REIQ Queensland
MarketMonitor
PROPERTY RESEARCH




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What next for property?

With the Australian residential property market coming out of an upward cycle not seen since the late 1980s, speculation has been rife throughout 2004 as to the market's short to medium-term prospects.

As Table 1 illustrates, the market rose on a sudden wave of enthusiasm back in late 2000 early 2001. Median house prices more than doubled in half of Australia's capital cities in the last six years and the Commonwealth Productivity Commission found the upswing was "bigger and more widespread than in previous cycles".

To gain a better understanding of the future of the market, it is worth looking at how the market arrived at where it is and what was driving it?

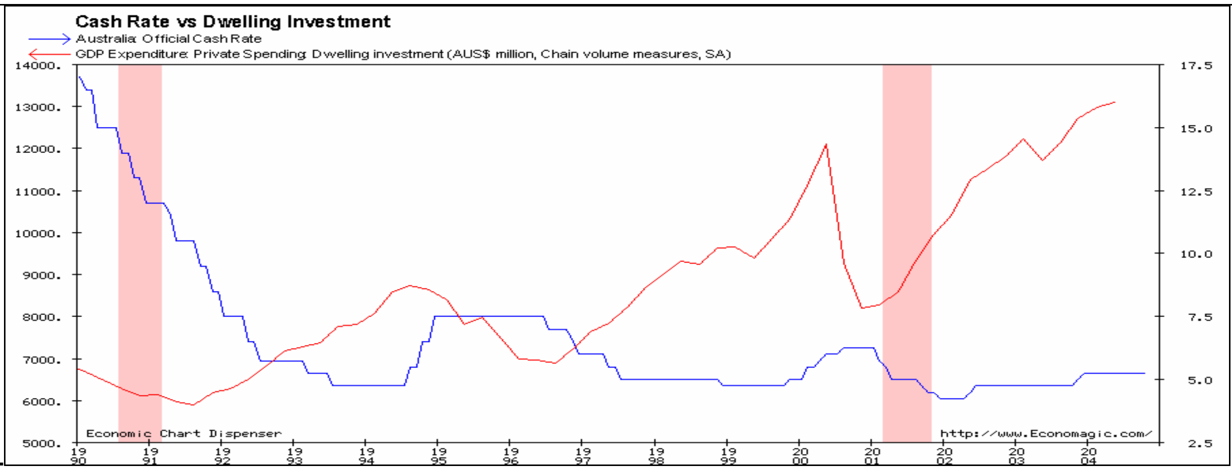
There are three main drivers affecting demand for residential property: interest rates, household income and government policy and taxation. Interest rates have a major impact on property investment, with the majority of residential property being purchased with some level of borrowed funds. This relationship is displayed in Graph 1, and it is no surprise that as interest rates hit their lowest level in generations, dwelling investment soared. However, current conditions are driven by much more than just low interest rates.

Table 1 – Change in House Prices to September 2004

	1 Year	2 Years	6 Years
Sydney	1.1%	13.9%	82.7%
Melbourne	-0.5%	10.6%	91.6%
Brisbane	8.9%	38.9%	136.6%
Adelaide	16.4%	45.6%	121.5%
Perth	9.8%	27.4%	68.7%
Hobart	30.2%	89.2%	143.8%
Darwin	21.9%	26.0%	48.3%
Canberra	0%	42.9%	123.7%

Source: *State & Territory Real Estate Institutes*

Graph 1



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Major deregulation in financial markets over the last 20 years has lead to mainstream banks in the mortgage lending market coming under increasing competitive pressure from mortgage brokers, foreign banking interests and the like. Graph 3 illustrates the gap between the lending rates of banks and those of mortgage brokers has decreased since the mid 1990s, which reflects the increased competition for business between lenders. Coupled together, these circumstances have allowed both investors and owner-occupiers to gain easier access to finance, and when money is highly accessible at lower interest rates, people are more likely to invest in property.

If we also add into the mix the poor returns on world stock markets following the "tech crash" of the late 1990s a very strong impetus was created for large amounts of investor interest in the housing market. As Graph 4 shows, house prices rose dramatically after the stock market falls in both 1987 and 2000. Graph 5 reflects this movement of investors into the property market, with investors accounting for some 40% of total housing finance in 2002/2003, compared with an historical average of around 25%. The latest data for the September quarter 2004 show investors still account for some 35% of finance commitments.

