

# Australian Housing - End of the Boom?

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# INTRODUCTION

Despite the stronger than expected property price data we've seen this week, Australian property prices look to have peaked in late 2017, with the average price of a residential dwelling sitting at AUD \$686,700, according to data released by the Australian Bureau of Statistics.

Apart from Hobart, and some regional areas, property price weakness is evident across the nation, led by Sydney, where prices fell by 2.40% in the three months to end February 2018.

Property bulls will quite rightly point out that many financial commentators have for years been calling for a bust in Australian house prices, and that it is still too early to say definitively that this current period of price weakness does in fact represent the end of the largely uninterrupted bull market in residential property prices that got under way in earnest around the beginning of the 1990's.



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The fact that year to date, house prices are only down 0.8% at an aggregate level across our five mainland state capitals (based on CoreLogic data to 12th March 2018), lends credence to their argument that there is no need for wide spread panic at this point.

Be that as it may, even the most optimistic of forecasters would acknowledge the multiple headwinds facing the Australian residential property market today, which include:

- Near world-leading household debt to GDP, debt to income and debt servicing ratios in Australia.
- Record low wage growth and high underemployment.
- A low, and declining savings rate of just 2.70% (note this includes compulsory superannuation of 9.5%), with surveys suggesting nearly half of all Australians are not saving any money on a month-to-month basis.
- Higher borrowing costs, with banks hitting borrowers with multiple out of cycle rate hikes over the last couple of years, though they are now starting to reverse course and edge rates lower.
- Rental yields near record lows, especially for detached housing, meaning investors are almost entirely reliant on capital gains to justify their investments.



- The looming principal and interest (P+I) cliff, with tens of billions of dollars of 'interest only' loans set to convert to P+I loans in the coming years, which will add further pressure to already stretched household finances.
- Less accommodating regulators, with APRA acting to clamp down on investor lending, as well as putting caps on interest only lending (see point above), whilst the federal government has taken greater measures to clamp down on foreign investors.
- A significant uptick in residential property supply, which is particularly acute in East Coast apartment markets.

Overhanging all of this is the Royal Commission into our banks, the potential end of the RBA's rate cutting cycle, and most importantly, the increasing likelihood of a change in government at the next Federal election, which is set for the first half of 2019.

A Shorten led Labor government is promising to end negative gearing tax concessions on established dwellings (though existing investors will be grandfathered), as well as halving existing capital gains tax exemptions for investors.

Little wonder given the above headwinds that housing related credit growth, arguably the major factor pushing prices higher over the past 25 plus years, has slowed markedly, and that property prices themselves have begun to head lower.

The question is how far they will fall, and how long the correction will take.



