

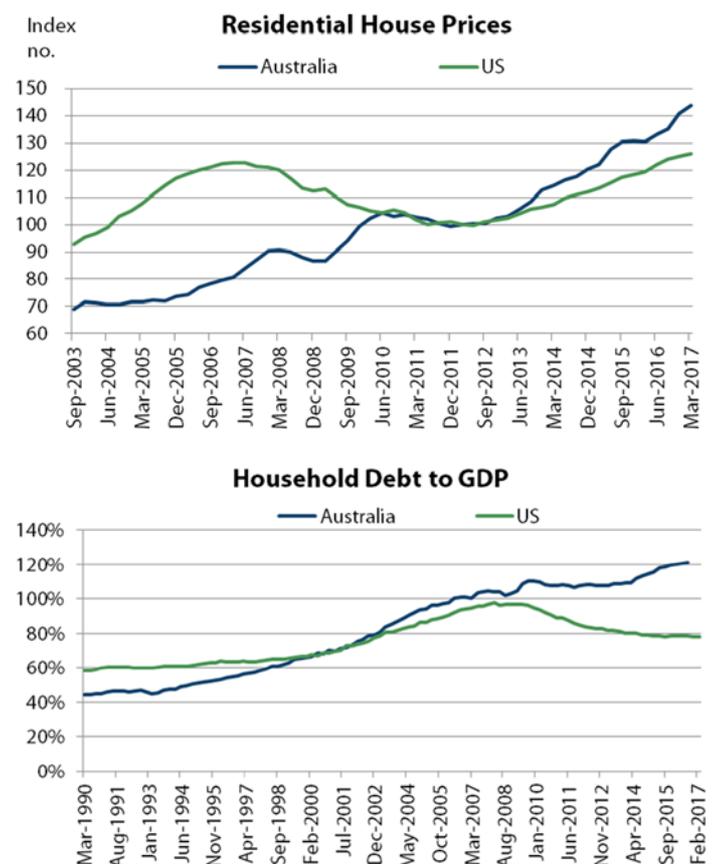
# AUSTRALIAN HOUSING – STILL WAITING FOR THE DECLINE

Over the past five years, multiple forecasters have called the decline of Australian housing only to see prices continue moving from strength to strength. Indeed, some global investors are watching for a downturn as this could foreshadow a decline in other developed markets. In this article, we identify the fundamentals that have supported Australian housing and the signals that investors should look for to determine if this period of positive appreciation is coming to an end.

## Sky high: Australian house prices and household debt

Australian house prices have continued their meteoric rise since the start of the decade, increasing by approximately 6% per year since 2010. This means that house prices have risen by over 40% since 2009, reaching historically high levels. Over the same period, households have seen only limited wage growth, which has caused both household debt-to-income and household debt-to-GDP to rise to all-time highs. In 2016, household debt-to-GDP surpassed 120%, which is over 20% above the level where the US peaked in 2007 before its housing crisis. Because of these metrics, many forecasters believe that Australian housing is due for a correction.

Chart 1: Australian and US house prices vs household debt-to-GDP

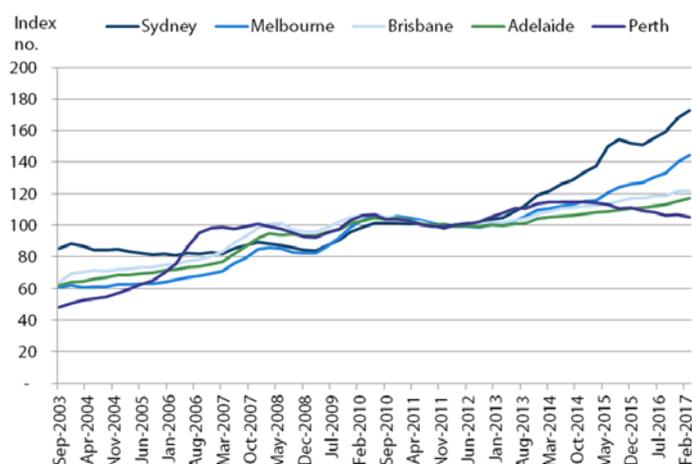


Source: Bloomberg House prices indexed to March 2012

While Australian house prices have risen strongly over the past five years, a more nuanced picture emerges when looking from a regional perspective. The capital cities of Sydney and Melbourne have seen very strong house price appreciation, Brisbane and Adelaide only moderate appreciation and Perth has actually declined over the past two years. So despite Australian house prices rising quickly overall, certain areas have experienced the bulk of the increases—in particular Sydney and Melbourne, which garner the front page stories calling for imminent decline.

