FLASHNOTE
11 December 2015

HSBC Global Research

Downunder Digest

Australia's housing market cools

MACRO ECONOMICS

Australia

- Housing prices have steadied in Sydney and Melbourne in recent months, after strong growth in recent years
- This reflects the impact of prudential tightening, recent mortgage rate increases by the major banks, a ramp-up in housing supply and declining affordability
- We expect national housing price growth to slow from 10% in 2015 to around 3-4% in 2016 and the contribution of housing construction to GDP to fall from 0.5ppts to 0.2ppts

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The boom is over, but a soft landing is expected

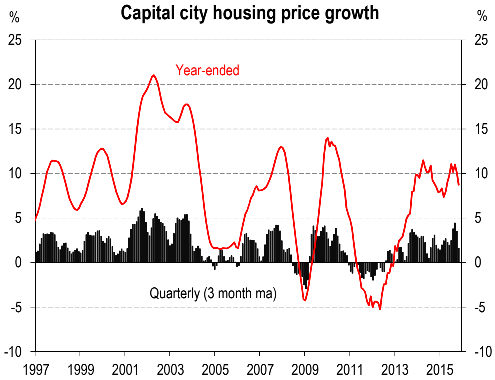
A housing boom was always part of the rebalancing plan. When the mining boom was strong, interest rates were lifted to hold back the housing sector. This helped to make way for the mining upswing without excessive inflation. As the mining boom ended, interest rates were cut, which drove strong growth 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% and 32% 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.

Concerns about excessive housing price growth in Sydney and strong growth in investor activity, saw the prudential authorities tighten lending standards over the past year to contain growing risks. This factor, combined with recent mortgage rate increases by the major banks (in response to higher capital requirements), the recent ramp-up in housing supply and some reduction in affordability due to the housing price rises, have seen the housing market cool in recent months. We expect housing price growth and construction to slow noticeably in 2016, but see sharp price falls as unlikely, given continued low mortgage rates.

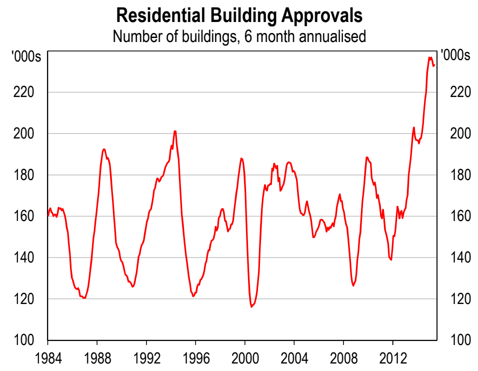
The slowdown in housing price growth and construction means that these will contribute less to GDP growth in 2016, although the lagged wealth effect from previous housing price gains could support some spending (via reduced household saving). As the housing sector pulls back, the rebalancing act moves to its next stage: a lift in the services sectors. This is creating jobs, which supports household incomes and should mean that the housing boom ends with a soft landing.

1. Housing boom has helped rebalancing



Source: CoreLogic RP Data

2. Housing construction has ramped up



Source: ABS

Housing boom has been part of the rebalancing act

Sydney and Melbourne housing prices have risen substantially, while the other capital cities have seen much more sluggish growth

When the mining boom was at its height, in 2011 and 2012, housing prices and residential construction were falling (Chart 1 and 2). Interest rate hikes through 2010 and 2011 had held back the housing sector. Subsequent cuts to interest rates, to now around record lows, drove a strong upswing in housing prices and a historically large residential construction boom.

As might be expected, the pick-up in housing market activity has been uneven across the country (Chart 3). The states with the least exposure to the mining boom have been the strongest performers, with Sydney and Melbourne housing prices rising substantially over recent years, while the other capital cities have seen much more sluggish growth.

