



CENTRIC Wealth

# Investment Insights

June 2010

## About this report

*Investment Insights* is Centric's monthly publication for the communication of our view on economic and investment matters. Each edition carries Centric's assessment of the current value and direction of investment markets as well as in depth analysis on one or two key issues that really drive outcomes for investors.

There has been a recent spate of commentary on the Australian housing market, with many predicting that house prices are set to fall dramatically.

In this issue of *Investment Insights*, we give Centric Wealth's view on the future of Australian house prices and explore those elements that make Australia different to other global markets.

The ideas and views explored in *Investment Insights* are key inputs into Centric's client portfolio management process.

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## Australian housing prices: will bricks and mortar turn to water?

**What has become known as the “global financial crisis” started out as the US “sub-prime crisis” in mid-2007 and is still causing major upheavals in global financial markets three years later. It was initially triggered by the bursting of the US housing boom and the US housing finance market that had fuelled it. A problem that initially was all about sub-prime home loan borrowers in the US, ended up triggering the deepest global banking crisis, government debt crisis and economic recession since the Great Depression.**

Dozens of banks and other financial institutions that were holding toxic US mortgage securities collapsed and caused global credit markets to seize up almost completely by September 2008.

The sudden failure of the banking system spread to the broader economies in several countries, cutting access to finance and in turn causing production, trade and employment to contract suddenly and, in many countries, severely.

Governments not only bailed out banks and other financial institutions to keep their banking systems working, but they also found themselves having to dig deep into their already high budget deficits to fund spending programs to stimulate their economies out of the recession.

The crisis spread to many other countries that didn't have a sub-prime financing crisis of their own, but still had experienced booms in housing, construction and banking, fuelled by high levels of debt. These included Iceland, Dubai, Greece, Portugal, Spain, Ireland, Italy and Britain, and probably others to follow.

Australia has so far escaped the worst of the crisis – but are we the next to fall?

Of all the “developed” economies, Australia stands virtually alone in escaping the worst impacts of the GFC to date. It went into the GFC with low levels of government debt, low levels of unemployment, a relatively flexible labour market, a flexible currency and a relatively low reliance on exports.

But Australia also had its own housing boom in the 2000s. Its house prices are among the highest in the world and the level of household debt (which is primarily housing debt) is also among the highest in the world. Households have low savings rates and are heavily reliant on foreign debt, via the banks.

Do these factors make Australian house prices an accident waiting to happen?

### Forces driving house prices

The rapid price growth in Australia over the past couple of decades has been primarily due to a number of one-off effects that will not be repeated – including:

- Declining inflation – as Australia rode the global trend toward smaller government, privatization; de-regulation of industries, floating currencies, lower

protection and more flexible labour relations – this was the primary driver of falling interest rates;

- De-regulation of banking and home lending markets - which freed up credit rationing and introduced competition from foreign banks, non-bank lenders and mortgage brokers;
- Declining lending margins – which have halved since the early 1990s, enabling borrowers to borrow around 20% more with the same repayments;
- Longer loan terms – a standard home loan is now 30 years instead of 20 years, which means borrowers can borrow around 15% more;
- The period was characterised by higher loan-to-value ratios (LVR) – borrowers no longer needed a 20% deposit, but could borrow 90% and even 95% of a property's value. Despite recent tightening