A recent speech from Reserve Bank of Australia (RBA) Governor Phillip Lowe identified this disparity by showing that house price-to-income ratios for New South Wales (NSW) and Victoria have moved to all-time highs while the other states remain around average levels for the past 15 years. This means that it is the eastern states of NSW and Victoria which potentially face the biggest housing problems.

Chart 2: Residential price index by region



Source: Bloomberg. Prices indexed to 2012

Looking purely at house prices and household debt-to-GDP, the Australian housing sector looks stretched. However, there are positive features of the Australian market which have helped to support these lofty valuations and which must be considered when analysing the risk of decline.

### Positive factors: Full recourse, limited supply and interest coverage

The Australian mortgage system operates on a full recourse basis, meaning that should a borrower default, the lender is able to pursue all the borrower’s assets. In addition to this, the social stigma attached to bankruptcy in Australia makes it fairly undesirable to default on a loan. Because of these two factors, Australians typically prioritise the repayment of their mortgage in times of stress and continue repaying a loan for as long as possible. Further, the Australian mortgage market has more robust underwriting practices than the US saw prior to the GFC, with the Mortgage & Finance Association of Australia stating in 2015 that non-conforming loans comprise less than 2%<sup>1</sup> of the Australian mortgage market, a figure which reached close to 15%<sup>2</sup> in US at the peak of the property market bubble.

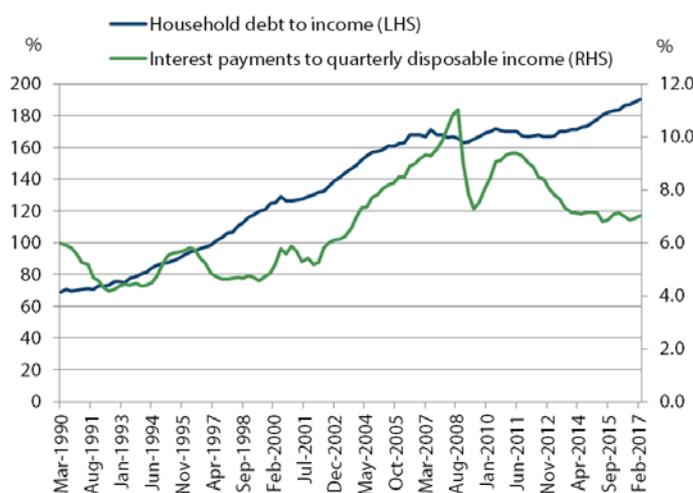
Another positive for the Australian market is that strong population growth and international migration over the past 15 years has led to continued demand for housing. Using dwelling completion data, the RBA shows that during the 2000s “the rate of home-building did not respond to the faster population growth”<sup>3</sup> and it wasn’t until the past few years that housing supply was expanded at a fast enough rate. Therefore, while increased supply continues to come on to the market, this is partly alleviating the shortfall of the 10 years prior.

Furthermore, over the past few years foreign demand for Australian housing has been strong, with Chinese buyers showing a particularly strong interest. While some would argue that this demand could fall away quickly, certain features of the market mean that this should have only limited effect. The main reason is that the Foreign Investment Review Board (FIRB) maintains a policy which aims to “channel foreign investment into new dwellings” to create “jobs in the construction industry”<sup>4</sup>. Because of this, foreign investors can be limited in the established home market, with National

Australia Bank estimating that foreign investors account for approximately 11% and 7% of new and established home sales, respectively<sup>5</sup>. Hence while foreign buyers have shown increasing levels of demand, this is still only a relatively small part of the overall market compared with local buyers.

The third positive for the Australian housing market is that while debt-to-GDP is high, debt service ratios remain good. This is because interest rates and mortgage rates are close to all-time lows, allowing households to service these large levels of debt. In this respect, as long as interest rates remain low, households will be able to afford the repayments to continue servicing their loans.

Chart 3: Household debt metrics



Source: Reserve Bank of Australia

Taking these three positive factors into account, we expect that for housing to decline significantly there will need to be an event that leads to borrowers being unable to meet their repayments.

