The QBE Australian Housing Outlook

2017-2020

Fundamentally sound

A downturn in residential construction likely to create a subdued national economy, while low interest rates support affordability in some markets

Low interest rates have boosted affordability, but strong price growth is only occurring in those regions where economic conditions and population growth have performed well. At the national level, the economy is expected to provide little support to the residential market, with economic growth forecast to be relatively subdued over the next three years.

Economy

The economy is forecast to continue to grow at a similar moderate pace to that seen over the past four years. Falling resource sector investment since the peak of the mining boom is only partly being offset by growth in other sectors of the economy. The result is a generally soft labour market, and although the unemployment rate is now close to 5.6%, most of the jobs growth over the past five years has been part-time, while underemployment is near record highs. New dwelling commencements have now started to fall and will be a drag on the economy, adding to the weakening mining investment. The unemployment rate is forecast to drift up to 6% and remain at this elevated level until mid-late 2019, when dwelling construction and mining investment bottom out. Signs of an acceleration in the economy is then expected from 2019/20.

Interest rates

Interest rates have been steadily reducing since 2011, as economic conditions remain subdued and inflationary pressures remain benign. The current cash rate of 1.5% is at a record low, as is the standard variable rate of 5.2%. However, it should be noted that low risk borrowers with a loan-to-value ratio below 80% can typically borrow at a significantly lower discounted rate. Published indicator rates by the Reserve Bank suggest a typical discount on the standard variable rate by the banks of 75 basis points, while many smaller lenders are offering variable rates below 4%.

Interest rates for investors and interest-only borrowers have increased over the past two years in response to regulatory pressure, with an interest rate differential opening up between rates available to owner occupier borrowers, and investors and interest only borrowers. However, any increase to the cash rate is not expected until 2019/20 when emerging signs of a strengthening in the economy are expected to appear.

Affordability

Low interest rates have improved affordability in all capital cities for owner occupiers, with the exception of Sydney and Melbourne, where substantial house price growth has more than offset the influence of lower borrowing costs. This has caused affordability to deteriorate to previous record lows in these two cities. Weak local economic conditions are preventing any major upturn in prices in the other capital cities, despite the relatively attractive affordability.

State of play

Gross Domestic Product (GDP)

Australia has recorded annual economic growth, as measured by growth in real Gross Domestic Product (GDP), around the 2.5% range over the past four years to 2016/17. This is below the 3.6% average in the decade leading into the Global Financial Crisis. The boom in resource sector investment that peaked in 2012/13 is now negatively affecting the economy. Balancing the economic challenges has been growth in mining exports. Dwelling construction has also risen in response to strong population growth and undersupply, while tourism, agricultural and education exports have increased as a result of a fall in the Australian dollar since 2013. New South Wales and Victoria have been the stand out economies.

Consumer spending

Growth in consumer spending (private consumption expenditure) has been solid, averaging 2.4% per annum in the five years to 2016/17. In comparison, wages growth has been subdued. Households have been maintaining consumer spending levels by dipping into their savings, resulting in the savings ratio falling. This trend of consumer spending growth being higher than wages growth cannot continue indefinitely. If wages growth continues to remain subdued, households are likely to become more conservative and reduce growth in their expenditure.

Employment

Employment recorded healthy growth of 2% through the year to July 2017, particularly over the past five months. The unemployment rate tightened only marginally to 5.6% at July 2017, being down just 0.1 of a percentage point over the year. The unemployment rate has remained in the 5.6%–6.1% range since 2012/13. This highlights that there is still considerable underemployment in the labour market.

Inflation

Soft demand, spare capacity, intense competition and weak wages growth has kept a lid on inflation, with growth in the Consumer Price Index (CPI) of 1.9% over 2016/17. The potential for employees to seek higher wages growth is limited while the slack remains in the labour market. Businesses have also responded to the slower growth in the economy by focusing on keeping costs down.

