ANZ Research

Australian Economic Insight

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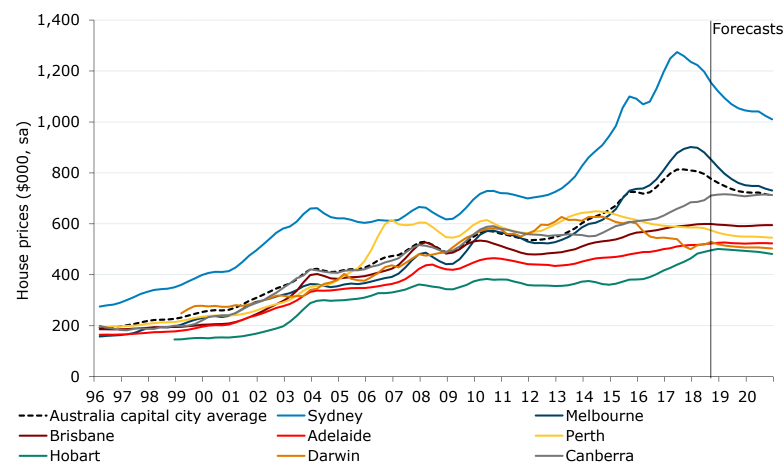
A deeper and longer housing downturn, and later RBA tightening

- While the pace of decline in Sydney and Melbourne housing prices has been in line with expectations to date, we see no evidence that it is easing. Accordingly, we have revised our housing price forecasts lower.
- We now expect housing prices to fall a total of 15–20% across Sydney and Melbourne, largely on the back of ongoing credit tightening.
- Credit tightening primarily hinders the Sydney and Melbourne markets. Some spill-over is likely to weigh, to a lesser extent, on Canberra, Brisbane and Adelaide. Perth and Darwin are weak, which is a mining, not housing, story.
- Lower prices are positive from an affordability point of view. We see evidence that people believe it is now a good time to buy. Improving affordability will be important to eventually help turn this cycle.
- As is characteristic of this cycle, which is unusually led by prudential tightening, there is material uncertainty around the outlook. It is difficult to ascertain for how long banks will continue to implement further credit tightening, or if further tightening will flow from the Royal Commission's final report. Also, next year's federal election could see a change of government and adjustments to negative gearing and capital gains tax breaks. While not explicitly included in our forecasts, we run through a scenario of what the removal of negative gearing could mean for the marginal investor.
- The current environment is not all bad, and the risks are not all downside. Risks to the upside include the possibility that a strong competitive response across lenders limits the further tightening of credit, or even unwinds some of the recent changes. Improving affordability could drive buyers back to the market earlier than anticipated. Also, dwelling price adjustment is coinciding with falling unemployment and rising household income. This is likely to continue despite the weaker housing market, which in turn helps affordability.
- A key influence on the timing of our RBA rate hike call is evidence of stability in dwelling prices. With the housing market not expected to stabilise until early 2020, we think it will be difficult for the Bank to tighten until sometime after that. Earlier is possible if housing stabilises sooner than expected.

