HSBC Global Research

Macro
Australian Economics

Downunder Digest

Australia's housing boom may get bubbly

- **We expect continued strong national housing price growth of 7-8% in 2015, driven by record low mortgage rates**
- **Housing construction is also set to pick up strongly, with a new record of 200,000 dwellings approved in the past year**
- **Given the recent RBA cut, the risk of a housing bubble is increasing, particularly in Sydney; efforts by the prudential regulator to tame investor activity bear watching closely**

A tricky balancing act

Monetary policy is being pushed to its extremes as Australia's policymakers seek to rebalance growth following the mining boom. Last week, the RBA cut its cash rate to a new record low of 2.25%, and markets are pricing in a further cut to come.

An area that is getting clear support is the housing market. Housing prices have risen by 23% over the past 2½ years and are currently growing at 8% y-o-y. In Sydney, they are up 33% and rising at 13% y-o-y. Building activity is also booming, with national residential approvals reaching a record high of over 200,000 dwellings over the past year. Low interest rates are the main driver of the upswing, although foreign demand remains strong and the recent fall in the AUD/RMB exchange rate could give it a further boost.

In general, this is a positive story. When the mining boom was at its height, in 2011 and 2012, tight monetary policy saw housing prices fall, such that there has been room for prices to increase, simply to catch up with previous levels. Also, when mine construction was booming, too few houses were being built to meet the demand from a rapidly growing population, creating a housing undersupply. Now is a good time to boost housing supply.

However, it is also possible to have too much of a good thing. Construction of new housing is welcome, but further housing price gains may present challenges. Recent cuts in mortgage rates to new all-time lows increase the risk of the housing market over-inflating.

In response, the prudential regulator announced new mortgage guidelines in December 2014 in an attempt to tighten lending standards. Since then, however, mortgage rates have fallen further as the RBA cut again. New prudential measures seem designed to give the RBA room to cut rates further without excessive house price growth, but they remain untested.

We expect national housing prices to rise by 7-8% in 2015, once again well ahead of household incomes. We see Sydney prices rising by 9-10% in 2015 and expect that, when rates do eventually rise, there is now a high risk that Sydney will see price falls.

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1. Housing prices have been surging for 2½ years

Source: RP-Data Corelogic

2. Low mortgage rates set to drive housing price growth

Source: ABS, RP-Data Corelogic

Low interest rates to continue to support demand

Australia's housing prices have risen by 23% over the past 2½ years and are currently growing at 8% y-o-y, supported by a number of factors. Population growth has been strong, housing supply has, so far, been weak and foreign demand has been rising, reflecting a global search for yield and an on-going trend increase in foreign interest in the local housing market, particularly from China. However, the single most important determinant of housing price dynamics in Australia is interest rates, and mortgage rates are now at new record lows. A simple bivariate model with interest rates and housing prices – as shown in Chart 2 – goes a long way to forecasting housing prices. Given the current level of mortgage rates, we expect national housing prices to rise at a similar rate to 2014 of 7-8% over 2015 (Table 3).

Significant national divergence as the economy rebalances

Of course, there remains significant divergence across the housing markets in Australia. Given the geographical distance between major cities, these markets often have cyclical dynamics that vary greatly, reflecting state-specific economic factors. However, the states do typically have a synchronised cycle overall, driven by the common national mortgage rate.

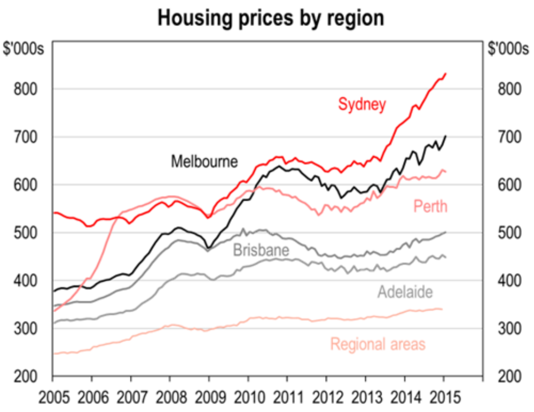
At present, the divergences are larger than usual, as the end of the mining boom is having a larger negative impact on Western Australia and Queensland than on the other states. We expect these geographical divergences to continue as growth gradually rebalances following the end of the mining

