SPECTRUM ASSET MANAGEMENT

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Spectrum Insights

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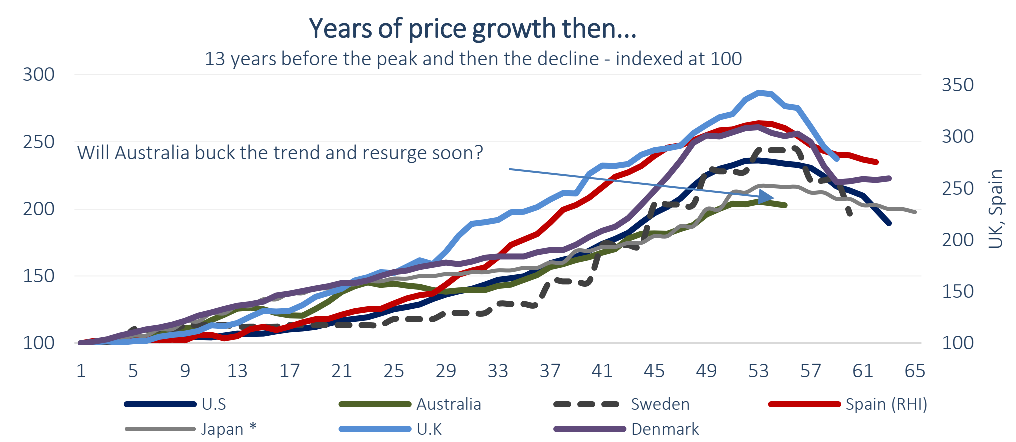
Australian property – harsh comparisons from history – part 1

There appears to be a competition among Australian financial commentators of late about who can give the most bearish outlook on residential property prices. First down 5%, then 10%, 15%, 20% and recently 25%. The truth is no one really knows. What our study of other developed markets suggests, though, that after sustained periods of credit-fueled price appreciation residential property often falls in the region of 15% to 30%. This decline can be sharp or prolonged. The pace of the drop depends largely on how tight lending conditions become. In Australia home lending growth has slowed notably of late. Should this trend continue the risk jumps that Australia's property market could echo severe declines seen elsewhere over history. At Spectrum we are preparing for the risk of sustained residential property weakness.

Similarities in booms

Below we compare several property market booms at different times from various countries. The periods compared are the thirteen years leading up to the peak. As can be seen in the graph below a similar pattern emerges.

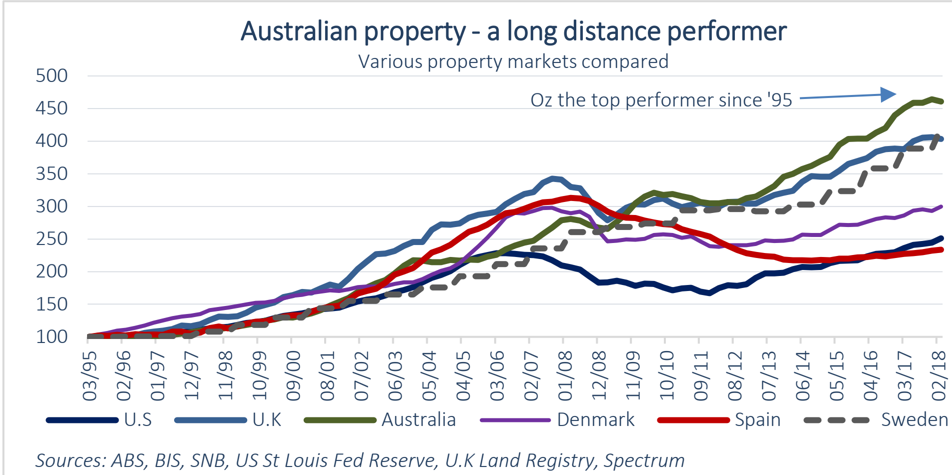


Sources: ABS, BIS, SNB, US St Louis Fed Reserve, U.K Land Registry, Spectrum * Metrolpolitan land prices, other measure

But Australian prices grew slower than the other markets

That's true. In the thirteen years to the recent peak of December 2017 Australian property was a laggard in the boom property cycles compared. There is a good reason, however.

