

The Only Way Isn't Up

A Special Report into the Pending Correction of Australian Residential Property Prices

By Steve McKnight



Do you remember the 1980's pop group YAZZ? They had a hit with 'The Only Way Is Up'.

Well, if you were born after 1985 then you could be forgiven for thinking YAZZ were singing about Aussie property prices, because from the time you started noticing real estate values, they've pretty much gone up, and up, and up!

Yet property prices don't always go up. Those a little longer in the tooth can testify that real estate values have a tendency to go sideways for long periods of time when prices stagnate, and can even fall from time to time as happened in regional cities such as Gladstone and Moranbah, and even in metropolitan Perth.

Property prices don't always go up.

Skill is not particularly needed during periods when real estate values are rising rapidly because *all ships float on a rising tide*, which means that during a property boom just about all property – regardless of location and condition – will tend to increase in value because sentiment and speculation, rather than sense, drive value.

However, *all booms must eventually end* (usually when sense overrides sentiment), and when they do, markets that have overshot on the upside tend to overshoot on the downside; the bigger the boom, the bigger the bust.

Markets that have overshot on the upside tend to overshoot on the downside.

Of course, if you're trying to time your entry and exit to perfection, the ideal time to buy is at the bottom when prices are cheapest, and the ideal time to sell is at the top when prices peak. Being able to do this though is pure speculation and requires extraordinary luck, as you never know the highs and lows of market cycles until after they've occurred. This is why practically (as opposed to theoretically) the best time to sell is just after the peak, and the best time to buy is just after the bottom.

Sophisticated investors strategise rather than speculate. They look to the data, not their emotions, to set their strategy and match it to the prevailing economic conditions of the day, *being greedy when people are fearful, and fearful when people are greedy* – a saying attributed to Warren Buffett.

Sophisticated investors strategise rather than speculate.

So what does the data say about current market conditions? While a detailed analysis of the conditions in each State will be provided at my **upcoming 1-day seminars**, two interesting graphs based on research from investment house JP Morgan are particularly thought provoking.

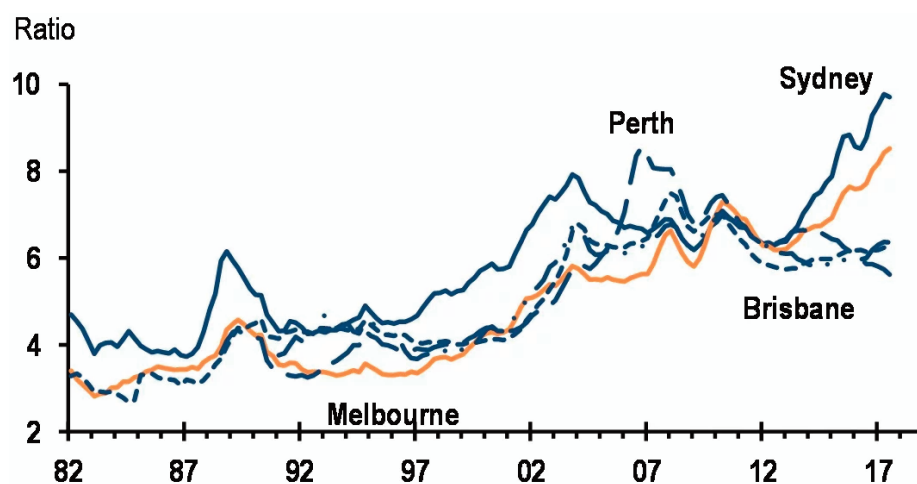
Find out more

To find out more about Steve McKnight's upcoming 1-day seminar series, including details, dates, venues and how you can come 'at cost', visit: www3.propertyinvesting.com/one-day-live-2018

Hurry! Seats are limited and being snapped up quickly, especially in Sydney and Melbourne.

