Current State of Australia's Housing Market

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If you were just a passing observer of Australian housing markets, even a regular newspaper reader, you could be forgiven for thinking that house prices are still rising. In fact, **house prices have been falling throughout most of Australia since February of this year**. (It is to be hoped that the release of the ABS September quarter figures showing widespread house price falls will be more widely reported.)

What's more, **Darwin is the ONLY Australian capital city** covered by the RP Data-Rismark Hedonic Price Indices where house prices **did not fall** in the 6 months to August 2008 (the most recent month for which finalised data were available in their 31 October release).

For much of this year, that house prices were falling was somewhat of an insider's secret. Even the Reserve Bank of Australia joined in the deliberate confusing of the situation, and the extreme example of this is the speech by Mr Ric Battelino on 30 October 2008 (www.rba.gov.au/Speeches/2008/sp_dg_301008.pdf).

In an earlier paper I forecasted that data will show that the Australian housing market peaked in the March quarter of 2008 (www.geocities.com/homes4aussies/080708paper.pdf - also see www.geocities.com/homes4aussies/bubanat.pdf). In that paper I suggested that in the early stages of the downturn there may be some confusion as to the direction of the market because of the very significant vested interests in strong house prices by the companies that provide these data and the media companies which report the findings to the public. I highlighted some of the tricks to disguise that the market had turned. Those tactics have been on display recently.

The involvement of the RBA in the "muddying of the water" surrounding the housing markets surprised me. But their involvement needs to be seen in the context of the current financial crisis, and especially it's intensification over the last 6 weeks. More specifically, it needs to be seen in terms of the Rudd Government's view on the potential affects of the crisis on their re-election chances. I would suggest that Mr Rudd has convinced himself that - 1) his chances of becoming a second term PM depend on the economy staying out of recession, 2) that a non-recessionary economy depends on maintaining house prices at or near to these ridiculous bubble levels, and 3) that RBA comments will help him in those aims.

In his comments regarding housing, Mr Battelino, thus the RBA, concentrated more on confidence than on substance. And I guess he, and possibly they (who knows whether Glenn Stevens approved of his speech), would argue that a "once in a lifetime" economic crisis justifies the RBA stepping out a little further on the risk reward continuum themselves (risk being loss of RBA credibility, reward being "improved economic stability")

One thing is for certain, though. Speeches like Mr Battelino's can only damage the RBAs credibility and, at times like these, that can have serious consequences for the Australian economy.

That said, my concerns are for the young Australians that are not getting a clear picture of what is happening in the market and who are being bombarded with poor advice from the vested interests

(and that includes the PM's encouragement to a young couple on prime time television to buy a home – at bubble prices - post-haste.)

This paper aims to provide some balance to the discussion. I provide data and analysis on the current state of Australian housing markets, give some tips on seeing through the statistical tricks that are often used to confuse young Australians, and then provide an update on how Australian housing markets are tracking relative to those in the United States.

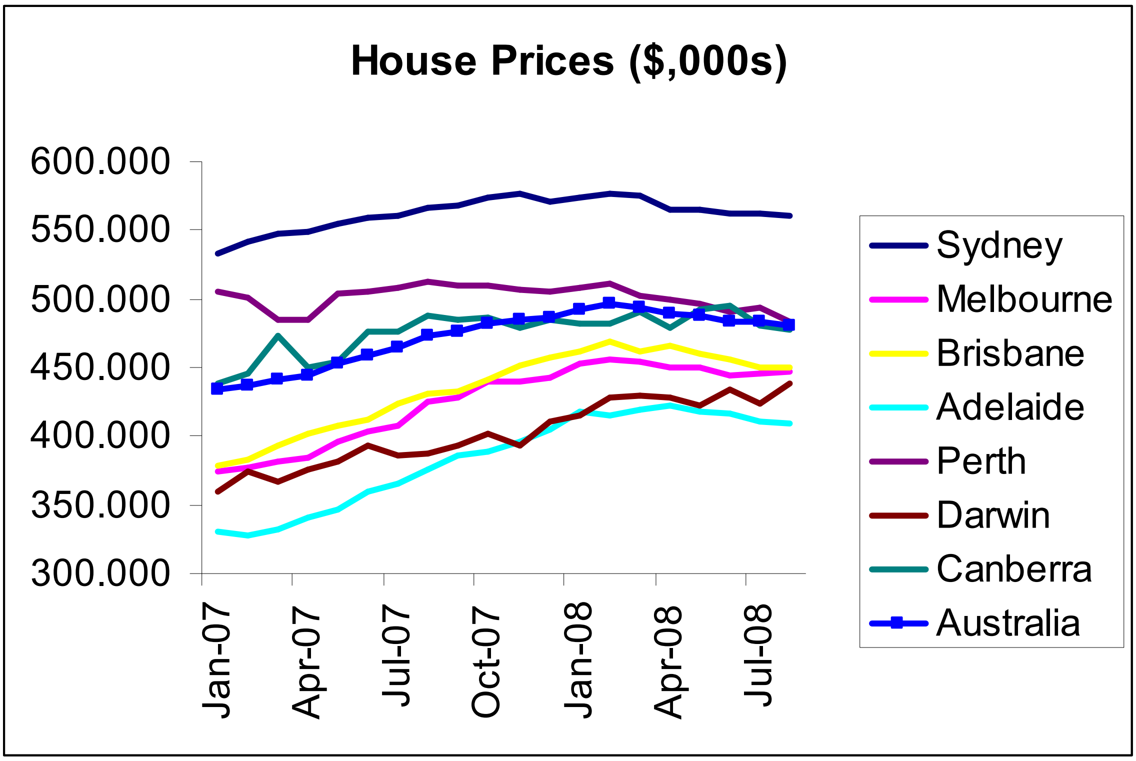
Data Sources

Australian data are from the RP Data-Rismark Capital Gains Indices (final values) – houses - accessed from the RP Data website on 31 October 2008. The quarterly data are from the media releases, the last one available at time of writing being the 1 October 2008 release. US data are from the S&P\Case-Shiller House Price Indices available on the Standard and Poors website. The US national index used in this paper is the 20 city composite.