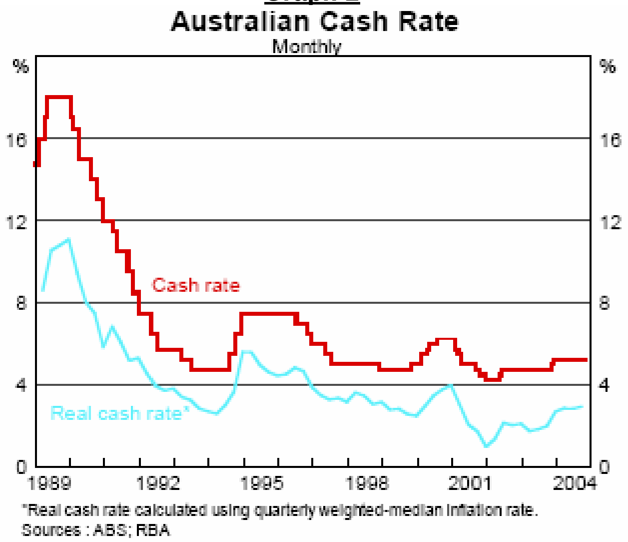
Nonetheless, taxation and government policy also played a critical role in fostering unprecedented interest in direct investment in residential real estate. In particular, changes to capital gains tax and the introduction of the First Home Owner's Grant (FHOG) have had a major impact on the recent behaviour of the market.

The FHOG, which applied to owner-occupiers, was a catalyst for increasing housing demand. The grant was introduced by the Federal Government on 1 July 2000, and led to a strong increase in demand from both typical first homebuyers, and also from people who, under normal circumstances could not afford to be in the market.

Graph 6 shows first homebuyer approvals rose dramatically above their 10 year average as a result of this government intervention. Following the withdrawal of the additional grant for new buildings, approvals dropped back below the average, suggesting that a vast proportion of demand was brought forward to take advantage of the situation.

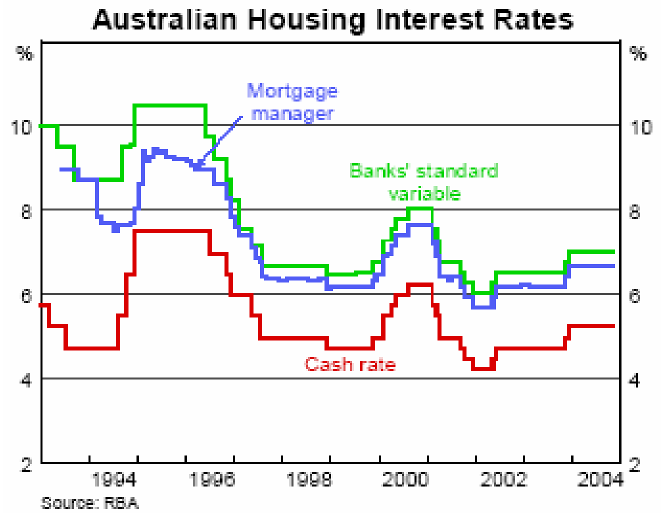
It can be assumed that the FHOG played an important role in house price increases during this extended upward housing cycle, as supply failed to keep up with the policy-induced demand.