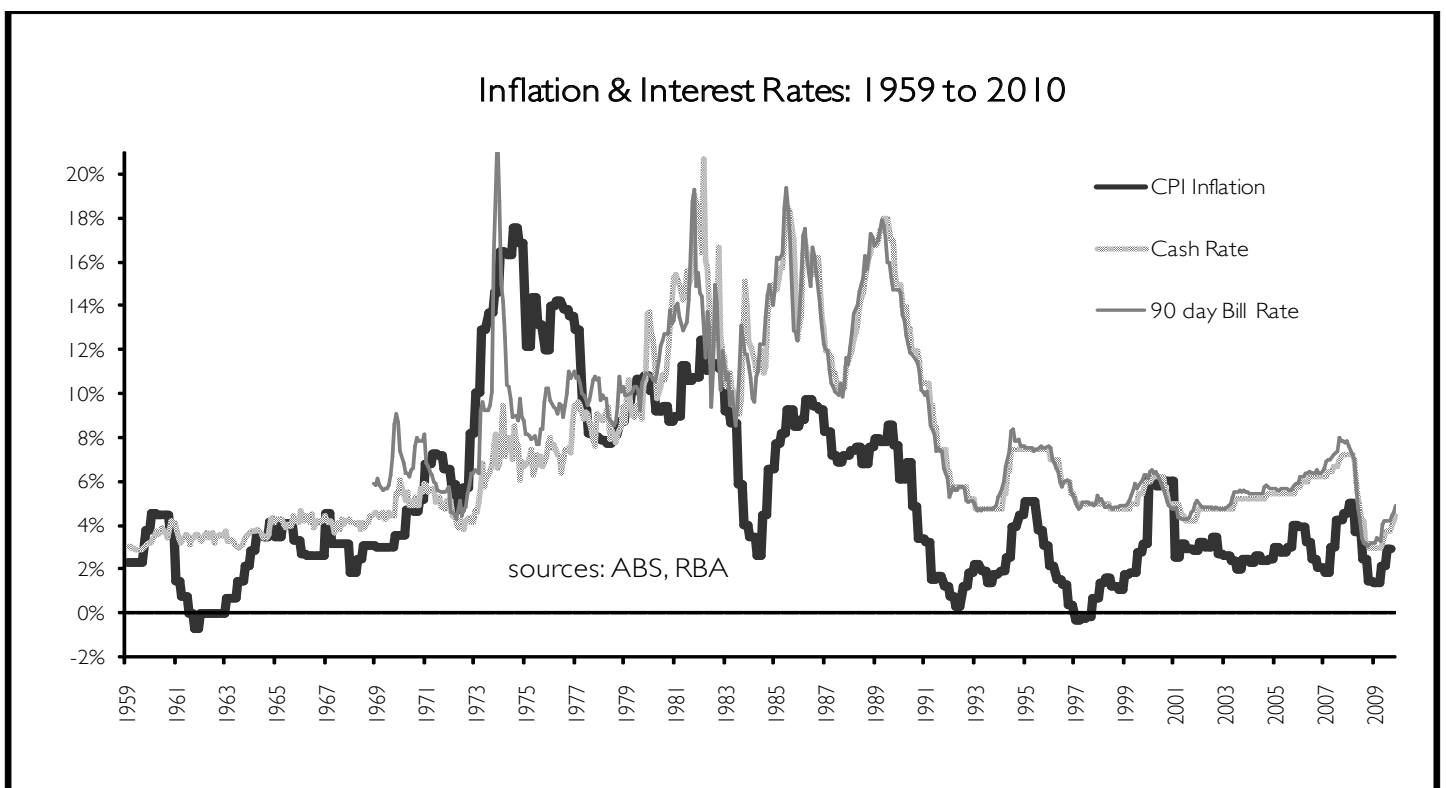
of LVRs, this dynamic will continue longer term.

The combined impact of these changes over the past two decades brought about significantly lower home loan interest rates and even lower mortgage repayments. This more than doubled the level of housing debt that could be supported per dollar of household disposable income devoted to mortgage repayments.