Affordability Conundrum

Figure 1: Price to household income by city



Source: J.P. Morgan, ABS, CoreLogic

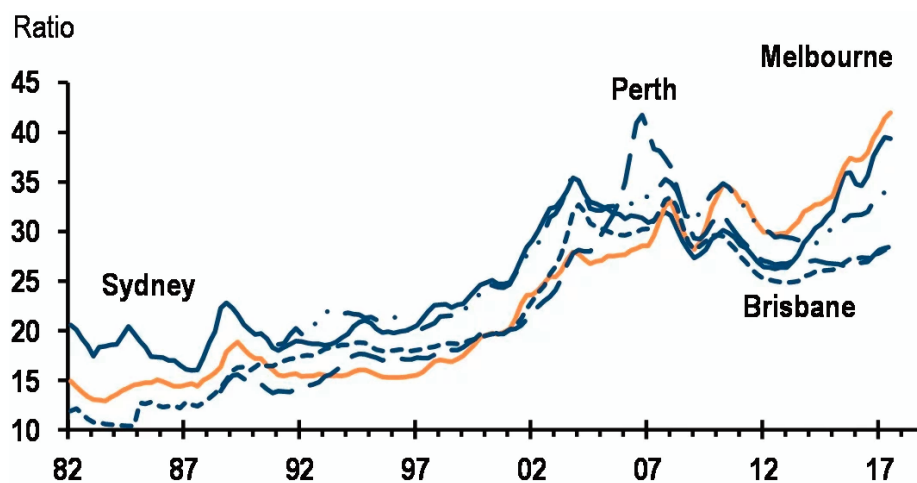
Figure 1 measures property prices as a ratio to household income over a 35-year period in Melbourne, Perth, Sydney and Brisbane. It reveals:

1. As far as risk of over-valuation is concerned, the present order of high to low risk (at least by the portion of income needed to afford a home) is as follows: Sydney, then Melbourne, then Brisbane, and lastly Perth.

2. If you are looking for affordability with respect to median house price as it pertains to income, then you should be targetting (in this order): Perth, then Brisbane, then Melbourne, then Sydney. This is relevant because the more affordable a house is, the less susceptible it is to price shock. Hence, if you wanted to own real estate in a capital city that offered 'value for money', and was also less likely to fall in a pending correction, then presently Perth looks good.
- You want to be 'invested' during the growth times, and 'divested' soon after the peak until the next growth period begins.
3. After market 'peaks', there tends to be a multi-year 'catch up' when property prices stagnate while incomes rise, before another 'growth' cycle begins. The lesson here is that you want to be 'invested' during the growth times, and 'divested' soon after the peak until the next growth period begins again. This is because during the flat and down times the risks of owning property exceed the returns.

Investing Sense and Sensibility

Figure 2: Price to market rents by city



Source: J.P. Morgan, ABS, CoreLogic

Figure 2 speaks to the 'sense' of values as they pertain to income returns, and reveals a level of speculative lunacy, particularly in Sydney and Melbourne, which is worrying.

Back in the early 1980s, investors bought real estate primarily for positive cashflow rental returns first, with any capital growth a bonus. This was a valid strategy because the debt underpinning the property was self-liquidating; meaning the loan could be serviced and repaid from the net rent.

Fast forward today and net rental returns are negligible or negative. Now property is purchased for growth with the underpinning debt usually not repaid at all. Instead interest-only loans are the debt instrument of choice, and loans are ‘traded up’ when the property is sold or refinanced into the next more expensive deal. Today, debt is something you get in to and never out of.

Did you notice the switch? Sometime in the early to mid 1990s, investors swapped owning real estate for income to owning real estate for growth, and debt changed from self-liquidating to speculative.

Purchasing an asset with the strategy of making a certain (income) loss today in the hope of an (uncertain) growth profit tomorrow is inherently high-risk. That said, such a strategy has worked, by and by, in Australia since around 2000. The question remains: how long can property prices rise in a market where income returns are negligible or negative? The answer is: only as long as investors can afford it.

Sometime in the early to mid 1990s, investors swapped owning real estate for income to owning real estate for growth, and debt changed from self-liquidating to speculative.