3. Housing price forecasts*

y-o-y	2014	2015f	2016f
Sydney	12	9-10	-2-2
Melbourne	8	7-8	4-8
Brisbane	5	6-7	4-7
Perth	2	3-4	1-5
Adelaide	4	5-6	3-7
National	**8**	**7-8**	**2-6**

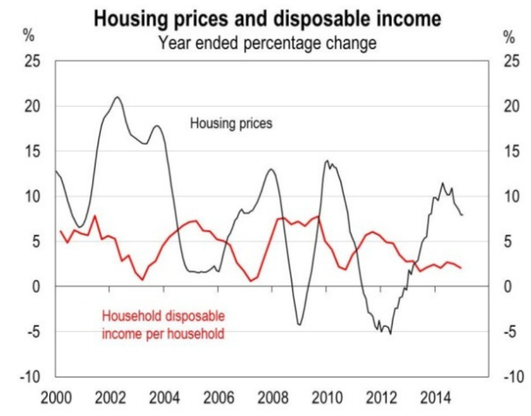
Source: RP-Data Corelogic, HSBC forecasts. *Assumes our cash rate assumptions in Table 16.

4. Sydney market continues to see boom conditions



Source: RP-Data Corelogic

5. House price growth is significantly outpacing incomes



Source: ABS, RP-Data Corelogic

boom (for more on this see: Bloxham, P. and Smith , D. (2015) *Australia in 2015: Still rebalancing*, 21 January). Since the RBA has been cutting interest rates, beginning in late 2011, the strongest housing price growth has been in Sydney and Melbourne. From their troughs in mid-2012, Sydney and Melbourne housing prices have risen by 33% and 20%, respectively (Chart 4). In 2015, we expect Sydney and Melbourne to continue to outpace the rest of the nation (Table 3). We also expect national housing price growth to continue to significantly outpace household disposable income growth (Chart 5).

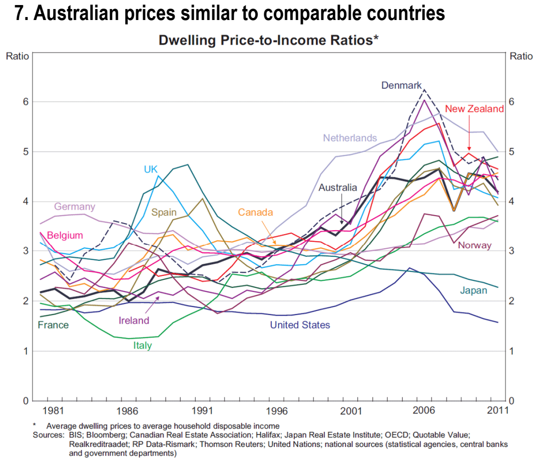
The bubble question

For many years there have been questions about whether Australia's housing prices are over-valued and, for a long time, we have had the view that Australia does not have a housing bubble. Although Australia's housing prices are high, there are strong fundamental reasons for their levels. Supply of housing has been weak and demand has been strong. Australia's major cities also have low urban density, reducing the number of housing units for any given level of demand. In addition, over the past decade, Australia's housing prices have grown in line with household disposable incomes (Chart 6) and the housing price-to-income ratio is also not exceptionally high when compared with a range of countries (Chart 7).

6. House price-to-income ratio rising, though not exceptional

Source: ABS, RP-Data Corelogic, HSBC estimates

7. Australian prices similar to comparable countries



In previous work, we have noted a range of supporting factors for our view that Australia does not have a housing bubble. These include that: Australia's housing debt is well allocated and mostly held by higher income households; that Australians are, on average, well ahead on their mortgage repayments; and, that Australia does not have sub-prime loans; that all mortgages are full-recourse loans. For more details on these issues see: Bloxham, P. (2013) *Downunder Digest: Australia's housing boom: no bubble yet*, 8 October and Bloxham, P. (2014) *Downunder Digest: Australia's housing market is still booming*, 13 July.