Figure 1. Expected fall returns Sydney prices to 2015 level



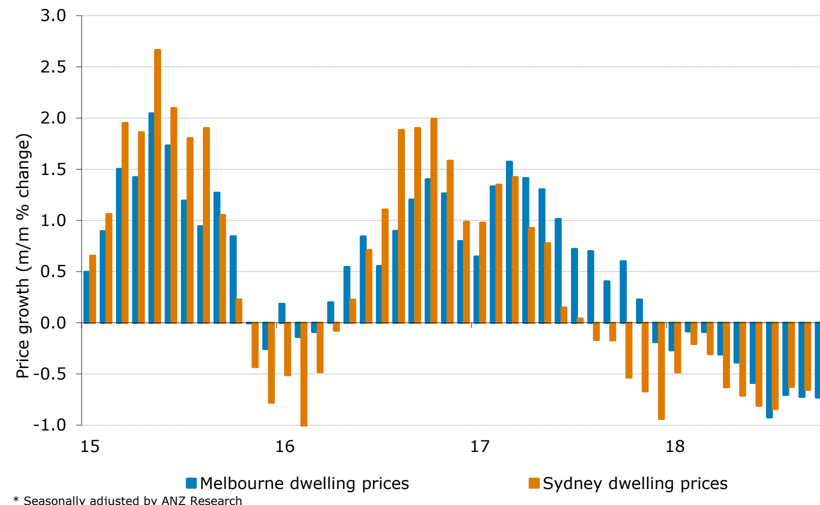
Source: CoreLogic, ANZ Research

A weaker state of play

Until recently, housing prices have been performing broadly as we expected. And in fact, most capital cities are still tracking in line with our forecasts.

Sydney and Melbourne, however, are not. We had expected by this stage to see some evidence that price declines in these cities were moderating, as the impact of credit tightening started to wind down. But price falls are continuing at a material pace and are broadening through most segments of these markets.

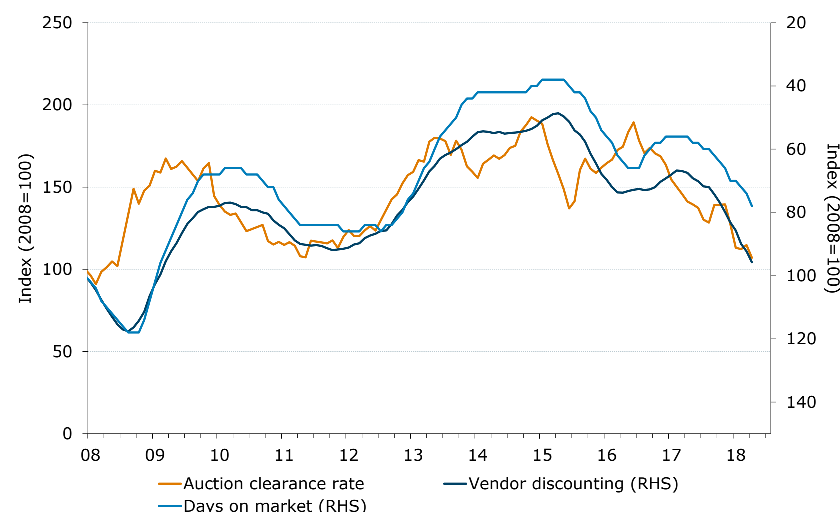
Figure 2. Housing price declines in Sydney and Melbourne are yet to show any sign of abating



Source: CoreLogic, ANZ Research

It is no longer just the top quartile of properties in Sydney and Melbourne that are experiencing price declines. Even the lower end of the market, which is still being supported by stamp duty discounts for first home buyers, is seeing prices fall. Prices of detached houses are faring the worst, but unit prices are also in decline. And most recently the weakness has spread outside the capital cities, with prices in the 'rest of New South Wales' and 'rest of Victoria' also recording falls.

Figure 3. Most housing indicators in Sydney are the weakest in years



Source: CoreLogic, ANZ Research

Rather than seeing some tentative improvement at this stage, almost every housing market indicator is at the weakest level in a number of years. Auction clearance rates are at the lowest levels in a decade in Sydney and Melbourne. Housing finance approvals are nearly 15% lower than a year ago, and owner-occupier financing has recently started to fall in line with investors. The number of days on market is steadily rising across the two cities, and the average property now takes nearly 40% longer to sell compared to a year ago. The median vendor discount is also heading higher, and in Sydney is the largest since the GFC. As such, the current state of play is weaker than we previously anticipated.

A unique cycle

When we think about where prices might go from here, we need to identify the cause of the current downturn. Most cycles in Australian housing prices have been driven by interest rate movements. But this time the price cycle is driven by a tightening in credit availability, rather than the cost of credit (ie mortgage interest rates).

