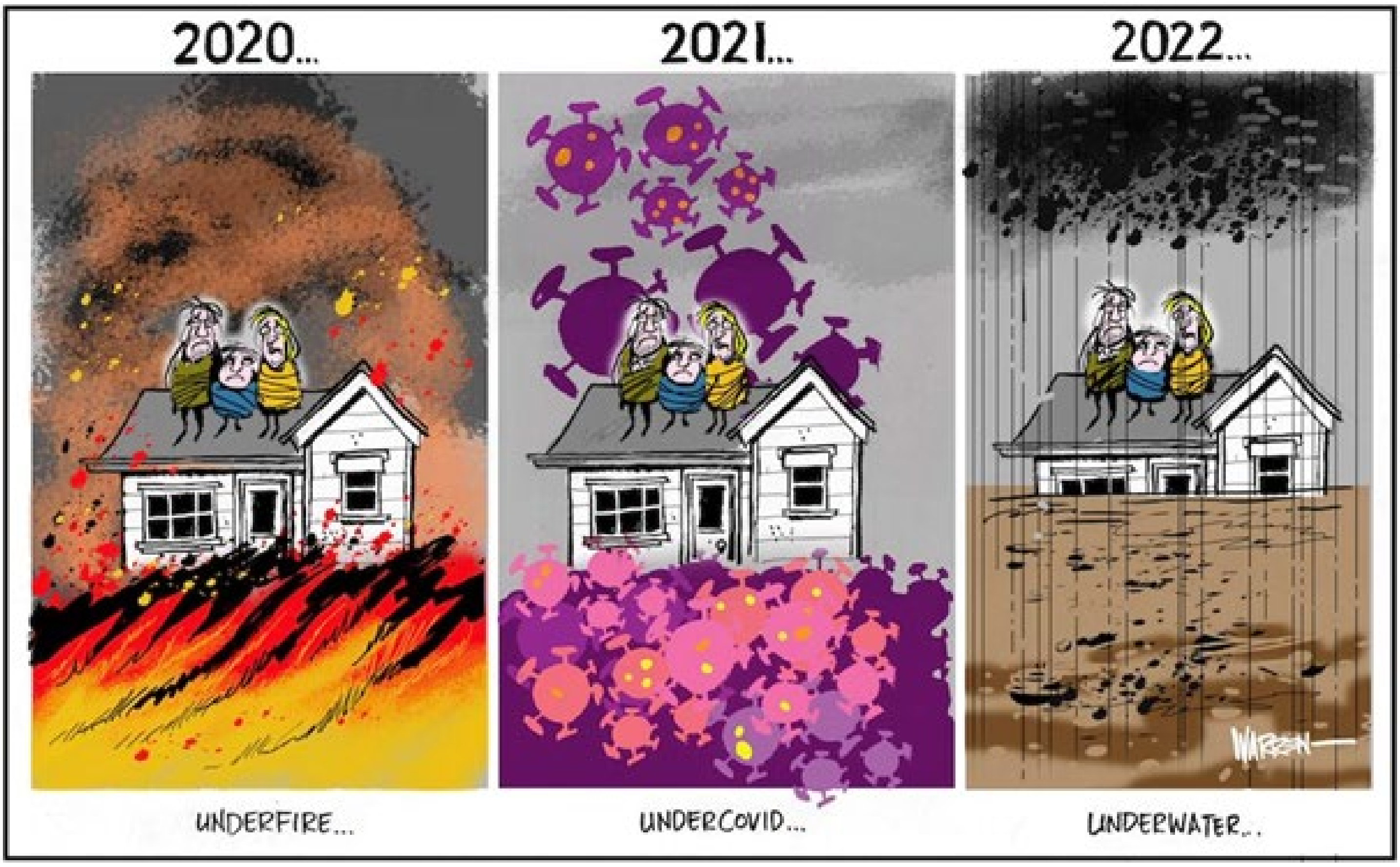
PROPERTY – A RELIABLE ASSET IN UNCERTAIN TIMES?



PROPERTY – A RELIABLE ASSET IN UNCERTAIN TIMES?

BY PAUL MIRON

Amidst a war in Eastern Europe, our central bank is grappling with the impacts of a rising cost of living, a severe energy crisis (not experienced since the 1970s), official inflation hitting 3.5%, and lastly, COVID-19 and its variant accomplices. This is not to mention the constant heartaches inflicted by fires and floods over the past three years and their financial implications on the economy.

Thus, we must ask ourselves - how will this impact everyday Australians? What will be the effect on interest rates, property prices and the general economy?

The RBA Governor's message to mortgage holders last Friday 10 March 2022 has been much more sobering than previous statements - "Mortgage Holders should start preparing for interest rate increases." In our view, we had been lulled into a false sense of security that low-interest rates were here to stay, at least until 2024. However, the financial markets are now factoring up to 5 increases this year alone, with more to follow in 2023. The experts predict increases in official cash rates totalling 1.5% between now and Christmas next year. The first of these increases will be the first increase in official cash rates since November 2010.