Graph 2



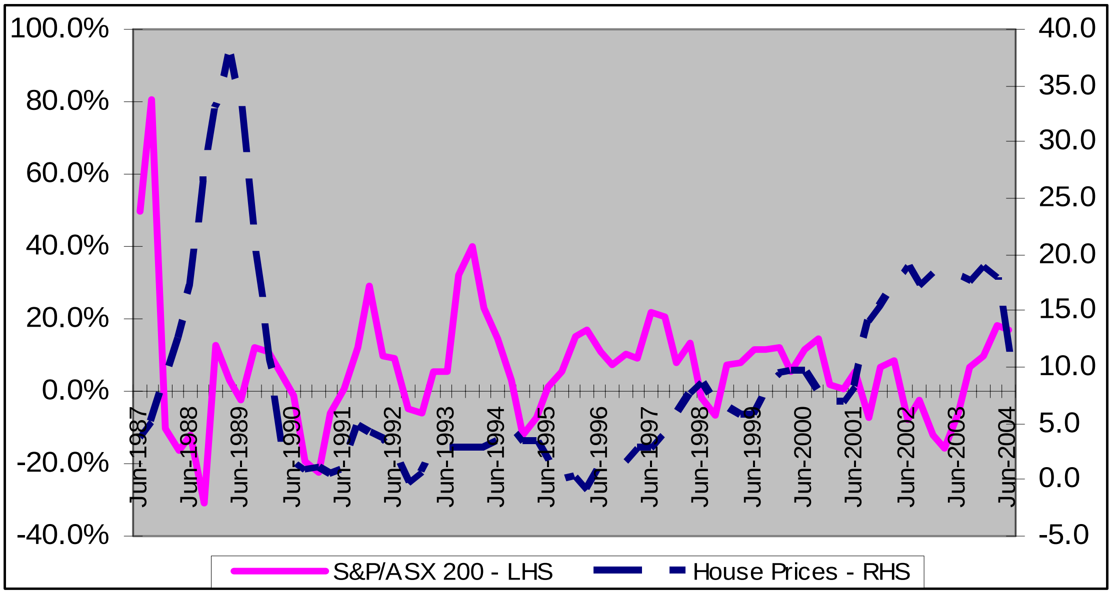
Source: *Reserve Bank of Australia – Chart Pack*

Graph 3



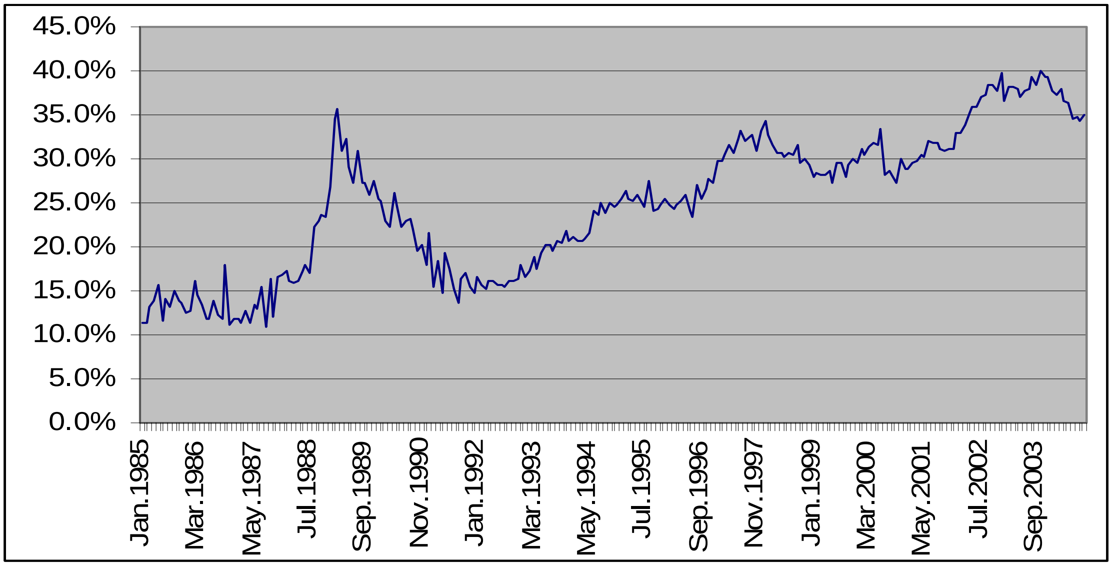
Source: *Reserve Bank of Australia – Chart Pack*

Graph 4 – Share Market Returns & House Prices – Quarterly Percentage Movement



Source: *Australian Bureau of Statistics*

Graph 5 – Investor Finance Commitments as a Percentage of Total Housing Finance Commitments



Source: *Australian Bureau of Statistics*

Another important taxation policy intervention was changes to capital gains. According to *The Economist*, a London-based weekly publication, the tax rate on capital gains in Australia has effectively been half of the top income tax rate since changes were introduced in 1999. Given the easy availability of credit and the poor performance of the stock market at the time, together with the benefits of negative gearing, it is little wonder that investors jumped into the market.