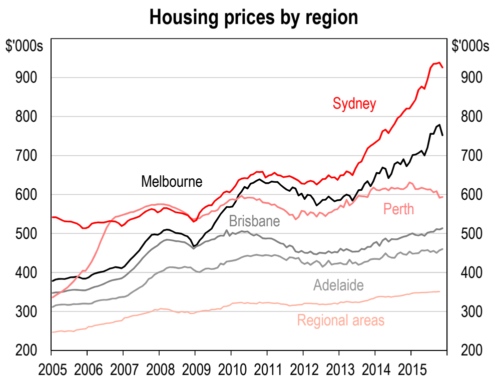
The lift in the housing sector has been a testament to the power of monetary policy and has helped to fill the gap left by falling mining investment and commodity prices. Ideally, the rise in housing construction would have occurred with a less rapid ramp-up in housing prices, but monetary policy is a blunt instrument. Given concerns about excessive housing price growth in the Sydney and Melbourne markets, the prudential authorities began tightening their settings in December 2014, to contain the risks and, in effect, to sharpen the instrument.

Clear evidence of a pullback, which is helpful

Timely measures suggest housing market activity in Sydney and Melbourne has pulled back in recent months

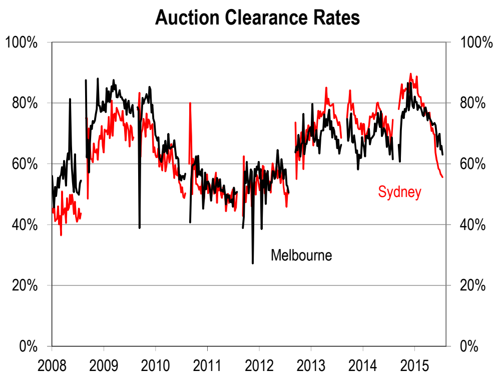
There is now increasing evidence that activity in the housing market is pulling back. Auction clearance rates, which are a timely measure of housing market activity in Melbourne and Sydney, have been falling in recent months, having peaked around mid-2015 (Chart 4). They are now at levels that imply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

3. Price gains have been uneven



Source: CoreLogic RP Data

4. Sydney and Melbourne are now cooling



Source: ABS, CoreLogic RP Data

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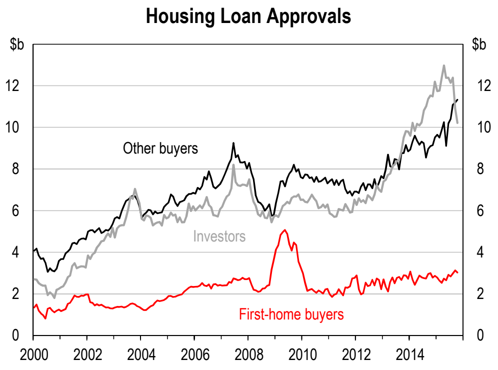
5. New lending has levelled out recently

Source: ABS

6. Investor lending appears to have fallen



Source: ABS

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% y-o-y; and, requesting that some banks hold more capital, which has seen a recent lift in mortgage rates by the major banks.

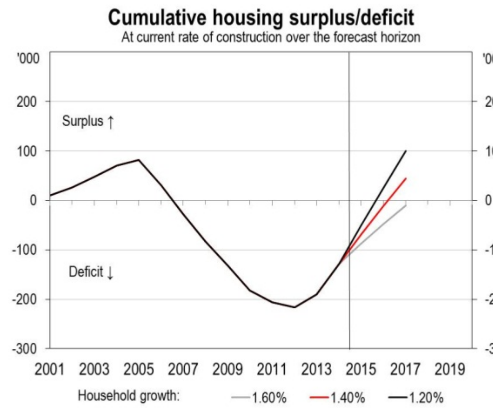
The housing pullback reflects prudential policy, rising housing supply and reduced affordability

As a result, loan approvals have steadied recently, with the numbers showing a particularly sharp fall in new lending to investors (Chart 5 and 6). 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.

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 (Chart 7).