In short, we do not think that Australia currently has a national housing bubble. However, we do see that the longer housing prices continue to increase faster than household incomes (see Chart 5), the greater the chance a bubble could inflate. We are also starting to see pockets of the market where bubbles could be forming, given that interest rates have now been low for quite some time.

Sydney market at risk of a bubble

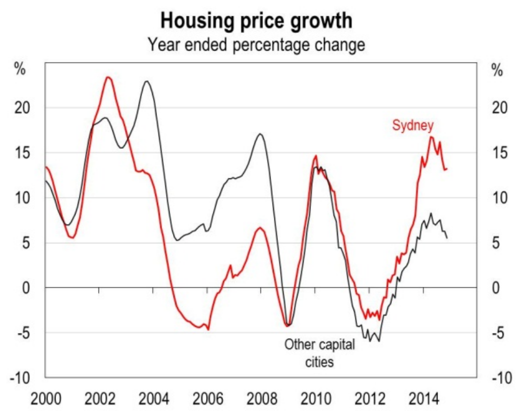
Although we do not see a national housing bubble, we believe that growth in Sydney housing prices is currently running at an unsustainable pace and that any further growth is likely to be met by housing price declines in future years, when interest rates do begin to rise (Chart 8). A signal of the growing risk of over-inflation in the Sydney market is the high level of investor demand. Housing loan approvals for investors currently account for a record high share of new loan approvals in New South Wales (Chart 9).

The high involvement of investors suggests that there is a speculative dynamic in the Sydney market that may be worrisome. Investors are typically seeking capital gains, rather than rental yield, as Australia's tax system favours capital gains. Investors themselves tend to be lower risk borrowers, as they typically have equity in another owner-occupied property and have lower loan-to-valuation ratios than first home buyers. In this way, it is not clear that investor involvement is leading to increased financial system risk. However, it does seem likely that increased investor activity is driving housing prices to rise faster than fundamental factors suggest they should in the Sydney market.

Prudential regulator is tightening, but the RBA is cutting

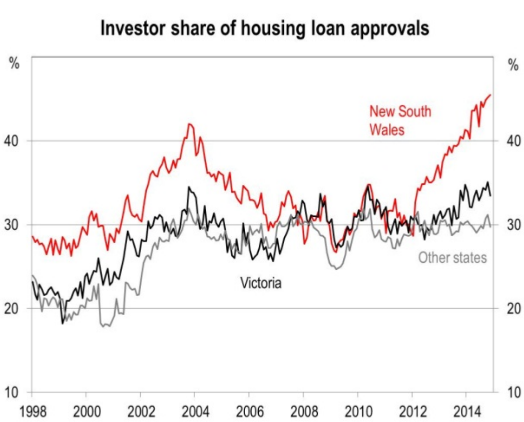
To address concerns about growing risks, the Australian Prudential Regulatory Authority announced a set of enhanced guidelines for mortgage lending in December 2014, which Australian banks are being asked

