Australia Economic Viewpoint

Housing: A mixed recovery is underway

16 August 2023

Economics
Australasia

No housing boom, but higher prices

A large housing downturn that reflected an aggressive tightening cycle and increased cost of living for consumers is now coming to an end as the Reserve Bank of Australia approaches the end of the hiking cycle. A recovery is already underway, with house prices recording five consecutive monthly increases. Based on leading auction clearance rates, we would expect modest rises to continue. We estimate a 5-10% rise in house prices in the next twelve months. In our view, a strong labour market, improved demographics and little expectations for mortgage rate increases support the outlook for housing.

Activity is soft and supply is rising

Backlogs from supply chain issues and labour shortages are easing supporting the near-term outlook for construction. Yet, weakening economic conditions and high costs mean dwelling investment is unlikely to increase sharply, in our view. While there are early signs of a turnaround in building approvals, these are rising from the lowest levels in at least a decade. Soft construction means spillovers into broader activity will be modest. A large pipeline of public infrastructure projects is expected to support public dwelling investment going forward and rising rent prices may increase interest from investors.

Unlike the previous cycle, there has been some increases in listings. These offset larger gains in house prices, but we think the market will be able to absorb the increased supply as demand remains solid. While the flow of new listings added to the capital cities has increased of late, it remains 23.3% below its five-year average.

Risks ahead: the mortgage cliff and household spending

Households with fixed rate mortgages are yet to feel the full rise in interest rates. Fixed loans refinance will peak in 3Q. We ran a simulation to assess the impact of the increase in mortgage repayments on households' balance sheets We project total mortgage payment to reach 10% of disposable income in end-2023 and peak at 10.1%. This will be the highest on record. Strong labour market, slightly better savings relative to the previous hiking cycle and a low cash rate level provides some offset.

Market implications: wider money markets

We see further tightening in funding markets as Term Funding Facility (TFF) maturities step up and Australian bank funding tasks expand but prefer to pay 6m 6s3s than BOB for three reasons: firstly, the cheapening of 6m bank bills to 3m bank bills (i.e.,6s3s) has seen the 6m 6s3s curve flatten aggressively. By paying Mar24-starting 6m 6s3s, we gain exposure to the peak of TFF maturities in May/ June 2024. Also, the flatness of the curve means the roll on a paid position is positive and will lag tightening in spot positions. Lastly, regulatory disclosures suggest the major banks' call on money markets has stepped up in H1 2023 as TFF maturities loom and deposit growth lags credit growth, expanding the major banks' funding task and placing upward pressure on 6m 6s3s.

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Prices: we see further slow-paced rises

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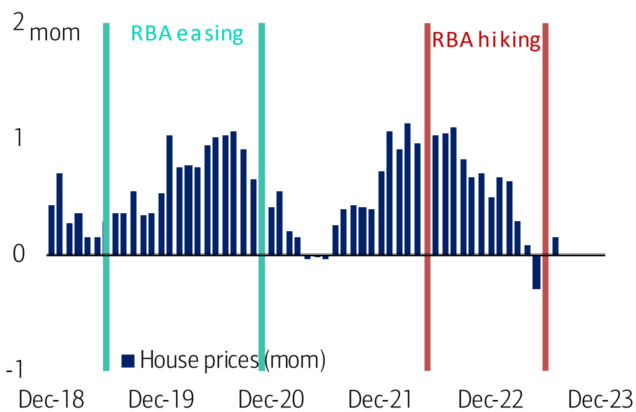
The end of the Reserve Bank (RBA) hiking cycle See: Australia Economic Watch: RBA review: A surprising pause 01 August 2023 raises questions around the outlook for the housing sector. Following the large housing downturn that reflected an aggressive tightening cycle and increased cost of living for consumers, house prices have already started to recover on expectations that rate hikes have come close to an end (Exhibit 1). Indeed, leading auction clearance rates also suggest the downturn is behind (Exhibit 2).

While we do not expect a housing boom as such, prices are set to rise further albeit at a slower pace. Our estimation is for a 5-10% rise in house prices over the next twelve months. With little to no more mortgage rate rises and a strong labour market the outlook for house prices is positive. However, sustained elevated mortgage rates, high rent inflation and overall cost of living, a small increase in supply of houses, limited policy support and little household savings mean a sustained housing "boom" is unlikely, in our view.