Current State of Australian Housing Markets

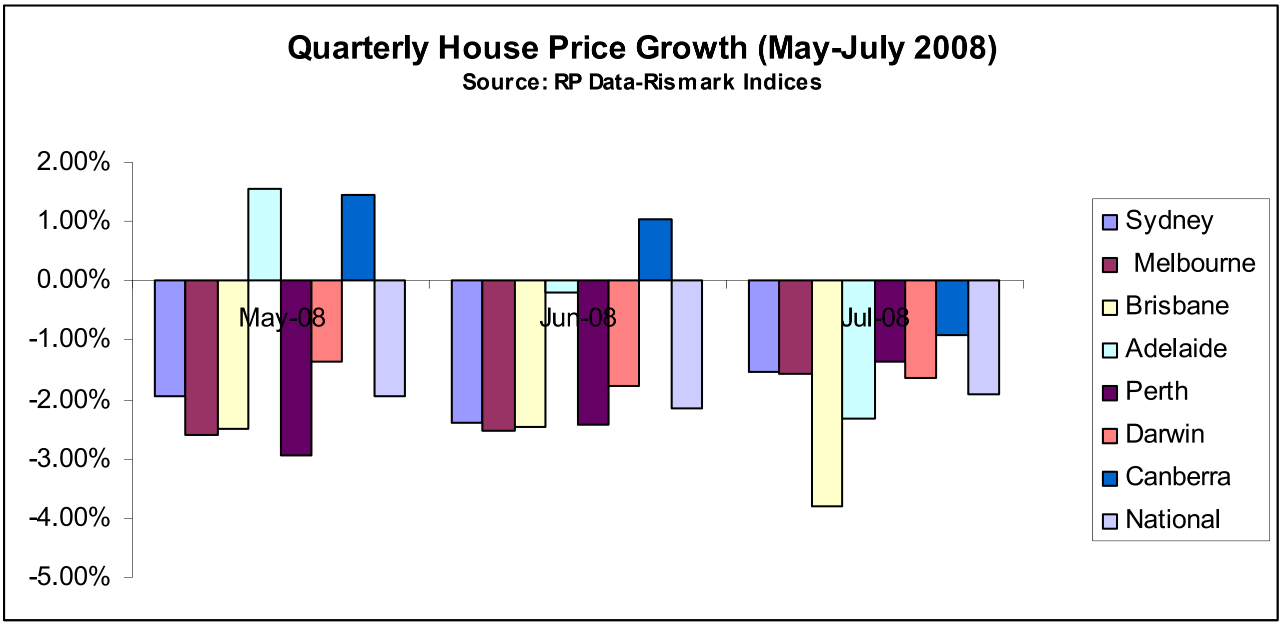
The Australian houses index peaked in February 2008, coincident with peaks for Sydney, Melbourne and Brisbane. Whilst Perth houses peaked 6 months earlier, they made a second peak in February 2008 at just 0.26% below the earlier peak. Adelaide prices peaked 2 months later in April, and Canberra 4 months later in June. Darwin is the only capital city covered by the index which has not yet exhibited a monthly peak.

Figure 1 – Australian house prices Jan 2007 to August 2008. (Source: RP Data-Rismark Indices)



On a rolling quarterly (3 month) basis, nationally house prices have declined each quarter since the one ending in May 2008 (Figure 2).

Figure 2 – Quarterly (rolling 3 months) house price movements for all Australian capital cities (except Hobart) and for the national index. (Data source: RP Data-Rismark indices.)



So the data clearly show that nationally the market peaked in February 2008. And it is important to note that **the downtrend in Australian housing markets was firmly established well before there were any major impacts from the global credit crisis**.

When Statistics are Used to Confuse

Have you noticed that, unlike 12 months ago, stories of house price increases are not splashed everywhere? Well, that's the first point to make. The data are not conducive to promoting residential housing as an investment, so the media are relying on other tactics – stories of huge rental increases, fears of the increase to the FHOG causing a surge in house prices – to get home buyers and naïve investors interested in housing again.

You may have noticed that you actually have to read well into articles, often well into the newspaper, to get some actual figures on house prices. And when you do, they probably show house prices increased – right?

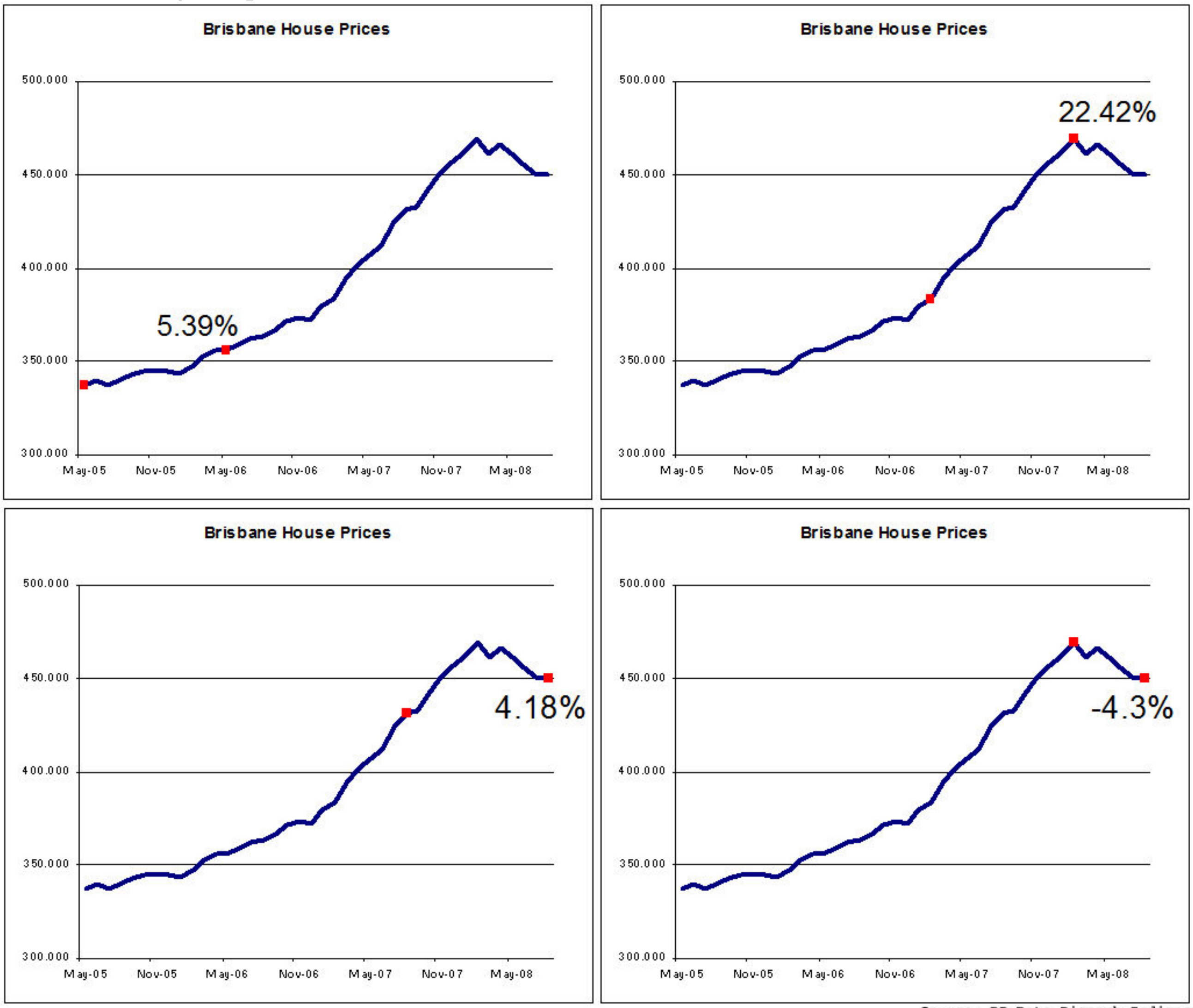
How are they doing that when the data clearly show that house prices are falling? Well they have stopped quoting short term data and are reporting primarily – often only – the annual data. And the annual data will be the last to show the price falls because it "smooths" out "lumpy" data and disguises turning points in the markets.

