

MyConsultant

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Investing in the Australian Residential Housing Market "Stairway to Heaven or Close to the Precipice?"



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The turbulence in global financial markets is causing some Australians to pause and re-assess their wealth. Looking at **Exhibit 1**, at present 62% of household wealth is stored in residential housing with an aggregate value of some \$4 trillion. Hence perceptions of residential housing values can have an important impact on consumer sentiment and spending in the Australian economy, as part of what is known as the 'wealth effect'. Superannuation comes in a distant second at 22% of stored wealth; however it can represent a valuable conduit for households to diversify their wealth more broadly over global markets and other asset classes.

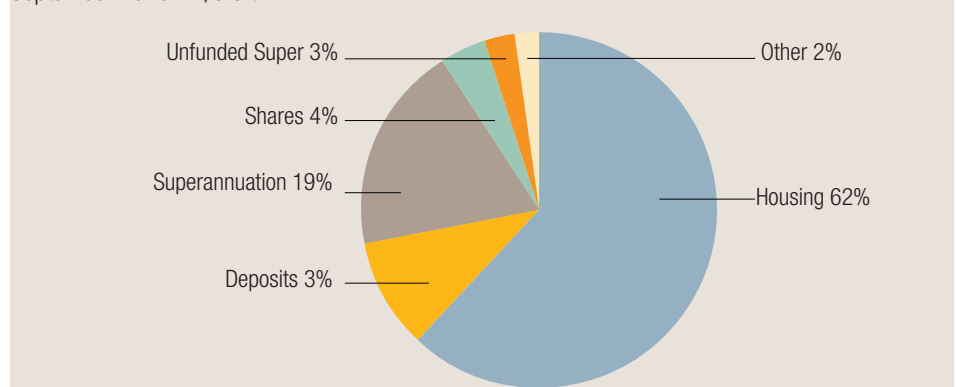
A number of widely reported international studies suggest that the Australian housing market is currently amongst the most expensive in the world. Valuation measures pointing to this include the house price to rent ratio, the land to house price ratio and the house price to income ratio.

If the Australian housing market is significantly overvalued, could we see the same savage price correction as observed in the US, Japan and many European countries of around 30-50 per cent or more? Or are there other factors at play?

In this edition of My Consultant we consider

Exhibit 1: Aggregate household gross assets at September 2011

Aggregate household gross assets
September 2010 = \$6.5 trn



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these questions in the context of their broader implications for the economy, as well as for the growing importance of superannuation investments as a means to diversify household wealth.

Residential property as an investment asset

Whilst housing in Australia is conventionally viewed as a non-investment asset – the primary purpose being to provide a residence – it would be fair to say that for many households it serves a dual purpose, also acting as a key store of wealth.

In fact, notwithstanding the rise of other forms of household investment such as superannuation, housing remains the largest store of household wealth by far. This picture is no different to 20 years ago.

The relatively rose-tinted view of housing as an investment is embedded in the perceptions by many that: housing is treated more favorably from a tax perspective than other investments; housing has enjoyed a long period of superior returns; and housing is a low risk investment.

Whilst the tax treatment for owner-occupied housing in Australia is favorable, its lack of a yield undermines the returns it delivers. It is a capital gain story. Investment in rental housing has a similar tax treatment to many other investments. It does offer a rental income. However, the net rental yield, after allowing for a range of costs associated with managing and maintaining an investment property, has generally not been as attractive as that delivered by many other investments.

In contrast the Australian share market has

delivered lower capital gains through time but a significant part of the share markets overall return has come from a strong and stable dividend yield. There is also the additional benefit of franking of dividends, making the income stream tax efficient for investors who can benefit from these credits.

Taking into account the potential and realised income available to both, **Exhibit 2** shows that the total returns from investing in Australian residential property have been matched by the total return of the Australian share market over the past 25 years, even allowing for the impact of the GFC on the share market.

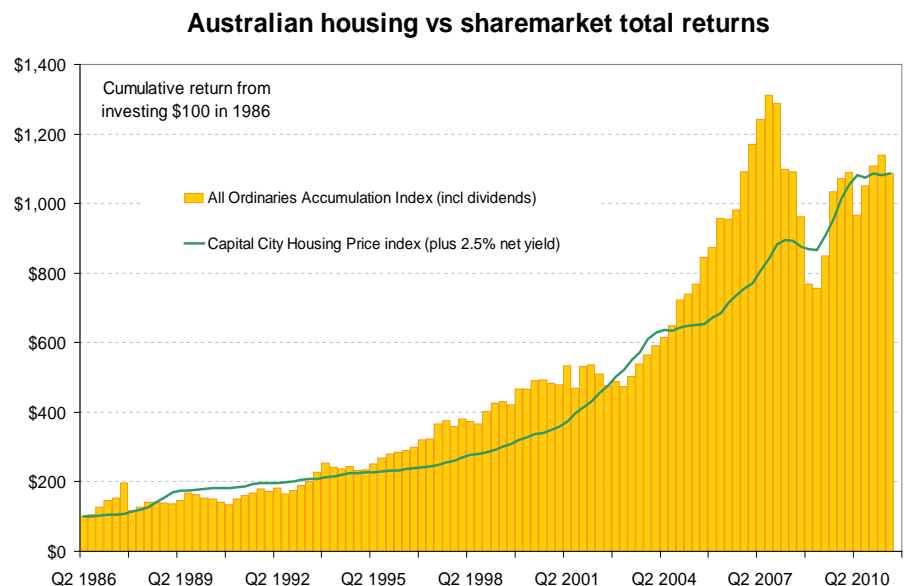
Whilst housing market returns have apparently been less volatile than share market returns over time, it should be remembered that housing as an illiquid investment hides perhaps a greater degree of volatility than truly appreciated. This illiquidity makes it very difficult to realise