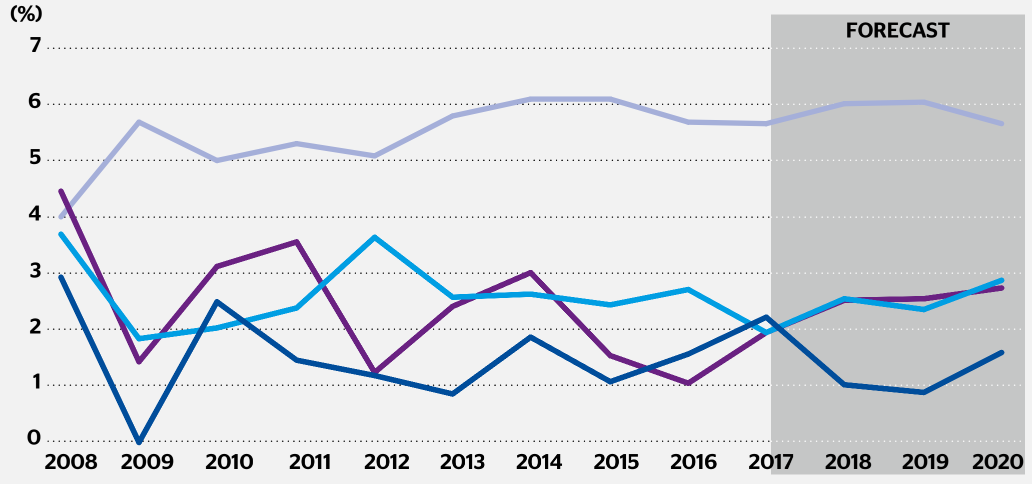
Global climate

The Trump administration in the United States was elected on the promise of a boom in infrastructure spending and tax cuts, which would benefit the global economic outlook. Growth in China, Australia's major trading partner, continues to remain strong and support commodity prices. This is tempered by Chinese Government concern about the pace of credit growth and capital outflows. The European economy is showing some improvement, while Japan's monetary and fiscal stimulus is having a limited effect. Tensions in the Korean peninsula have escalated recently and any significant increase could affect global markets.

Outlook

The emerging downturn in residential construction will join weakening mining investment as an additional drag on the economy. Other sectors continue to slowly pick up the baton of economic growth, although are not enough to accelerate economic and employment growth. GDP growth is forecast to stay soft at around 2.5% annually to 2020, but will begin to strengthen by the end of this period. By 2019/20, declines in mining investment and dwelling construction are expected to bottom out and will start to pick up, with businesses beginning to invest as excess supply in the economy is soaked up. The unemployment rate is forecast to remain around, or just under, 6% to 2020. This will limit wages growth and keep inflation in the Reserve Bank's preferred band of 2%–3% per annum. As conditions begin to pick up around the turn of the decade, employment growth and eventually wages growth will strengthen, as will inflationary pressures.

Key economic indicators[1]



2020 FORECAST

GDP Growth
△ 2.9%
2017 **1.9%**

Employment Growth
▽ 1.6%
2017 **2.2%**

Unemployment Rate
◁▷ 5.7%
2017 **5.7%**

CPI Growth
△ 2.7%
2017 **1.9%**

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[1] Employment growth to August and unemployment rate as at August.

Interest rates

Changes to the cash rate

The most recent changes to the cash rate were 25 basis points reductions in each of May and August 2016, taking it to 1.5%. The cuts were in response to weak economic conditions. In its minutes that follow each decision, the RBA judged that residential price growth was sufficiently contained and the interest rate reductions were unlikely to re-ignite excessive price growth in Sydney and Melbourne. At this level, the indicative standard variable rate used by the banks for owner occupier residential loans sits at 5.2%.

Variable rates are moving independently to the cash rate

Traditionally, there has been a consistent margin between the cash rate set by the RBA and the standard variable lending rate set by the banks. However, the gap has widened in recent years as the cost of funding for banks has increased since the Global Financial Crisis. Banks have also differentiated between customers by offering a discounted variable rate for borrowers with lower risk.