So, vested interests – the media included – will use short term data (even auction clearance rates) to emphasise a take off in the market, and will use long term data when the market has turned down.

These comparisons involve comparing prices from one point in time to another (perhaps a year earlier), but they do not necessarily give the full picture of what has happened between those points. Following is a series of graphs of Brisbane house prices to show how it works (Figure 3). Notice that a high value – either positive or negative – gives a relatively accurate indication of the market (the top right graph). But smaller values could either reflect a market that is consistently heading in the one direction, albeit at a moderate pace (the top left graph), or there may have been a turning point in between the two points in time being compared (the bottom left graph). In the last case the annual figure of a 4.18% increase disguises the fact that house prices actually **dropped** 4.13% over the final 6 months of that period (bottom right graph).

Six months ago the media was yelling from the roof tops that Brisbane house prices had increased 22%. Three months ago they were reporting annual house price growth of 13%. Right now they are struggling to hide their anxiety when they mention annual growth of 4%. They are anxious because they know that, unless something drastic happens in the market very soon, over the next few months they will have no other choice but to openly admit house prices are falling because short term and annual data will all be negative! (This was a lot of the motivation for the increase to the FHOG – the Government would have been hoping for a quick impact to produce some positive short term data – such as improved auction rates – which could have been used to crowd out from media reports the longer term trend of falling house prices.)

Figure 3 – Four graphs displaying calculations on the growth of Brisbane house prices. Each graph is identical (from May 2005 to August 2008) and the red icons represent the two moments in time which are being compared.



Source: RP Data-Rismark Indices

So the lesson is to not just accept the superficial figures from the media reports. Seek out the full story and even go to the relevant websites and read the entire report (and also note that the titles of the reports may often be quite contradictory to the content reported within them.)

How Australian Housing Markets are Tacking Compared to the US

In an earlier paper (www.geocities.com/homes4aussies/080708paper.pdf) I argued that the US experience was a convenient model for forecasting the likely movement in Australian house prices and prepared a forecast for Brisbane. Moreover, I took what I argued to be a relatively conservative approach of modelling based on the national US experience – even though my research showed that nationally we had experienced a significantly greater bubble than the US had – noting that the risks to my forecast were consequently to the downside.

The premise of this paper – the US experience being an apt model for Australian housing markets – is primarily what Mr Battelino argued against in his speech.

Firstly I think it is absolutely critical to point out the massive inconsistency in his treatment of the two asset markets in which most middle to upper income Australians invest – residential property and shares.

On the former, he seemed somewhat annoyed (that the RBA's confidence sales pitch was being countered) in saying:

> "And, to top it off, some commentators are predicting sharp falls in house prices here in Australia".

Later, in reference to share markets, he states:

> "after a few years, a cyclical upswing starts to look like a trend and more of us try to jump aboard. Eventually this pushes asset prices to levels that are higher than can be justified by the income produced by the asset, and prices correct down."

This contradiction is ridiculous! I would suggest that 90% of Australians who read the latter statement out of context would immediately jump to the conclusion he was talking about house prices. Why is the RBA prepared to admit that the share market was due for a correction, but was talking down the possibility of a correction in house prices when they are clearly far more overpriced than shares were prior to the correction?

Mr Battelino's **entire** argument for continued strong house prices in Australia **hinges** on his farcical assertion that our housing markets peaked in 2003, three years earlier than in the US (See the graph of Australian house prices – ABS data – compared with the US in my earlier paper www.geocities.com/homes4aussies/bubanat.pdf to understand just how farcical is that argument).

In earlier papers published on www.geocities.com/homes4aussies, including the ones mentioned previously, I conclusively argued that, on a national basis, house prices did not peak in Australia in 2003. Rather I forecasted that they would peak in the March quarter of 2008, and recent data (as presented above) add further weight to my forecast.

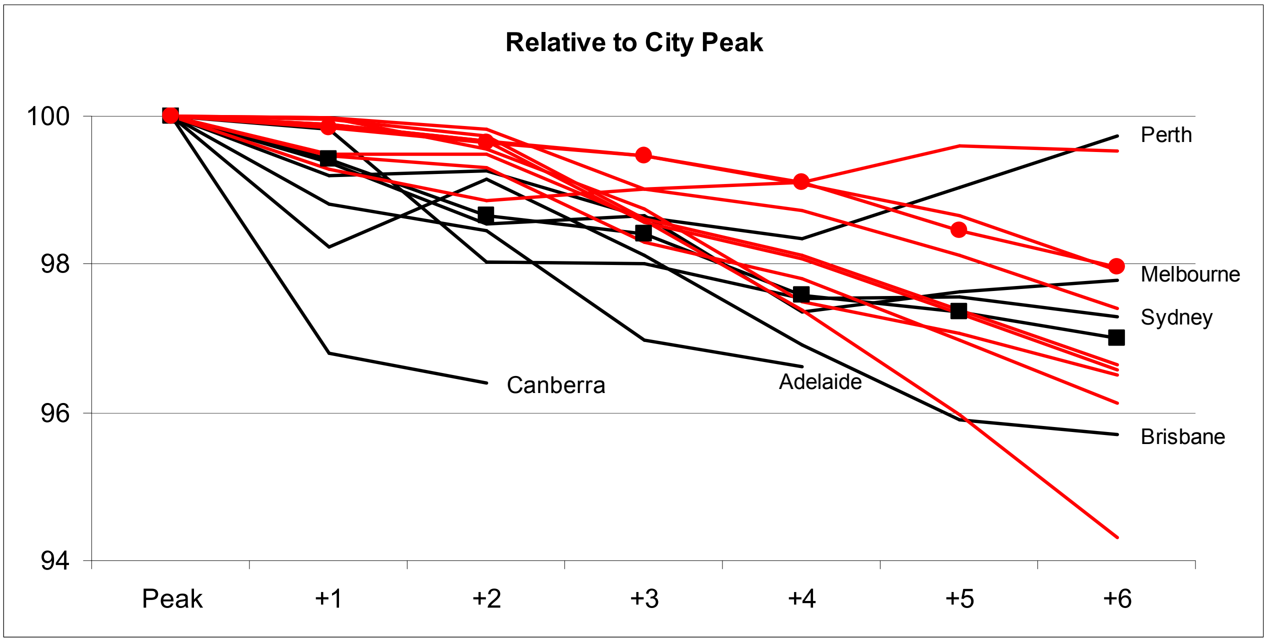
Now that the downward trend in Australian house prices has been established, it is useful to revisit my forecast and compare the early stages of the bursting of Australia's housing bubble with those in the US.