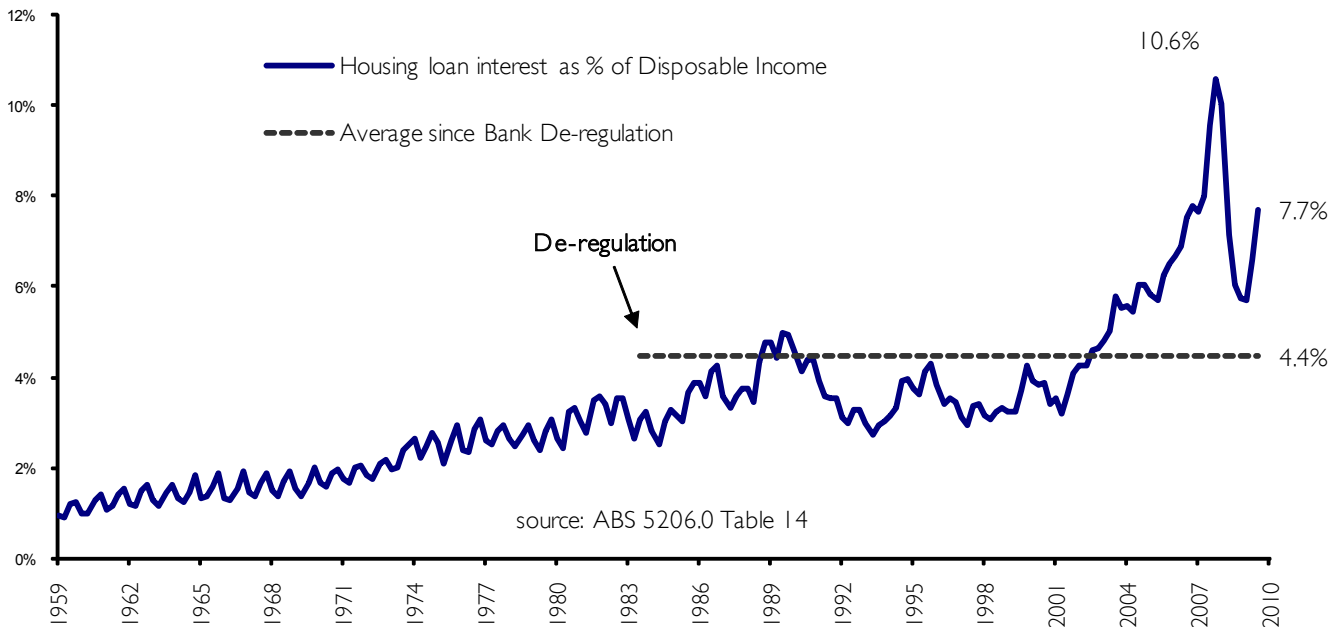
These were one-off changes that will not continue in the same direction and therefore will not continue to be forces that drive house prices higher in the future. However, as long as these structural changes remain in place, they are likely to support house prices at their current levels.

### Inflation

Of the forces listed above, the shift to lower inflation is one that



## Housing Interest & Household Disposable Income Australia: 1959 - 2010



may reverse partially in future, flowing on into higher interest rates.

Once the developed world de-leverages - which will probably take several years yet - we are then likely to face a period of structurally higher inflation and higher base interest rates.

We would expect to see higher inflation due to the likely effects of the current shift back to re-regulation, bigger government, protectionism, monetary expansion, capital controls and less central bank independence. In essence, the un-doing of much of the Thatcher, Reagan, Volker reforms in the 1980s that brought down inflation over the past 30 years.

To the extent that these translate into higher home loan interest rates, this may put downward

pressure on house prices. However, it is very unlikely that inflation will return to 15% and interest rates return to 18% as they were at various times during the 1970s and 1980s.

### What sets Australia apart?

In addition to the one-off, non-repeatable effects of changes in inflation, deregulation, interest rates, lending margins, etc, described above, there have also been several additional underlying forces that are sustainable and are likely to continue to drive higher housing prices in the future. These include:

- Population growth – Australia has had the fastest growing population in the developed world in the post World War II era, and this is likely to continue to be the case;

- Immigration – Australia has the highest level of immigration in the developed world. This is especially potent because the majority of immigrants are work-ready adults with children. This is keeping the rate of growth of Australia's aging population and our dependency rates lower than most other developed countries;
- Growth in real incomes per capita – which have been the highest in the developed world over the past decade, and are likely to continue growing, but not necessarily at rates higher than other developed countries;
- High concentration of population in relatively few large, isolated, self-contained cities with diversified industries – the level of population concentration is the highest in the developed

world, and is likely to continue in the same pattern. This keeps demand and prices for housing in and around the big cities high, compared to other countries in which populations are much more widely spread out in small cities and towns;

- High levels of foreign direct investment into housing – particularly from long term owners from Asia, which is likely to continue at perhaps an even quicker pace in the future, with the rapidly rising middle classes in several large Asian markets seeking second homes or safe havens here.

The above factors are unique to Australia and have been driving house prices higher not only in recent years but are likely to continue to sustain high levels of price growth in the foreseeable future.