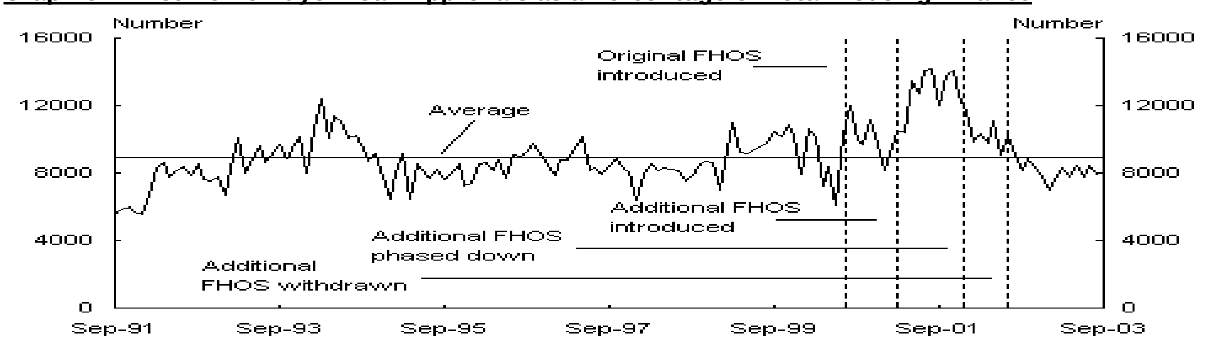
The final issue to consider is household income. Put simply, if a person receives a pay rise and expects that increased level of pay to continue, then their demand for housing is likely to increase, as they can now afford to "trade-up" to a newer or better property.

Alternatively, any decrease or uncertainty in incomes, which is likely to persist into the near future, will lead to a lower level of demand for housing as households will be unwilling to lock themselves into a larger mortgage.

GDP growth in Australia has averaged 4% per annum over the last 12 years. This is reflected in Graph 7 with high levels of year-on-year GDP growth. If we couple these high growth rates with extremely high levels of consumer sentiment, as shown in Graph 8, we can begin to build a picture of household confidence which is extremely positive - and reflective of the huge gains in residential property prices.

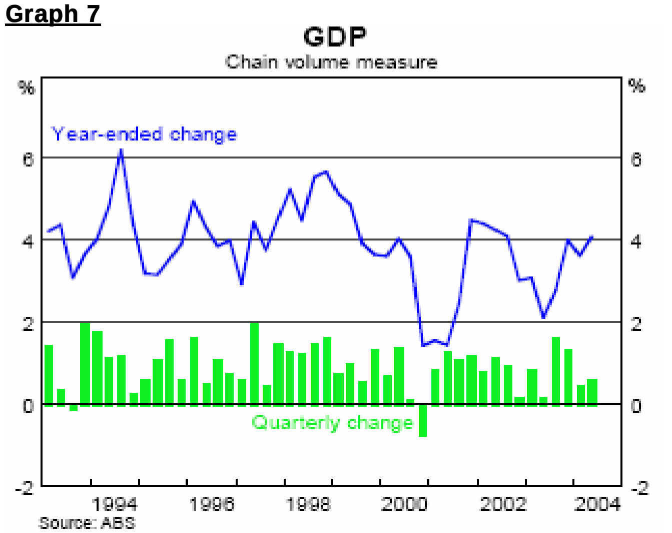
The huge level of consumer spending based on increased asset prices (for example, new cars financed by home loan equity draw downs) is a clear sign that most consumers expect the good times to continue.

Graph 6 – First Home Buyer Loan Approvals as a Percentage of Total Housing Finance



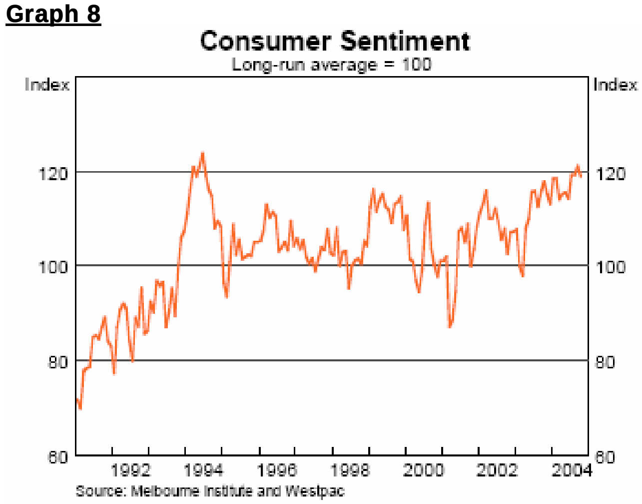
Source: *Summer Roundup 2003-2004: First home buyers in Australia*, The Department of the Treasury, Canberra