At the outset I need to stress that this comparison – like the earlier studies – is being made between **ALL Australian capital cities** (except Hobart, this time, because the source data excludes it) and the **8 US cities that have experienced the greatest price declines since their bubble popped**.

In other words, this comparison is between **THE WORST AFFECTED** of the US housing markets with **ALL** of the Australian capital city housing markets.

Firstly I plotted the monthly movement in house prices for each city relative to that city's peak on one graph (Figure 4). Darwin is not represented because it registered a new high in the latest monthly data (which may or may not mark its peak). The intention is not so much to highlight individual cities – though the Australian cities are identified for interest – rather it is to gain an overall picture of the rate of fall in Australian house prices relative to the US cities that have experience the greatest price declines.

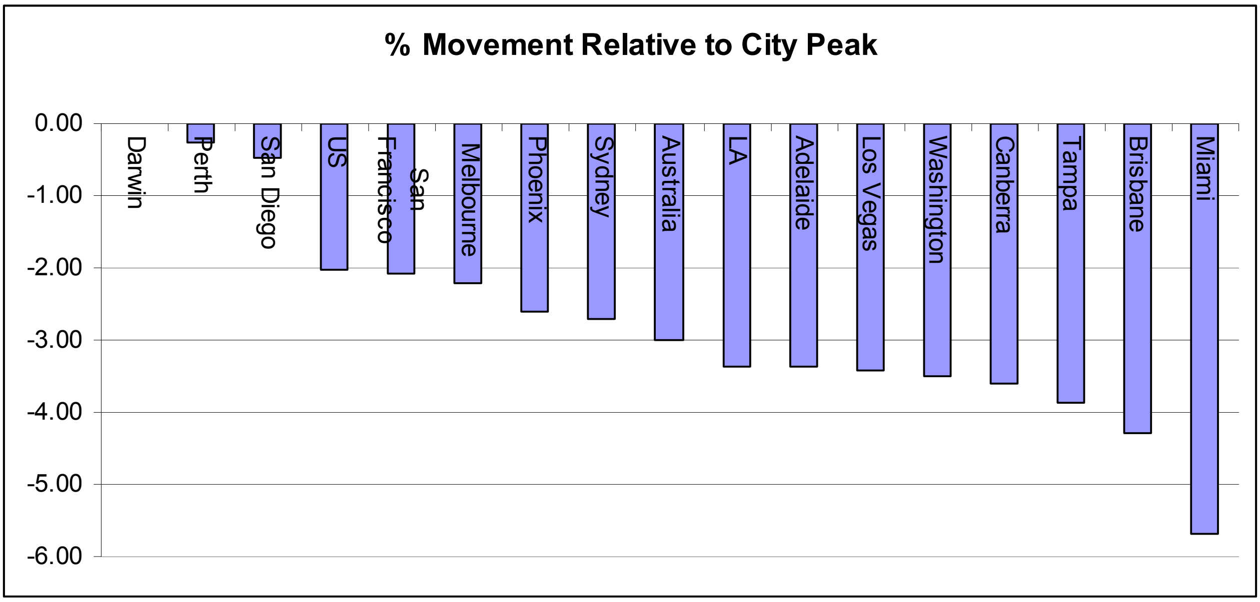
Figure 4 – Relative to their peaks, monthly house price movements for Australian capital cities (except Darwin and Hobart) and the 8 US cities that have experienced the greatest house price falls. Australian cities are all indicated by black lines, US cities by red lines, and the respective national indices are differentiated by having their data points marked. (Data source: RP Data-Rismark Indices, Capital Gains indices (Final Values); S&P Case Shiller individual city and 20 city composite indices; peak = 100)



Clearly, the early stages of the bursting of Australia's housing bubble are progressing at a pace consistent with the US experience, if not at a slightly more rapid pace.

At 6 months post their peaks, the rate of decline of the Australian index has been more rapid than the US index. What's more, it is very significant that **the Australian index decreased more rapidly than all except the 5 worst US bubble cities**. Conversely, all Australian cities except Perth exhibited a more rapid decline than the US index of 20 cities. And the Australian index had fallen by around 50% more than the US index at the same stage of the housing cycle (Figure 5).

Figure 5 – Percentage movements in house prices 6 months after the peak in the index for each city. (As Canberra and Adelaide peaked more recently, their values are for 2 and 4 months post peak respectively.)