Australia's property boom is a prolonged journey since the 1990s. Unlike other countries there was no recession to help cleanse the credit system - just a road bump during the global financial crisis. The slower climb in recent years was built on a multi-year price surge previously. In long dated property booms Australia is a modern-day top performer!



"Australia is different"

As is often said in property circles, "real estate is local". Each market has its own nuances and drivers. Comparing different countries with vastly different tax structures, population growth rates and foreign investor influences has its limitations.

That said, the relationship between credit and prices has long been discussed by economists throughout history. When credit growth to finance assets is high, asset prices tend to rise sharply. If the velocity of credit growth slows, post a surge in lending, price increases tend to first stall and then values fall substantially. This will be discussed in more detail in part 2 of *harsh comparisons from history*.

Isn't it all about inflation and unemployment?

A common belief is that property prices will not crash unless inflation or unemployment soar. That is often correct. Favourable economic conditions, as Australia has long had, support an environment where the vast majority service their home loans.

Where Australia challenges this view is that prices and leverage may be so high the market is somewhat self-correcting. Demographia[1] recently placed Sydney and Melbourne the 3rd and 4th least affordable housing markets in their international study as at 2018. As what occurred when the Nasdaq index stumbled after it went above 5000 in 2000 or Tokyo property prices in the early 1990s there was no apparent fundamental catalyst for the large price correction – except that the price was unsustainable. High prices can matter - as can falls in credit growth and reductions in tax incentives as we discuss below.

Marginal borrowers the concern

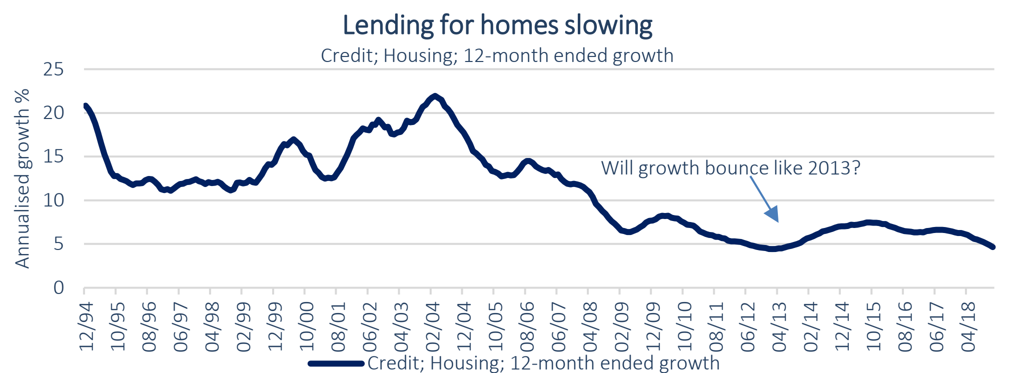
We acknowledge the bulk of $1.8t of housing loans will be serviced - even under severe property price falls scenarios. What concerns us is the material level of marginally creditworthy borrowers.

For example, the "off the plan" investor with one or more properties, a falling equity buffer and who needs to refinance an interest only loan but has to compete with around $250b other interest only borrowers in the next couple of years – when credit conditions are likely to be tighter than when the loan was taken out.

We suspect a continuing ebbing tide on credit provided and falling prices would expose a material level of borrowers that cannot cope tougher market conditions.

Credit already tightening

From this analyst's perspective home lending credit standards often appeared to be uber relaxed from around 2011-2016. Then, around 2016 APRA started to curtail some of the excesses. More recently the Hayne Royal Commission shone the light on some poor home lending practices. In response the banks turned the mortgage dial from marketing loans towards rationing them.



Sources: RBA, Spectrum

The RBA notes banks are apparently willing to lend around 20% less to a borrower than in the past[3]. This reduces the prices that can be paid for properties previously desired.