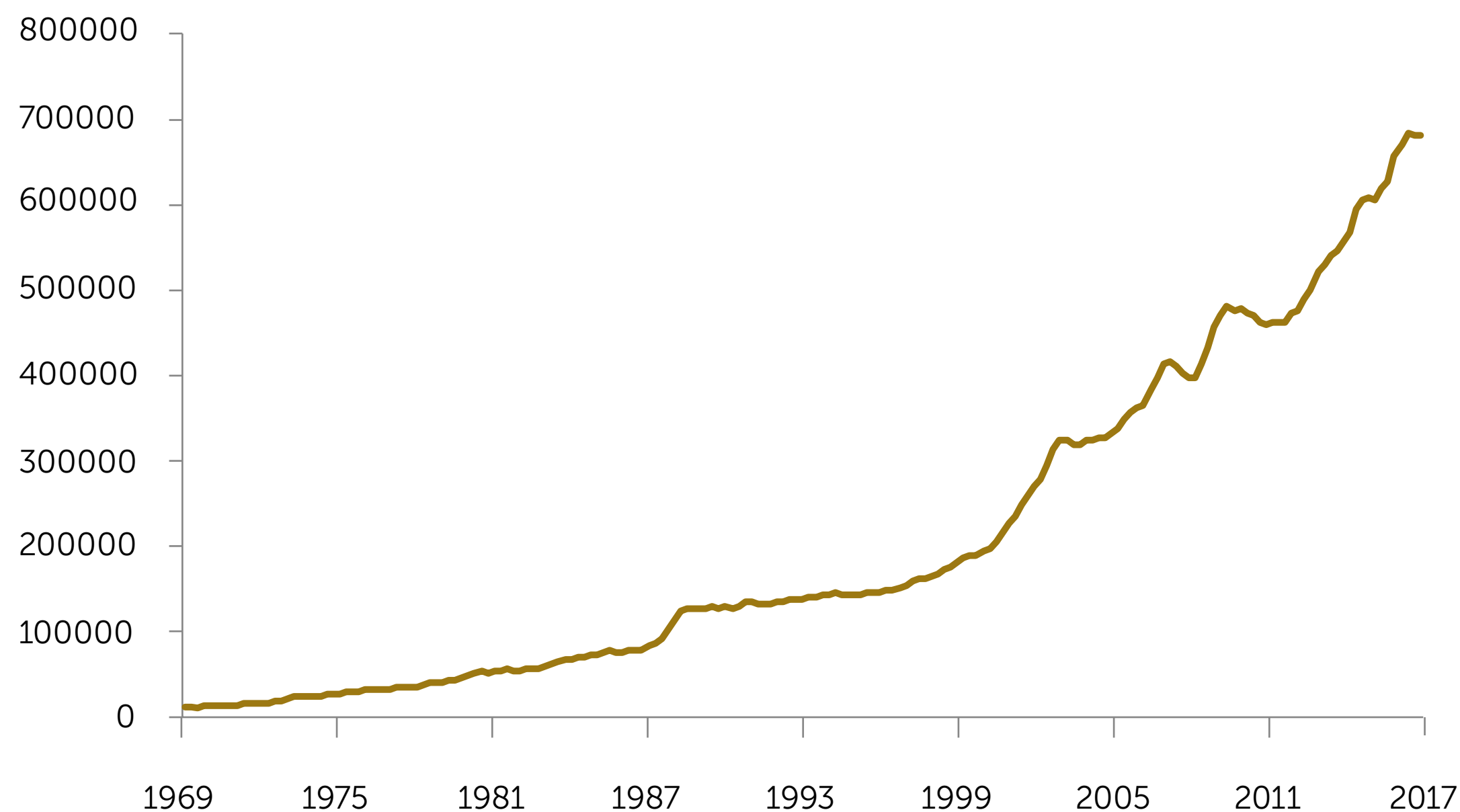


# HOW FAR COULD PROPERTY FALL?

Before looking at how far property could fall in the event that we enter a full blown housing correction in Australia, it pays first to look at how far prices have risen over the long-run.

The chart below, which begins at the start of the 1970s, plots the rise in Australian housing values, which have increased from around AUD \$12,500 in 1970, to AUD \$686,700 by the end of 2017.

AUSTRALIAN RESIDENTIAL PROPERTY PRICES - 1970 TO 2017



Source: Bank for International Settlements, Australian Bureau of Statistics

Note that the gain you can see in the chart comes to an amazing 5,261% over this 45 year plus time period, or just shy of 9% per annum. No wonder we call it the great Australian dream.

That's the upside homeowners and property investors have benefited in the past, but what about the potential downside risk in the future?

According to a May 2009 study titled "The Aftermath of Financial Crises", carried out by renowned economists Carmen Reinhart and Kenneth Rogoff, the average fall in residential real estate prices during a 'housing crash', across the multiple countries they studied, was an eye-watering 35%.

However, as per the chart on the next page, which comes from the Reinhart and Rogoff study, not all housing crashes are equal, with some relatively mild ones seen a decade age (in Austria and Hungary for example) where prices fell by only 10%.