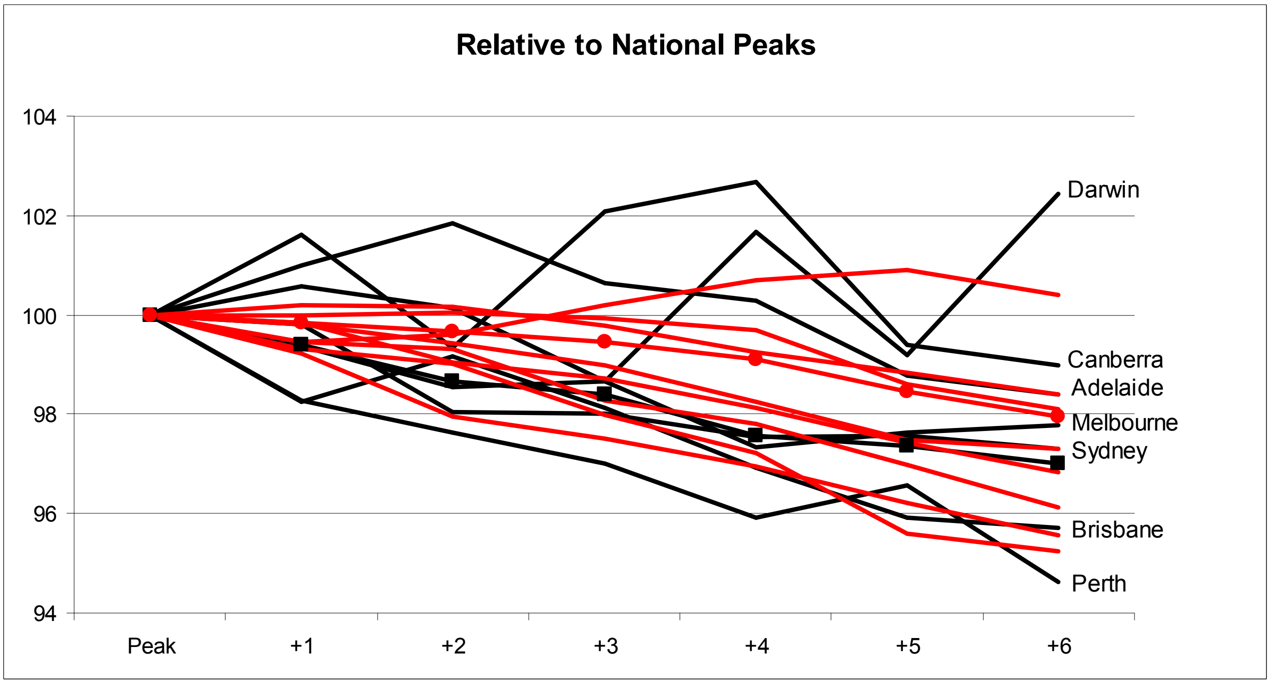


The above approach gives some indication on the pace of house price falls, but the plots for Darwin and Perth reveal that further analysis is required. As mentioned earlier, the Perth market peaked 6 months prior to the national peak. However, it exhibited a second only marginally lower peak at the same time that the national index peaked. The synchronicity of Australian housing markets is marked.

In an earlier paper I discussed the striking synchronicity in the US market.

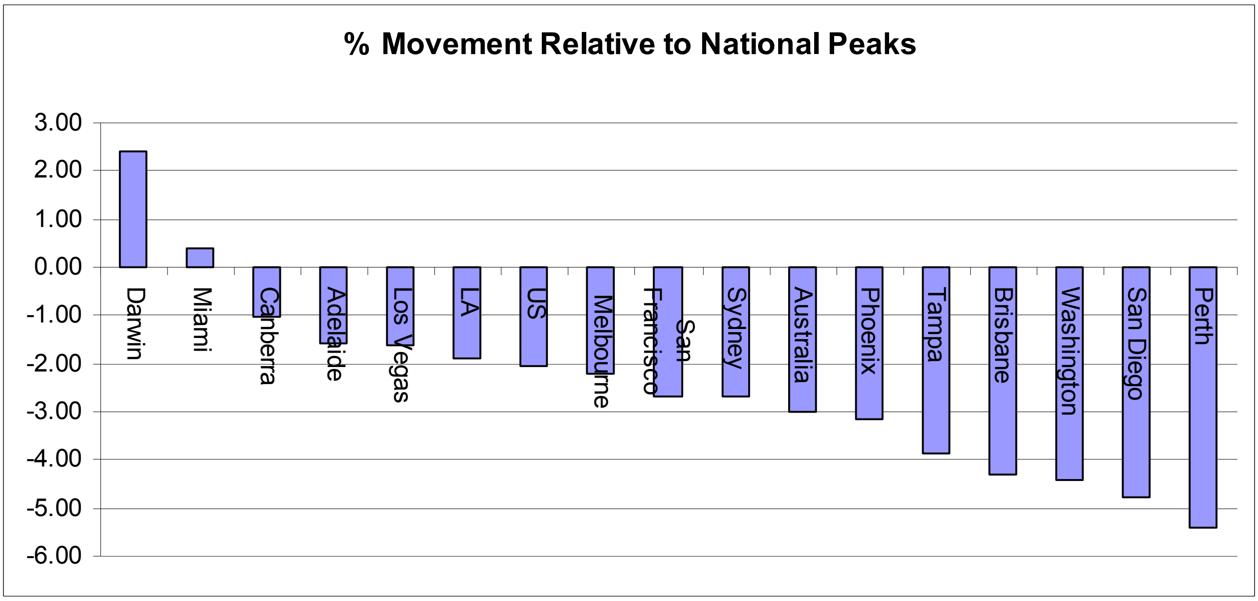
The synchronicity of housing markets within Australia and the US suggests that there were national factors affecting the formation and bursting of the bubbles. Therefore, it is important to also examine house price movements relative to the peak in the national index (Figure 6).

Figure 6 - Relative to national peaks, monthly house price movements for Australian capital cities (except Hobart) and the 8 US cities that have experienced the greatest house price falls. Australian cities are all indicated by black lines, US cities by red lines, and the respective national indices are differentiated by having their data points marked. (National peaks = 100)



The relevant differences between Figures 4 and 6 are these: Perth now exhibits the greatest price decline of all cities (including US cities), Darwin is indicated on the graph showing an increase in price, and there is no "outlying" US city line to the downside, rather it is to the upside. The reason for mentioning the "outlying" US city should be clear to all in Figure 7. (Hint – look at which US city recorded growth after the national peak and compare that with Figure 5).

Figure 7 - Percentage movements in house prices for each city 6 months after the national peak.



Yes, that's right. Miami did not peak until well after the other US cities peaked, but it caught up in a hurry! I would suggest that this should serve as a word of caution to anybody feeling optimistic about Darwin house prices.

Conclusions

Whatever way you wish to look at it, it is inescapable that **<u>these analyses confirm that we are witnessing significant house price falls in Australia.</u>**

Sure when you look at long term graphs of Australian house price movements, and indeed very short term graphs of Australian house price movements (like Figure 1), it may seem that current house price falls are not all that significant.

But the US experience shows that housing markets tend to turn slowly, and there are factors specific to housing markets – particularly those that have experienced enormous price run ups built on sharply growing personal debt levels – which tend to result in house price falls accelerating after turning points.

Houses prices in most of the US cities covered in this study have decreased by over 30% from their peaks, and the 20 US city composite index has decreased by just over 20% in the two years since it peaked.

Of course, that our housing markets have turned down, and the early stages of the downturn are occurring at a pace reminiscent of the US housing downturn, does not mean that our housing downturn will be as severe as the US experience. And certainly there are many analysts – mostly from vested interests – including Mr Battellino, who argue that our housing markets will not follow the US lead.

In earlier papers and in online debates I have effectively argued against all of these points that have been raised. I have updated those arguments and placed them in appendices at the end of this paper.

Suffice to say that, whilst there are undoubted differences between the US and Australian housing markets – some of which are likely to have the affect of lessening the potential for house price falls – it is also true that all of these are more than countered by other factors specific to Australia which will tend to worsen the downturn.

Therefore, I remain of the view that the US experience is an apt model on which to forecast likely Australian house price movements going forward. And, in the fullness of time, this approach may well be proven to be conservative.

Data thus far reported strongly supports a number of my forecasts: 1) the Australian housing market peaked in the March quarter of 2008; 2) in the early stages, Australian house price falls have occurred at a rate similar to, or slightly faster than, that observed in the US; 3) mortgage default rates have exhibited a strong uptick as markets peaked and prices began to fall; and 4) Brisbane and Perth have experienced the greatest house price falls since their peaks.

Many of my fundamental views of markets are informed by my reading of many of the most experienced and successful investors, and especially Warren Buffet. One thing is consistent with all of them – they all recognise that asset price bubbles occur from time to time – and they don't get carried away with the herd! They sit back, watch and observe and make astute decisions.