### Bigger houses but fewer people per house

The demand for dwellings is rising at an even faster rate than the population growth rates because of the declining number of people per household. This trend has been caused by a number of social and demographic shifts taking place in all developed countries:

- Longer life expectancies due to improvements in health, nutrition and medicines;
- Couples getting married later or not at all;
- Adults having fewer children or no children at all;
- The rise of single parent and single person households;
- High divorce rates.

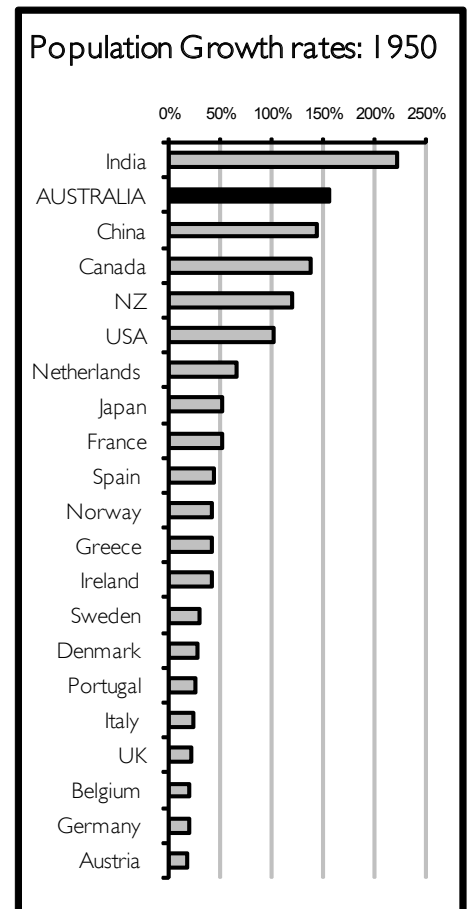
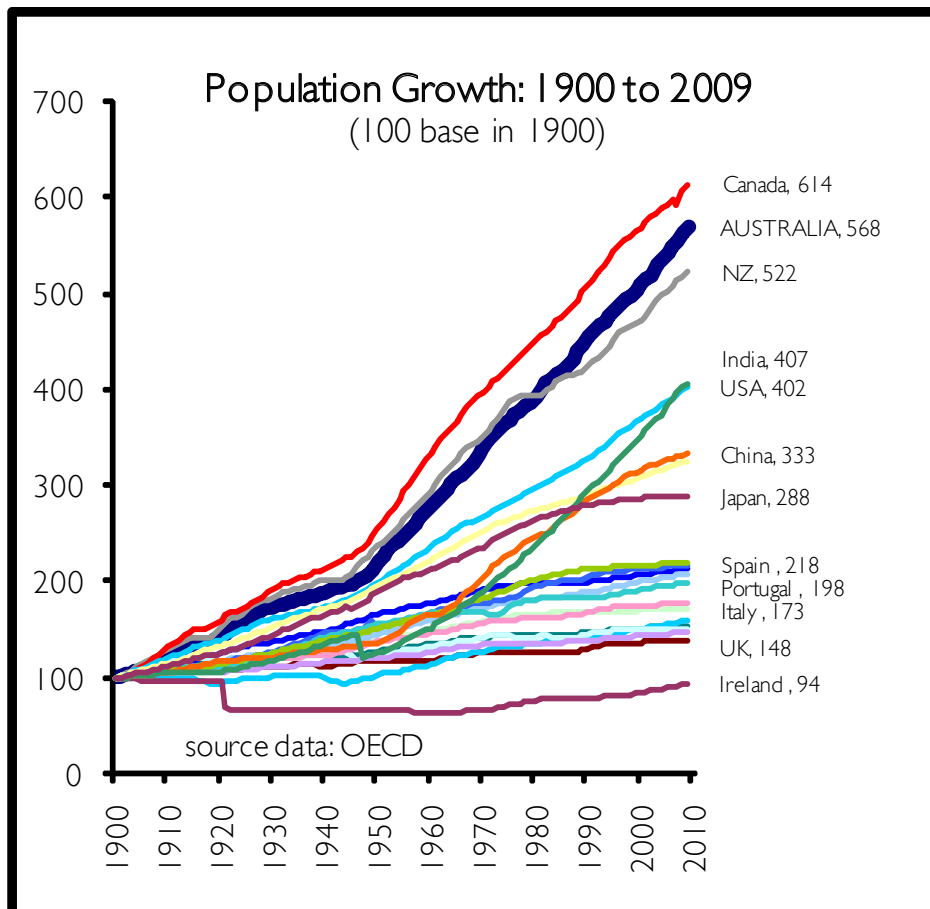
As the number of people per household continues to decline,