Exhibit 1: House prices vs monetary policy
End of hikes means higher prices



Source: CoreLogic

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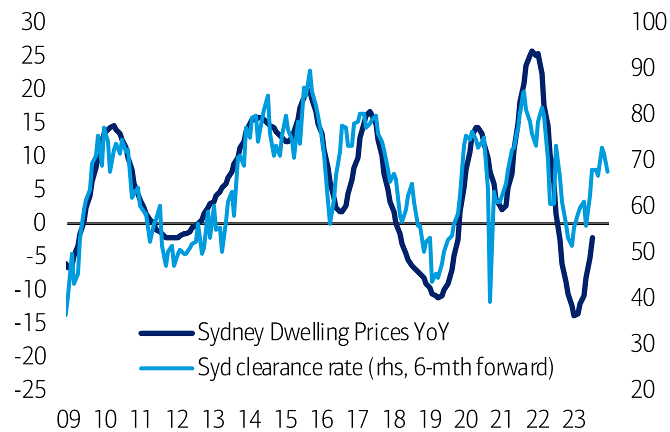
Exhibit 2: House prices are picking up
As the RBA reaches the end of the hiking cycle



Source: CoreLogic

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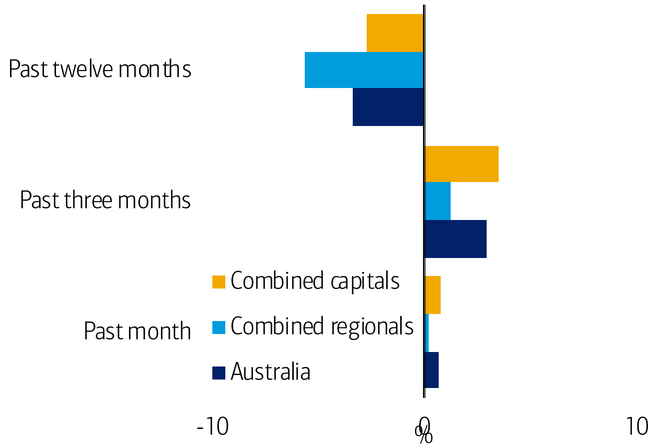
Our estimation for a 5-10% rise in the next twelve months is in addition to the recovery that we have already seen. While prices remain 3.4% lower than last year, according to the most recent data from CoreLogic, we have seen a 2.9% rise over the last three months (Exhibit 3). The latter has been driven by the capital cities while regional areas (that had been benefited by the COVID boom) are now recording small increases.

Despite the most recent decline in prices that ended in February 2023, median values for Australian houses have continued to rise and the annual change in median prices for Sydney and Melbourne remain too high relative to household incomes (Exhibit 4). This means affordability remains a key constraint to enter the Australian housing market. While inflation is currently well above the RBA target, wages growth has not kept up, reducing both purchasing power and borrowing capacity for consumers.

Exhibit 3: Broad based rises
Driven by capital cities



Source: CoreLogic

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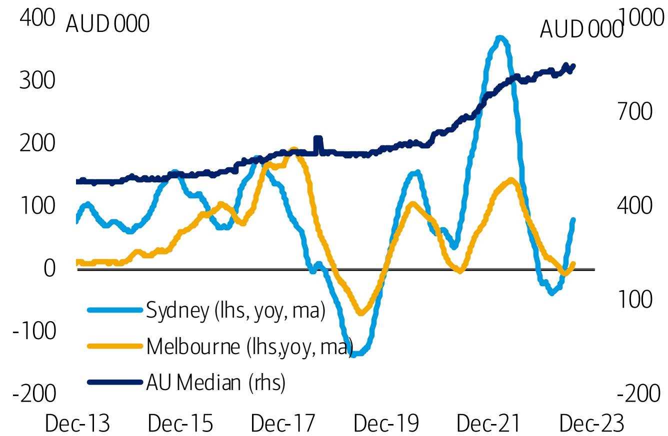
Exhibit 4: Change in median house prices for Syd & Mel
AU median prices are too high



Source: SQM research, Macrobond

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Unlike the previous cycle, there has been some increases in listings. These may offset larger gains in house prices, but we think the market will be able to absorb the increased supply as demand remains solid. The flow of new listings added to the capital city housing market lifted by 3.9% in July but remain low relative to historical levels. Indeed, Sydney is the only city where the flow of fresh stock to market was higher than a year ago. Notably, overall capital city advertised stock levels remain low, tracking18.3% below a year ago and 23.3% below the previous five-year average.