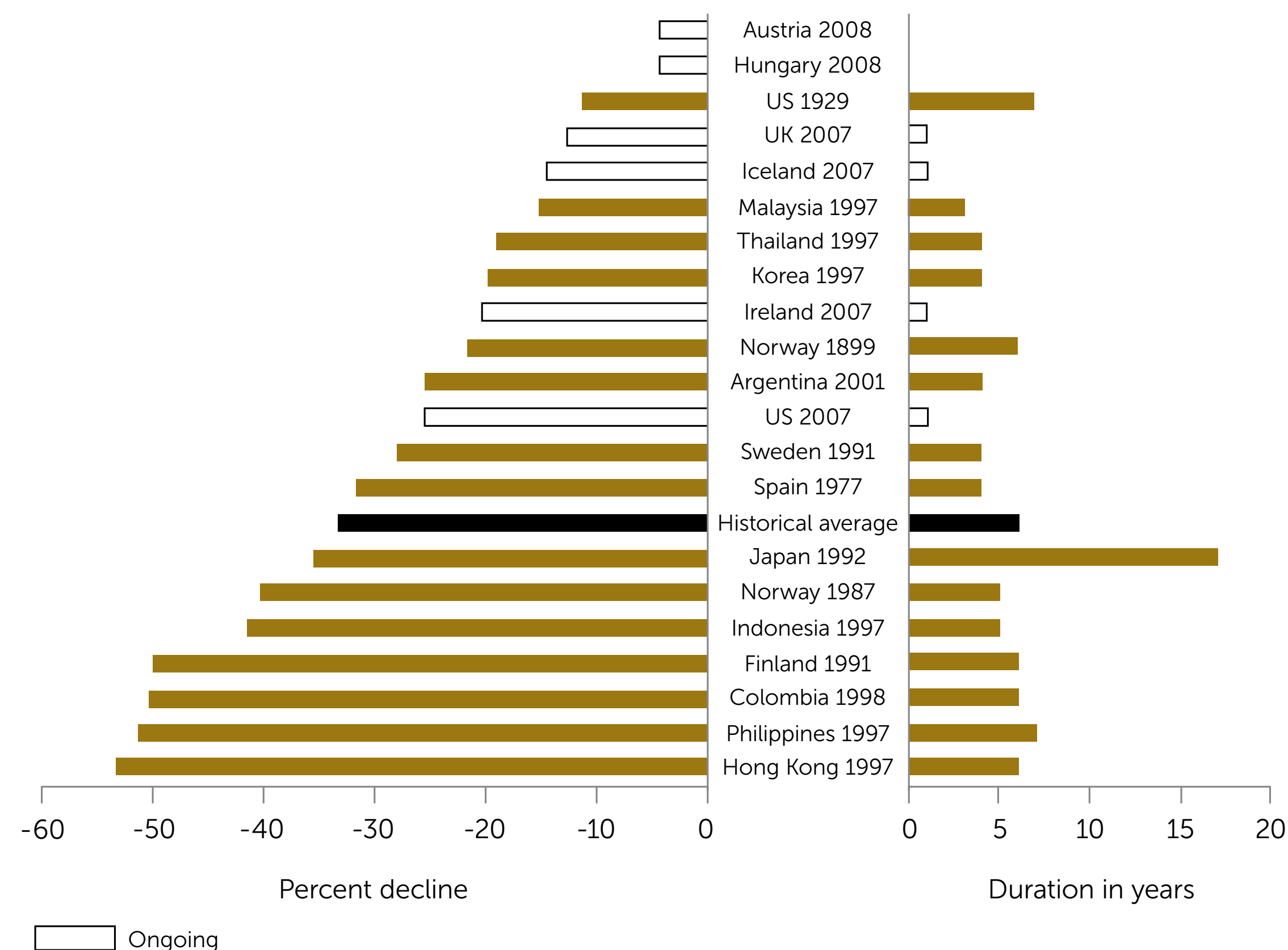


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At the other end of the spectrum, Finnish property prices were ravaged by the countries banking crisis and recession in the early 1990s, whilst residential real estate in countries like Indonesia, the Philippines and Hong Kong all suffered falls of 50% or more in 1997, as the Asian Financial crisis wreaked havoc across the region. Thailand and Malaysia were also affected, though the falls weren't as severe.

Note that at the time Reinhardt and Rogoff wrote their paper, some of the housing corrections they were analysing were still ongoing, with Austria, Hungary, the UK, Iceland, Ireland and the United States still reeling from the effects of the Global Financial Crisis (GFC).