this is likely to result in smaller physical dwelling sizes, smaller blocks of land per dwelling and a higher proportion of flats rather than free-standing houses.

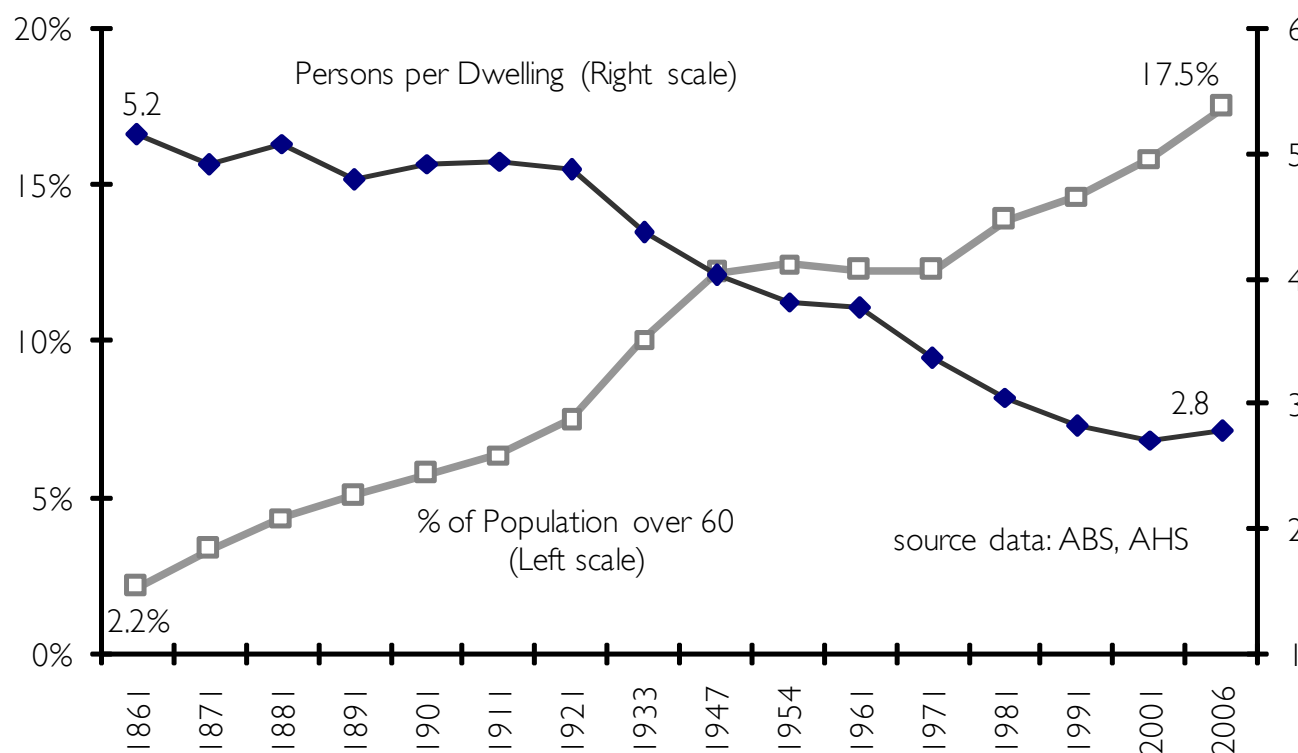
This is likely to reduce the published figures for “median” prices but will actually be good for land values per metre. This is primarily what investors are interested in, especially near the centre of the existing major cities.

Meanwhile, supply of new housing has continued to be kept well below the number of new dwellings required.