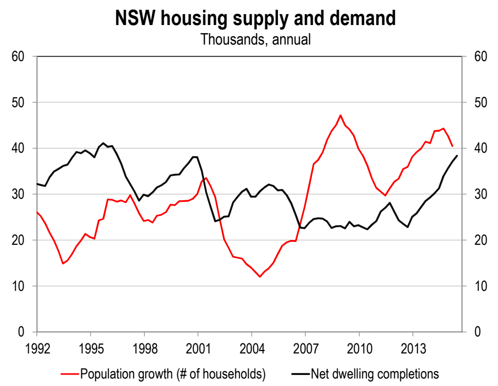
We also noted that these trends differ across different states. There are growing concerns about oversupply of apartments in the Victoria and Queensland markets, although new supply of housing is still running below population growth in New South Wales (Chart 8). For more details see *Downunder Digest: Australia's housing supply ramp-up*, 9 September 2015.

7. Headed back to supply/demand balance



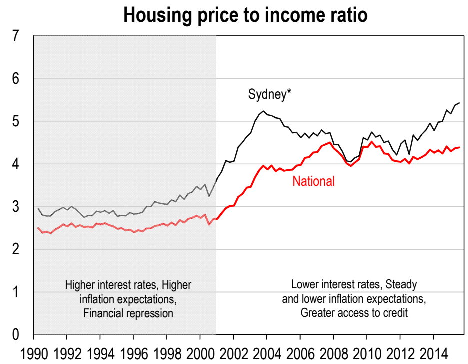
Source: ABS, HSBC estimates

8. Sydney still has undersupply



Source: ABS, HSBC estimates

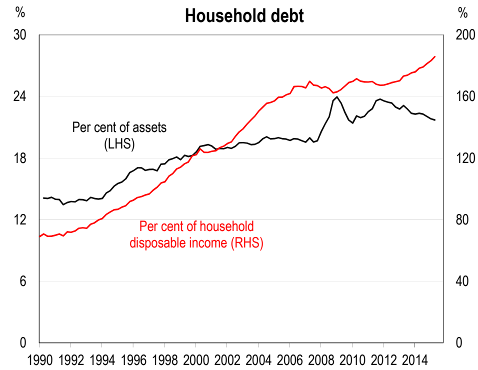
9. House price-to-income ratio has risen



* Uses Sydney median house price and national disposable incomes (regional breakdown unavailable)

Source: CoreLogic RP Data, ABS

10. Household debt has increased



Source: ABS, RBA

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 (the red line in Chart 9). 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.

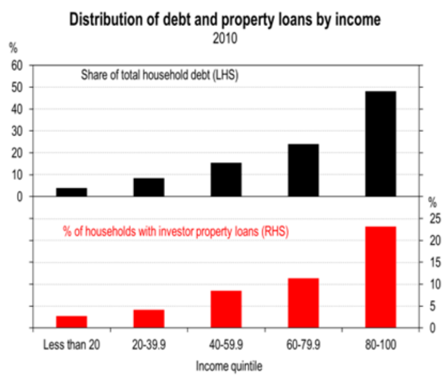
Household debt has risen, but it's the allocation that matters

Household debt has risen, but is fairly well allocated to those households that can afford to service it

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%, up from a trough of 167% in 2011 (Chart 10). 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.

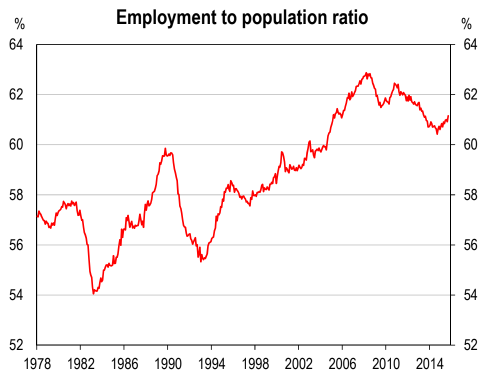
In Australia's case, household debt has been fairly well allocated to those households that can afford to service it. Australia does not have sub-prime or non-conforming loans and all mortgages are full-recourse loans, so households have clear incentives to maintain repayments. Around three-quarters of all household debt is held by the top two-fifths of income earners (Chart 11). Most households are also well ahead on their mortgage repayments, with the latest