Graph 7



Source: Reserve Bank of Australia – Chart Pack

Graph 8



Source: Reserve Bank of Australia – Chart Pack

Conditions in Australia were ripe for a property boom to take hold. Just recently *The Economist* described the residential property market in Australia as a "hotbed of irrational exuberance". So we must ask - has this boom overstepped the mark?

We have experienced rapid price gains over the last two years and investors have played a massive role in creating this boom, seemingly unperturbed by low rental yields.

As Graph 9 shows, rental yields on typical investment properties have dropped substantially over the course of the boom. This suggests that investors were relying on capital appreciation alone to realise an overall return on their investment.

Similarly, if we look at the affordability index in Graph 10, we see that prices are at extreme levels compared with incomes.

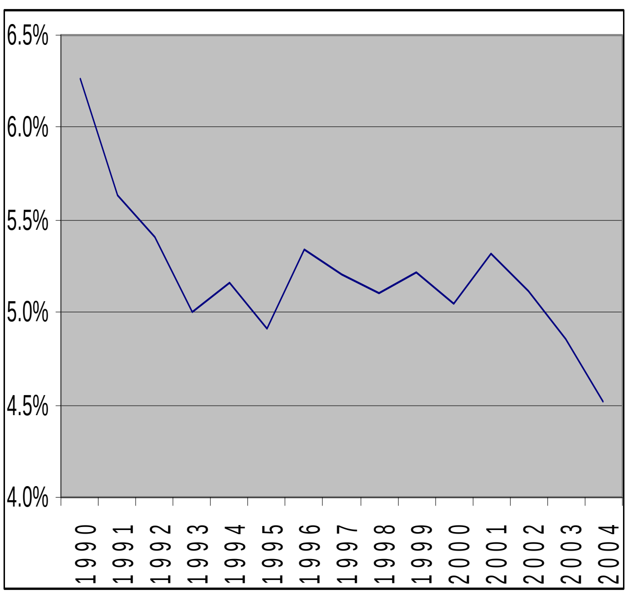
Going forward the two key issues driving the direction of the residential property market will be debt levels and the future behaviour of investors.

Household debt in Australia has expanded rapidly since the middle of the 1990s. As Graph 11 shows, compared to other OECD countries our debt levels have gone from being relatively low, to one of the highest. Household debt is currently at 150% of disposable income, which is basically double the level of 10 years ago. Again, continued declines in interest rates, as well as easier access to credit, have been contributing factors.

While interest rates are low households are able to meet repayments, however as both Graph 2 and history tell us, interest rates do not stay at one level forever. Given these factors some property owners look exposed to any major unfavourable movements in interest rates.

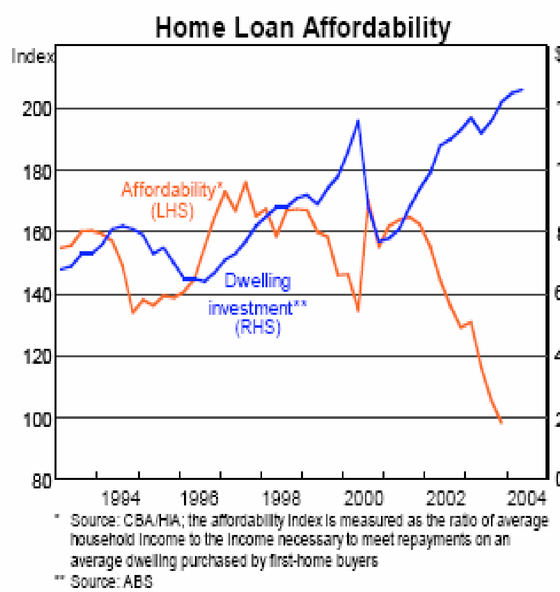
As the right hand side of Graph 12 shows, interest payments relative to disposable income are now above the peak levels preceding the recession of the 1990s, even though interest rates have basically fallen by two-thirds from the 17% plus levels seen during that time. Unless there are significant upward movements in average earnings going forward, it is unlikely that price rises like those experienced in the last few years can continue into the next, as many property owners are already heavily indebted.