Even the most optimistic property pundits understand that rate hikes will challenge future price appreciation and signal an inflexion point leading to property prices falling. Moreover, these anticipated rate increases will have broader ramifications on other asset prices and the wider economy.

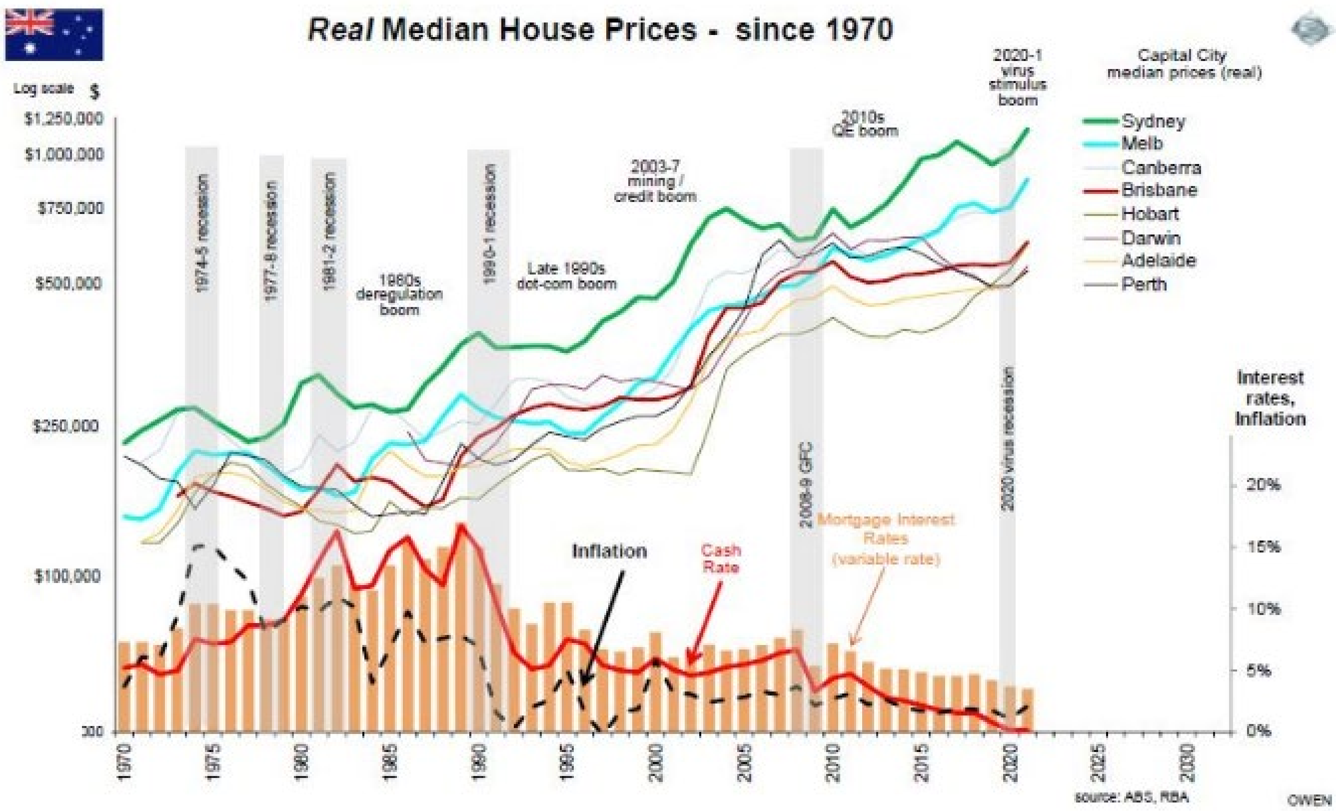
The Federal Government and the RBA are trying to balance on a precarious tightrope as they gradually taper economic support and raise interest rates, whilst not beating the economy into a recession.

Despite these significant economic challenges, especially the inevitable withdrawal of free money, Australia is once again better-equipped than its international peers in dealing with these challenges, with Australia's mineral-rich economy being a benefactor of high energy prices. This advantage in selling minerals also acts as an inflation hedge in a world of rising prices. In addition, having immigration as part of our export mix effectively cushions the economy and limits labour constraints, while improving our national GDP figures and fending off stagflation fears.

I guess the million-dollar question (or more like, the $1.6 → million question in Sydney – or $1.1 million question in Melbourne) is "How far will property prices fall over the next 12 months?"

As Albert Einstein once said, "If you want to know the future, you need to look into the past".

On 6 March 2019, the RBA Governor presented at the AFR business summit. As can be seen in the graph below, the benefit of hindsight lays out the foundation and justifications for future rate reductions for the sole reason of increasing property prices. Looking at the benefits of property price appreciation, a 10% increase in property prices would increase consumer spending by circa 1.5% (Keynesian Wealth effect) to give the economy some additional stimulus.



