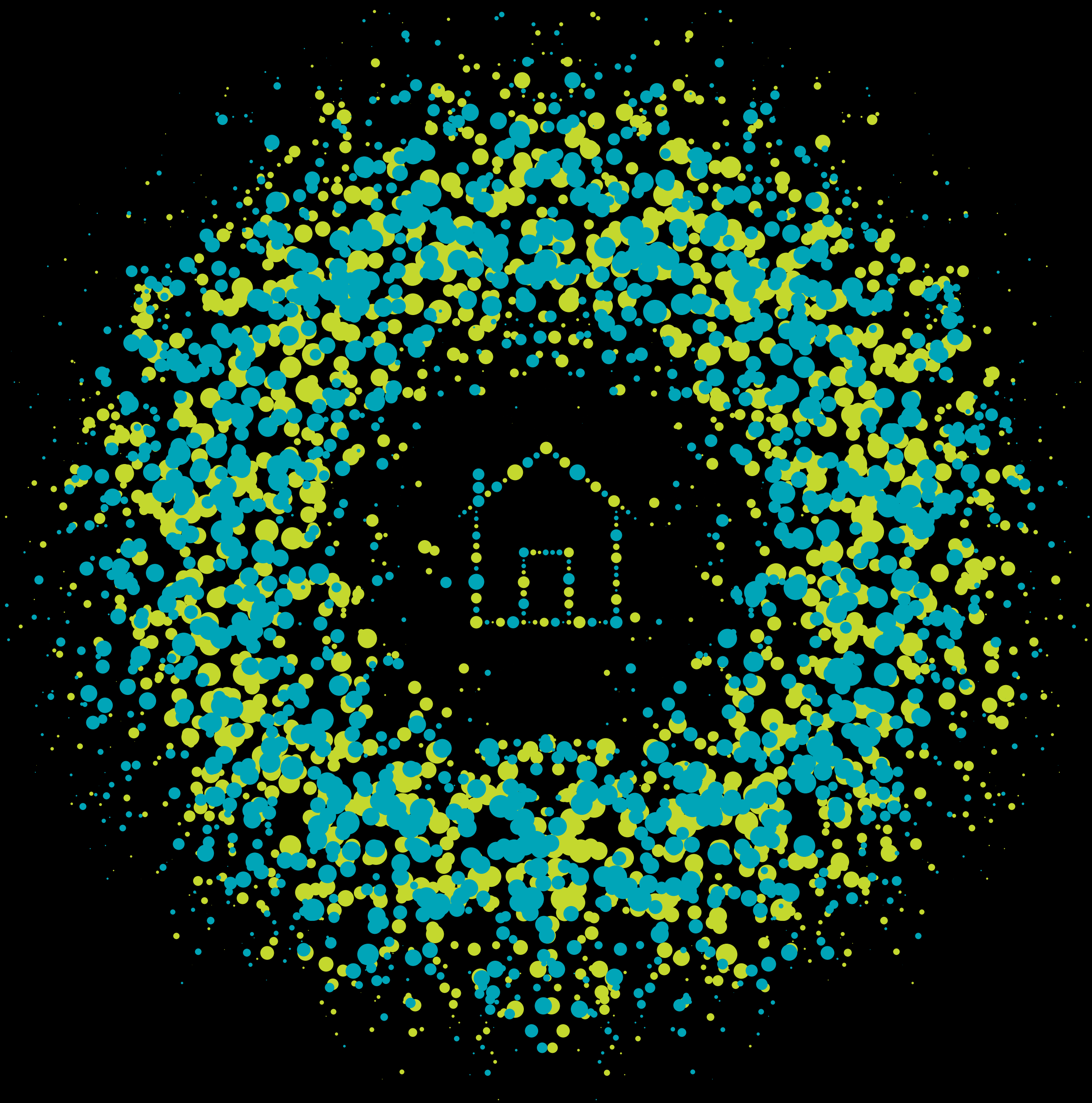
Deloitte.



# Finding focus in a complex market

## Mortgage Report 2017

12th Annual Deloitte Australian Mortgage Report

# Property prices:
## the stresses, their drivers, investors, and some solutions

Having covered the lending side of the equation in the roundtable, this article by **Deloitte Real Estate & Construction Sector Lead Alex Collinson** focuses on residential property prices which back most mortgages.

There are few topics which demand more column inches presently, whether it is the issue of housing affordability for first home buyers, interest rates, auction clearance rates, FIRB approvals for offshore buyers, capital gains tax, negative gearing, Sydney house prices, or apartment gluts in Melbourne and Brisbane.