## INTERNATIONAL HOUSING CORRECTIONS



Source: Reinhardt and Rogoff, *The Aftermath of Financial Crises*

# WILL AUSTRALIA SUFFER AS BADLY?

Whilst the Reinhart and Rogoff study gives us a useful guide as to how far housing can fall during a genuine property crash, every nation is different, and one could make a case that the Australian experience will be either more, or less severe than the global average decline of 35%.

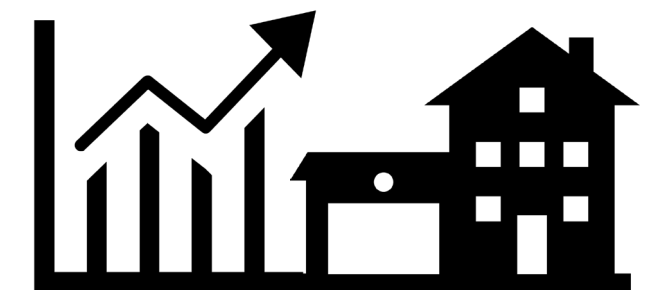
No doubt the more alarmist of housing price forecasters in Australia would argue that given the scale of our housing boom, and its duration, a local housing bust, should it eventuate, will likely be at least as bad if not worse than those we've seen in other countries.

We are not so sure.

Indeed given the fact that some of the more extreme falls we've seen in historical property price crashes have occurred in emerging markets, and given Australia's (current) high immigration rate as well as our popularity as a destination for foreign capital, we are of the view that a local property price crash, were it to occur, would likely be more benign than the historical average from other countries captured in the chart above.

Note this is not to appear cavalier about the risks we face Down Under, for a crash of even 20% would still be devastating to the Australian economy, wiping some AUD \$1.4 Trillion off the value of the nations housing stock, equivalent to roughly 75% of one year of our gross domestic product.

Of course not every city and region would suffer exactly the same price decline in a nationwide property correction. Cities like Perth, where house prices have already fallen over the past few years, might see more modest price declines from here. Sydney and Melbourne, the two primary destinations for foreign capital, may also hold up better, though given both cities have seen property price growth of close to 35% in the last three years alone, some would argue they are more exposed as this cycle comes to an end.



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A fall of such magnitude couldn't help but spill over into the broader economy. Debt laden Australian households would bunker down, placing further strain on an already struggling retail sector. Combine this with a finance and building sector that would likely go into hibernation, and a fall in housing prices would have profoundly negative consequences for unemployment and already moribund wage growth.

Budget deficits would skyrocket, threatening our AAA rating in due course, with data from Reinhart suggesting that countries that go through a housing crash also see an average increase in fiscal deficits of 7% of GDP, measured from pre-crisis to its peak.

As housing crashes and banking sector crises tend to go hand in hand, it is relatively safe to say that a property price crash would decimate the local sharemarket, given the almost absurd financial sector concentration of the ASX.

This in turn would drag down the performance of our +AUD \$2.5 Trillion superannuation industry, which, based on the latest ASFA data, has a circa 25% allocation to listed Australian equities.

Be in no doubt, an Australian property price crash, even if it's relatively mild when compared to the experience in many other nations, would be devastating for the country.

In terms of the time that housing markets take to fully correct, Reinhart and Rogoff's study estimates that housing market crashes have on average taken around six years to fully play out, which you can also see in the chart on page 4.

They are protracted affairs that take nearly twice as long to play out as equity market crashes, though as per the magnitude of the corrections in terms of price declines, there is a large difference across nations in regards to the time period these housing corrections take to fully play out, with Japan being the standout.

Apply these findings to Australia, and we can estimate that if local property prices did indeed peak in late 2017, then it may take until around 2024 before the Australian residential property market heads meaningfully higher again.



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# WHAT IF WE MEASURED HOUSING IN GOLD?

If Australian property prices were to fall 20% by 2024, then we would expect to see the average residential dwelling trade hands for around AUD \$550,000 by the end of this corrective phase.

This would suggest that the easiest course of action for would be owner occupiers and property investors in Australia is to simply sit still on their hands, and build up their savings for the next few years, earning some income along the way.

But with interest rates at record lows today, and set to remain that way for some time, saving in cash is becoming an ever more untenable option in Australia.

Saving in cash will only become more painful if inflation in Australia rises, as it may well do.