### What could go wrong?

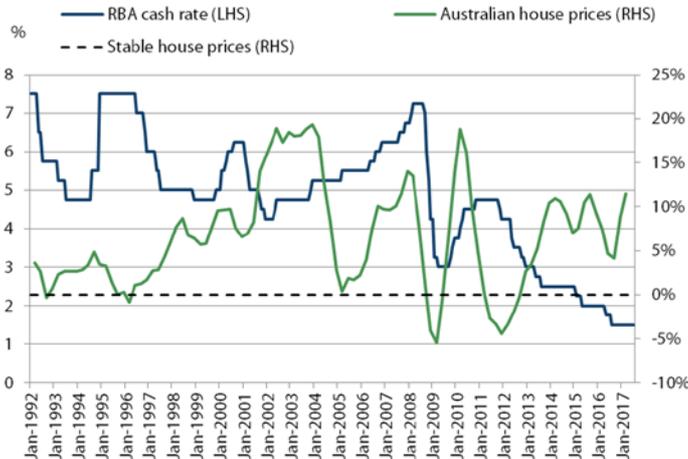
Given that most warnings on Australian property are about wholesale declines rather than a manageable fall, what might the catalyst be to make mortgages unaffordable? In our view, there could be two main threats to the housing market: rising interest rates causing borrowers to be unable to afford repayments, or rising unemployment which makes households incapable of making repayments. Neither of these outcomes currently look likely in the short to medium term—hence we believe that both house prices and demand for housing will remain robust, although we will be watching for any deterioration given the build-up of household debt.

#### Threat no. 1: Rising interest rates

The most obvious reason for households being unable to repay their mortgage is that rising interest rates cause mortgage repayments to become unaffordable. Currently, interest coverage ratios remain strong as mortgage rates are at all-time lows; however, due to the high levels of debt in the economy this metric will deteriorate quickly if interest rates rise (see a previous article, ‘3% is the new 5% for the Australian cash rate’ for how we calculate this).

When looking at Australian house prices from a historical perspective, rising interest rates have usually been associated with lower house prices and falling interest rates with rising prices. As can be seen in chart 4, the two periods of house price weakness in Australia (in 2008 and 2011) saw rapidly rising interest rates. However, once the RBA started cutting cash rates, lower house prices instantly rebounded.

Chart 4: Australian house prices and cash rate



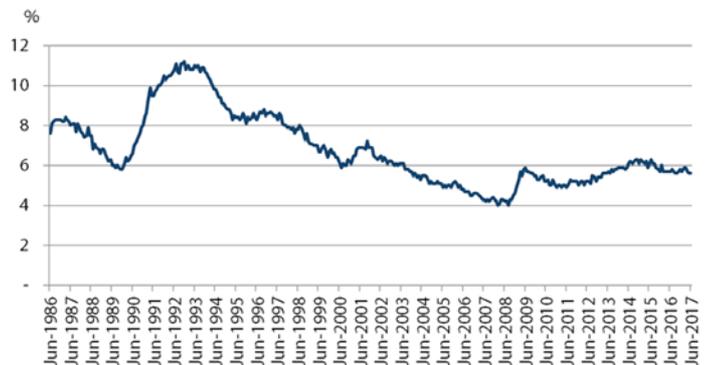
Source: Bloomberg

Over the short term, the RBA has a stable cash rate outlook, with markets forecasting no rate hikes over the next 12 months. This implies that households are not going to see significantly higher mortgage rates over the next 12 months and will continue to face average levels of interest coverage. Should the RBA move to a more hawkish bias and start lifting cash rates higher than the market expects, then this should raise some concern for investors exposed to housing. However, at the moment this looks like a relatively low probability outcome.

### Threat no. 2: Unemployment

A key variable for mortgage affordability is income and this is achieved through employment, so we monitor the unemployment rate closely. Rising unemployment was associated with weak house prices in both the early 1990s when the unemployment rate rose from 6% to 11% and in 2008 when the unemployment rate rose from 4% to 6%. In both of these periods, the RBA cut interest rates considerably to give household income a boost. However, given that the cash rate is now at a record low of 1.5%, if the unemployment rate begins to rise quickly, the RBA only has limited scope to cut rates further and this could see households fall under economic stress as income drops.

