

January 2009 Newsletter

Happy New Year!

The Empower Wealth team would like to wish everyone a Happy New Year! We hope you all enjoyed a well deserved break over the Christmas period gearing up for what is looking to be a very interesting and exciting year ahead in the property market.

We think the article below is definitely worth a read as it gives a good insight into the current state of the property market.

We look forward to answering all of your property and investment enquiries in 2009!

Foolish to Worship in Real Estate's Temple of Doom

*The Australian - 3 December 2008
Article by Christopher Joye*

The economics of Australia's \$3.3 trillion housing market are widely misunderstood, with sensationalist claims that a housing bubble caused the global credit crisis and that Australian house prices will fall by 30 per cent to 50 per cent.

In fact, the latest RP Data-Rismark Index results show that Australian house prices declined by just 0.8 per cent in the 12 months to October this year, and increased during the most recent three months.

The primary cause of the global credit crisis was a prolonged period of relaxed lending standards across asset markets, which led to excessively high levels of debt. This was further propelled by the US Federal Reserve's maintenance of unreasonably low interest rates in response to the 2001 tech wreck.

In the US, the crisis was exacerbated by poor regulatory practices in which lenders had no recourse to borrowers if they defaulted (which is not the case in Australia) and the presence of two quasi-government agencies that crowded the private sector out of the prime lending market.

Subsequent damage has been wrought by the tendency of today's highly interconnected financial markets to wildly overreact to positive and negative events.

As the inevitable unwinding of debt takes place, almost all asset prices have declined, especially in the US

and British housing markets, where the coincidence of very high default rates, bank failures and severe credit rationing has precipitated price falls.

According to the Case-Shiller Index, US house prices are off 21 per cent. (This data is arguably biased downwards given that distressed sellers account for 40 per cent of all sales even though they represent only 3 per cent of homes.) In comparison, the S&P 500 has fallen by 43 per cent since its apogee in October 2007.

The contrast is more striking in Britain, which does not suffer from the US problem of overbuilding. According to the FT Index, which importantly captures all British sales, house prices have fallen by just 6 per cent from their peak.

Yet the FTSE All Share Index has contracted 39 per cent. Indeed, the FTSE has fallen more on individual days than the British housing market has from peak to trough. If one wants to talk about bubbles, the most credible conclusion is that the biggest bubbles were in shares.

In Australia, the hyperbolic predictions of economists Steve Keen and Gerard Minack that house prices will fall by 30 per cent to 50 per cent have been relentlessly recycled in newspapers and purportedly credible programs such as 60 Minutes and The 7.30 Report.

The doomsayers' claims are based on the assumption that housing affordability is at an all-time low.

They dismiss the fact house prices are determined by supply as well as demand (affordability is a demand-side factor) and conclude that prices must fall by some arbitrarily large margin. Keen likes to shock by quoting statistics about the rise in household debt without acknowledging that debt-servicing ratios have remained unchanged thanks to vastly lower real interest rates, the emergence of two-income households and higher real incomes.

Recent analysis by the Reserve Bank of Australia has comprehensively demonstrated that housing affordability is not at an all-time low. According to one of the Reserve Bank's benchmarks, the representative household in June 2007 had more real disposable income left over after purchasing a home and servicing a 90 per cent mortgage than at any other time since June 1982.

The bank also found that the representative household could afford to buy 33 per cent of all homes in June 2007, which, although less than the historical average of 45 per cent, was markedly better than the 13 per cent of homes available to it in June 1990.

Importantly, the Reserve Bank's present 4.25 per cent cash rate is considerably lower than the 6.25 per cent rate that existed in June 2007. Since mortgage rates peaked at 9.6 per cent in August, the Reserve Bank has pushed them down to about 6.7 per cent, with markets predicting that they will be less than five per cent by mid-2009. At the same time, house prices have not appreciated.

These improvements in affordability have been augmented by the Government's \$10.4 billion spending package, which has focused on supporting incomes and boosting the first home owners grant.

Thus, despite assumptions of rising unemployment and slowing wages growth, ANZ and Westpac believe that Australian disposable incomes will grow solidly by eight per cent or more during the next year.

Perhaps the best insight into mortgage stress is default rates. Only 0.4 per cent of all home loans on Australian bank balance-sheets were delinquent in August 2008, a fraction of equivalent rates in the US (more than 2.5 per cent) and Britain (1.3 per cent). The Reserve Bank has noted that although August was the peak of its recent monetary policy cycle, Australian delinquency rates were still materially lower than levels experienced in the mid-1990s.

Australia also benefits from the fact we don't really have a sub-prime market, which accounts for 15 per cent of US loans. And in contrast to the US and Britain, where most loans are fixed for years, about 85 per cent of all Australian mortgages are variable so Reserve Bank rate cuts immediately benefit borrowers.

The biggest risk to Australian house prices is a credit squeeze. Yet, unlike the US and Britain, which have suffered multiple bank failures, there is no evidence of Australian banks systematically denying residential credit. Since the crisis began the big banks have profited immensely from a decline in competition and tremendous deposit inflows.

While the banks are restricting credit to businesses, they are happily investing in the home loan market, which attracts a much lower risk-weighting from the regulator. Today, high-quality borrowers have no difficulties getting 95 per cent loans. Indeed, Australia's largest mortgage broker, AFG, reported that approvals in October were the strongest since November 2007.

The main reason most forecasters believe Australian house prices will rise in the medium term is because of enormous excess demand. Treasury projects that housing demand is growing at more than 190,000 properties a year compared with housing starts of 145,000 homes each year. Building approvals in NSW, our largest state, are at a 23-year low. This had led to a severe housing shortage, which Westpac and ANZ estimate at more than 120,000 homes and growing. ANZ forecasts that Australia's housing supply deficit will rise to 200,000 by 2010.

When the demand for an asset exceeds supply, prices rise as the market seeks to stimulate new production. This is why, despite the prophets of doom, and the five rate hikes borrowers endured between late 2007 and mid-2008, house prices have remained largely unchanged.

The Reserve Bank believes Australia's housing market is leading the US by three years, having entered into its downturn in 2004. There is also a consensus between the Reserve Bank and most economists that the doomsayers' predictions will be proven wrong. A striking counterfactual is the 1990-92 recession, when unemployment hit 10.9 per cent yet house prices rose by two per cent a year according to the Australian Bureau of Statistics.

The media would do well to interrogate sensationalism.