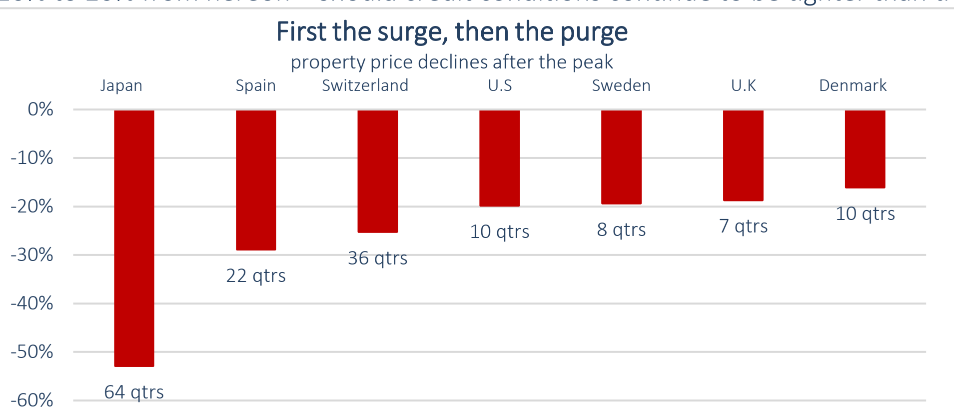
Demand for credit is also at risk. The poll-leading Labor party is promising reforms to negative gearing and capital gains tax discount. This will make property, as an investment, less attractive for many if they pass into legislation.

How big a decline?

Looking at other property markets a major correction is generally in the scale of 15% to 25% off peak prices. The period is often in the range of 1.5 years to six years.

Core Logic[2] recently reported for Australian residential property prices have fallen around 6% since October 2017 to January 2019.

Taking cues from international history suggest the overall market could still fall another 10% to 20% from hereon – should credit conditions continue to be tighter than the past.



Sources: ABS, BIS, SNB, US St Louis Fed Reserve, U.K Land Registry, Spectrum

Why property prices are important to us

Property lending is intertwined with the Australian credit markets. The biggest lenders – the banks – are also the biggest A$ corporate bond issuers. Third tier lenders utilise the mortgage backed security market to fund deals. There are also a handful of the property developers which have bonds outstanding. And the wider Australian economy has multiple links directly and indirectly into the residential property market.

Should price declines continue the amount of borrowers facing balance sheet stress will rise. This will likely cause:-

- more forced property sales
- defaults to jump, from a very low level
- credit charges at the banks to increase
- the quality of the underlying assets supporting RMBS to decline
- some property developers to face financial pressure and
- a headwind for the overall economy.

What could stablise the market in the near term?

Further residential property price falls are not assured. Like in 2013, when credit growth slowed to the current levels, a rebound followed. Two key plausible catalysts for a near term recovery include:-

- a surge in demand from creditworthy borrowers.
- renewed demand from offshore investors. We note the proportion of foreign purchases for local properties has fallen since 2014[4].

The former may occur if mortgage rates are cut sharply. That outcome is likely to co-incide with sharp cuts in the official interest rate. The latter stabliser is near impossible to predict.

The risk of a pronounced downturn has risen

We have long been concerned about the high level of indebtedness funding the residential property market in Australia. Links to the articles are below. With sustained falls in overall market since late 2017 and credit growth slowing history suggests a rising risk the currently orderly correction could turn into a damaging price slump. We may be wrong, or the resulting fall out may be minimal. But as credit investors our approach is to prepare for the plausible worst. We maintain minimal direct exposure to domestic residential property and maintain an underweight position in the lenders to the sector.

Spectrum Insights relating to Australian property and household debt.

- Can the interest-only bomb be defused? - March 18, 2018
- Australian banks – flaunting history? - April 17, 2017
- The problem with "bubbles". - February 15, 2017
- What a waste of debt. - August 4, 2016

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(1) 15th Annual Demographia International Housing Affordability Survey
(2) Core Logic – January Home Value Index Results Signal Weak Start to Housing Market 1 Feb 2019
(3) RBA – Assessing the Effects if Housing Lending Policy Measures Nov 2018
(4) NAB Residential Survey Q3 2018

Market	Measure	*Peak period used*
U.S.	National Home price index	Jun-06
Spain	All Dwelling per sqm	Mar-08
Japan	Japan Metropolitan Land	Mar-91
Sweden	One- or two-dwelling buildings for permanent living	Mar-91
Switzerland	Owner occupier houses	Dec-89
U.K.	House price index All property types	Jun-07
Denmark	Single family houses	Jun-86
Australia	Detached houses capital cities	Dec-17

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CROWN FUND RATING

As at 31/12/2018 TM

SQM Rating

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