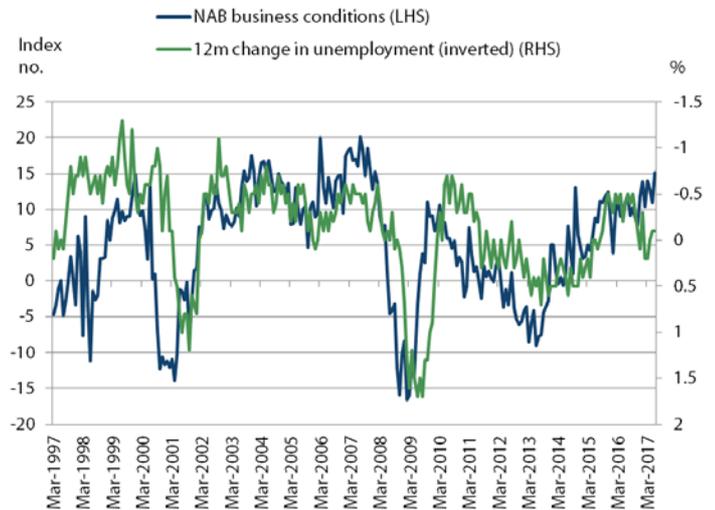
Chart 5: Australian unemployment



Source: Bloomberg

We can use business conditions as a forward indicator to determine the direction of unemployment. Currently, Australian business conditions are at 10-year highs, having risen steadily over the past four years. Looking at Chart 6 which compares the NAB Business Conditions Index with unemployment, it is clear that rapidly falling business conditions is a sign that employment in the economy is at risk. In 2000 and 2008, business conditions started deteriorating a few months ahead of the unemployment rate. Hence, as a forecasting tool business conditions provide a timely signal of the future unemployment rate and households' ability to pay. Currently, the strength in the business conditions does not suggest that a large fall in unemployment is just around the corner. Rather, it shows the opposite—that we should continue to see a stable unemployment rate, which would be supportive for housing.

Chart 6: Australian unemployment and business conditions



Source: Bloomberg

## Stable for now, but watch for signs of household stress

Looking at the outright level of Australian house prices and with the memory of the US housing market crash still imprinted on investors' minds, many are fearful that prices will fall catastrophically from here. However, investors should be aware of the fundamentals that have driven prices to their current levels and what could cause them to fall. As long as both unemployment and interest rates remain low, it's hard to envisage huge declines in the Australian market. In this environment it is more likely that prices move sideways, allowing wages and income to catch up.

For investors that are worried about house price declines, it will be important to monitor both unemployment and interest rates as key metrics for borrowers' ability to pay. If either of these begin to rise and put pressure on Australian households, then investors will be rightly concerned about the implications for Australia's housing market.

1. <https://www.mfaa.com.au/AboutUs/Documents/Canadian%20Mortgage%20Report%20July%202015%20Final.pdf>
2. <http://www.rba.gov.au/speeches/2008/sp-ag-160508.html>
3. <https://www.rba.gov.au/speeches/2017/sp-gov-2017-05-04.html>
4. <http://firb.gov.au/real-estate/>
5. <http://business.nab.com.au/wp-content/uploads/2017/01/nab-residential-property-survey-Q42016.pdf>

## Important Information

This document is prepared by Nikko Asset Management Co., Ltd. and/or its affiliates (**Nikko AM**) and is for distribution only under such circumstances as may be permitted by applicable laws. This document does not constitute investment advice or a personal recommendation and it does not consider in any way the suitability or appropriateness of the subject matter for the individual circumstances of any recipient.

This document is for information purposes only and is not intended to be an offer, or a solicitation of an offer, to buy or sell any investments or participate in any trading strategy. Moreover, the information in this material will not affect Nikko AM's investment strategy in any way. The information and opinions in this document have been derived from or reached from sources believed in good faith to be reliable but have not been independently verified. Nikko AM makes no guarantee, representation or warranty, express or implied, and accepts no responsibility or liability for the accuracy or completeness of this document. No reliance should be placed on any assumptions, forecasts, projections, estimates or prospects contained within this document. This document should not be regarded by recipients as a substitute for the exercise of their own judgment. Opinions stated in this document may change without notice.

