The housing boom is over, what's in store for 2016?

PAUL BLOXHAM & DANIEL SMITH BUSINESS SPECATCULAR 11 DEC 2016

A housing boom was always part of the rebalancing plan. When the mining boom was strong, interest rates were lifted to hold back the housing sector. This helped to make way for the mining upswing without excessive inflation. As the mining boom ended, interest rates were cut, which drove strong growth in housing prices and motivated a large upswing in housing construction, to help fill the gap left by mining.

However, the housing boom cannot go on forever. With Sydney and Melbourne housing prices having increased by 46 per cent and 32 per cent since mid-2012, respectively, some cooling is now needed. If not, prices could become over-inflated and eventually threaten financial stability. Likewise, although the residential construction ramp-up has helped to reduce a previously accumulated housing undersupply, another step-up in housing construction could mean an eventual oversupply.

There is now increasing evidence that activity in the housing market is pulling back. Auction clearance rates, which are a timely measure of housing market activity in Melbourne and Sydney, have been falling in recent months, having peaked around mid-2015. They are now at levels that imply annual housing price growth of around 2-4 per cent in Sydney and 5-7 per cent in Melbourne. The pullback in price growth reflects a number of factors.

First, it reflects that the prudential measures are taking effect. Starting in December 2014, the authorities have been gradually ‘turning up the dial’ on prudential settings to contain the build-up of risk in the financial system. Amongst other things, this has involved: requiring all banks to test new borrowers for higher interest rates; requiring banks to slow growth in their new lending to investors to less than 10 per cent year-on-year; and, requesting that some banks hold more capital, which has seen a recent lift in mortgage rates by the major banks.

As a result, loan approvals have steadied recently, with the numbers showing a particularly sharp fall in new lending to investors. It is worth noting that there has been concern about the measurement of these sub-categories, with previously investor loans being re-classified as loans to owner-occupiers. Nonetheless, the collection of indicators suggests that investor activity has pulled back.

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Second, housing supply has been rising to meet demand, which is likely to be dampening housing price growth. Housing supply has ramped up most significantly for inner-city apartments and it is these dwellings that have seen the largest slowdown in price growth. As we pointed out in recent work, if the level of construction continues at its current rate, the previously accumulated housing undersupply could be worked off by around 2017.

We also noted that these trends differ across different states. There are growing concerns about oversupply of apartments in the Victoria and Queensland markets, although new supply of housing is still running below population growth in New South Wales.

Third, the ramp-up in housing prices is reducing affordability, which may also be starting to weigh on housing demand. Housing price growth (measured as the median) has exceeded growth in household disposable incomes (measured as the mean) since the middle of 2012. This has seen the housing price-to-income ratio rise. However, it is still below previous peaks, in part because the distribution of housing price gains has been uneven. Housing price gains have been concentrated in the two largest cities, which also have the highest housing prices. In Sydney and Melbourne, housing price growth has significantly exceeded national income growth, forcing the Sydney housing price-to-income ratio to its highest level on record.

Household debt has risen, but it's the allocation that matters

As housing prices have risen and new loan approvals have picked up, household debt has also been climbing. The household debt-to-income ratio has risen to 186 per cent, up from a trough of 167 per cent in 2011. At the same time, because housing prices have been rising, the household debt-to-asset ratio has been trending lower. Importantly though, it is not the aggregate levels of household debt that are most relevant for assessing financial sustainability, it is the allocation that matters most.

In Australia's case, household debt has been fairly well allocated to those households that can afford to service it. Australia does not have sub-prime or non-conforming loans and all mortgages are full-recourse loans, so households have clear incentives to maintain repayments. Around three-quarters of all household debt is held by the top two-fifths of income earners. Most households are also well ahead on their mortgage repayments, with the estimates suggesting that the average mortgage is pre-paid more than two years. For previous detailed work on this point see Downunder Digest: Australia’s household debt: why we are not worried, 21 November 2013.

The recent lift in jobs growth should also help support the sustainability of household debt. The employment-to-population ratio has picked up since its trough in Q4 2014, which has seen the unemployment rate steady at 6-6.25 per cent over the past 18 months or so.

The outlook for 2016

We expect the factors that have driven the recent pullback in housing price growth to persist in 2016, with national housing price growth expected to slow from around 10 per cent in 2015 to 3-4 per cent in 2016 and to remain modest into 2017. The trends clearly vary across the cities, with those areas most affected by the end of the mining boom, such as Perth, expected to continue to experience weak conditions. The housing construction boom also seems likely to be close to its peak, with dwelling investment expected contribute less to GDP growth in 2016 than it did in 2015, before becoming a modest drag on growth in 2017.

As housing activity makes less of a direct contribution to GDP growth in 2016, than it was in 2015, a key question is: what will be the next driver of growth? Our view is that the services sectors are set to continue to be a driver of growth and particularly to support jobs growth. This is expected to be supported by low interest rates, the lower AUD and rising Asian demand for services.

Another factor that may support growth is the lagged wealth effect from the rise in housing prices that has already occurred. The fall in the household saving rate has been slower than might have been expected, given the rise in wealth that has already happened. With interest rates expected to remain low, or fall further, and household wealth expected to climb further, albeit more slowly, the household saving rate may edge down through 2016, supporting consumption growth.

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