Mortgage stress may rise as consumers' balance sheets adjust to high interest rates. This means listings could increase going forward if stressed consumers decide to sell. However, a very tight labour market suggests stress in the mortgage sector will be modest. In addition, entry barriers due to housing affordability along with increased rental prices and the lack of supply of properties for rent means only consumers that are under significant financial stress will sell their properties, in our view.

Construction activity is soft and steady, with some risks

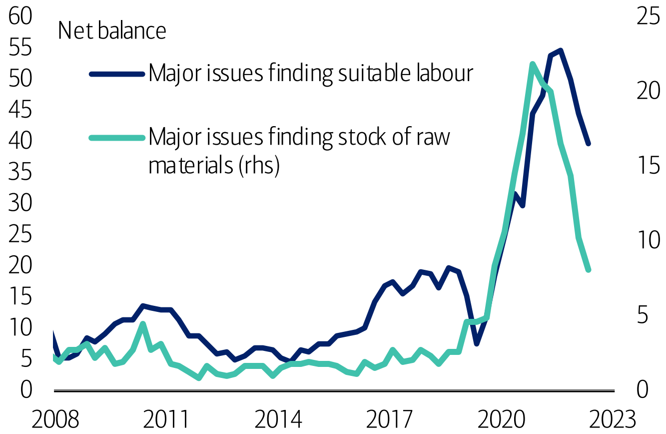
Backlogs from supply chain issues and labour shortages are easing supporting the near-term outlook for construction (Exhibit 5). However, weakening economic conditions and high rates mean dwelling investment is unlikely to increase sharply going forward. Survey based measures of confidence in the construction sector are mixed, suggesting current conditions are relatively good, but there is less confidence in the outlook (Exhibit 6).

High costs of land and construction along with a decline in established home prices over the last year makes buying an already built dwelling more attractive than building a new home. Indeed, news around builder insolvencies and construction delays are not supportive of sentiment in the sector.

A large pipeline of public infrastructure projects is expected to support public dwelling investment going forward, though ongoing labour and materials shortages may limit the pace at which work can be completed. While there are signs of a turnaround in approvals, these are rising from the lowest levels in at least a decade. Therefore, we think the current housing cycle is not expected to add upside risk to economic growth. Soft construction means spillovers into broader activity will be modest relative to the previous cycle.

Exhibit 5: Easing supply constraints

Support the near-term outlook for construction work



Source: NAB, Macrobond

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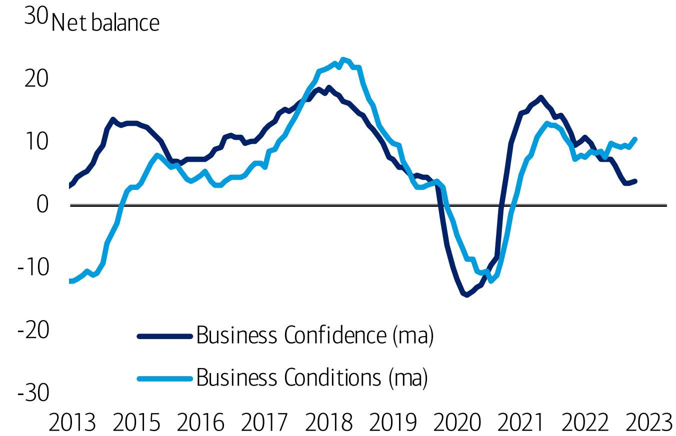
Exhibit 6: Confidence in the construction sector holds up