Regulatory influences

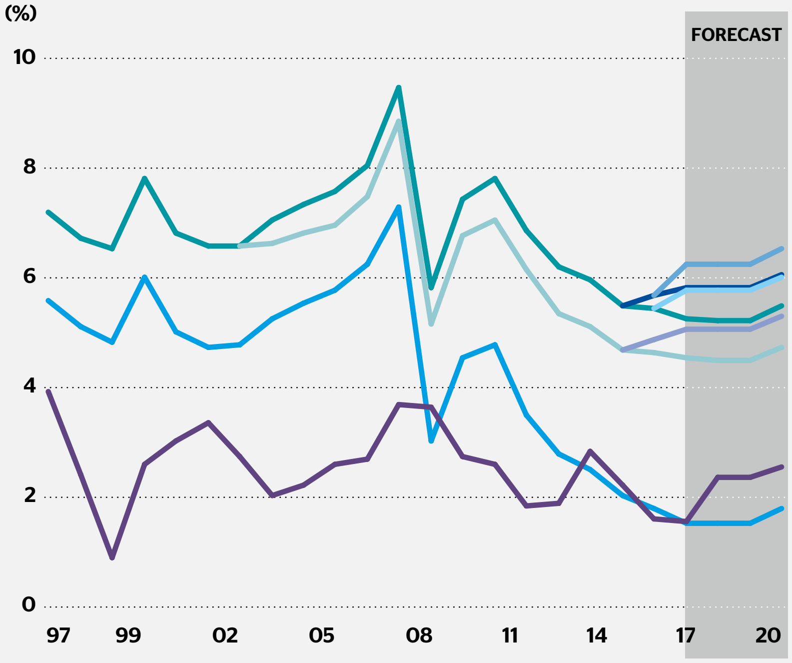
Increased regulatory requirements have also influenced lending rates outside of movements to the cash rate. The requirement by the APRA to provide more stability to the financial system has had an impact on the setting of interest rates. Since December 2014, APRA has progressively increased oversight, mandated the strengthening of bank balance sheets, and tightened lending guidelines, with a focus on containing growth in investment lending.

The result has been an increased differentiation in lending by the banks between owner occupiers and investors. Maximum loan-to-value ratios offered to investors have been reduced, and investors now pay an interest rate premium of about 55 basis points over the equivalent owner occupier rate. More recently, an increased regulatory focus on interest only borrowing, which is more favoured by investors, has resulted in a further premium for interest only loans (100 basis points over the standard variable rate for investors). In contrast, approved owner occupiers can still receive varying discounts to the standard variable rate on their borrowing.

Outlook

When setting the cash rate the RBA considers interest rate movements outside of changes to the cash rate and how they have influenced borrowing costs overall. In this regard, there have already been out-of-cycle rises in the past two years, albeit mainly for investor and interest only loans. Moderate economic growth is expected to continue, with the unemployment rate forecast to remain close to the 6% mark, and there will be little wage and inflationary pressure. The cash rate is forecast to be stable at 1.5% for much of the next three years. The RBA is forecast to begin to tighten interest rates toward the end of 2019/20 with a 25 basis point increase in the cash rate to head off inflationary pressures as signs emerge of a strengthening economy. This will take the standard variable rate to 5.45% by June 2020. Equivalent increases are expected in other lending rates, although further pressure by APRA could result in additional out-of-cycle changes.

Indicator lending rates[1] as at June



2020 FORECAST

Cash rate
△ 1.75%
2017 **1.50%**

Housing rate (Discount investor)
△ 5.30%
2017 **5.05%**

Housing rate (Variable)
△ 5.45%
2017 **5.25%**

Interest only (Owner occupiers)
△ 6.00%
2017 **5.75%**

Housing rate (Discount variable)
△ 4.70%
2017 **4.50%**

Interest only (Investors)
△ 6.50%
2017 **6.25%**

Housing rate (Standard investor)
△ 6.05%
2017 **5.80%**

CPI baseline
△ 2.51%
2017 **1.55%**

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[1] Forecasts for interest rates outside the standard variable rate are set at a consistent margin to the standard variable rate. These have the potential to change relative to the variable rate.

Housing affordability

While the demand and supply balance is important in determining pressure on prices and whether rents rise or fall, there is an upper limit on how much of a household's income can be spent on mortgage repayments. As it becomes more difficult to service a mortgage on a property, further price growth becomes less possible unless incomes rise or interest rates reduce by a sufficient enough margin to make purchasing more affordable.

