House Price to Earnings Ratio: Comparison between Brisbane and United Kingdom
- UK from Jeremy Grantham's 2Q2008 Newsletter -

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Legendary investor, Jeremy Grantham, had an excellent article on the UK and US housing bubbles in his latest newsletter (Grantham 2008). He plotted the house price to earnings ratio – a frequently used fundamental analytical tool – to determine the degree of over pricing in these markets. He concluded that the US market would need to drop another 17% immediately, or remain flat for 4 years, and the UK market would need to drop 38% immediately, or remain flat for 7 years, for these markets to come back into balance according to their long term average. Mr Grantham concluded that one way or another, the ratio would correct to the long term average in both markets – because they always do – and also suggested that it is more common than not that prices overshoot to the downside after a bubble.

I thought it would be an interesting exercise to compare the UK graph to Australia since we already know that Australian houses are the most expensive in the developed world.

Methodology

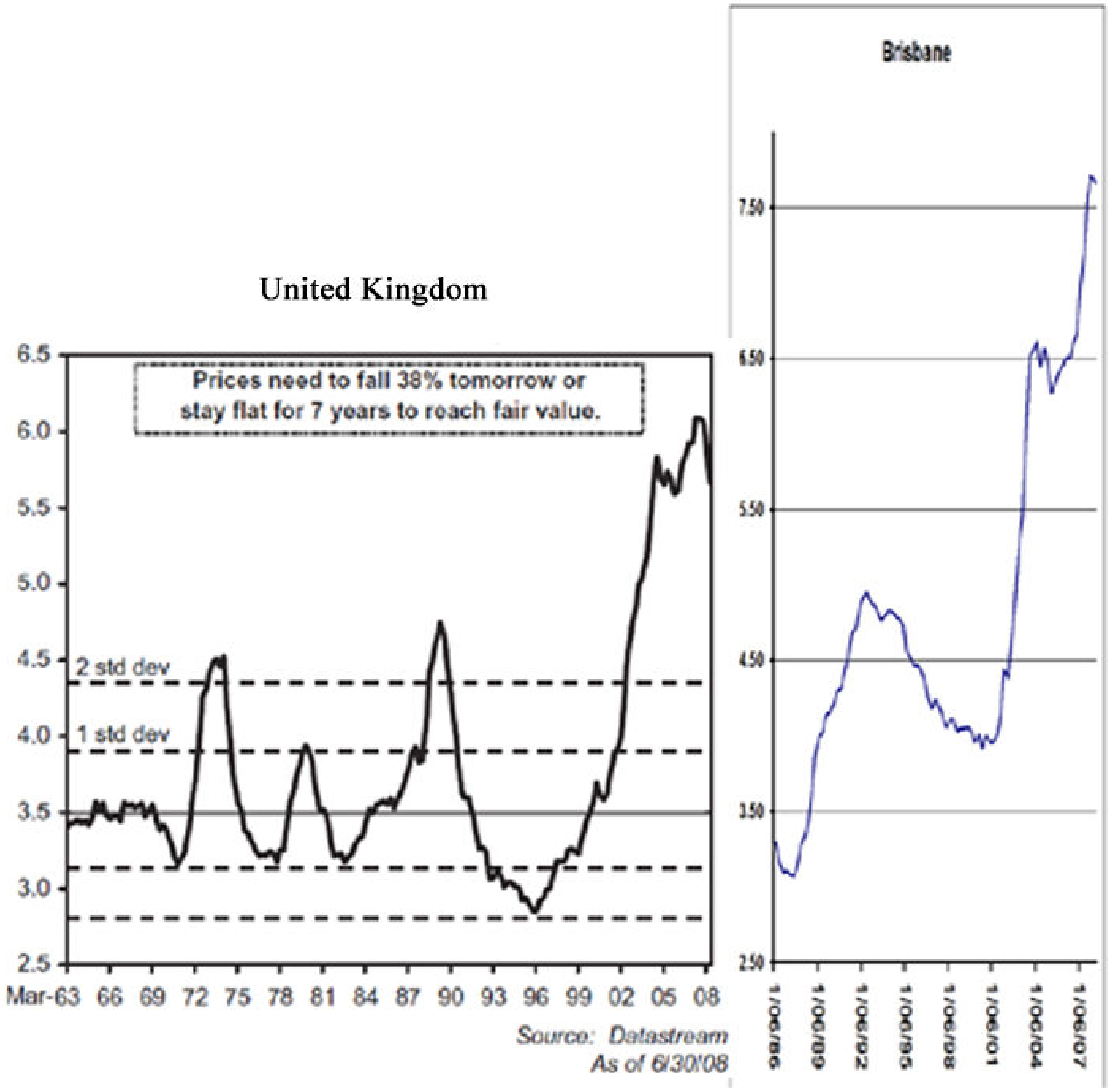
I was unable to find nominal house price data for the whole of Australia. The ABS does not publish an Australia-wide nominal house price series – the 8 capital weighted city series is an index. So I used the price series for Brisbane from the Australian Bureau of Statistics (ABS). The price series starts at 2002, and I used the house price index for Brisbane (pre-2005 method) to extend the series back to 1986 (the start of that series). The house price to income ratio was calculated using the Queensland adult full time ordinary time earnings seasonally adjusted (advanced one month) from ABS.

Results

I considered that the period covered was insufficient to allow statistical analysis as in Grantham (2008). The mean and standard deviation clearly would be elevated above genuine long term levels because the entire period was within a period of abnormal price appreciation as discussed in Keen (2007).

Instead, to gain some perspective, I plotted the ratio series on a graph with both x and y axes scaled exactly to the Grantham (2008) graph, and produced a figure with the graphs adjacent (Figure 1).

Figure 1. Plots of house price to income ratios for the United Kingdom (left; from Grantham 2008) and Brisbane



Conclusions

They say a picture paints a thousand words, and this one certainly does – it makes any words I could come up with redundant! No surprises that I share Grantham's view that bubbles always give way to reality, and often overshoot on the downside. The Brisbane house price to income ratio peaked at 7.72 in the March quarter 2008. This analysis suggests to me that Steve Keen's view (stated on the Business Channel on 2 September 2008, and on Insight on 9 September 2008) of a possible 50% fall in Australian house prices is more likely than my fairly conservative prediction of a 30% fall.

References

Grantham J (2008) The U.S. Housing Bubble and the Poor U.K. GMO Quarterly Newsletter, July 2008, P4.

Keen S (2007) Deeper in Debt: Australia's addiction to borrowed money. Centre for Policy Development, Occasional Papers No. 3, 52 pages (plus appendices)