8. Sydney housing price growth unsustainably rapid



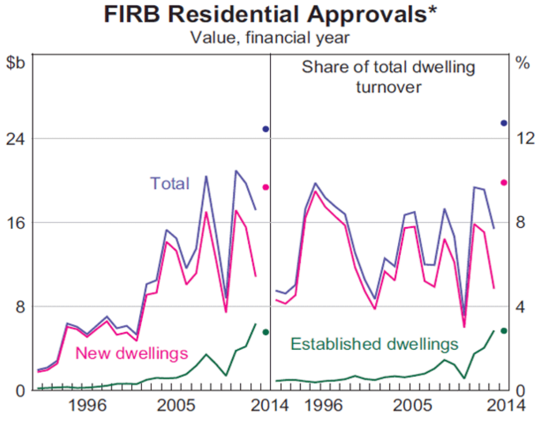
Source: RP-Data Corelogic

9. Investor loan approvals are at a record high in NSW



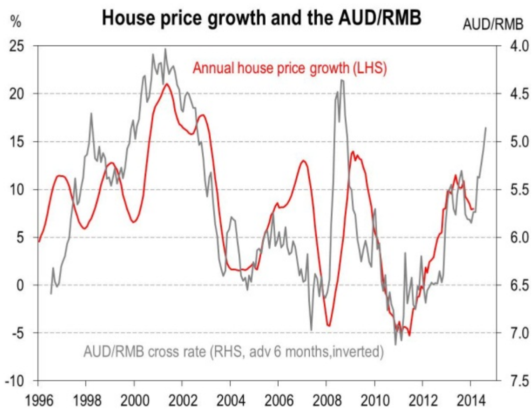
Source: ABS

10. Foreign demand for local housing has been rising



* Data for 2013/14 are for the nine months to March 2014
Sources: FIRB; RBA; RP Data-Rismark

11. A lower AUD/RMB exchange rate could support demand



Source: Bloomberg, RP-Data Corelogic

to work with. These measures include: the prudential regulator 'paying particular attention to' higher risk mortgage lending such as higher loan-to-income loans, high loan-to-valuation loans, interest-only loans and loans with long terms; the prudential regulator noting that if banks grow their lending to investors faster than 10%, the regulator may consider 'further action"; and that all new borrowers need to incorporate an interest rate buffer of 'at least 2ppts above the loan product rate and a floor of at least 7%, which banks need to consider when assessing a borrower's ability to service a loan.

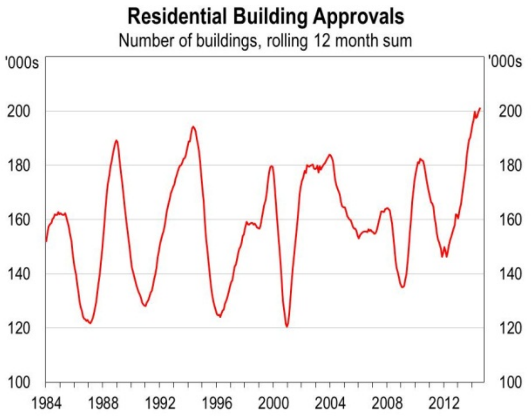
The challenge to these measures is that the RBA has just delivered a further cash rate cut, which has seen Australian mortgage rates fall to new all-time lows. It is unusual in Australia for prudential policy and interest rate settings to be working in opposite directions. As the RBA noted last week, it is 'working with other regulators to contain the economic risks that may arise from the housing market'. Time will tell if these measures are successful; however, historically, the interest rate setting has had a far more powerful influence on Australia's housing market than other factors.

Foreign demand to be further supported by a lower AUD

Another driver of demand for housing in Australia has been increased foreign buying, particularly from China. Timely statistics on foreign buyers are limited, but there are some data available from the Foreign Investment Review Board (FIRB) as all purchases by foreigners need approval from the FIRB. These numbers suggest a strong rise in foreign investment in Australian housing in 2014, with particular strength in investment in new dwellings (Chart 10). Much of the interest from foreign buyers is in the Sydney and Melbourne new apartment markets.

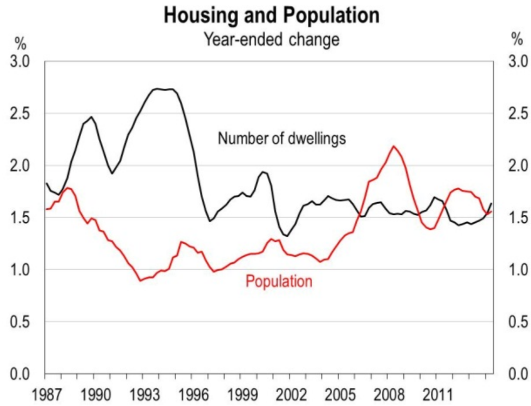
Foreign investment in Australia's housing market is only a relatively small proportion of overall housing turnover, but is likely to be having some effect on housing prices. There also appears to be a strong positive correlation between the AUD/RMB cross rate and Australian housing prices growth (Chart 11). The recent fall in the AUD against the RMB could help to encourage a further ramp-up in Chinese purchases of Australian residential property.