It is essential to note this was all whilst property prices took an 18% hit in 2018 – it was not due to a lack of demand; it was induced by APRA's intervention combined with the Banking Royal Commission which restricted bank finance and the flow of capital to buy property.

It was not too long after these events that interest rates began to decrease from the 1.5% official cash rate, with the RBA Governor uttering one of the most important quotes in regards to property prices. He believed that property prices could go up as high as 30% without being a risk to the general economy.

Remember, this was during a time when most property economists believed property prices would fall between 20%-30%.

Indeed, since this statement, property prices have increased by 30% over the 18 months, nationally.

How did he get the property prediction so accurate?

As I have written in my previous articles, the most effective property modelling conducted in Australia has been commissioned by the RBA itself - a joint paper by Trent

Saunders and Peter Tulip titled, ['A model of the Australian Housing Market'].

The paper outlines the key drivers of property prices - no surprise, it had reaffirmed the RBA's property price prediction that with a 1% drop in interest rates, property prices would rise by 30%.

It would be easy to conclude, with the RBA's admission that interest rates will go up between 1% and 1.5% over the next two years, that the property gains over the past few years can be equally reversed; that is, a rational conclusion would be that property prices would fall back to the levels seen in 2018, where the cash rate was sitting at 1.5% – but the reverse is not automatically true in this case.

The model also outlines other contributing factors: changes in income, unemployment, population growth, housing stock and rental vacancy.

Upon looking closely at all these elements, we believe that despite rising interest rates placing downward pressure on property prices, all other factors are positive for the property market and this may limit the downside. As inflation expectations are increasing, wage inflation will increase from its present level of 2.3%. The other significant metrics to note are that unemployment is at record lows, immigration will increase even more significantly than its pre-COVID-19 level, we are still not building enough dwellings to meet demand and rental vacancies are trending in the right direction and are now higher than pre-COVID-19 levels.

We believe that property prices will fall once the cash rate increases by up to 1.5% over the next 12-18 months. Importantly, we believe falls will be modest – between 10% to 15% – due to the other aforementioned factors moving in favourable directions. If the Reserve Bank needs to raise rates above 1.5% over the next 24 months, we may be looking at a credit crunch with more severe property price declines. Hence, we believe the RBA will be more cautious than the financial market is anticipating.

However, this is useful in examining property prices on an aggregate level. It is also essential to look more closely at a micro-level; we envisage a divergence in property prices across different geographical regions, different property classes, and specific trends that impact property.

Regional Property

Perhaps one of the biggest surprises that has emerged during the pandemic has been the stellar performance by the regional property market — inspired by the combination of low-interest rates and COVID-19, cohorts were encouraged to try the tree and sea lifestyle, despite the backdrop of zero net migration.

For those who can afford a second home, this change can be sustained; however, the reality is that the work-from-home phenomena will eventually run its course, and health, education and work options are much more plentiful in the cities. Thus, we believe people will move back to the cities and reverse some of this trend in the coming 24 months.

Sydney, Melbourne and Brisbane

However, despite Queensland being a star outperformer on the internal migration front (7,035 net migration just in Q4 2021), with Brisbane being the most affordable city on the eastern seaboard, we believe the rise in Queensland property prices will not outperform those of NSW and Victoria. This is because Queensland, especially Brisbane, can quickly deliver sufficient supply to meet demand; credit for this can be given to Queensland having a much quicker planning process and being less constrained with land, allowing developers to meet market demand and quickly keep prices affordable.

Units Versus Houses

The price gap between units and houses has never been wider. As affordability becomes more realistic, we believe units will be the feasible alternative. There is a significant shortage of larger, luxury apartments suitable for young families and empty nesters. Property developers are focusing their attention on creating a more suitable product catered for this market, which may lead to a psychological shift in property preferences in the future.

Commercial

Commercial property is indeed sensitive to interest rates, but unlike residential, there is less emotion associated with making a purchase decision. With interest rates going up, upward pressure will be placed on rentals. It is important to keep in mind that a 1% interest rate increase translates to a 29% increase in mortgage repayments. However, the question is – is it feasible to pass this cost onto tenants?

If tenants' businesses are not earning the additional profit this puts risk to the tenancies, leading to higher price inflation, hence undermining employment and the wider economy over the long-term in the event that increased rent cannot be passed onto consumers. It is important to consider that this is occurring in an environment where interest rates are going up, hence we should see some resistance to further price appreciation in this investment class.

Msquared Capital is a private credit provider with investment opportunities backed by quality property along the Eastern Seaboard, we ensure that all investment opportunities are based on risk-to-reward as our core offering. Investors are in the driving seat when it comes to choosing the type of investments, as well as risk and return, via our unique structure and offering.

This gives investors the peace of mind that the Msquared strategy can withstand economic shocks and deliver stable, consistent monthly returns.

If you would like more information, please feel free to contact myself or our dedicated team of professionals at our office.

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