11. Debt mostly held by wealthy



Source: HILDA, RBA

12. The labour market is improving



Source: ABS

Around three-quarters of all household debt is held by the top two-fifths of income earners

13. Housing price forecasts*

Year-end rates (%)	2015	2016f	2017f
Sydney	15	2 to 3	0 to 4
Melbourne	12	4 to 5	2 to 6
Brisbane	4	5 to 6	3 to 7
Perth	-3	-2 to -1	-3 to 1
Adelaide	2	2 to 3	3 to 7
National	10	3 to 4	1 to 5

Source: HSBC forecasts. *Assumes cash rate assumptions in Table 16.

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 (Chart 12). 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% over the past 18 months or so.

The outlook for 2016

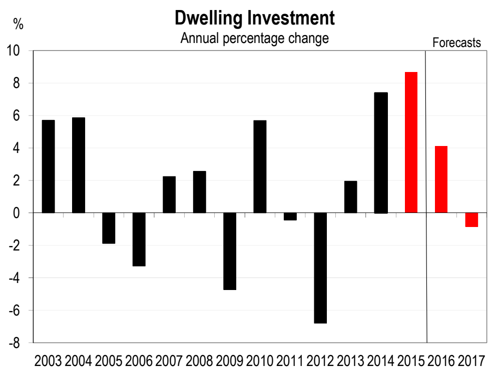
We expect the factors that have driven the recent pullback in housing price growth to persist in 2016, with national housing price growth expected to slow from around 10% in 2015 to 3-4% in 2016 and to remain modest into 2017 (Table 13). The trends clearly vary across the cities, with those areas most 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 (Chart 14).

National housing price growth is expected to slow from around 10% in 2015 to 3-4% in 2016 and to remain modest into 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 (see *Australia's next growth driver: The rise of the services sector*, 10 July 2015). This is expected to be supported by low interest rates, the lower AUD and rising Asian demand for services.

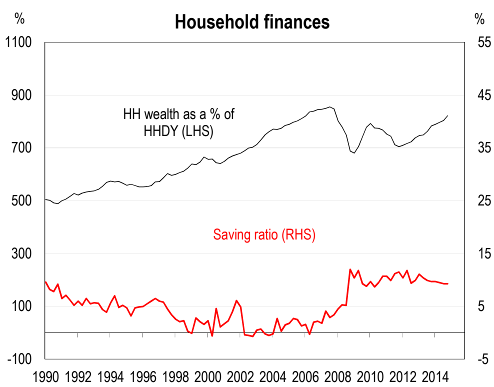
Another factor that may support growth is the lagged wealth effect from the rise in housing prices that has already occurred. The fall in the household saving rate has been slower than might have been expected, given the rise in wealth that has already happened (Chart 15). With interest rates expected 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.

14. House construction still rising in 2016



Source: ABS, HSBC estimates

15. Higher wealth could mean lower saving



Source: ABS

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Table 16. HSBC's forecasts for Australia and New Zealand