Graph 9 – Brisbane Average Rental Yield – 2 Bedroom Units



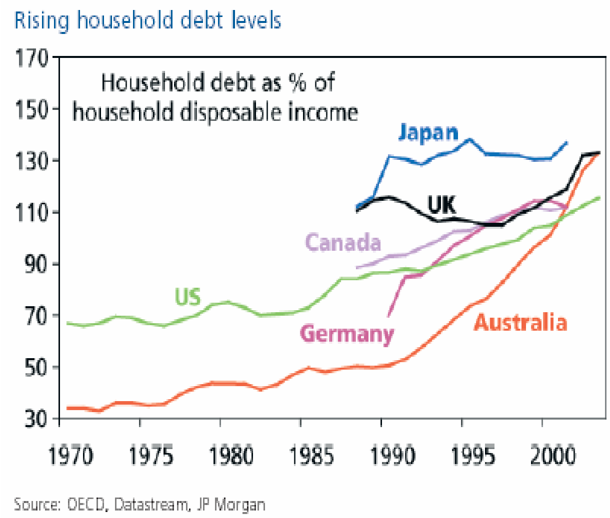
Source: REIQ

Graph 10 – Home Loan Affordability



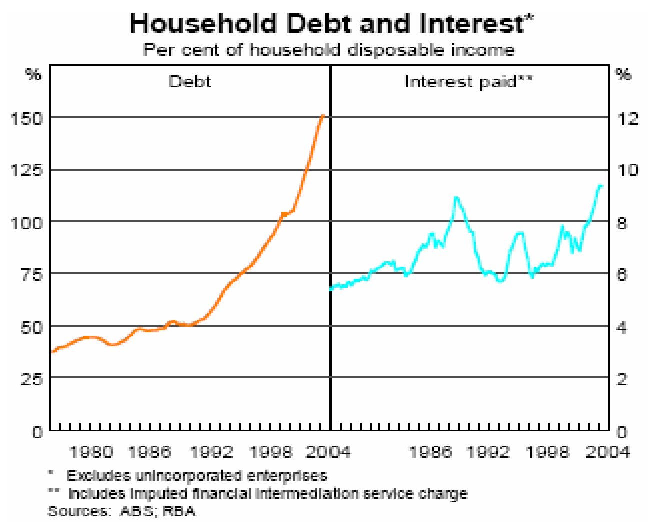
Source: Reserve Bank of Australia – Chart Pack

Graph 11



Source: Oliver's Insights 2003, *Household debt – the next big problem?* AMP Henderson Global Investors

Graph 12 – Household Debt & Interest



Source: Reserve Bank of Australia – Chart Pack

In recent years investors have accounted for as much as 45% of residential property activity, compared to an historical average of 25%. One of the key tests of the market will be the delivery of major residential projects over the course of 2005. Projects which are currently being constructed are those which were marketed at the height of the market 'boom'.

However it will be interesting to see if the vast majority of investors actually settle on their contracts or pull out, now that banks have tightened their lending levels and the market has paused for breath. Many investors were relying on continued price growth, in the hope they could on-sell finished apartments and collect a profit; however in most cases the apartments are still worth what was paid for them off-the-plan in 2002 and 2003, while in inner Sydney and Melbourne some apartments are actually worth less.

As we already know, investor activity has dropped off substantially in 2004. Both house and unit sales are down roughly 45% in volume terms in the year to September 2004 compared with the same period in 2003. Such evidence shows that speculative, short-term' investors realise that the days of making a 'quick buck' are over for the time being; however better returns on the stock market are also likely to be attracting some of those funds that were previously entering the residential property sector.

The near future is hard to predict. The most likely outcome for investors is solid income and rental gains (which is already happening across parts of Queensland), thus limiting the scope and argument for price declines.

Some rental gains are currently being seen in pockets across the state – bolstering depressed rental yields. In reality the most likely outcome over the next few years is moderate growth in property prices as the rest of the economy catches up. This will allow traditional relationships between income, rents and house prices to be restored over the long-term.