12. Building approvals hit new record highs



Source: ABS

13. Building dwellings to meet population demand



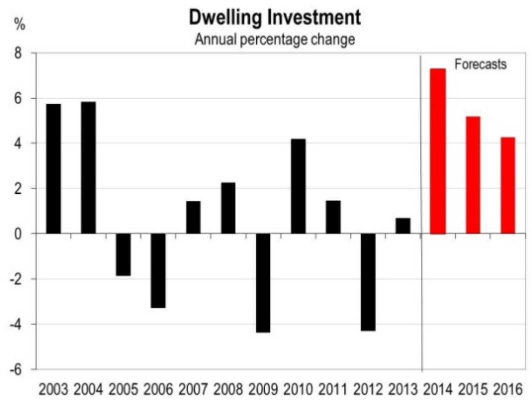
Source: ABS

Housing construction upswing to continue

Rising housing prices and low interest rates have supported a significant upswing in residential construction. Over the past year, new residential dwelling approvals have risen to a new record high, with over 200,000 dwellings approved for construction over the past year (Chart 12). This is generally a positive story, as most estimates suggest that Australia still has an undersupply of dwellings relative to demand, given the strong population growth (Chart 13). Dwelling investment is expected to once again rise at its fastest pace in a decade in 2015, following similarly rapid growth in 2014 (Chart 14).

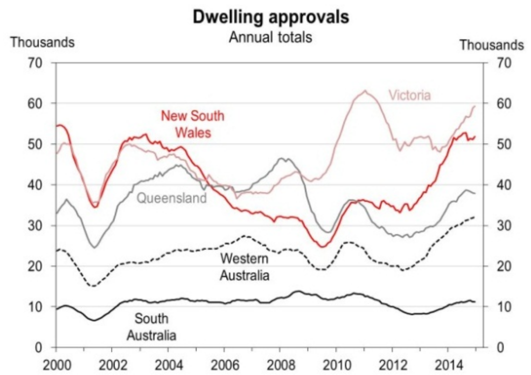
As Australia's growth rebalances away from the mining states towards the south-eastern states – of New South Wales and Victoria – the strongest ramp-up in construction should be expected in these states. To date, New South Wales has shown the strongest ramp-up in new dwelling approvals (Chart 15). Although this generally a positive story, there are some risks. For Sydney, the combination of rapidly rising housing prices, record levels of investor involvement, a significant ramp-up in dwelling supply and rising foreign interest combined with historically low mortgage rates, do, together, signal that a housing bubble may be inflating in this market. At the least, we now expect that Sydney housing prices are likely to fall when interest rates start to rise, which could be as soon as 2016.

14. Dwelling investment forecast to remain strong



Source: ABS, HSBC estimates

15. Ramp-up in dwelling approvals has been broad-based



Source: ABS

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16. HSBC's forecasts for Australia and New Zealand