In any investment, past performance is neither an indication nor guarantee of future performance and a loss of capital may occur. Estimates of future performance are based on assumptions that may not be realised. Investors should be able to withstand the loss of any principal investment. The mention of individual stocks, sectors, regions or countries within this document does not imply a recommendation to buy or sell.

Nikko AM accepts no liability whatsoever for any loss or damage of any kind arising out of the use of all or any part of this document, provided that nothing herein excludes or restricts any liability of Nikko AM under applicable regulatory rules or requirements.

All information contained in this document is solely for the attention and use of the intended recipients. Any use beyond that intended by Nikko AM is strictly prohibited.

**Japan:** The information contained in this document pertaining specifically to the investment products is not directed at persons in Japan nor is it intended for distribution to persons in Japan. Registration Number: Director of the Kanto Local Finance Bureau (Financial Instruments firms) No. 368 Member Associations: The Investment Trusts Association, Japan/Japan Investment Advisers Association/Japan Securities Dealers Association.

**United Kingdom and rest of Europe:** This document constitutes a financial promotion for the purposes of the Financial Services and Markets Act 2000 (as amended) (FSMA) and the rules of the Financial Conduct Authority (the FCA) in the United Kingdom (the FCA Rules).

This document is communicated by Nikko Asset Management Europe Ltd, which is authorised and regulated in the United Kingdom by the FCA (122084). It is directed only at (a) investment professionals falling within article 19 of the Financial Services and Markets Act 2000 (Financial Promotions) Order 2005, (as amended) (the Order) (b) certain high net worth entities within the meaning of article 49 of the Order and (c) persons to whom this document may otherwise lawfully be communicated (all such persons being referred to as relevant persons) and is only available to such persons and any investment activity to which it relates will only be engaged in with such persons.

**United States:** This document is for information purposes only and is not intended to be an offer, or a solicitation of an offer, to buy or sell any investments. This document should not be regarded as investment advice. This document may not be duplicated, quoted, discussed or otherwise shared without prior consent. Any offering or distribution of a Fund in the United States may only be conducted via a licensed and registered broker-dealer or a duly qualified entity. Nikko Asset Management Americas, Inc. is a United States Registered Investment Adviser.

**Singapore:** This document is for information only with no consideration given to the specific investment objective, financial situation and particular needs of any specific person. You should seek advice from a financial adviser before making any investment. In the event that you choose not to do so, you should consider whether the investment selected is suitable for you. Nikko Asset Management Asia Limited is a regulated entity in Singapore.

**Hong Kong:** This document is for information only with no consideration given to the specific investment objective, financial situation and particular needs of any specific person. You should seek advice from a financial adviser before making any investment. In the event that you choose not to do so, you should consider whether the investment selected is suitable for you. The contents of this document have not been reviewed by the Securities and Futures Commission or any regulatory authority in Hong Kong. Nikko Asset Management Hong Kong Limited is a licensed corporation in Hong Kong.

**Australia:** Nikko AM Limited ABN 99 003 376 252 (**Nikko AM Australia**) is responsible for the distribution of this information in Australia. **Nikko AM Australia** holds Australian Financial Services Licence No. 237563 and is part of the Nikko AM Group. This material and any offer to provide financial services are for information purposes only. This material does not take into account the objectives, financial situation or needs of any individual and is not intended to constitute personal advice, nor can it be relied upon as such. This material is intended for, and can only be provided and made available to, persons who are regarded as Wholesale Clients for the purposes of

section 761G of the Corporations Act 2001 (Cth) and must not be made available or passed on to persons who are regarded as Retail Clients for the purposes of this Act. If you are in any doubt about any of the contents, you should obtain independent professional advice.

**New Zealand:** Nikko Asset Management New Zealand Limited (Company No. 606057, FSP22562) is the licensed Investment Manager of Nikko AM NZ Investment Scheme and the Nikko AM NZ Wholesale Investment Scheme.

This material is for the use of researchers, financial advisers and wholesale investors (in accordance with Schedule 1, Clause 3 of the Financial Markets Conduct Act 2013 in New Zealand). This material has been prepared without taking into account a potential investor's objectives, financial situation or needs and is not intended to constitute personal financial advice, and must not be relied on as such. Recipients of this material, who are not wholesale investors, or the named client, or their duly appointed agent, should consult an Authorised Financial Adviser and the relevant Product Disclosure Statement or Fund Fact Sheet (available on our website [www.nikkoam.co.nz](http://www.nikkoam.co.nz)).

