Mark Bouris, Wizard Home Loans

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Property Outlook

Following two rate hikes in May and June of 2002 there was a lot of speculation about what would happen in the following months.

"The one event that can burst the current real estate bubble and send property values into a tailspin is a rate hike or rather a series of rate hikes, due to the marked increase in debt levels. A sharp hike in rates (either with many consecutive quarter per cent rises or a couple of consecutive half per cent rises) could lead to forced sales by property owners pushed to the wall by the increased mortgage costs."
(Mark Bouris, August 2002)

But it was another 15 months before rates moved up again, which they did at the end of 2003 in November and December. And then they sat steady again for another 15 months - not moving up until March 2005.

The interesting phenomenon that emerged out of the historic low rate environment is the change in the debt borrowers have taken out. The large debt to income ratios have actually heralded a sort of built-in price stabilizer.

Not only were interest rate rises a factor, but also the amount borrowed has nearly doubled for the same house and that has acted as a natural stop on house prices.

So even if rates stay the same, the amount borrowed will stop any major growth. If the RBA makes a couple of rate reductions, all that will happen is that over a short period, house prices will adjust up slightly. We are in for a long stable period of rates and house price growth.

Small rise V Large rise

A lesson from recent experience in Australia, Britain and the Netherlands is that a big rise in interest rates is not necessary to materially effect house prices.

The more interesting discussion for the future is what impact the momentum effect will have on the greater economy. That is, the impact of consumer spending and in particular the consumer spending deficit on household items and construction.

Australia stands out for its robust capacity to resist excess. It could be that we have always come off relatively speaking low bases, for example, a relatively immature tech sector, with high retail rates. Now we are in a finely balanced place – where the mix is just right.

We have taken the soft landing. We have not crashed down and burnt. We are seeing a return to normal growth - not the 20 per cent growth of the boom.

Borrowers and lenders are adjusting without – it seems – too much fallout, especially in delinquencies and arrears.

Property slump – Overseas comparisons

In Britain, the government is in typical pre-slump mode. The Blair government wants to introduce a scheme that will take property ownership rates up to 75 per cent with a shared equity scheme that will help an extra 100,000 extra households into home ownership in the next five years.

Under the scheme, poorer people will no longer need to stump up the full cost of a home. Instead they will acquire a share of it, worth between 50 per cent and 75 per cent. For 80,000 of the purchases, the government will finance the remaining cost. For 20,000 of the deals,

mortgage lenders will take a share. They and the government will each put in an equity stake of 12.5 per cent.

In 2003 Australia had the Productivity Commission inquiry into affordability resulting in the Menzies Report into Housing Affordability heralding new forms of loans such as shared equity schemes. Despite a positive outlook, the risks were deemed to be on the high side for lenders and consumers alike. There is still a lot of work needed to ensure these are viable products.

These types of schemes are clear indicators that a boom is about to end when the asset class becomes so trendy that even politicians try to leverage it. Britain is a year behind us but is already experiencing a slow down with lending abating and delinquencies on the rise.

US mortgage market response to the slowing market

In the world's biggest mortgage market – the US - the industry has responded to the property market with new products targeted at interest rate sensitive consumers.

Lenders are rolling out a new crop of 30 year fixed rate mortgages that let homeowners make low, interest only payments for as long as 10-15 years.

Also, getting a new push in America are 40 years mortgages, first offered in the 1980s in America, with market leader Fannie Mae expanding into this market.

Interest-only loans have been on the rise to eager rate-sensitive borrowers, though the majority of them have been variable rate loans and interest-only features.

These new trends in the US are all about the mortgage market trying to generate inquiry through product pushes – not selling services.

US Federal Reserve Chairman, Alan Greenspan, has these new products on his radar telling congress in June that the "dramatic increase in the prevalence of interest-only loans, as well as the introduction of other relatively exotic forms of adjustable-rate mortgages, are developments of particular concern.

Of real concern are the home equity products that basically allow Americans to use the family home as an ATM.

Property on the global market

To highlight how significant an asset class property is on the global market, the Economist says that the total value of residential property in developed economies *rose* by more than $30 trillion over the past five years to over $70 trillion – an increase equivalent to 100 per cent of the countries combined GDPs.

Not only does this dwarf any previous house price boom, it's larger than the global stock market bubble in the 1990s or America's stock market bubble in the late 1920s (55 per cent of GDP). This makes the boom the biggest bubble in history.

In half of the developed nations prices are still rising. In places like California, Florida, Nevada, Hawaii house prices soared by more than 20 per cent in the first quarter.

The IMF recently reported that the household sector has increasingly and more directly become the shock absorber of last resort in the financial system.

Australian products and practice

Australia is a world leader when it comes to innovative mortgage products, which comes down to credit policy, increased income ratios, LMI, legal system and the Aussie psyche.

On the whole, the innovation of the Australian market – underpinned by our cultural tradition of wanting our own roof over our head – has created a stable market, with high home ownership.

