Brief Update: House price outlook

by NAB Group Economics

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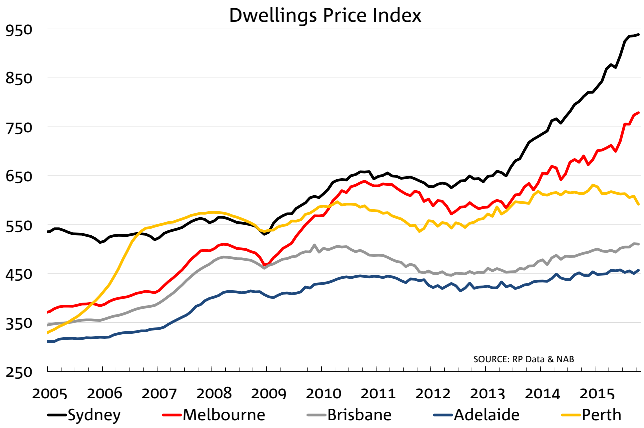
National Australia Bank

- **Australian residential property price growth has continued to surpass expectations in recent quarters, suggesting more limited scope for further gains.**
- **Consequently, NAB Economics has reduced its forecasts for detatched house price growth in 2016. Nationally, prices are now forecast to increase 2% in 2016 (from 3%), largely reflecting a slower pace of growth in Sydney and Melbourne.**
- **While price growth will slow, a sharp correction in prices is still not expected given supportive market fundamentals and continued foreign demand for new dwellings.**
- **Risks have increased, however, especially in the apartment market which has seen a sharp increase in construction activity.**

House price strength not expected to continue

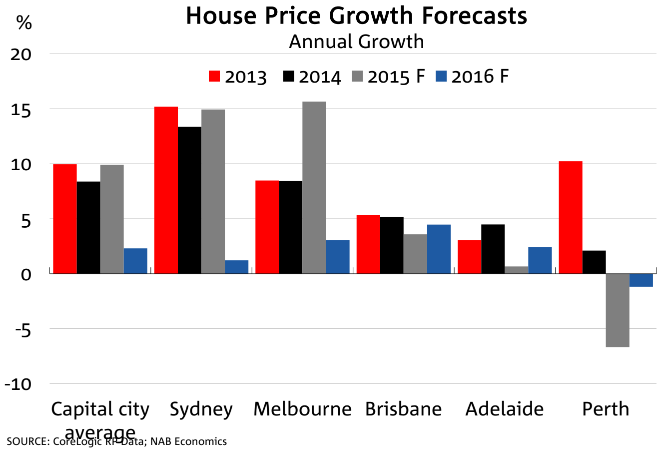
In last week's NAB Residential Property Survey (link), we cut our forecasts for house price growth in 2016. This was a reflection of both the stronger than expected growth seen in house prices to date, which appears increasingly unsustainable, and some tightening in financing conditions observed in the mortgage market (largely brought about by macroprudential changes and major banks' reactions to higher capital requirements).

Chart 1: Dwelling price growth – faster than expected



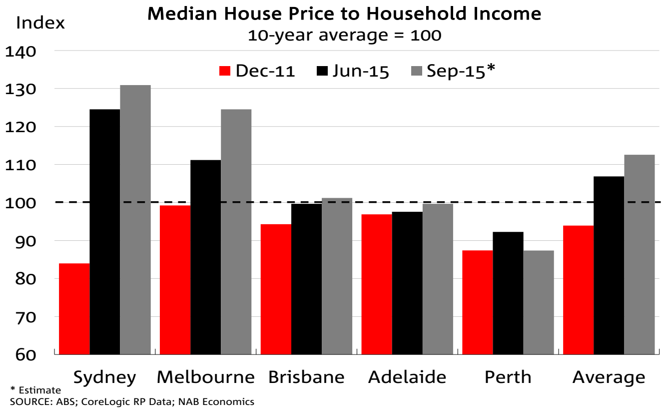
For 2015, NAB Economics is expecting average national house price growth of 9.9%, which is much higher than expected earlier in the year. The rapid pace of house price growth has not been experienced uniformly across the market. Capital growth has been led by Sydney and Melbourne, with house price growth forecast to be 14.9% and 15.7% respectively over 2015. Modest gains in 2015 are also forecast for Brisbane (3.6%), while Adelaide will be up modestly. In Perth, house prices are expected to fall (-6.7%), with the slowdown in the mining sector and associated softening in population growth playing a negative role in the local market.