But the outlook is more uncertain



Source: NAB, Macrobond

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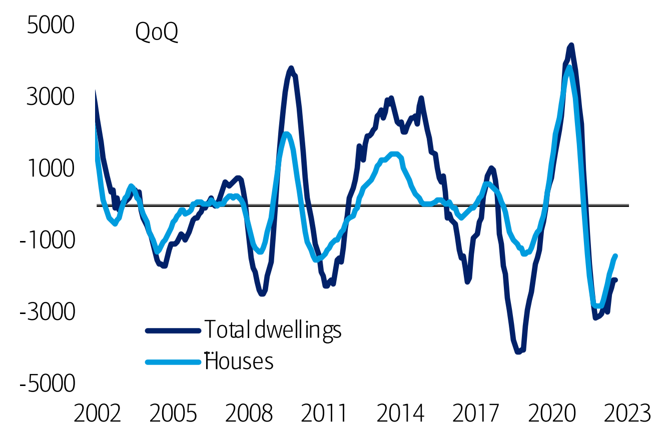
The Reserve Bank of Australia's Contacts liaison program have noted that some firms in the construction sector are experiencing cash flow issues and insolvencies (Exhibit 8). In the RBA's view, this is because of the lengthening in detached dwelling completion times, along with substantial increases in construction costs and firms still working through fixed-price contracts signed prior to these increases. For developers, cash-flow constraints and an increase in insolvencies could create further delays in completions.

Overall, the lack of government support measures for construction combined with tight financial conditions and some pockets of stress in the construction sector due to capacity constraints means a sharp increase in construction activity is not our base case. However, increased house prices and expectations for the end of the RBA's hiking cycle are likely to further boost construction in the medium-term.

Exhibit 7: Dwelling approvals remain low but have bottomed

This should rise as interest rates rises peak



Source: Macrobond, ABS

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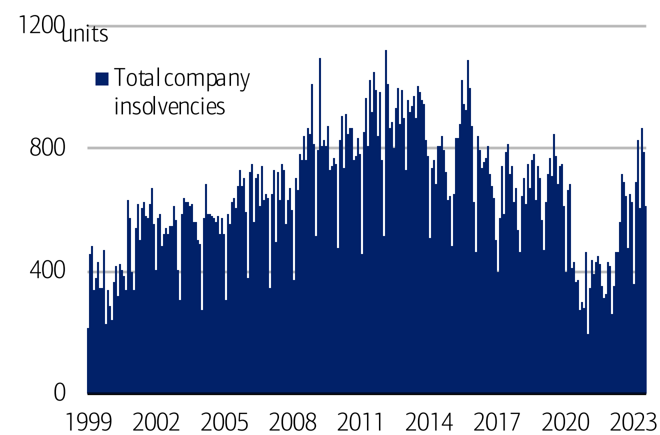
Exhibit 8: Company's insolvencies have risen

But remain below GFC



Source: Macrobond, AU Securities and Investment

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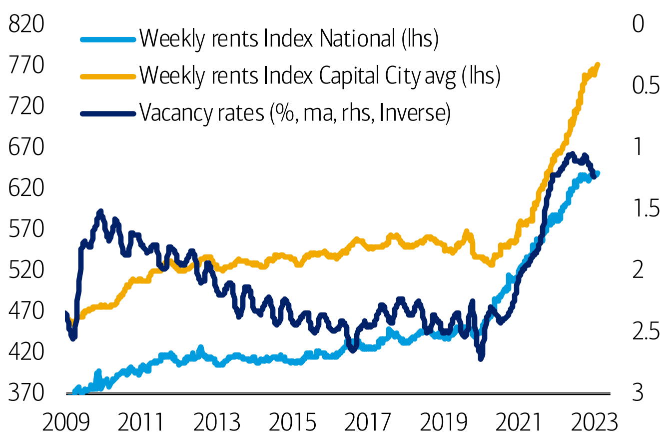
The tight rental market

A pick-up in population growth to pre-pandemic levels continues to support a very tight rental market. Rental vacancy rates remain below their long-run average levels in Melbourne and Sydney and are around record lows in most other capital cities (Exhibit 9). Rent prices continue to rise as support measures come to an end as rental agreements expire. Strong demand for rentals also continues to boost prices. CoreLogic data suggests growth in advertised rents (for new leases) has been strong in capital cities, with advertised rents rising at their fastest pace in at least two decades in Sydney and Melbourne. By contrast, advertised rents growth has eased in most regional areas over the past year.

Rents have grown more strongly for units than houses. Rental yields remained above pre-pandemic levels in all capital cities, though they have declined for Sydney and Brisbane in recent months as increases in housing prices have outpaced growth in rents. The strongest rental conditions are seen across the unit sector relative to houses. Higher living costs including rents mean affordability remains a problem in Australia and explains part of the demand for units over houses.