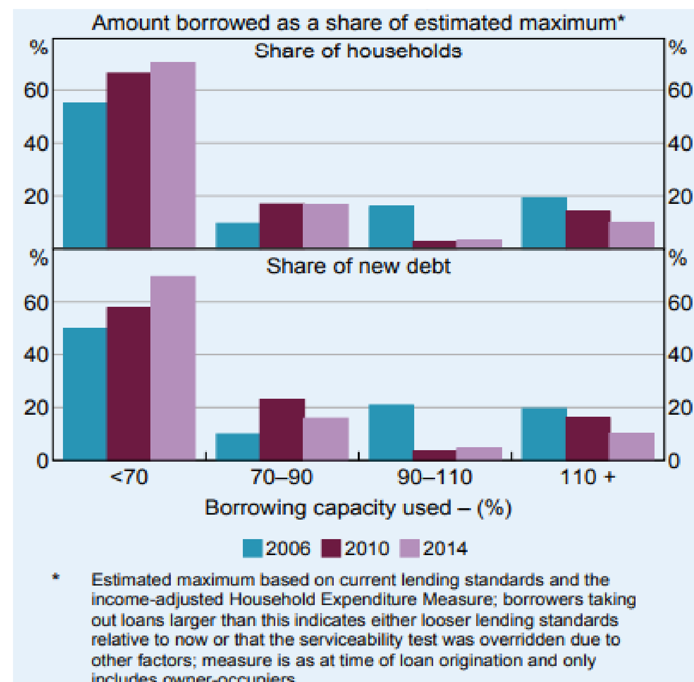
The uniqueness of this cycle makes it tricky to assess how long the current downturn might persist. APRA's macro-prudential controls kick-started the credit tightening, meaning that there have been several iterations of tightening. Further, the changes implemented to reach those targets have differed across the banks. As a result, it is difficult to quantify their cumulative effect on the average borrower.

The RBA has addressed this in recent communications, noting that these changes "tended to reduce the maximum amount that a lender will extend to a new borrower". However, they also point out that only a small proportion of purchasers actually borrow at their limit. As of 2014, according to the RBA, around 13% of new owner-occupiers borrowed close to the lending limit (Figure 3). However, greater scrutiny from the banks around potential borrowers' income and expenses means that the application process is taking longer even for good quality borrowers.

Credit tightening initially affected investors to a greater extent. The investor share of lending has steadily fallen from a peak of 55% in May 2015, to 42% as of September 2018. This has essentially seen a significant withdrawal of demand from the market, which is causing prices to ease. Figure 4 illustrates the extent to which areas with a larger investor presence have seen much weaker price outcomes compared to areas dominated by owner-occupiers.

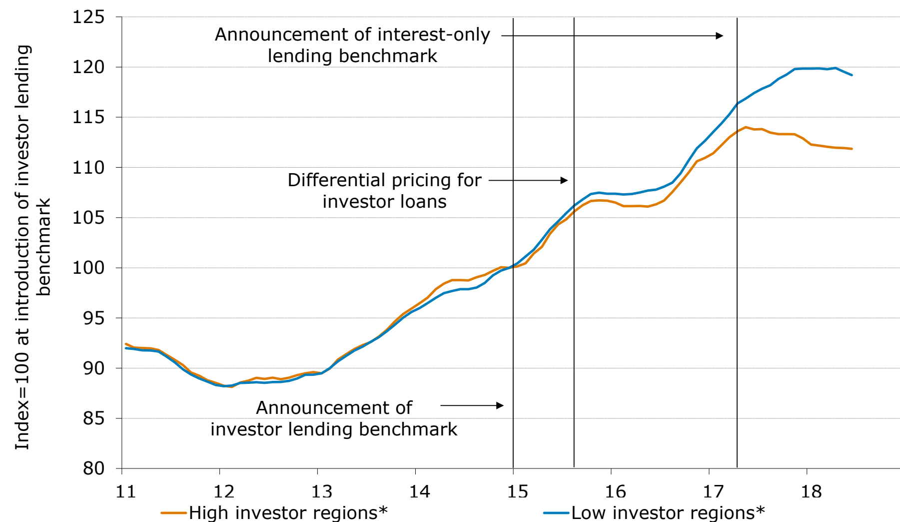
Increasingly, credit tightening is also having an impact on owner-occupiers. Housing finance data show that the average loan size of owner-occupiers as of September has dipped to $392,000 from May's peak of $399,000. Reducing the debt load of new borrowers is a positive development from a financial stability point of view, but it has likely contributed to the weakness in housing prices. Indeed, this has been a policy focus with the household-debt-to-disposable-income ratio at almost 200%.