Chart 2: House price growth to slow



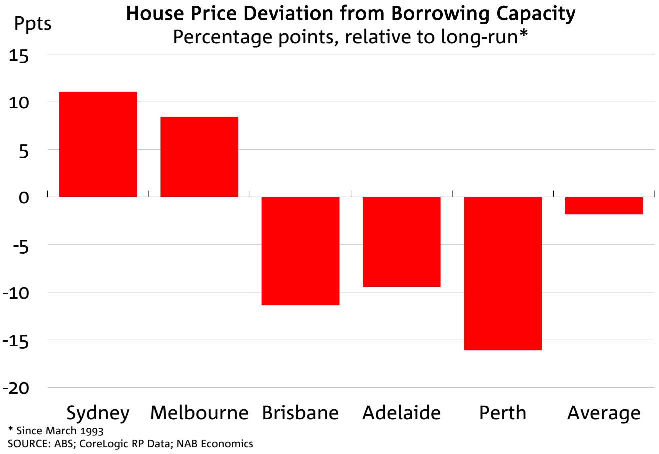
In an environment where income growth continues to be modest, alongside lower population growth, the rates of house price growth seen in Sydney and Melbourne are unlikely to continue, suggesting more modest price gains in 2016. The ratio of median house prices to household disposable income has lifted considerably in these markets since the RBA commenced easing monetary policy in 2011, cutting the cash rate from 4.75% to 2% currently (Chart 2). Additionally, regulatory changes to address risks in housing credit (particularly investor credit) have tightened conditions in the mortgage market, which is likely to have at least some impact on housing demand (even if only at the margin). However, the response from some corners claiming that these factors point to a sharp correction in house prices in the medium term, are extreme in our view.

Chart 3: Price to income measures



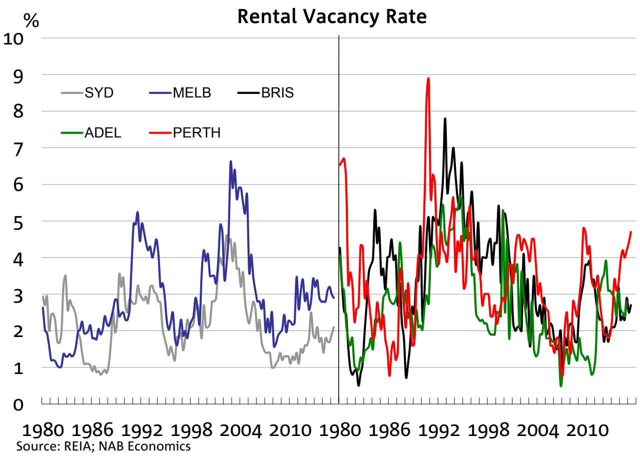
One major reason for this is because housing affordability has not deteriorated as much as price to income ratios would suggest. A major drawback of these simple ratios is that they do not capture the offsetting (positive) impact from lower interest rates (smaller mortgage repayments) on housing affordability. To capture the effects of lower interest rates, it is more informative to compare median house prices to the hypothetical borrowing capacity of the average household (in each respective state). This comparison suggests much less cause for concern, although continues to point to a somewhat overheated market in both Sydney and to a lesser extent Melbourne.

Chart 4: Prices relative to borrowing capacity



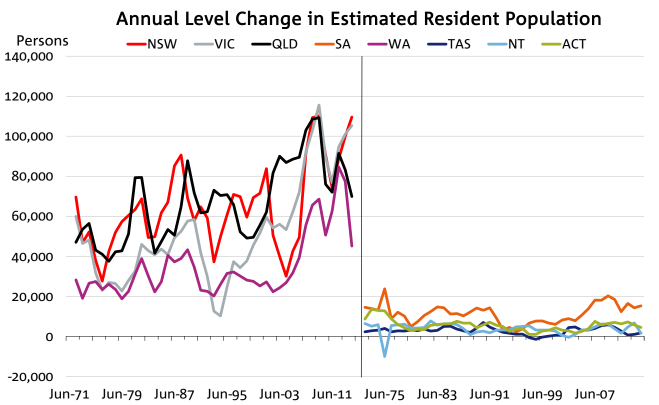
This result is broadly consistent with estimates of market (over)valuation produced by the IMF in their latest 'Australia – Selected Issues' report (published in September). It is important to note that all property market valuation techniques have their shortfalls – such as being highly sensitive to the assumptions made – but can be a useful guide to market risk. The IMF concluded from their analysis that house prices in Australia were moderately higher than fundamentals, but less overvalued than 'a comparison to historical or international averages would suggest.' We would concur with this finding.