	Year-average			Year-ended						
	2015e	2016e	2017e	Q215	Q315e	Q415e	Q116e	Q216e	Q316e	Q416e
%*										
AUSTRALIA										
GDP	2.4	2.8	3.2	2.0	2.5	2.5	2.4	3.0	2.9	2.9
Consumption	2.6	2.9	3.1	2.5	2.7	2.7	2.7	3.0	3.0	2.9
Public consumption	3.3	2.0	1.5	4.0	3.7	3.6	3.6	1.6	1.5	1.4
Investment	-2.6	-0.9	2.9	-3.7	-1.0	-1.8	-1.2	-1.4	-0.7	-0.1
- Dwelling	9.7	5.4	2.6	7.4	11.9	9.3	5.0	7.8	5.2	3.9
- Business	-6.6	-3.6	2.3	-6.8	-6.6	-6.8	-4.8	-4.8	-3.1	-1.6
- Public	-1.8	1.0	5.1	-4.5	5.7	3.6	4.5	-0.5	0.0	0.0
Final domestic demand	1.5	1.9	2.8	1.2	2.0	1.8	2.0	1.7	1.8	1.9
Domestic demand	1.5	1.8	2.8	0.9	1.6	2.0	1.8	1.7	1.8	1.9
Exports	5.4	7.8	7.7	4.5	4.7	4.8	3.8	9.7	8.6	9.2
Imports	1.9	3.6	6.0	-0.7	1.6	4.0	1.8	3.8	3.8	5.1
GDP (% quarter)	--	--	--	0.2	0.8	0.6	0.8	0.7	0.8	0.6
CPI	1.5	2.2	2.9	1.5	1.5	1.7	2.0	2.1	2.2	2.4
Trimmed mean	2.2	2.3	2.7	2.2	2.2	2.1	2.0	2.0	2.3	2.5
Unemployment rate	6.1	5.9	5.6	6.1	6.2	6.1	6.0	6.0	5.9	5.8
Labour price index	2.2	2.4	2.9	2.3	2.2	2.2	2.3	2.4	2.5	2.5
Current A/C (%GDP)	-4.2	-3.7	-3.8	-4.7	-4.4	-4.4	-4.0	-3.8	-3.6	-3.5
Terms of trade	-9.8	-2.1	-2.3	-10.6	-8.6	-7.8	-5.3	-2.0	-1.0	0.0
Budget balance (%GDP)	-2.5	-1.9	-1.5							
Capital city house prices	10.1	4.7	3.7	9.8	12.6	10.9	9.4	5.1	2.0	2.7
Private sector credit	6.4	7.8	8.0	5.9	6.6	6.9	7.4	8.2	7.9	7.8
USD/AUD (end period)	0.72	0.70	0.70	0.77	0.73	0.72	0.71	0.71	0.70	0.70
Cash rate (end period)	2.00	1.75	2.50	2.00	2.00	2.00	1.75	1.75	1.75	1.75
%*										
NEW ZEALAND										
GDP	2.3	2.6	2.4	2.4	2.1	2.0	2.5	2.8	2.7	2.6
Consumption	2.6	2.7	2.4	3.1	2.2	2.4	2.9	2.6	2.6	2.6
Govt consumption	3.1	2.5	2.7	3.1	3.0	3.4	2.8	2.4	2.4	2.4
Investment	2.2	4.4	2.1	2.9	1.0	2.3	5.3	4.7	3.9	3.5
Final domestic demand	2.6	3.1	2.4	3.0	2.1	2.6	3.4	3.1	2.9	2.8
Domestic demand	2.4	3.0	2.4	2.4	2.2	2.3	3.7	2.8	2.9	2.8
Exports	5.9	3.6	4.8	6.8	8.2	2.4	1.9	4.1	4.1	4.6
Imports	6.0	4.7	4.4	6.1	6.6	4.7	5.2	4.1	4.5	4.9
GDP (% quarter sa)	--	--	--	0.4	0.6	0.7	0.7	0.7	0.5	0.6
CPI	0.4	1.8	1.5	0.4	0.4	0.6	1.6	1.7	1.9	1.9
Unemployment rate	5.9	5.8	5.6	5.9	5.9	6.0	6.0	5.9	5.7	5.6
Labour price index	1.8	1.8	2.0	1.8	1.9	1.8	1.9	1.8	1.8	1.8
Current A/C (%GDP)	-3.6	-3.8	-3.3	-3.4	-4.0	-4.3	-4.4	-4.0	-3.5	-3.5
Budget balance (%GDP)	0.1	0.3	0.5							
NZD/USD (end period)	0.68	0.68	0.68	0.68	0.68	0.68	0.68	0.68	0.68	0.68
Cash rate (end period)	2.50	2.25	2.25	3.25	2.75	2.50	2.50	2.25	2.25	2.25

Source: ABS, RBA, HSBC forecasts. *unless otherwise specified

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