Exhibit 9: A very tight rental market
As demographics improve



Source: SQM research, Macrobond

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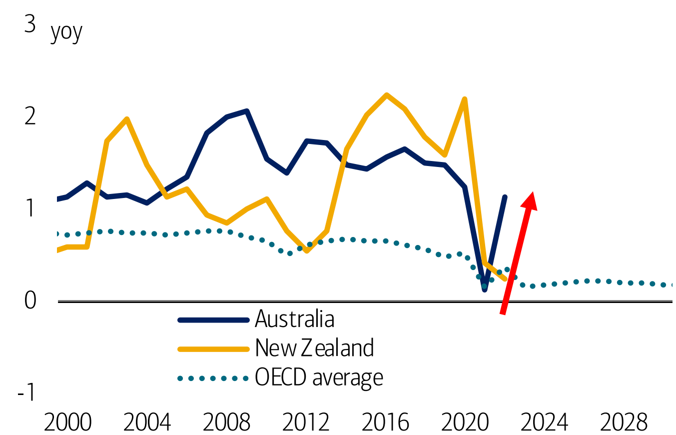
Exhibit 10: Improved demographics
Supporting rental demand



Source: Macrobond, OECD

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While a tight rental market is positive for housing investors, and a large rise in population growth (Exhibit 9) supports aggregate demand, the tight rental market has boosted prices by 6.7% annually. This is the largest annual rise since 2009. With households experiencing sharp increases in electricity, childcare, petrol prices and overall cost of living there are expectations for government support ahead.

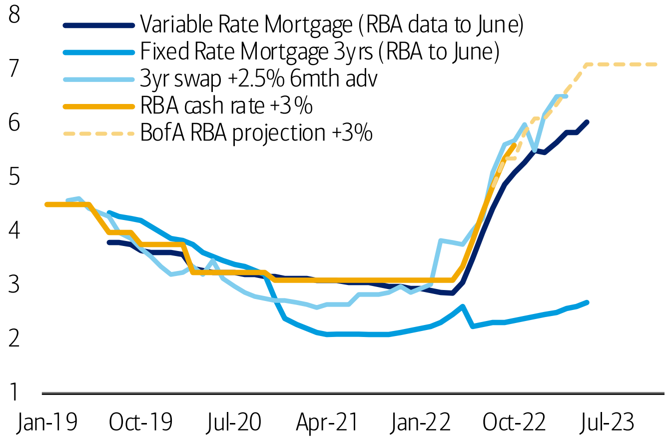
Fixed rates roll over and financial stability

In Australia, monetary conditions have significantly tightened over recent months. The increase in the cash rate has seen a slowdown in home lending activity for new loans as affordability is elevated and the price of money has increased significantly. Banks have increased both lending and deposit rates further, but the overall increase in this tightening phase has been less than the increase in the cash rate (Exhibit 11).

Overall credit growth has stabilised recently, though at a noticeably lower level than late last year. Interestingly while housing loans remain well below its peak in early 2022 (Exhibit 12) it has increased a little since earlier this year alongside increases in activity in the housing market and in housing prices. These data are consistent with our view for a mixed recovery in housing activity and turnover. Yet, with significant risks.

Exhibit 11: Banks tighten lending rates

But below the cash rate



Source: Bloomberg, BofA ex

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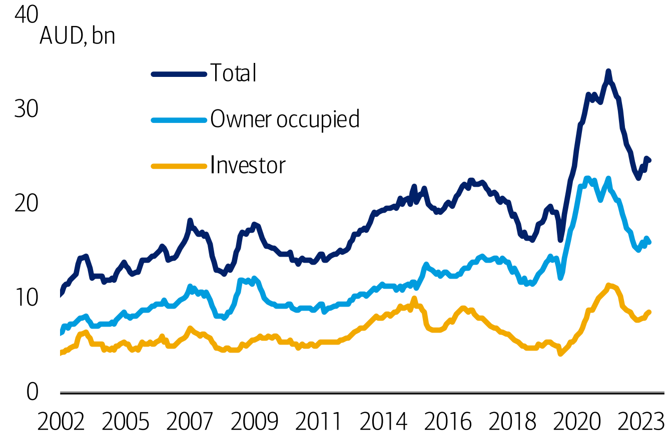
Exhibit 12: Lending activity picks up