Chart 5: Rental vacancy rates still low in the east



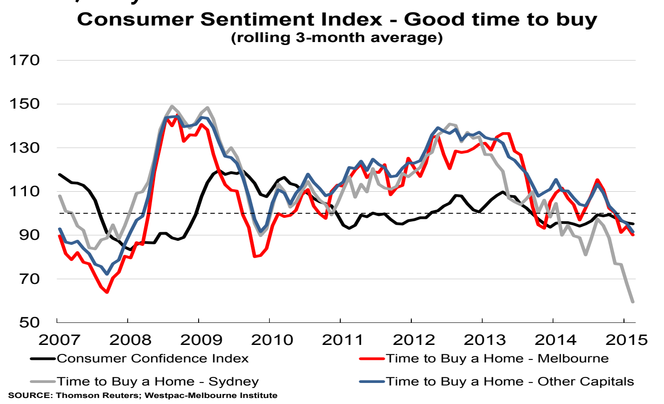
In addition to record low interest rates, a number of years of sluggish growth in housing supply (relative to demand), has helped to allay fears of a severe market correction – at least in certain markets. While measures of pent-up demand are highly sensitive to the assumptions used, simple measures such as rental vacancy rates suggest that pent-up demand is still supportive in some markets, especially Brisbane and Sydney. While new supply through apartments has come on line, new detached housing supply has not increased greatly for most markets relative to population (see below). Having said that, population growth in Australia has been slowing in line with the winding down of the mining boom, although growth in the major eastern states has remained robust, supported by interstate flows. Foreign student arrivals are also expected to be strong, especially in these states, assisted by a more favourable AUD – which should be particularly beneficial for apartment demand. Overall, these trends suggest that slower population growth will imply weaker house price gains, but that the major eastern states should prove to be somewhat more resilient.

Chart 6: Population slowing, but mainly in mining states



In light of pent up demand and an environment of low interest rates , it would most likely require a substantial shock to the labour market and/or for interest rates to increase sharply to trigger significant declines in house prices – while there are risks, neither of these are anticipated in our forecasts. Rather, the most likely outcome would be a prolonged period of very subdued capital growth. A period of subdued capital growth would also be consistent with our expectation of a period of subdued rental growth.

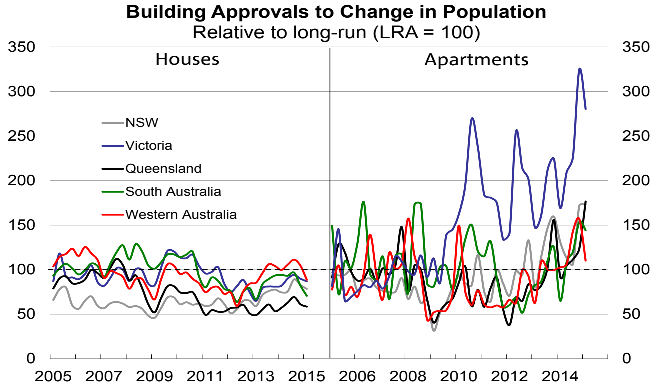
Chart 7: Buyer enthusiasm has waned



Nevertheless, there are signs that elevated prices are discouraging home buyers and cooling the housing market. The Westpac-Melbourne Institute survey of consumer sentiment, for example, shows that households consider it to be a pretty poor time to buy a property. This sentiment has been reflected in market indicators, with the national clearance rate holding below 70% in the week ending 18 October (Sydney was at 66.6%).

The forecast for average national house price growth in 2016 has been lowered to 2.3%, previously 3.0%, following an expected 9.9% for 2015. A strong supply response in the apartment sector (Chart 8), however, suggests a weaker outlook for this market, and greater reliance on foreign buyers and domestic investors adds a degree of unpredictability to the outlook. In 2016, the slowdown in average national house price growth to 2.3% is largely driven by a moderation in both Sydney and Melbourne prices growth (see Chart 2). NAB Economics expects house price growth to decelerate in Sydney to 1.2%, while price growth in Melbourne will ease to 3%. Brisbane is tipped to see the fastest house price growth (4.5%), and the Adelaide market is expected to improve (2.4%). Perth will remain weak, although price declines are forecast to ease (-1.2%).

Chart 7: Potential apartment overbuild in some areas



Overall, our assessment is that the possibility of a sharp correction in the Australian housing market is remote, although continued rapid price growth in Sydney and Melbourne over the past 6 months suggests the risks have risen. While it would take a sharp deterioration in the labour market and/or a large increase in interest rates to trigger a severe decline in house prices, worsening affordability will most likely cap price growth going forward. Supply is also responding to higher prices - this may exert downward pressure on some segments of the market, although measures of pent-up demand (under-supply) vary across markets (e.g. still quite supportive for Sydney housing) and do not capture foreign demand. However, approvals for new apartments have been large in some areas (e.g. Melbourne CBD), which poses a risk in these segments.

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Table 1: Detached house price forecasts

Hedonic house prices	2011	2012	2013	2014	2015 F	2016 F
Capital city average	-4.0	-0.5	9.9	8.4	9.9	2.3
Sydney	-2.6	1.3	15.2	13.4	14.9	1.2
Melbourne	-4.4	-2.9	8.5	8.4	15.7	3.0
Brisbane	-7.0	-0.5	5.3	5.2	3.6	4.5
Adelaide	-3.8	-0.8	3.0	4.5	0.7	2.4
Perth	-3.4	0.6	10.2	2.1	-6.7	-1.2

Percentage changes represent through-the-year growth rates to Q4

Source: Corelogic, NAB Economics

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