As a way of picturing this, whilst the latest CPI data showed official inflation is currently rising at just 1.9% per annum, the long term inflation average from the 1970s to today is closer to 5.3% per annum, as the image on this page (from the RBA's inflation calculator) highlights.

Given Australian dollar savings in a bank account are likely to remain unappealing for some time, Australians may be better off looking for monetary alternatives to build their wealth in, and physical gold is the most obvious choice.

Calendar Year

Financial Year

Quarterly

A basket of goods and services valued at \$

100

in calendar year

1970

,

would in calendar year

2017

cost \$

1,137.34

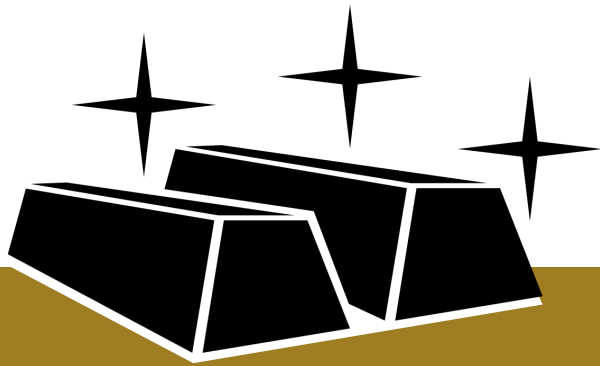
Reset

Calculate

Total change in cost is **1037.3 per cent**, over **47 years**, at an average annual inflation rate of **5.3 per cent**.

Values are denominated in dollars for periods from March quarter 1966 and in pounds (£) for preceding periods. For periods before 1966, use our [pre-decimal inflation calculator](#).

Source: RBA



Gold is also an easy asset to invest in, with products like the ABC Bullion Gold Saver allowing aspiring homeowners to build savings from as little as AUD \$50 per month, with their savings then benefitting from the long-term appreciation in the gold price.



Saving in physical gold has become more attractive to many types of Australian investors including SMSF trustees and managed funds over the past few years, as the precious metal has offered investors a number of benefits, which include;

- Strong long-term returns, with gold prices rising by circa 8% per annum in Australian dollar terms since the turn of the century
- An asset that is uncorrelated to financial markets, with gold the best performing defensive asset in environments where the share market falls fastest
- A simple hedge against a potential fall in the Australian dollar, which increases the price of gold in AUD.

Gold is also an easy asset to invest in, with products like the ABC Bullion Gold Saver allowing aspiring homeowners to build savings from as little as AUD \$50 per month, with their savings then benefitting from the long-term appreciation in the gold price.

And as per the chart on this page, which represents a long-term study of physical gold vs. Australian residential housing prices, whilst the value of an Australian house priced in dollars may well fall by up to 20% in the years ahead, the price of an Australian house when measured in ounces of physical gold could plunge a lot further.

The chart highlights that today, an Australian would need to own 416 ounces of physical gold in order to afford the average property in this country. However, it hasn't always been this way, and at various points in time, you've needed to own either a lot less, or a lot more gold in order to buy a house.