One of the most entertaining discussions of the recent housing bubble was by Jeremy Grantham in his July 2008 newsletter. Mr Grantham said about the US housing bubble:

> “this bubble has burst quite rapidly, in fact about as rapidly as it went up, which is also typical of large bubble events….. what we must worry about is the normal tendency for bubbles to overrun on the downside.”

He went on to discuss the UK bubble:

> “Exhibit 2, my recent favorite exhibit, shows the dramatic differences between our housing prices and those in the U.K. While the U.S. is a newcomer to housing bubbles, the Brits are old pros. It’s practically their national past time. They may not win at Wimbledon, but they can do really good housing bubbles!”

In a paper I compared his graph of UK house prices with Brisbane’s which towers over the former (www.geocities.com/homes4aussies/hp2earn.pdf). Grantham adds (and think about this in relation to our bubble):

> “The U.K. housing event is probably second only to the Japanese 1990 land bubble in the Real Estate Bubble Hall of Fame…. The current U.K. housing event had become the biggest tease in bubble history, beginning to decline almost 4 years ago, then putting together another 2-year rally before finally flagging this year. The bad news is that as usual it will go all the way back to normal – which you can barely see from here – and very probably will overrun just to rub it in. It will make our troubles look like a toothache to their hip replacement.”

It would be very interesting to know whether Mr Grantham has ever looked at Australia’s housing bubble. I would doubt it – our economy is not significant enough at the global level. But I reckon that we might give the Brits a run! We can BOTH win Wimbledon and do really good housing bubbles!!

The point to these last comments is, the RBA should just forget about going in to bat for the Rudd Government on housing – it is only damaging their credibility.

As Ian MacFarlane said in his Boyer lectures, if they are not going to play a role in preventing bubbles from occurring, then all they really can do is clean up the mess AFTER they have burst. This bubble has gotten so out of hand that I doubt very much that there is anything they or the NEW Rudd Government (I emphasise new because I do think it is unfortunate that they have to clean up the mess created for them) can do to prevent it from popping, in any case.

We all would be much better served by them if they got serious about preparations for the clean up – including ensuring that the housing policy frameworks are adjusted to lessen the likelihood of this happening again – and so that higher income Australians are not able to gain while lower income earners suffer. That, I suspect, is what Glenn Stevens had in mind when he said in his speech on 21 October 2008:

> “Perhaps we will need also to get better at turning borrowing for housing into more dwellings rather than just higher house prices”

Appendix 1 – Argument: we have better lending standards in Australia than in the US

We know that subprime lending is a major cause of downward spiralling US house prices. But it is also important to note that it was not necessarily the cause of the US housing bubble popping. No, poor lending standards are usually only revealed when prices at least stagnate because overcommitted borrowers are unable to refinance and extract "equity" to cover their mounting cash flow problems.

To highlight this point, I will provide the following quote from a Fitch Ratings paper from August 2006 – just a few months after the peak of the US market (Baily 2006):

> "Despite rising rates and the cooling housing market, performance on outstanding loans generally remains strong as reflected in the rating actions to date in 2006. Across the prime, Alt-A, and subprime sectors, upgrades have outnumbered downgrades by approximately a 4:1 ratio this year."

And the US experience shows that once over leverage and poor lending standards are revealed, the downward spiral is severe.

So let's turn our attention to Australia. It is frequently said – including by the RBA – that the lending standards of our institutions were far superior to those in the US. That "non-conforming" is the only category of Australian lending comparable to US subprime, and they only represent 1% of outstanding mortgages as opposed to the 12% that subprime represents in the US.

Again, of course the RBA is going to paint a positive picture. They must tread a fine line between maintaining their credibility and selling the credit worthiness of our financial institutions. (Although, present indications are that they are becoming less concerned about their credibility.)

Because our market has only recently peaked, it is still early days in terms of finding out just how robust were lending standards here in Australia. However, there are early signs that standards were not as robust as many argue.

Following is a quote from a different Fitch Ratings paper (McCarthy et al. 2008):

> "Property prices in New South Wales, and in particular Sydney, stalled at the end of 2003 and this coincided with a rising missed payment rate for this market. The most pronounced property price declines occurred in South West Sydney, where property prices fell as much as 30%. In these circumstances, highly geared borrowers have few options when they get into difficulty, as refinancing or sale of the security property becomes more difficult. This pattern appears to be evident in Western Australia over recent months, where property prices are falling leading to distressed borrowers being unable to refinance or sell the property to repay the loans in full.
>
> Fitch is of the view that rising property prices have masked the true performance of Australian residential mortgage loans and that the experience in South West Sydney ‐ and more recently, Western Australia ‐ provides a window to what performance may look like in circumstances of falling or static property markets."

In an earlier paper I compared the mortgage delinquency (default) rates on Australian and US mortgages RELATIVE TO THEIR PEAKS. What I found was that, as suggested by the first Fitch Ratings quote, delinquency rates on US mortgages were relatively low at the market peak, including for subprime, but especially for the other categories (with prime being very low). And comparing the level of defaults between Australian securitised mortgages and the US subprime mortgages at the housing peaks showed they were very similar. It was not until the market peaked that the default rate on US mortgages, especially of subprime mortgages, began to pick up strongly.

In its latest Financial Stability Review (September 2008), the RBA provided significant detail on the performance of Australian mortgages especially of securitised mortgages. The RBA stated:

> "For housing loans on banks' domestic books (which account for around three quarters of all outstanding housing loans), the proportion of loans that are in arrears by 90 days or more was 0.41 per cent at June 2008, up a little from the end of 2007 but unchanged from a year ago (Graph 49)."

So, like in the US, default rates on prime loans were low at the peak (and in the US these have not increased anything like subprime.)

They go on to say:

> "In contrast, the arrears rate on prime securitised housing loans is higher than a year ago, at 0.57 per cent as at June 2008. This likely reflects the lower average credit quality of these loans with, for example, the share of low-doc loans in the pool of securitised loans higher than that for loans on banks' balance sheets. In addition, there is some evidence that the arrears rate on prime, fully documented loans made by some non-ADI lenders (that relied heavily on securitisation) is higher than that for many bank lenders"

So, there are signs that the default rates on the pool of securitised Australian mortgages as a whole – representing 18% of outstanding mortgages – are beginning to increase. And this is shown well graphically in their Graph 49 by a very strong uptick.

The RBA associates this mostly with the strong increase in defaults on non-conforming loans, but does concede that defaults on other securitised loans are rising.

We hear a lot about NINJA loans in the US. But these were an extreme and minor component of subprime lending. If they made up 6% of subprime loans, then they are proportionately equivalent to our non-conforming loans. But what is much less frequently said is that many people who would easily have qualified for prime loans were convinced to take out subprime loans. So the topline data on subprime mortgages represent a wide range of quality of mortgages – as does the topline data on Australian securitised mortgages.

