Rate relief locks in housing recovery

Rising rents, a drop in interest rates and a rebound in consumer confidence are finally giving investors something to cheer about. CHRISTOPHER JOYE

Last month I implored you to keep your eyes peeled for the inflation data, which was to be published after I filed my column, since it would have major consequences for Australia's housing market.

I told you that if it "printed" low – at, say, less than 0.6 per cent for the September quarter – then the Reserve Bank of Australia (RBA) was likely to cut rates in November.

The good news for all housing investors, save perhaps the most pessimistic doomsayers, is that this is precisely what panned out.

In the September quarter, Australia's underlying inflation rate printed exceptionally low: at just 0.3 per cent, which was significantly below market expectations.

The RBA duly obliged by cutting its target cash rate one quarter of a percentage point to 4.5 per cent.

Even the banks came to the party, with most moving their lending rates down 1:1 with the RBA.

In something of a perfect storm for housing investors, rents have continued to rise rapidly.

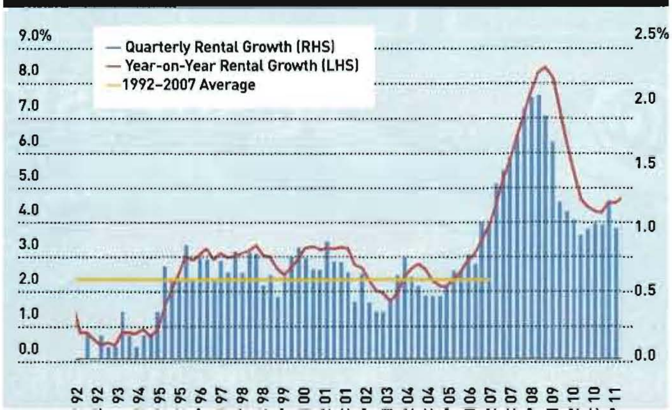
In the year to September, the dollar value of rents across Australia has risen by 4.6 per cent, according to the Australian Bureau of Statistics (ABS).

Rents expressed as a share of the value of the average home, known as yields, are now averaging five per cent for Australian apartments based on RP Data-Rismark figures.

The rental story in and of itself is an interesting one. As my chart below shows, there has, in fact, been a structural increase in the (dollar value) growth rate of Australian rents in recent times.

Between 1992 and 2007, rents grew by an annual average rate of 2.3 per cent. Yet since late 2006, rents have expanded by at least three per cent per annum, and in 2008-09, by as much as eight per cent (refer to the red line). This shift is almost certainly explained by the fact that building approvals haven't kept pace with population growth, which has in turn led to a tightening of rental vacancy rates.

THE GREAT INFLATION: AUSTRALIAN RENTAL COSTS OVER TIME



Housing as an investment class generated most of its total return during the 1990s and the first half of the 2000s via capital gains.

Over the past half decade, however, rents, or income, have well and truly stepped up to the plate and compensated investors for the periods in 2008 and again in 2011 when capital gains have turned negative (i.e. house prices have fallen, albeit modestly).

Before the RBA cut rates in November, regular readers will recall that we felt that the housing market was starting to bottom out. This was confirmed in our house price index data for the month of September, which was the best result since February 2011.

National prices were only down 0.2 per cent in September and by 3.6 per cent in the first nine months of the year. However, once we account for gross rents, total housing returns (i.e. capital growth plus rents) were actually up 0.7 per cent over the year to date.

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Compare this to the sharemarket, which has fallen by as much as 20 per cent during the course of 2011.

Recent information has lent further weight to our "market basing" narrative with the exception perhaps of auction clearance rates, which remain weak.

On the positive side of the ledger, first-timers have been coming back into the market after a hiatus following the 2009 spike care of the government's first homebuyer 'boost' (a temporary additional grant on top of the First Home Owner Grant).

According to the latest ABS data, first-time buyers are now capturing 16.4 per cent of all new loans, which was up from 14.9 per cent in February 2011.

The housing finance data also looks encouraging. In seasonally-adjusted terms, the number of new home loans approved in September for the purchase of established dwellings was up 15.7 per cent from its level in March this year.

More recently, we've seen consumer confidence rebound in November to levels above the long-term average, which was rate might sound insignificant, I've argued that the impact is likely to be much more far reaching. This is because the RBA's decision to lower rates represents a radical shift from what Australian families have been expecting for much of 2011.

As I've noted in this column throughout the year, the average Australian family was budgeting on two to three rate hikes over the next 12 months. A remarkable 25 to 30 per cent of families thought they would be hit with four or more hikes. These 'virtual' hikes were a key driver of the soft housing conditions that have prevailed in 2011.

Average consumer expectations will now swing from banking on a series of future rate increases to anticipating no change in rates or more cuts. This will immediately improve sentiment surrounding the highly interest-rate-sensitive housing market.

You can now get one-year fixed-rate home loans for 5.89 per cent. There are three-year fixed rate loans available for as low as 6.25 per cent. UBank is offering a variable rate home loan for 6.39 per cent.

Crucially, the financial markets are pricing in another three to four rate cuts by June next year. While I think this is unlikely to occur, all the talk about lower rates will be a positive influence on housing market activity.

We were officially forecasting a recovery in house prices by the middle of 2012 based, critically, on our assumption that the RBA would be forced to hike rates at least one to two more times.

The very low inflation result in the September quarter, combined with continuing troubles in Europe, have allowed the RBA to shift monetary policy back into neutral territory.

As a consequence of these changes, we now expect better housing activity to materialise sooner than previously projected. In particular, our models imply that house prices should respond quite quickly to the change in the community's mood, the RBA's positioning and rates more generally. This is a function of the fact that around 90 per cent of all home loans are fully variable and get the benefit of any rate relief.

In 2010 we forecast that 2011 would be a tough year for house prices, but a very good one for rents.

Nonetheless, one of our universal beliefs has been that if the global economy took a turn for the worse, housing was, contrary to popular conjecture, going to be a great hedge against adversity. That's because just as housing is normally the first casualty of any rate increase, it's also the chief beneficiary of rate reductions.

If the RBA keeps rates at their current levels, or reduces them further, 2012 should see house prices bounce back into the black. api