Figure 4. Most home loans are well below the maximum loan size



Source: ABS, HILDA Release 15.0, Melbourne Institute, RBA

Figure 5. Housing prices and investors



* Dwelling stock weighted indices of SA3 regions where the rental share of the dwelling stock is in the top (high investor) and bottom (low investor) quartiles of the nationwide distribution in the 2011 Census.

Source: CoreLogic, RBA, ANZ Research

And the cycle isn't over yet

Importantly, the credit tightening isn't yet complete. Although APRA's Chair Byres noted in July that the "heavy lifting on lending standards has largely been done", the implementation of various policies across the banks still has some way to go.

In particular, the implementation of Comprehensive Credit Reporting (CCR) will give lenders greater visibility around borrowers' debt obligations. Banks are still digging deeper into borrowers' income and expenses and tightening their controls around credit cards, costs associated with rental properties and retirement planning.

On top of this, there is the potential for greater changes from the Royal Commission when the final report is released in February 2019. We have not explicitly assumed further tightening directly in response to this report, but this risk is present.

In summary, we think that the credit tightening we have experienced so far is not over and, while there is little clarity on the extent, additional changes are likely and could weigh on the housing market for some time yet.

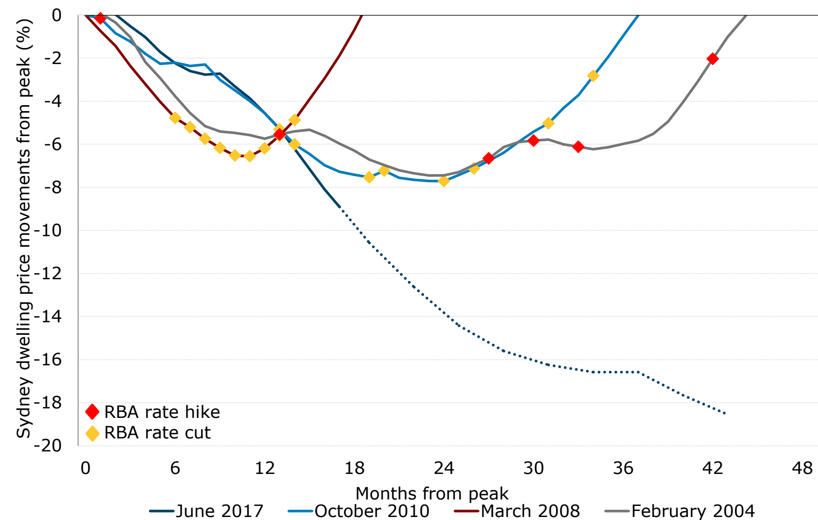
There is also some risk that the credit tightening may not continue for as long as we currently expect. If housing credit growth continues to slow down, banks may relax some of their tightening measures to stimulate demand. We saw this in late-2017/early-2018 when the banks overachieved in slowing investor lending below the target set by the regulator and responded competitively in various ways. These competitive forces should not be ignored as an upside risk to the outlook.