	Year-average			Year-ended						
	2014	2015	2016	Q314	Q414e	Q115e	Q215e	Q315e	Q415e	Q116e
%*										
AUSTRALIA										
GDP	2.8	2.8	3.2	2.7	2.6	2.3	2.6	3.2	3.4	3.5
Consumption	2.5	2.6	2.9	2.5	2.4	2.6	2.5	2.6	2.8	2.9
Public consumption	2.1	1.9	1.6	1.7	2.1	2.1	2.1	1.7	1.6	1.7
Investment	-2.2	0.0	2.8	-3.0	-2.1	-2.2	-1.9	1.5	2.8	3.2
- Dwelling	7.3	5.2	4.3	6.8	7.4	3.3	4.0	6.7	6.7	5.8
- Business	-4.2	-1.7	1.6	-5.4	-3.4	-2.8	-2.6	-1.5	0.2	1.3
- Public	-3.9	0.5	5.6	-3.9	-7.2	-6.2	-6.2	7.7	8.2	7.2
Final domestic demand	1.2	1.8	2.6	0.9	1.1	1.2	1.2	2.2	2.6	2.7
Domestic demand	1.4	2.1	2.6	1.3	1.6	2.2	1.2	2.3	2.6	2.7
Exports	6.7	8.1	8.8	7.1	7.2	5.2	9.1	8.7	9.4	9.6
Imports	-0.8	4.2	6.4	-0.8	1.4	3.6	2.4	5.0	5.7	6.1
GDP (% quarter)	--	--	--	0.3	0.7	0.7	0.8	0.9	1.0	0.8
CPI**	2.5	1.9	3.0	2.3	1.7	1.4	1.6	2.0	2.6	3.2
Trimmed mean**	2.7	2.4	2.9	2.6	2.3	2.2	2.2	2.5	2.7	3.0
Unemployment rate	6.1	6.0	5.6	6.1	6.2	6.2	6.1	5.9	5.8	5.7
Labour price index	2.6	2.8	3.5	2.6	2.6	2.6	2.7	2.9	3.1	3.3
Current A/C (%GDP)	-3.0	-3.1	-2.6	-3.1	-3.3	-3.4	-3.2	-3.0	-2.9	-2.7
Terms of trade	-7.5	-5.3	-0.4	-9.0	-10.7	-9.9	-6.4	-2.9	-1.5	-0.5
Budget balance (%GDP)	-3.1	-2.5	-1.9							
Capital city house prices	9.4	8.0	5.1	9.1	7.6	8.1	8.1	8.3	7.3	6.2
Private sector credit	4.9	6.0	6.5	5.1	5.4	5.9	5.9	6.1	6.1	6.2
USD/AUD (end period)	0.82	0.72	0.70	0.87	0.82	0.75	0.74	0.73	0.72	0.71
Cash rate (end period)	2.50	2.00	2.75	2.50	2.50	2.25	2.00	2.00	2.00	2.25
%*										
NEW ZEALAND										
GDP	3.3	3.0	2.8	3.2	3.6	3.3	3.2	2.7	2.6	2.6
Consumption	3.3	3.6	2.4	4.0	4.1	4.6	4.0	3.1	2.7	2.5
Govt consumption	3.6	1.9	1.6	3.0	3.3	2.4	1.8	1.8	1.6	1.6
Investment	9.6	10.2	5.9	6.9	10.9	10.4	11.1	10.0	9.2	8.1
Final domestic demand	4.8	4.9	3.1	4.5	5.6	5.6	5.3	4.6	4.1	3.8
Domestic demand	4.9	4.7	3.1	4.3	5.6	5.9	4.4	4.6	3.9	3.5
Exports	0.9	-0.5	2.3	1.6	-1.7	-4.2	0.2	0.8	1.6	2.3
Imports	7.4	5.1	3.1	5.7	6.1	5.4	3.9	5.2	5.8	5.1
GDP (% quarter sa)	NA	NA	NA	1.0	1.0	0.6	0.5	0.5	0.9	0.7
CPI	1.2	1.0	2.1	1.0	0.8	0.3	0.6	1.1	1.9	2.4
Unemployment rate	5.6	5.2	4.9	5.4	5.4	5.3	5.3	5.2	5.0	4.9
Labour price index	1.8	2.2	2.4	1.9	1.8	2.0	2.1	2.2	2.3	2.4
Current A/C (%GDP)	-3.4	-4.3	-4.4	-4.2	-4.8	-4.6	-4.4	-4.3	-4.1	-4.4
NZD/USD (end period)	0.77	0.70	0.68	0.78	0.78	0.72	0.71	0.70	0.70	0.69
Cash rate (end period)	3.50	3.75	4.50	3.50	3.50	3.50	3.50	3.50	3.75	4.00

Source: ABS, RBA, HSBC forecasts. *Unless otherwise specified. **Includes the effect of the carbon tax from Q312 and its removal from Q314

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