Another long term structural shift that is occurring is that Australia’s historically high levels of home ownership are likely to fall slowly, as the workforce becomes more mobile.



## Smaller Households & Aging Population



This trend is being driven by several factors: more flexible labour laws, more flexible career structures, greater availability of continuing education, lower industry protection and fewer children.

These shifts, when combined with the rising proportion of single person and two-person households and rising real incomes, are likely to increase the demand for rental accommodation especially in and near the major cities, forcing up rent and prices in centrally located areas.

### The current cycle

The above comments relate to some of the long term structural forces driving housing prices. We must also consider cyclical forces relating to short term

impacts of the GFC. As it is today, Australian house prices are very similar to those in other major countries when compared on a like-for-like basis, even after house prices in other countries have fallen by 20-30% and more during the GFC.

Regardless of the level of overpricing or underpricing at any time, prices will always suffer if large numbers of borrowers can no longer make their mortgage payments. There are three things that are most relevant to do this: interest rates, unemployment and the likely impact of a slowing China and Europe.

### Interest rates

Home loan interest rates have already risen due to the Reserve Bank's six interest rate hikes that began in October 2009 and

banks' lifting of lending margins after competition effectively disappeared in the GFC.

On the surface this looks like a dramatic rise in mortgage payments but, for most home borrowers, it means little change.

While interest rates were being more than halved between September 2008 and April 2009, it is usual bank practice in Australia for borrowers to leave their monthly repayments at the same level, so the recent rate rises in most cases didn't translate into higher monthly repayments.

Interest rates are still well below their peak levels in 2008 and most borrowers are still making payments at levels set when interest rates were at their peak. This means they are paying off principle faster than they had

originally planned and there is still leeway for interest rates to rise further before the actual dollar amount of repayments need to rise.

The interest rate rises since October 2009 did, however, affect new borrowers. The rate rises, together with the reduction of fiscal stimulus payments, have stopped the artificial boom

in first home buyer house purchases at the bottom end of the market. This is a good thing. But first home buyers constitute a very small minority of transactions and have little impact on the rest of the market.

It is likely that interest rate rises have paused for the time being while the European debt problems are sorted out. This

will take many years and the solution will not be simple.

## Unemployment

Unemployment levels are very low by historical standards in Australia and are on the way down further as the local economy remains relatively strong compared to the rest of the developed world.

### Why high house prices are bad

Even if higher house prices may be sustainable in the future, this is not necessarily a desirable outcome for Australia. There are a number of disadvantages in carrying high levels of housing debt, including the following:

- Australian housing loans are primarily financed by floating rate loans, and high levels of housing debt makes householders vulnerable to changes in short term interest rates, in particular to unexpected outbreaks of inflation.
- Because Australia has always relied heavily on foreign capital, high levels of housing debt mean households are highly vulnerable to events affecting global debt markets – this is what drew Australia into the GFC, despite our strong fundamentals.
- All of the four big Australian banks are highly reliant on foreign medium term debt markets and remain vulnerable to further upheavals in global credit

markets. They are all now desperately shifting their focus back to collecting retail deposits in Australia. When, not if, further crises in global debt markets occur, the Australian government has shown its willingness to guarantee the banks' debts with its strong national balance sheet.

- Since the high levels of house prices are being supported by, and are reliant upon, continued access to debt, house prices are subject to any impacts on credit growth as a result of re-regulation of banks and tightening of bank capital rules. However, whatever the changes to the rules in the coming years, housing debt is still likely to receive preferential treatment because we think bankers and bank regulators still believe that "house prices never fall!"
- As household spending constitutes two thirds of national spending in Australia, high levels of housing debt and high sensitivity to interest

rates have the effect of entrenching and exacerbating business cycles. Business cycles are always going to be with us and high household debt levels make them more pronounced.

- Housing is a relatively non-productive "asset". True, it provides employment for builders and trades-people but housing for most Australians has moved beyond essential shelter and is now largely an unnecessarily frivolous lifestyle expense. It doesn't generate the export revenues or foreign exchange we need to buy all the items we import to continue our current lifestyles.
- High levels of housing debt make the workforce less mobile. We don't have the US system of walking away from non-recourse housing loans and simply handing back the keys on the way out of town. People tend to hang on grimly and stay put, which slows them from moving on to find work elsewhere.