To conclude, any one of us can make anecdotal statements that our lenders had robust lending standards through the bubble, or alternatively that they were throwing credit at us.

But the proof will be in how mortgages perform as house price growth slows and then prices fall – which is where we are at now. And I would suggest that the early signs are that we are going to see a significant rise in mortgage default rates. What's more, in the fullness of time we may come to consider our entire securitised loan segment on a par with the US subprime segment in terms of credit quality. Even if it is not quite as bad, proportionally securitised loans make up 50% more of outstanding Australian mortgages than do subprime mortgages in the US. So a significant increase in defaults in this segment will place a great deal of downward pressure on Australian house prices.

Appendix 2 – Argument: we have full recourse loans in Australia

In the US, many mortgages are non-recourse which means that a borrower in financial difficulty has the option of handing their house (the keys) back to the bank and walking away without being liable for any shortfall when the house is sold (because current prices are usually less than the outstanding mortgage.) These mortgagee in possession sales are having a downward drag on house prices.

The argument runs that troubled Australian borrowers have more incentive to work through their difficulties because they do remain liable for any shortfall.

First of all, this popular argument involves the premise that it is a relatively easy decision for a US borrower in financial difficulty to give back their home. I don't believe for a second that would be an easy decision for anybody. No matter whether you will remain liable or not for any financial shortfall, for most people it would be a gut wrenching decision to give up your home. Thus it will only be done under the most difficult circumstances.

That there are many mortgagee in possession sales in the US is more a sign of the advanced stage of their housing cycle than about non-recourse loans.

Leaving aside this emotional argument, there is a critical counter issue which is likely to have far greater impact on our housing markets.

We have a very large small scale investor segment that has been very active through this bubble making use of easily available credit. (When people talk about speculation in US housing they are mostly talking about people who bought big homes with cheap credit aiming to sell in a year or two profiting enough to buy a more modest home outright and possibly even have cash in the bank.) This is a major difference to the US, and in this regard our situation is similar to the UK. Every Australian and Brit knows that speculation by small scale "investors" has been a major factor in our housing bubbles being significantly larger than in the US. And most analysts consider this to be a particular area of weakness for our markets.

This is what billionaire investor Wilbur Ross had to say about the issue on CNBC Squawk Box on March 7, 2008:

> "I think the credit crunch is not only getting worse in the US but it is spreading overseas. I was in England about two weeks ago, and my take of the housing market there is that it is in at least as bad a shambles as what we have in the United States. They had an activity there called "build to let" where little people, not real realestate professionals, but average citizens were building houses, highly leveraged, on speck, with the idea of renting them out. And I don't think that realestate is a very good game to play "Amateur Hour". And it's now coming back to haunt them. So I see the credit crunch spreading to England. Housing prices have been very badly hit in Ireland. Very badly hit in Spain. Even as far away as Australia. So I think "credit crunch" may be one of our big export products near term."

This quote shows just how "foreign" to Americans is the concept of small scale investing in rental housing, and how foolhardy it is to engage in it in a speculative manor.

Appendix 3 – Argument: we have a massive undersupply issue compared with oversupply in US

It is very frequently stated – by banks and housing industry representatives (in other words, vested interests) – that there is a significant shortage of housing in Australia.

One thing is certain – there is a shortage of affordable rental accommodation!

There are a lot of points to be made on the issue of whether there is – at this very moment – a shortage of available housing. In recent times there has been much said about the vacancy rates that are published. And it needs to be said that the widely quoted data are from the realestate institutes – another vested interest. Louis Christopher of Adviser Edge recently launched a new index based on internet advertising of properties for rent which suggest that vacancy rates are nowhere near as low as the realestate institutes' data suggest. And there have been other issues that have arisen, especially the issue of houses (and units) being left vacant by investors – see www.bubblepedia.net.au for extra information.

Again, let's leave that debate aside, and move on to discuss what is likely to be the case in the future – because this argument of undersupply makes clear inferences to the future – that the level of demand will, at the very least, remain at current levels.

So it comes down to **supply and demand going forward**. That **dynamic will be heavily influenced by the state of our domestic economy**, and on that front, things are not looking strong.

Spruikers like to talk especially about our recent high levels of net immigration. However, our current immigration program is based heavily on skilled migration especially under the 457 **temporary** visa scheme. Its temporary nature suggests that this form of migration will be very quick to adjust to economic circumstances, and we have already seen the first signs of that in this slowdown with intense debate about migration levels and an admission from the Federal Government that levels are being assessed.

Furthermore, as the migrants in question are highly mobile and skilled, in an economic downturn they may well leave to go to better performing economies. In other words, we could have much significantly lower levels of net immigration over the next few years.

And finally on the demand side, the domestic economic situation will have very significant impacts on household formation by Australian citizens. The demographics underlying the increase in household formation may well change abruptly and we are likely to see significant "bunching" up. Already this is occurring due to the high cost of rents. However, the tougher economic conditions – especially rising unemployment – will cause this to accelerate. All of the factors already noted – children staying home until older or moving back in with parents, and friends "couch surfing" – are likely to increase. And young adults, couples or even families struggling to meet financial commitments will take on boarders to help ends meet.

On the supply side there are also likely to be some significant changes going forward. Most importantly, the issue of homelessness is likely to grow as a major issue. Certainly Mr Rudd read those tea leaves on winning the election and consequently instructed all of his MPs to visit a homeless shelter.

Governments are going to need to respond to this issue. The National Rental Affordability Scheme is one such response, but pressure to lift their game is likely to (hopefully) see them expand on it. Moreover, pressure on incumbent state Government should see them playing a role in solving the crisis – including through the provision of Government housing.

And finally, the deleveraging process which is going on world wide will have significant impacts on housing supply in Australia. Some argue that there actually is no housing shortage – it is just that a lot of Australian houses are vacant because they are either holiday homes or are "investment" houses not made available for rent.

Growing financial pressures on middle to upper income Australians – due to stockmarket declines and changes in the employment market (middle management is likely to be targeted for layoffs, particularly in the finance industry, through this slowdown as in the early 1990s) – is likely to result in a decrease in the stock of vacant housing.

Finally, to finish on this point it is worth including a statement from Mr Battellino's speech:

> "The overhang of unsold houses in the US has created downward pressure on house prices as builders and developers have been forced to sell. This is absent in Australia."

I would not be surprised at all if the RBA has been informed by builders and developers that there are growing inventories of unsold houses in Australia. Certainly there has been a lot of discounting in the new house market. I suspect that the increase in the FHOG on newly constructed homes may have been an attempt to get those growing inventories down. Moreover, it is noteworthy that many builders have added to the grant themselves – more discounting. (And, incidentally, since the justification for the FHOG increase is to stimulate more construction of housing, the Government should stipulate that "newly constructed" refers to a house that was not completed or under construction at the time that the policy was announced.)