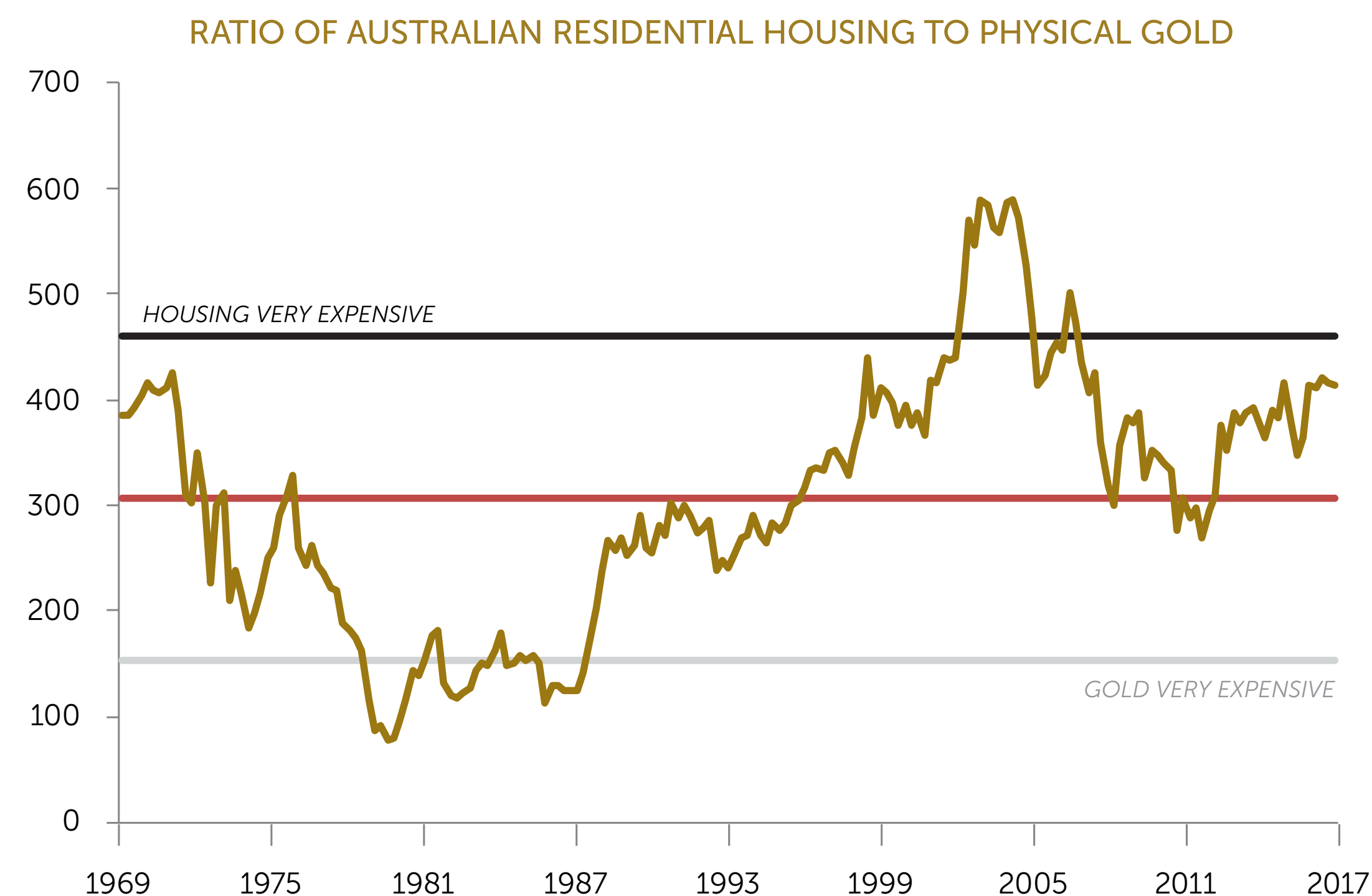


Chart Source: Real Estate Institute of Australia, "Housing Prices in Australia" (Abelson and Chung), "Long Term Housing Prices in Australia and Some Economic Perspectives (Stapledon), Bank for International Settlements, Bloomberg, RBA



Over the long-run, the average ratio between Australian housing and gold has been 306, which is the red line you can see on the chart.

Note that the black line and the grey line on the chart represent points above and below which property is very expensive (black line) or very cheap (grey line) relative to gold. Very expensive is defined as 1.5x the long-term average whilst very cheap is defined as 0.5x the long-term average.

As you can see, the peak in property relative to gold occurred in the early 2000s, when you needed nearly 600 ounces of gold to buy the average Australian property.

At the other end of the spectrum, back in 1980 when gold was at its most valuable level relative to property, Australian's would only have needed to own 79 ounces of gold in order to afford the average house.

To put that in perspective, if you were to buy 79 ounces of gold right now, it would only cost you around AUD \$135,000, which is not even enough for a 20% deposit on the average Australian property today.

The message from the chart, and the observations above is clear. At present, housing is expensive relative to gold, with the current housing to gold ratio some 25% above the long-run average. This alone suggests gold is likely to outperform housing in the coming years.