This time, prices won't be saved by RBA rate cuts

Also unique to this cycle is the likelihood that there may not be rate cuts to trigger a rebound in housing prices. In fact, we still think the RBA's next move is likely to be up, even if it is some way off.

Sydney's two most recent downturns in housing prices, starting in 2008 and 2010, rebounded fairly quickly once the RBA began cutting interest rates (Figure 6). It is hard to see that happening this time around. The RBA will be cautious about cutting rates given the potential of re-inflating the housing market and reigniting financial stability concerns. More importantly, the economy is in good shape despite weaker house prices and does not need lower rates.

Figure 6. Rate cuts stimulated the fastest rebounds in Sydney housing prices



Source: CoreLogic, ANZ Research

That said, we still think the RBA will not hike rates while housing prices are falling. Although households and the economy more broadly have absorbed falling housing prices quite well, we think the RBA will be cautious about adding to the downside risks by tightening while housing prices are under a reasonable degree of downward pressure. We see housing prices as entering a broadly stable pattern by early 2020. As a result, we now expect that the RBA will hike rates in August 2020 as evidence accumulates that the downturn in housing is coming to an end. Earlier is possible if house prices stabilise sooner than we expect.

It's worth noting though that the RBA did, once before, hike rates while Sydney housing prices were falling. In March 2005 it hiked 25bps while Sydney housing prices were down 5% y/y. As a result of that and subsequent hikes later in the cycle, prices took time to recover. The 2005 cycle differs from today, however, in that the price declines were largely centred in Sydney and, to a lesser extent, Brisbane. Melbourne prices were rising and the mining cities were booming, which would have given the RBA comfort that the economy could handle higher interest rates.

We're now expecting a deeper, longer downturn

With these features in mind, we have revised our housing price forecasts. Sydney and Melbourne, in particular, have been downgraded.

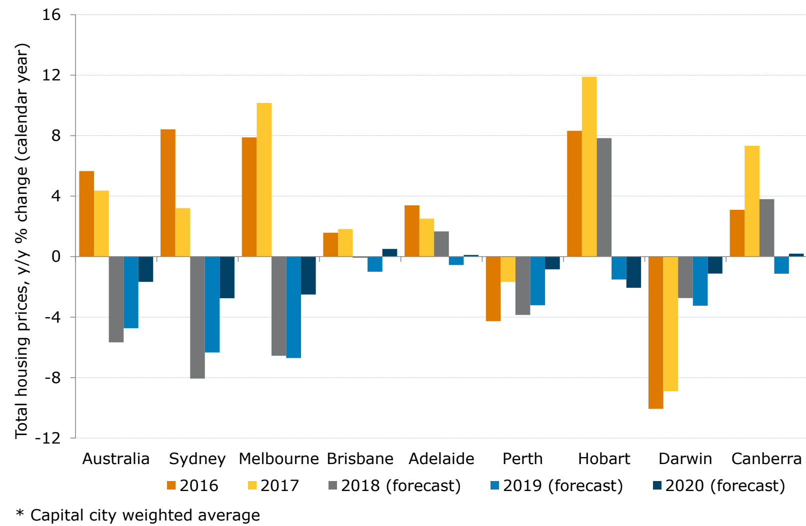
The fall in Sydney housing prices is already the largest in many years. Prices are now 9% below the June 2017 peak – a larger correction than in 2010-11 (-8%), 2008 (-7%), 2004-05 (-7%), 1994-95 (-4%) – and, by the end of this month, the fall will be larger than the 9% fall in 1988–91.

We think there is further to go. We now expect housing prices in Sydney and Melbourne to fall around 15–20% from peak to trough (Figure 7). This outlook is based primarily on ongoing credit tightening, while additional downside risks are possible changes to negative gearing and the eventual arrival of higher interest rates, whether from higher funding costs or RBA rate hikes.