**Kingdom of Bahrain:** The document has not been approved by the Central Bank of Bahrain which takes no responsibility for its contents. No offer to the public to purchase the Strategy will be made in the Kingdom of Bahrain and this document is intended to be read by the addressee only and must not be passed to, issued to, or shown to the public generally.

**Kuwait:** This document is not for general circulation to the public in Kuwait. The Strategy has not been licensed for offering in Kuwait by the Kuwaiti Capital Markets Authority or any other relevant Kuwaiti government agency. The offering of the Strategy in Kuwait on the basis a private placement or public offering is, therefore, restricted in accordance with Decree Law No. 7 of 2010 and the bylaws thereto (as amended). No private or public offering of the Strategy is being made in Kuwait, and no agreement relating to the sale of the Strategy will be concluded in Kuwait. No marketing or solicitation or inducement activities are being used to offer or market the Strategy in Kuwait.

**Kingdom of Saudi Arabia:** This document is communicated by Nikko Asset Management Europe Ltd (Nikko AME), which is authorised and regulated by the Financial Services and Markets Act 2000 (as amended) (FSMA) and the rules of the Financial Conduct Authority (the FCA) in the United Kingdom (the FCA Rules). This document should not be reproduced, redistributed, or sent directly or indirectly to any other party or published in full or in part for any purpose whatsoever without a prior written permission from Nikko AME.

This document does not constitute investment advice or a personal recommendation and does not consider in any way the suitability or appropriateness of the subject matter for the individual circumstances of any recipient. In providing a person with this document, Nikko AME is not treating that person as a client for the purposes of the FCA Rules other than those relating to financial promotion and that person will not therefore benefit from any protections that would be available to such clients.

Nikko AME and its associates and/or its or their officers, directors or employees may have or have had positions or material interests, may at any time make purchases and/or sales as principal or agent, may provide or have provided corporate finance services to issuers or may provide or have provided significant advice or investment services in any investments referred to in this document or in related investments. Relevant confidential information, if any, known within any company in the Nikko AM group or Sumitomo Mitsui Trust Bank group and not available to Nikko AME because of regulations or internal procedure is not reflected in this document. The investments mentioned in this document may not be eligible for sale in some states or countries, and they may not be suitable for all types of investors.

**Oman:** The information contained in this document neither constitutes a public offer of securities in the Sultanate of Oman as contemplated by the Commercial companies law of Oman (Royal decree 4/74) or the Capital Markets Law of Oman (Royal Decree 80/98), nor does it constitute an offer to sell, or the solicitation of any offer to buy non-Omani securities in the Sultanate of Oman as contemplated by Article 139 of the Executive Regulations to the Capital Market law (issued by Decision No. 1/2009). This document is not intended to lead to the conclusion of any contract of whatsoever nature within the territory of the Sultanate of Oman.

**Qatar (excluding QFC):** The Strategies are only being offered to a limited number of investors who are willing and able to conduct an independent investigation of the risks involved in an investment in such Strategies. The document does not constitute an offer to the public and should not be reproduced, redistributed, or sent directly or indirectly to any other party or published in full or in part for any purpose whatsoever without a prior written permission from Nikko Asset Management Europe Ltd (Nikko AME). No transaction will be concluded in your jurisdiction and any inquiries regarding the Strategies should be made to Nikko AME.

**United Arab Emirates (excluding DIFC):** This document and the information contained herein, do not constitute, and is not intended to constitute, a public offer of securities in the United Arab Emirates and accordingly should not be construed as such. The Strategy is only being offered to a limited number of investors in the UAE who are (a) willing and able to conduct an independent investigation of the risks involved in an investment in such Strategy, and (b) upon their specific request.

The Strategy has not been approved by or licensed or registered with the UAE Central Bank, the Securities and Commodities Authority or any other relevant licensing authorities or governmental agencies in the UAE. This document is for the use of the named addressee only and should not be given or shown to any other person (other than employees, agents or consultants in connection with the addressee's consideration thereof).

No transaction will be concluded in the UAE and any inquiries regarding the Strategy should be made to Nikko Asset Management Europe Ltd.