

ARE WE IN A HOUSING BUBBLE?

When the Reserve Bank Governor says the Sydney property market is crazy, you have to take talk of a housing bubble seriously. And you don't have to live in Sydney to be concerned.

Governor Glenn Stevens' remarks helped fuel a growing national debate about house prices and affordability especially for first homebuyers.

While other property markets in Australia are definitely not in bubble territory, some of the remedies being discussed to tackle housing affordability have the potential to affect property investors wherever they live.

Definition of a bubble

So what is the definition of a housing bubble and are we there yet?

According to Investopedia, a housing bubble is a run-up in housing prices fuelled by demand, speculation and the belief that recent history is an infallible forecast of the future.

The website goes on to say that traditionally housing markets are not as prone to bubbles as other financial markets due to the large transaction and carrying costs associated with owning a house.

"However a combination of very low interest rates and a loosening of credit underwriting standards can bring borrowers into the market, fuelling demand."

Evidence of a bubble

So what is the evidence to support the bubble theory?

Property prices in Sydney have jumped 39 per cent in the past three yearsⁱ while Melbourne prices have risen 22 per cent. Elsewhere in Australia, growth has been closer to 10 per cent over that period.ⁱⁱ

If there is a bubble, it's only in Sydney and Melbourne.

But if you look at a 10-year period then Sydney's property price growth is 57 per cent, after some very flat years in the 2000s – well below the national average of 85 per cent.ⁱⁱⁱ

Low interest rates

Another factor contributing to high demand for property is that interest

rates are at historically low levels (the base rate is currently 2 per cent) with the possibility they could go even lower.

That in itself is a driver of the strong interest in property. After all, if interest rates on cash and fixed-interest investments are low, investors need to find better returns in other asset classes.

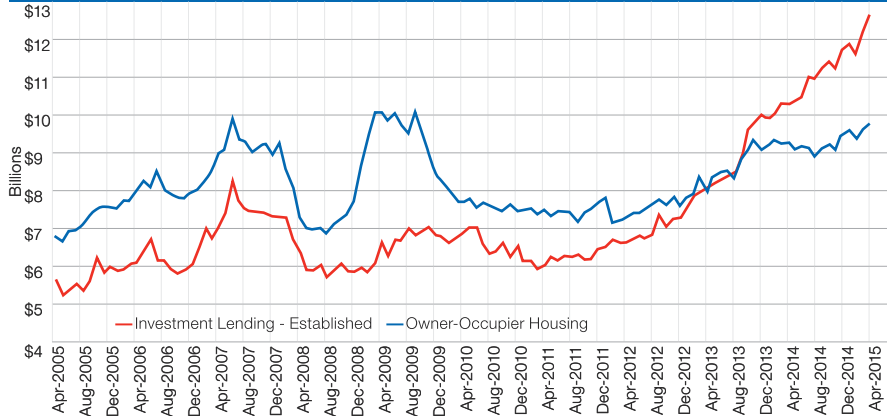
And that's why they are turning to property as well as high dividend-paying shares. As the chart (on the following page) shows, investors are pushing owner occupiers out of the market, particularly first homebuyers.

Investors are flooding the market, not only because they are turning their backs on cash but also to benefit from the tax advantages of negative gearing.

Of course, historically low interest rates imply that ultimately they must reverse the trend and rise. When they do, many borrowers may find themselves struggling to meet the repayments on property bought at highly inflated prices.



Owner-Occupier (ex-refi) v Investors for Existing Property Purchase (SA)



Source: Business Insider Australia

Housing affordability

While it may still be possible to buy reasonably priced property outside Sydney and Melbourne, housing affordability is a key issue in Australia when compared with the rest of the world.

Using a common measure of affordability (comparing the median house price to household income), Australia stands at 6.4 times household income compared with 3.5 in the US and 4.7 in the UK. And Sydney is one of the most expensive cities in the world with affordability at a high 9.8.

To try and stem this strong demand in Sydney and Melbourne, the Australian Prudential Regulation Authority (APRA) has sought cooperation from lenders to tighten their criteria for lending to investors to dampen activity.

While the major players have complied, The Property Professionals of Australia's chair Ben Kingsley does not believe that this is a sound solution to cooling the market in the long term. And he questions applying this restriction across Australia when it is only Sydney and Melbourne where the issue applies.

Other suggestions to improve the affordability of property include scrapping stamp duty to make it easier for owner occupiers and removing negative gearing to reduce the number of investors.

Returns on property

The return on investment property comes from a combination of capital growth and rental income. Yet many Sydney properties have a net yield less than the cash rate of 2 per cent. This means the price-to-earnings (PE) ratio is 50 or above, compared with a PE of 15 for the Australian sharemarket. On this measure, Sydney property appears to offer less value for money than shares.

Over the long term, such low yields will not deliver the results that many investors, particularly those building wealth for their retirement, want.

In addition, property is a bulky asset. If you need to lay your hands on \$50,000, you can hardly sell off the lounge room.

Whether or not you agree there is a housing bubble in Sydney and Melbourne is probably not the issue. Rather, concern should be focused on whether property, at current prices, stacks up as a long-term investment.

If you would like to discuss any of the issues raised in this article in relation to your investment portfolio, then call us.

- i www.afr.com/real-estate/no-housing-bubble-but-sydney-gains-worrisome-says-hsbc-paul-bloxham-20150610-ghkeu4
- ii www.businessinsider.com.au/heres-how-sydneys-property-market-is-making-it-hard-for-the-rba-to-properly-help-the-rest-of-australia-2015-6
- iii theconversation.com/blowing-bubbles-the-tricky-task-of-tackling-sydneys-property-market-42988

Fluid Financial

Suite 4a, Level 1, 5 Ridge St
North Sydney NSW 2060

P 02 9922 4448

F 02 8072 1386

E peter@fluidfinancialplanning.com.au

W www.fluidfinancialplanning.com.au

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