Keep in mind that even a price fall of this magnitude takes values in those two cities back to 2015 levels, which we see as an orderly correction. Having said this, there will be some purchasers who will lose money or may have negative equity.

This is largely a Sydney and Melbourne story, though, where price rises and subsequent falls have been steepest and the investor segment largest. We think there will eventually be some spill-over from these two cities to Canberra, Brisbane and Adelaide. However, we do not expect price falls in these cities to be as significant as in Sydney and Melbourne because they don't have the same concerns around highly leveraged borrowers and a lack of affordability. While the Perth and Darwin markets are expected to remain weak, this is based on the ongoing adjustment away from the mining boom, rather than issues around credit tightening.

Figure 7. Price falls will continue to centre on Sydney and Melbourne



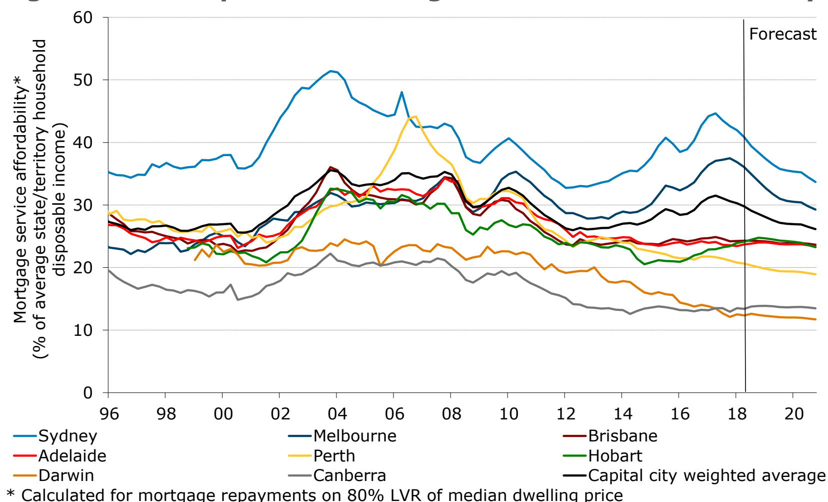
Source: CoreLogic, ANZ Research

Improving affordability is one of the keys to turning the cycle

Aside from credit availability, an important ingredient in turning around the current downturn is affordability. If prices keep falling in Sydney and Melbourne while the economy is strong, there will be a point where demand recovers.

If Sydney housing prices fall in line with our forecasts through to 2020 and incomes keep rising, we think affordability (mortgage repayments as a share of income) will actually be below the long run average (Figure 8). Similarly, the time taken for a FHB to save a deposit would likely be 25% lower than the previous peak, although at a still-lengthy nine years. This highlights that although the fall in prices is undoubtedly an issue for some existing home owners, the next generation of potential owners are largely welcoming of this price correction.

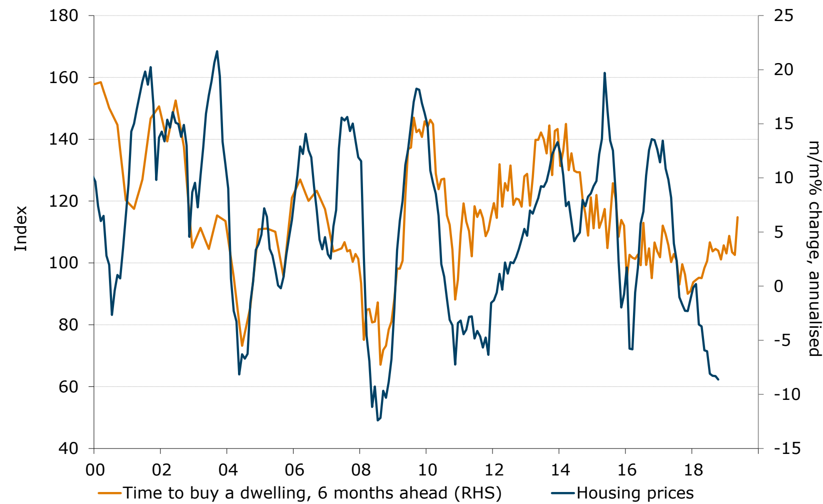
Figure 8. Lower prices and rising incomes mean affordability is improving