The importance of this of course is that more than 50% of household wealth in Australia is tied up in property. With the growth in house prices post the Global Financial Crisis, it is one of the best performing investments since its onset, well in excess of the returns from the ASX.

This has enabled the banks' success to underpin the economy with balance sheets that are heavily leveraged to residential property. So there is little wonder that the topic is so discussed.

**The stresses**

However there is a flip side to such growth in asset values. In this case it is mortgage stress driven by loans increasing in size, in combination with the size of deposit required for first time buyers who struggle to enter the market.

This has created chronic social issues in particular in Sydney, where it isn't just that people can't afford to buy houses, they can't afford to rent properties near to where they work. Add the social environment to the list of constraints and pressures on banks' lending practices due to stiff global regulatory requirements, volatile investing economies, and increasing costs and risks.

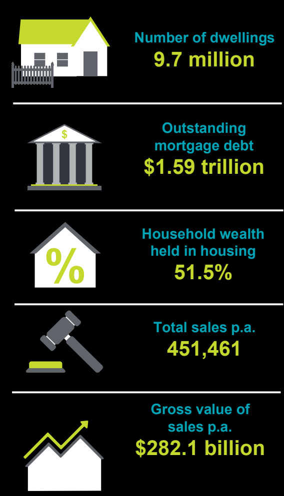
Recently various lending institutions have had to announce they are tightening their lending requirements - good news for the Reserve Bank of Australia, and possibly good news for some more sluggish parts of the economy, as it offers more options, given the concern about asset prices.

So what does it mean for lenders in terms of residential property prices?

**The drivers**

Supply is part of the solution. But not the sole answer given that housing construction in apartments in particular, is high by both international and historical comparisons, but is still struggling to keep up with demand.

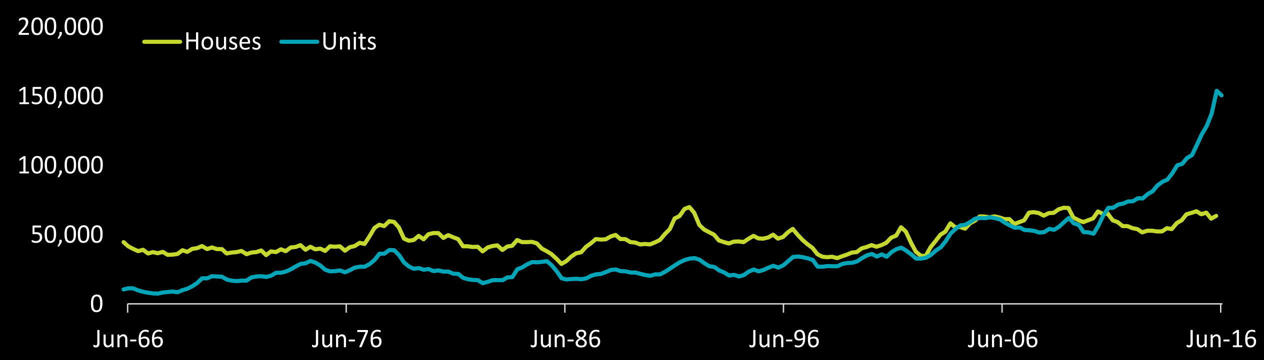
**Residential real estate underpins Australia's wealth and has reached $6.7 trillion**


As at the end of October 2016

Source – CoreLogic

### Number of dwellings under construction, national




Source - CoreLogic

New supply helps with those who can afford what is being built. But there is a parallel issue around social and affordable housing. Historically this was largely the domain of the public sector. Today we believe business has its part to play, something akin to the ' institutional multifamily dwellings' as exist in the US for instance, but policy settings need to be right.

Supply also needs to be coupled with infrastructure, so there are jobs near the new dwellings, or residents can commute to where jobs are easily and quickly.

Whether this is granting increased Floor space ratio (FSR) for developments in exchange for building affordable housing as part of development approval, changing zoning along transport links, reducing red tape and increasing the speed for approvals, this should serve to increase supply and keep costs in check.