## The impact of China and Europe

China is showing signs of slowing and Europe is also likely to slow much further before eventually recovering. However, Australian exports to Europe constitute just 11% of total Australian exports and accounts for just 2% of national income.

The whole of the mining industry, which is our main export to China, employs just 1.6% of the Australian workforce and despite the so-called mining “boom” here, employment in the mining industry as a share of total employment has been falling consistently for the past 25 years. Mining is a nice bonus from time to time for Australia but it is a miniscule employer.

### What if exports slow?

Australia is less dependent on exports than almost any other

country in the world – developed or developing.

The value of exports as a proportion of national income is lower in Australia than any other country except the US, Japan, Pakistan, Brazil and Colombia.

But, because our exports are predominantly raw materials and the industry employs so few people, the reliance of our economy on exports is probably the lowest in the world, except perhaps North Korea which is closed off from the world.

Even when growth in China slows, it will probably have little impact on Australia.

Japan was the great emerging market of the 1950s, 1960s and 1970s – similar to the Chinese boom over the past decade – and since 1967 Japan has been our biggest export customer.

Japan’s tremendous growth path stopped when its property and share bubbles burst in 1990.

The Japanese economy has been stagnant for the past 20 years but Japan still remains our biggest coal export customer.

Even if China’s growth stopped dead at zero growth for the next 20 years tomorrow, it would be no worse than what happened to Australia’s exports to Japan in the 1990s and 2000s.

China will still require raw materials from Australia and has huge surpluses to pay for them, just as Japan still needs our coal, even though Japan stopped growing 20 years ago and its population is declining.

In light of all these factors, Australian house prices are unlikely to suddenly fall 30% or 40%, as many commentators are predicting.

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## Market indices to 31 May 2010

Source: Morningstar

Index*	1 Mth %	3 Mths %	6 Mths %	1 Yr %	2 Yrs % pa	3 Yrs % pa	5 Yrs % pa	7 Yrs % pa	10 Yrs % pa
Australian Equities	-7.6	-3.3	-3.9	21.4	-8.2	-7.2	6.2	10.4	8.1
International Equities	0.5	2.8	4.0	9.0	-7.7	-10.5	-0.6	2.2	-3.6
International Equities (Hedged)	-7.9	-1.1	1.7	18.7	-	-10.1	1.6	6.3	-
Australian Real Estate Investment Trusts (REITs)	-4.1	-0.6	1.3	27.0	-21.0	-24.9	-7.0	-1.6	3.3
International Real Estate Investment Trusts (REITs)	-5.7	4.9	9.8	41.5	-11.5	-15.0	-0.1	7.3	9.7
International Bonds (Hedged)	1.7	2.7	3.8	9.1	9.9	9.3	7.1	7.1	8.0
Australian Bonds	1.7	1.6	3.1	5.8	8.8	7.0	5.9	5.6	6.3
Mortgages	0.4	1.2	2.2	4.4	4.7	5.4	5.7	5.7	5.7
Cash	0.4	1.1	2.1	3.9	4.7	5.6	5.8	5.7	5.6

\*ASX All Ordinaries Accumulation Index; MSCI World Acc Index; MSCI World ex-Australia Index (Hedged) in \$A (2yr and 10yr returns unavailable at time of writing); ASX 200 Property Trusts Index; UBS Global Real Estate Investors Index \$A; Citigroup World Gov Bond (Hedged); UBS Warburg Composite; Morningstar Aust. Mortgage Trusts Index; Australian 90 Day Bank Accepted Bill.

### About Centric Wealth

Centric Wealth is Australia's leading, non-institutionally owned wealth advisory group focusing on higher net worth clients. It has approximately \$5 billion in investment assets under advice. Centric's network of advisers provides services across financial planning, risk insurance, corporate benefits, lending and business advisory, general insurance and family office requirements. The group also has services in portfolio administration, private capital and private investment solutions.

Freedom from institutional ownership or control enables Centric to provide financial solutions and strategies that are in the best interests of clients, based on rigorous research, fact-based analysis and disciplined investment processes.

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