Affordability has deteriorated considerably in **Sydney** and **Melbourne** since 2012/13 due to strong house price growth. The ratio of mortgage repayments on a median priced house to average household disposable income is 39.7% in Sydney and 36.2% in Melbourne at June 2017. This is close to each city's previous highs, indicating limited scope for continuing solid price growth.

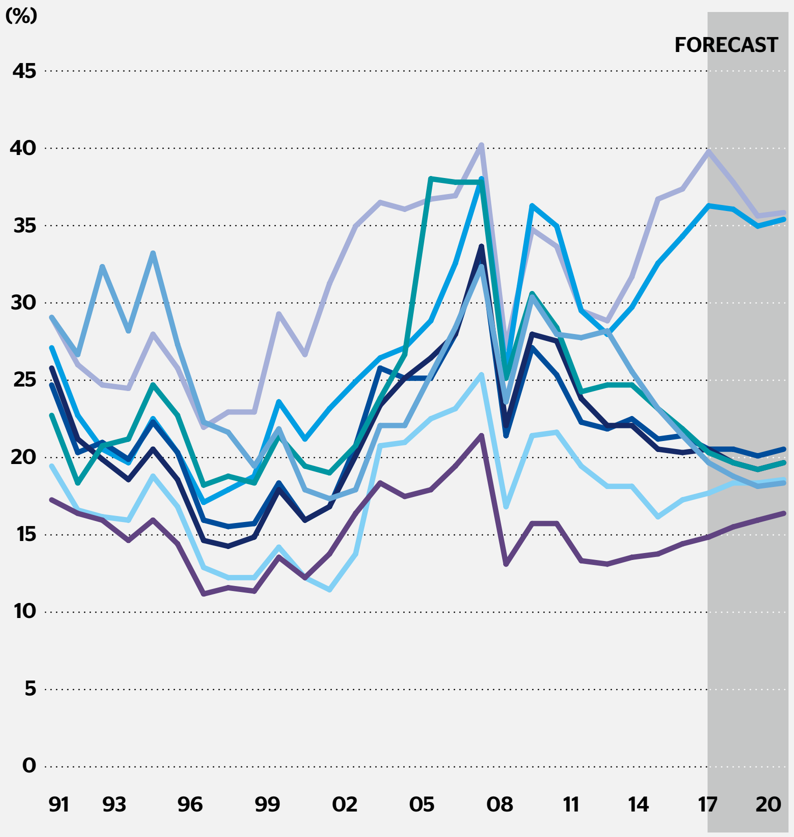
Affordability has also become more difficult in **Adelaide**, **Hobart** and **Canberra** over the past 12 months, again due to rising prices. Nevertheless, affordability is at levels similar to that seen in the early 2000s. In contrast, price reductions in **Perth** and **Darwin** have made purchasing a dwelling more affordable. **Brisbane** has remained at around the mid-point of its historical range.

Outlook

Low affordability in Sydney and Melbourne should begin to impact on the potential for purchasers to take on a larger mortgage and bid up prices too much further. Moreover, it makes these markets vulnerable to rises in interest rates, as the most recent purchasers may have stretched themselves to buy their dwelling.

Notably, the better affordability in other cities is having a limited impact on prices. Weaker economic conditions and little growth in household incomes has made buyers more reluctant to overcommit on a loan. The better relative affordability should mitigate some of the downward pressure on prices in oversupplied markets and in resource-sector exposed markets such as Perth, Darwin and to a lesser extent Brisbane.

Housing affordability[1]



2020 FORECAST

Sydney
▽ 35.8%
2017 **39.7%**

Adelaide
▽ 19.7%
2017 **20.5%**

Melbourne
▽ 35.4%
2017 **36.2%**

Hobart
△ 18.5%
2017 **17.8%**

Brisbane
◁▷ 20.6%
2017 **20.6%**

Darwin
▽ 18.3%
2017 **19.7%**

Perth
▽ 19.6%
2017 **20.2%**

Canberra
△ 16.3%
2017 **14.8%**

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[1] Housing affordability is shown as mortgage repayment based on 75% of the median house price. See Appendix for full definition.