Source: ABS, CoreLogic, ANZ Research

We are already seeing signs of this shift in sentiment. The Westpac consumer confidence series on 'time to buy a dwelling' has been trending higher for the best part of 18 months and recently leapt to the highest level in over three years (Figure 9, below). The ANZ Housing Search Index is also rising sharply, as more people search for property online. This suggests that a portion of the market is encouraged by the price falls and better affordability. Note, though, that these buyers may have difficulty accessing credit, limiting their ability to underpin prices.

Figure 9. Households report that lower prices mean it is a good time to buy



Source: CoreLogic, Westpac, ANZ Research

At some point in the cycle this improvement in demand will work to arrest the rate of price decline. But on the same basis of affordability it is difficult to see a strong increase in prices over the longer term. Interest rates are likely to gradually trend higher toward the neutral rate and financial stability concerns mean that credit growth is unlikely to return to the levels seen in the past decade or so. This will be a markedly different environment for households, and the negative impact of higher rates on affordability are likely to limit the potential pace of price growth in the future.

Changes to negative gearing present further downside risk – though it's only modest

One additional risk to the outlook for housing prices is the possibility of changes to negative gearing, should Labor win the next federal election. The implications of such a change are difficult to assess with certainty, though given that the purpose of the policy change is to reduce the return from housing investment, the impact on prices must be negative to some extent, unless rents rise to offset the reduced tax benefit.

While grandfathering the changes is an important part of Labor's policy, these properties will eventually be sold to purchasers who cannot use negative gearing. Economics teaches us that it is the marginal buyer that drives the market, meaning it is the impact on the next purchaser that will dictate where prices go. We think a worked-through example is one way to assess the possible impact on prices.

In our simplified scenario, we assume that a buyer is looking to purchase the mean Sydney unit, at $820,000 with a 20% deposit, leaving a mortgage of $655,000. Our buyer uses a principal and interest loan at 5.1%, making their annual mortgage payment $42,000, of which around $33,000 is interest.

If we assume other costs associated with holding the property total $6,000 a year (property management fees, insurance, rates, water bills, body corporate etc), and rental income achieves the Sydney unit average of $27,000 a year, then the property is making a loss of around $12,000 a year. If the purchaser is in the second-highest tax bracket of 37%, then negative gearing entitles them to an annual tax rebate in the order of $4,000–$5,000. It will be somewhat higher for those investors on the highest tax bracket.

It might be thought that this is the amount that the investor needs to recover each year either through higher rent or a lower house price to be no worse off after the policy change. This is true for investors thinking only about their cash flow over the next 12 months. But this ignores the fact that the losses accumulated can be used once the property becomes positively geared. So the losses do have value, it is just delayed for a period.

The impact of the policy change for a property investor is then the net present value (NPV) of the delayed tax losses over the years the property is running at a loss. To recoup this loss requires only a modest price adjustment to leave the investor unaffected in NPV terms. Depending on how quickly the principal of the loan is reduced, this NPV cost could be offset by a reduction in the property value of a few per cent or even less if the loan is reduced fast enough. We note that investors who assess the loss in NPV terms will be willing to pay a higher price for a dwelling than investors who think purely in annual cash flow terms and thus will increasingly dominate the market over time.

We haven't taken into account the impact of the reduction in the discount for capital gains tax proposed by Labor. The impact of this is even harder to assess than the NPV of the change to negative gearing because its value depends on the time the asset is held, the expected return and so forth. We note that capital gains are still tax preferred over other income even after Labor's change, which lessens the impact. Still, it does reduce the after tax return from investing so at the margin it must have some (small) impact.

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