But there are notable areas of concern, Low doc loans for example:

We keep our low doc lending fewer than 20 per cent of our book. Aggressive use of low docs sees them taking up to 35 per cent of some lenders' books. That's too high.

Low doc loans have a place in the overall product mix, but unless these products are well priced for risk, they are simply a poor tool for chasing market share.

Low doc lending has been on the RBA's radar, as has the broker practice of churning borrowers out of one loan into another to chase commission.

In 2002, ASIC released a report into broking, and legislative controls have started to take grip. And the recent crackdown on financial planners for unnecessarily churning customers is a clarion call to the mortgage broking industry.

ASIC is recruiting 300 consumers to be part of a surveillance operation to monitor whether financial planners take advantage of the new Super Choice by churning unwitting consumers.

Success of this operation will no doubt strengthen the regulators hand when it comes to legislating mortgage brokers.

Government has also turned its attention to poor valuation practices. The drive by valuation is probably the most dangerous of these. While most low doc loans are at low LVRs up to 80 per cent (relatively speaking) just a 20 per cent correction at 75 per cent LVR becomes a 95 per cent LVR.

Given that with a low doc loan, the lender has less financial data on the customer, by definition, this is an area to be seriously concerned about. And let's be reminded that losses peak after three years. This means problems could arise at the end of this calendar year.

Monetary policy

Throughout the recent property boom, the RBA put on the breaks; refining monetary policy into the sharpest tool it has ever been in our history.

The plan worked with the March 2005 rate rise dampening the market.

But looking at the March rate rise in the broader context and we see that since the end of 2002 we have had five interest rate hikes, which is a one and a quarter percentage increase on someone's loan.

And in actual fact, with petrol and other increases, the net effect on the household budget is more like seven or eight interest rate rises in that period. That's a two percent increase, which is at or just past the two percent buffer that responsible lenders advise borrowers to account for when taking out their mortgage in 2002.

There is no room left in the household budget for more rate rises. The debt servicing ratios of lenders are now being robustly tested. New borrowers from 2002 would be stretched.

Affordability on the improve

In Australia, new home affordability has been on improving. According to REIA, home loan affordability has improved for three consecutive quarters to the end of March 2005.

Average weekly income rose by 1.5 per cent while average monthly loan repayments grew by just $4 to $1,516.

The biggest driver on affordability has been house prices, not so much interest rates.

Take a property worth $300,000, with a loan of $200,000 at an interest rate of 7 per cent over 30 years for a couple with a monthly income of $4,000 and monthly repayments $1,331.

A ten per cent interest rate reduction reduces repayments to $1,238 per month. That is $100 saving.

A ten per cent price reduction in property price reduces monthly payments to $1,198 per month. That is $130 saving, a 25 per cent increase.

Of course, this is a lot different to the wealth effect created by the drop in rates five years ago and the tremendous economic boom that wealth effect sentiment provided. That period is over for now. But nonetheless the affordability sentiment should keep owner-occupier acquisitions steady.

A finishing note…
Recent changes to the Australian superannuation industry are set to have a large impact on the investment property.

All of a sudden Australians have to shake off their apathy and disinterest in the equities markets and have the knowledge they need to manage their super.

Before the housing boom Australians were nervous about shares and another collapse of equities markets. Shares were out. Housing was in.

Now with super options, consumers are obliged to read and understand shares – with the same zeal they consumed home lending information in the past five years, and housing is out.

But there is nonetheless strong evidence of a global property boom that will have a significant impact on the Australian market, defying conventional thinking on housing.

Economists traditionally say real estate, which can't be easily traded like stock or oil, is driven by local factors, like the availability of land in an area or regional employment trends.

Now, the persistence of low interest rates – increasingly in synch around the world – are a strong sign of a boom. Add to this the increasingly unconstrained flow of capital around the world, aggressive lending tactics by banks, and the frantic search by investors, large and small, for returns that beat stock and bonds.

While Americans are searching out castles in Umbria, Londoners are snapping up beachfronts in Bulgaria. The French are buying dream homes on the Indian Ocean near Durban. In Bangkok, eight years after the city's property market collapsed, there is a boom going on, with mortgage lending increasing 20 per cent annually, after contracting sharply in the late 1990s.

House prices have been rising steadily in Spain, (63 per cent in the past three years) and France (48 per cent) in the past three years, 48 per cent up in Bulgaria in just the past year and 19 per cent in Hong Kong.

Many believe that a global housing slowdown, if it comes, would be absorbed but the global economy without much disruption to overall growth rates. It's even possible that the globalization of this boom may help spread out the risk associated with it.

As part of a rebalance of Australian asset portfolios we will buy into property asset portfolios overseas. It achieves diversification and glossing and liquidity over time.

The new wave in the globalization of property purchasing will add another driver, meaning that the market won't retreat at the same pace as it might have were it just driven by domestic factors.

We are seeing a steady consensus in Australia that we will see rates on hold for the next 12 months –an phenomenal period of stability where solid lenders, with good backing and serious commitment to long term customer service will keep the Australian market as the world leader that it is.