The Canary in the Property Coal Mine

In the absence of rising wages (you’ve probably heard how wages in Australia have been stagnant for a long time), investors have been able to afford higher priced property because:

1. Interest rates have fallen, so for the same loan repayment they can afford a bigger loan sum; and
2. They shifted from principal and interest (P&I) repayments to interest-only repayments, thereby allowing them to borrow more for the ‘same’ loan repayment amount (that is, the previous principal portion now gets applied to additional interest).

The canary in the property coal mine is mortgage stress, defined as when a household’s income doesn’t cover its outgoings, including mortgage repayments.

According to Digital Finance Analytics in October 2017, 29% of Australian households are presently under mortgage stress at a time when home loan interest rates are at, or near, all-time lows. This finding is supported by the following particularly alarming **research done for the ABC in August 2017 by Inga Ting, Ri Liu and Nathanael Scott:**

The canary in the property coal mine is mortgage stress.

Increase in interest rates	Expected impact
+50bp	If interest rates increased by 50 basis points then approximated a third (i.e. 1 in 3) of all households* will be under mortgage stress. 170 new postcodes become 'mortgage stressed'.
+100bp	If interest rates increased by 100 basis points (i.e. back to interest rates as they were in August 2013) then mortgage stress increases to 40% of all households*. Furthermore, mortgage stress in some postcodes such as Keilor in Victoria, North Fremantle in WA, Church Point in NSW and Buranda in Qld is expected to reach as many as 8 in 10 households*.
+200bp	If interest rates increased by 200 basis points (i.e. back to interest rates as they were in June 2012) then it is estimated that 1 in 2 households will be mortgage stressed. In Sydney, virtually every household in Silverwater and Kurnell is forecast to be stressed, as is Fawkner in Melbourne's north. Imagine that, people in every home with a mortgage are struggling to pay their bills!
+300bp	If interest rates increased by 300 basis points (i.e. back to interest rates as they were in November 2011) then 9 in 10 metropolitan households* will be struggling to pay their bills.
+400bp	If interest rates increased by 400 basis points (i.e. back to interest rates as they were in October 2008) they'd have returned to roughly their average over the past 20 years. Now nearly 2,000,000 households* are in mortgage stress. It's a mainstream problem with 80% of the highest population postcodes affected.
+500bp	If interest rates increased by 500 basis points (back to interest rates as they were in March 2008) there are forecast to be only 20 metro postcodes in the entire country not in mortgage stress. At the other extreme, 170 metro postcodes have at least 90% of households* in mortgage stress.

* households with a mortgage

Conclusion

Pushed along by the extraordinary tailwinds of low interest rates, tax incentives, foreign demand and speculation, Australian residential home prices have enjoyed a near 20-year boom. It's been quite a property party.

Yet it's becoming harder and harder to mount a sensible argument for how price growth can be sustained, especially as economic conditions shift towards real estate headwinds: the prospect of higher interest rates – especially for investors – new restrictions and disincentives for foreign buyers, more restrictive lending practices, changes to depreciation, and negative gearing being targetted for change.

If it's true that markets that overshoot on the upside tend to overshoot on the downside, then surely Australia is 'due' for a property price correction. What will be the trigger? You now know the answer: rising interest rates. It doesn't need to be a dramatic increase. As mentioned, just a 50-basis points increase will add an extra 170 postcodes to the list of those areas where households with mortgages are struggling to meet their repayments.

You've been forewarned. If you want to be forearmed so you can protect your prosperity during times when property prices are flat or declining, then be sure to attend one of my upcoming one-day seminars. It's a non-profit community service event and all tickets are sold at cost. The alternative is to remain ignorant, take your chances, and expose your financial future to untold and avoidable risk. Choose wisely.

Regards,

Steve McKnight

It's becoming harder and harder to mount a sensible argument for how price growth can be sustained.

Australia is 'due' for a property price correction. The trigger will be rising interest rates.

BOOK NOW

Book your place by clicking here, visiting PropertyInvesting.com or calling +61 3 8892 3800 during business hours to attend one of Steve's upcoming one-day seminars.

Hurry! Tickets are selling fast and some venues are about to sell out.