capital quickly and cheaply versus listed assets like shares, particularly during distressed market environments such as during the GFC. Housing may therefore not be quite as low risk an investment as it often appears.

Lower expected housing returns suggest greater diversification is preferable

In 2007, following a long period of spectacular appreciation, the Australian share market appeared relatively expensive compared to many other investments including the local housing market. However, post the sharp declines in share prices through the GFC, this situation has reversed. As a result, despite having delivered excellent returns over the past 20 years we expect that returns from Australian housing are on average likely to be much less attractive looking forward.

Exhibit 2: Australian housing vs sharemarket total returns



Source: ABS and MLC Investment Management

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The lower expected returns from housing would argue that the current high level of Australian household wealth invested in housing is too high. As the second biggest store of wealth, superannuation therefore has an important role to play to increase exposure to shares, international assets, alternative asset classes and, towards commercial rather than residential property investments.

Housing affordability is poor

The most compelling argument for a more difficult period for housing prices is the poor state of housing affordability in Australia. Affordability looks at the capacity of households to service their mortgages and is perhaps the most significant driver of housing prices long term.

Despite the dramatic structural decline in interest rates in Australia since the late 1980s and the steadily rising levels of household incomes, the spectacular increase in housing debt over the same period has seen the current level of housing affordability deteriorate to a point comparable with the poorest levels of the past 20 years.

Any future improvement in Australian housing affordability can only come from renewed declines in mortgage interest rates, higher household disposable incomes, or a decline in housing prices.

In the absence of one of these factors adjusting radically in the near term, affordability is likely to remain poor. At the least this could see housing prices stagnating over the next few years. However, it could easily produce a period of falling housing prices in the next year or two

if interest rates were to rise.

Special factors may limit but not avoid housing price declines

Whilst the extent of overvaluation is concerning, are there factors which could prevent a more catastrophic collapse in Australian residential property prices as a whole?

There are indeed a number of 'special factors' that have supported the dramatic appreciation of the Australian housing market. These include supportive taxation treatment of housing, first home owner grants and, perhaps most significantly, the net shortage of available housing. We view these factors as helping to explain the exceptional price appreciation over recent years, and also potentially limiting the downside dangers that exist looking forward.

However, there is a general tendency to view these special factors as supporting continued price appreciation in any environment. We believe this is a dangerous perception to hold, particularly when these factors are at odds with very powerful market drivers like affordability.

Rather we see these factors cushioning any potential decline in the market rather than avoiding it altogether.

Are Australian housing prices close to the precipice?

The Reserve Bank of Australia is the key to the near term direction of house prices. Should the RBA raise interest rates in future then mortgage distress will likely escalate, particularly among more exposed

households. A moderate decline of on average 10-15 per cent in housing prices is quite possible in this case, although we are unlikely to see a uniform price pattern. Some parts of the housing market are likely to show greater price resilience, in particular those directly linked to the mining sector or certain agricultural regions.

Other parts of the housing market could, however, experience more painful price deflation. Some already have experienced this. Observe parts of the Queensland housing market over the past year (most notably the Gold Coast, Far North Queensland and the Sunshine Coast) or Mandurah near Perth to see sharp housing price deflation.

Irrespective of these special factors, domestic housing prices are unlikely to experience continued strong appreciation over the coming few years. It is quite possible that we could see a period of price stagnation, perhaps lasting five years or more. Mortgage rates are more likely to remain elevated on average over the next few years whilst the mining boom persists. This is not good news for the housing price outlook.

This cautious view will challenge the widely held belief that the Australian housing market 'always appreciates'. In fact a period of deflation or stagnation would be perfectly in keeping with the long term history of our housing market.

Looking back at post-World War II Australia, periods of housing price deflation and stagnation are just as much a part of the longer term housing story as price inflation. It is certainly not true to say that Australian house prices always go up, either in real or

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nominal terms.

However, because we have not observed a bout of significant price deflation or even stagnation across the entire housing market since the early 1990s, our memories of a more difficult housing market have faded with time. There are a large number of current home owners who have either not lived through, or are too young to recall, anything other than rising prices.

This lack of a longer term perspective is dangerous. What we can safely say then, is that Australian households need to pay increasing attention to how their stores of wealth are distributed. Given the over-reliance in aggregate on investing in Australian residential property, superannuation investments are likely to play an ever-increasing role as a diversifying store of wealth for Australians.



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