Appendix 4 – Argument: we have China!

Perhaps the most frequently used argument for housing markets in Australia remaining strong in the short term is the strength of the Australian economy, largely due to the China growth story.

I never put much stock in the "decoupling" theory, even prior to the recent acute phase of the financial turmoil. But the unravelling of the decoupling theory has picked up pace over the last few months, and I see two very significant indications of that: 1) for the first time, the RBA (in its statement after the 1% cash rate reduction) indicated a change of rhetoric (and confidence) over China in stating "evidence is accumulating of a significant moderation in growth in Australia's trading partners in Asia"; and 2) Tom Albanese, CEO of Rio Tinto and a long time proponent of the "stronger for longer" because of China argument, has shown a dramatic change of rhetoric in his recent comments.

And the general media has more recently started to examine the potential impacts of the global slowdown on China, rather than just accepting the decoupling theory as an "article of faith".

Let's look specifically at China. It is still very much a maturing economy, massively dependent on selling goods to the rest of the world. Moreover, the factors that have driven our "wealth effect" – which has driven our internal consumption economy – has been massively amplified in China with their stockmarket having gone up 500% in two years to October 2007, and property prices also undergoing massive growth. So too are the reverse wealth effects amplified in China – note that their stockmarket is down 60% this year. China's National Development and Reform Commission admitted that stockmarket losses and concerns for economic growth were now affecting buyers in their property markets. Property demand in some Chinese cities has almost halved in the year, and there are reports that property prices in Shenzhen have decreased by 40%.

Clearly all of this must be impacting Chinese consumers – and these issues were prevalent before the current acute phase of the financial market dislocations.

The Chinese government does have a huge pile of savings to call on for domestic stimulus. However, most savings are invested overseas. A young China observer – with an Asian-based investment advisory company – stated that of the USD$1.8 trillion in Chinese foreign reserves, $1 trillion is in US treasuries. So pulling those funds out of those countries – when those countries are desperate for all the cash they can get their hands on – will have a serious impact on the global economy, and ultimately China's export industries.

What's more, Alan Kohler (writing on BusinessSpectator.com.au) made the point that the US will be looking hopefully once again to China to buy up MORE treasuries to funds it's rapidly expanding balance sheet. And I read elsewhere that the International Monetary Fund is asking for China to provide more funds so it can restore its balance sheet in order to support the developing countries increasingly affected by the global turmoil.

Everybody is seeking help from China (what an amazing turn around in world geopolitics!) But there is no way in the world China is going to be able to carry the whole world!

I heard a while back – I think it was Alan Kohler on the 7.30 report – that already one-third of businesses in Guandong province in China have gone bankrupt! And I read in the Australian Financial Review that tens of thousands of factories have closed.

That is huge. It is little wonder that Robert Gottliebsen wrote on the Business Spectator website recently that the top level of the Chinese government is hugely concerned about the impact on

China of the US economic problems. And finally, if we take the argument the full circle, there is early evidence that Chinese demand for Australian resources is now being impacted by the global problems. Closed factories have no demand for resources. And the chief economist at the State Information Centre in Beijing has warned, and I quote, "Falling transactions may turn into widespread price declines and dampen real estate investment, which accounts for one-fifth of China's total fixed-asset investment. Subsequently, demand for steel, cement and other construction materials may shrink."

Certainly those views are beginning to be reflected in spot market prices for resources.

Our economy will be massively affected by the global problems and their affects on China. The size of the stimulus package in Australia is a good indication of that. That stimulus package will certainly result in a short term boost to consumption and GDP, as was witnessed in the US earlier this year. But it will not be enough to prevent a sharp rise in unemployment. And it will not provide the long term confidence in the economy that is necessary to promote investor or speculator activity in housing (thankfully), or indeed to make perhaps the most significant purchase of a lifetime – a family home (especially when they are at bubble prices).

Really – that people are still trying to fly the decoupling story shows just how desperate many are to hold on to SOMETHING (ANYTHING)!

There is no doubt that, barring massive political disruption, China will grow to be an economic powerhouse this century – and we will gain enormously from that – but it’s way too early for China to carry the world. I also note that JP Morgan has developed similar views over recent weeks about the impact on China and the consequent impact on our economy, predicting unemployment of 9% here by 2010.

Growing unemployment here will certainly worsen our housing markets. But it is important to note that our housing market had turned well before the worst affects of the credit crisis began to impact us, and those pre-existing factors alone would have resulted in a significant correction.

<u>Appendix 5</u> – Argument: interest rate cuts will increase buyer interest

This is argued against in the following paper – www.geocities.com/homes4aussies/renvbuy.pdf

Again, Mr Battellino also used this argument. And, once again, it's an interesting contradiction because the RBA spent most of last year stressing that rising interest rates were not the cause of the housing affordability crisis – thus the decision by many first home buyers not to buy. (They stopped short of saying the real cause – the bubble high house prices relative to earnings.)

So it really is a major contradiction to now suggest that decreasing interest rates will have a major effect in getting first home buyers to purchase. He said the following:

> "there are buyers waiting for better circumstances – e.g. lower interest rates or rising incomes – to facilitate their entry to the market"

This is another sign of political interference in their publicly expressed views, and their earlier views are the correct ones for the following reasons.

In the aforementioned paper I showed that renting is a far more economically sensible decision for all Australians who do not currently own their home. Currently the median priced house in most Australian capitals is $400,000 or more, and the median rent is around $350 per week. At a mortgage rate of 9%, and with very conservative estimates on the cost of ownership, you would need to have a deposit of $264,833 to buy that house and enjoy the same standard of living as you do renting it. At a mortgage rate of 7%, the figure is still a whopping $235,560.

And if the world went crazy and interest rates dropped by almost 4% overnight - down to 5% - somebody buying a roughly median priced home would still need a massive deposit of almost $200,000 to enjoy the same standard of living as they do renting that home!

Now, I don't think anybody is predicting mortgage rates of 5% in the very near future. And even if that were to occur, because our house prices are so ridiculously high, renting would still be the better financial option.

It is fair to say that all home buyers accept that they will not enjoy the same financial standard of living when buying. In other words, there is a premium to be paid for the emotional gain of living in your own home.

But at present that premium is very large. And it is my contention that the premium is well beyond rational levels and this is the primary reason that Australia's housing bubble stopped inflating in the March quarter 2008.

Once a rational premium for the emotional quantum gained by owning your own home is breached, the only way for house prices to continue to move higher is if there is an unshakeable belief among market participants that prices can only go higher. Those conditions existed in Australian housing markets up until 2007. They do not exist now.

This is exactly why decreasing interest rates will not bring back first home buyers.

There is no way to escape that house prices must fall significantly before young Australians will buy homes again.