However, given these ratios tend to overshoot in one direction and then the other, it is unlikely that the ratio between housing and gold will only drop to around 306, which is the long-run average.

Instead, if history is any guide, what may well happen is that the ratio continues to drop down to a point where gold is once again very expensive relative to housing, which could come about as the gold price rises, and house prices fall simultaneously. Indeed the ratio would need to decline from its current level of 416 all the way down to 153, which is the grey line on the chart and the point at which we would define gold as being very expensive.

Compared to current levels, a decline of this magnitude would mean that housing prices, relative to gold, could fall by over 60%.

If you are a highly leveraged property owner, a fall of that magnitude would likely be disastrous. If you're a physical gold owner, or if you're saving in gold so that you can invest in property or buy a family home in the future, it's an amazing opportunity.



# CONCLUSION

This article is not suggesting that Australians should sell their family home or put all of their money into physical gold. As I stated at the outset, there is no guarantee that property prices are going to fall meaningfully at this stage, with the correction in nationwide housing values over the last few months incredibly benign so far.

Indeed, given the importance of housing to the Australian economy, and the wealth of our nation, I, for one, hope that the property market doesn't crash at all. Instead, it would be far better for the nation as a whole if property prices spent the next few years stagnating, or at the very least lagging wage growth and inflation, which have a long way to catch up.

This echoes the sentiments of RBA governor Dr Phillip Lowe, who in February 2018 stated that; "it would be a good outcome if we now experienced a run of years in which the rate of growth of housing costs and debt did not outstrip growth in our incomes."

But hoping for best doesn't mean we shouldn't prepare for the worst, and the reality is that the Australian property market has a number of imbalances, and there is no easy way out the position we find ourselves in as a nation.

A meaningful property correction would not be a major surprise, and if it were to occur, it would hit household wealth, and the broader Australian economy quite dramatically.

Of all the steps that Australians can take to protect their wealth should such an event take place, owning gold is likely the smartest and simplest.

Whilst the sharemarket is one option, the ASX is almost certain to struggle in an environment where house prices fall, both due to weighting of our major banks in the index, as well as the fact that a housing correction would almost certainly lead to a recession.

Cash in the bank will also likely prove a suboptimal investment choice, if for no other reason than the RBA will almost certainly respond to a housing correction with even lower interest rates, meaning the real value of your money will continue to deteriorate.

Physical gold on the other hand will not only protect capital in its traditional safe haven role, but its price is likely to rise quite substantially in such an environment. This will mean the ratio between Australian housing and gold could decline meaningfully in the years ahead, helping make the great Australian dream that much more affordable again.



## A Note on the Housing Chart and Housing Data

According to the latest Credit Suisse Global Wealth Report, “real assets” make up 60% of total gross assets for Australian households. Residential property, currently valued at just under AUD \$7 Trillion is by far the largest of these “real assets”.

Given this fact, and the importance of property to the Australian economy, it is astounding that there is not one publically available and widely accepted data source which tracks Australian housing valuations over the very long run, by which we mean 100 plus years.

This is not to impugn the work of the industry bodies and businesses that are involved in property, including the REIA, CoreLogic, SQM Research, all of whom produce very useful property related data, or the official statistics which come from the ABS, but rather just a general observation given property underpins the local economy.

In the Australian residential property charts we have created and used in this publication, our primary data source is a residential property price index series that comes from the Bank for International Settlements.

The BIS series can be found at this link.

[https://www.bis.org/statistics/pp\\_long.htm?m=6%7C288%7C595](https://www.bis.org/statistics/pp_long.htm?m=6%7C288%7C595)

We have applied the moves in that index from the start of the 1970s to present day residential property valuations. Based on an end 2017 average dwelling value of \$686,700 (data courtesy of the ABS), the BIS series suggests that the average dwelling in Australia was worth just over AUD \$12,500 back in 1970.

That number is very close to the median house price reported in various other studies into Australian housing valuations, including Abelson and Chung; “Housing Prices in Australia”, and Stapledon; “Long Term Housing Prices in Australia and Some Economic Perspectives”, which for example, stated that a house in Melbourne was worth \$12,800 (Abelson/Chung) and \$12,670 (Stapledon) in 1970.

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