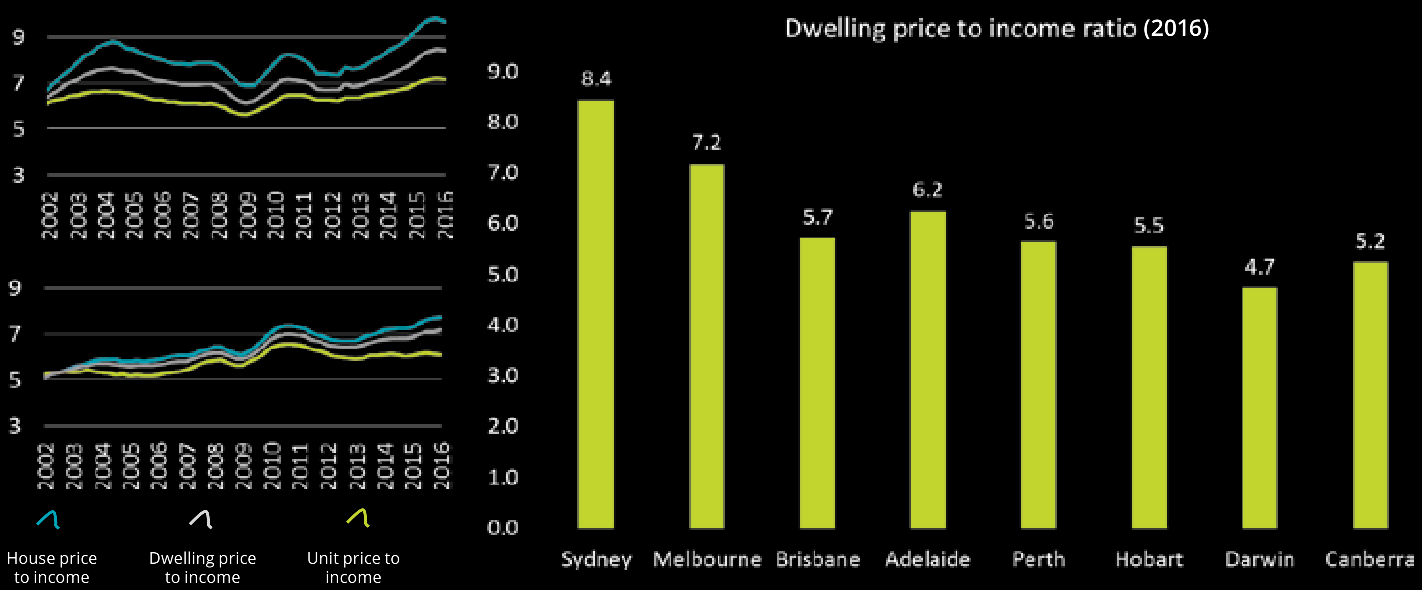
But there also needs to be a rethink of what people should expect and where the government should or shouldn't intervene. The demand side puzzle is ten times harder than supply side.

**The investors**

Banking profits have fallen due to increased regulatory capital requirements, low interest rates, a volatile economy despite the rise in commodity prices, a lower dollar and competitive pressures.

These pressures, coupled with uncertainty, have in turn caused lending to be increasingly cautious and has meant fewer people can afford to buy a property. So where then will growth come from? And who will own residential property in the future?

### Affordability has become more challenging in Sydney (top left chart) and Melbourne (bottom left chart) which is likely stifling activity




Source – CoreLogic

**Cumulative growth in dwelling values, Jan 2009 to Aug 2016**


Source – CoreLogic

Will the status quo continue in terms of the mix of buyers with another period of flat property prices like that after the house price increases up to 2003? Or will prices collapse?

Generally one of two things needs to happen to see prices fall leaving aside factors such as major tax reform or reduction in population growth:

1. Either wages fall in real terms or as a result of unemployment or
2. Interest rates rise significantly.

We believe interest rates rising is more likely than wages falling, given the fairly healthy current economic cycle, combined with the level of borrowings home owners have taken on to buy at current prices levels.

**Some Solutions**

However given low wage growth and low inflation, interest rates are remaining at their lowest ever levels and the RBA hasn't signalled any significant increases. It is possible that interest rates are more likely to rise now than 12 months ago, given the low levels of unemployment, commodity prices and positive economic sentiment in the US, but it is hard to see them increasing quickly.

Part of the conundrum is that investment income is becoming more important than wage income, and investors are becoming more important than owner-occupiers. So house prices are being more exposed to investment returns (from all sources) over time.

If house prices continue to rise at current rates, then the numbers of people who can afford to buy are reduced and with it a change in the make-up of ownership of our housing stock.

People may also vote with their feet, leaving high priced Sydney and moving to Melbourne with its recent lift on stamp duty for First Home Buyers, which should help absorb the apartments which have been built there.

Predictions are hard, but given the start to the year we've had, I think it is likely there will be growth in house prices in the current year but at more moderate levels the last couple of years. But as always this will be state and market specific with Sydney and Melbourne likely to outperform Brisbane and Perth.

# Contact

**Alex Collinson**
Partner, Assurance & Advisory
acollinson@deloitte.com.au
+61 2 9322 7921