As rate rises slow



Source: ABS (excludes refinance)

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With household debt to disposable income over 190% Australian households' leverage sits at one of the highest in the world. Concerns around the outlook for household spending have increased significantly as interest rates continue to rise. While the pass through of higher rates is already being felt by households with spending rising only 0.2% in 1Q GDP, there is uncertainty around the refinancing of loans that had been fixed during the pandemic (Exhibit 13). The proportion of fixed loans in new flows has already declined significantly as rates continue to rise though fixed loans' expiry dates and subsequent refinancing are yet to peak (Exhibit 14) higher borrowing costs when their fixed-rate mortgages expire. However, borrowers with fixed-rate loans have had a considerable period to adjust their finances to prepare for the increase in their mortgage payments and many appear to have similar savings to borrowers on variable rates[1].

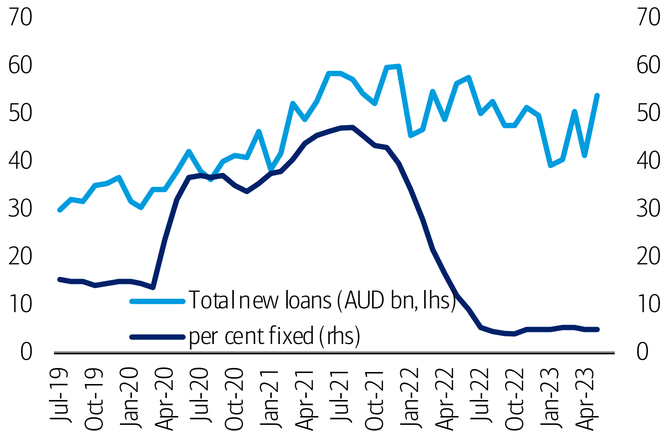
While a very tight labour market has contributed to higher wages, household savings continue to decline. The savings ratio fell to 3.7% which is the lowest level since June 2008. Savings fell as the rise in household consumption outweighed a softer rise in gross disposable income. This means while consumers do not count with much savings to afford extra spending the savings rate remains above historical levels.

Encouragingly, expectations for a peak in interest rates (we see the cash rate on hold this year) has seen an increase in house prices over the last five consecutive months. Indeed, rent price increases and higher population growth would likely provide support to domestic activity and may improve confidence through the wealth effect channel. Politically, housing affordability remains a key issue particularly for the current labor government though grants for construction of dwellings and tax relief policies were not included in the most recent Budget update.

In the RBA's view, fixed rate mortgages have delayed the effect of the higher cash rate on borrowers' cash flows. Indeed, a key issue for the economic outlook and financial stability relates to the ability of borrowers with fixed-rate loans to adjust to substantially higher mortgage payments while real income declines.

[1] https://www.rba.gov.au/publications/bulletin/2023/mar/fixed-rate-housing-loans-monetary-policy-transmission-and-financial-stability-risks.html

Exhibit 13: Share of fixed mortgages in new flows
Though ultra-low rates saw an increased in fixed loans



Source: ABS

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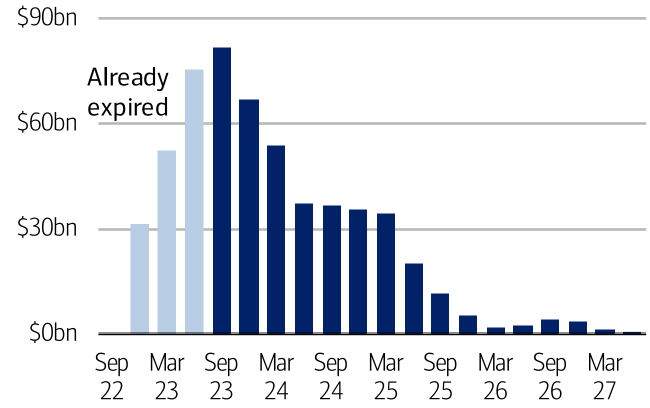
Exhibit 14: Outstanding fixed mortgages rates expiry schedule
As refinancing will be done at a much higher rate



Source: BofA, estimation based on AU major banks aggregate

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Mortgage payments to reach record-high by year end

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Successive policy tightening has significantly debt servicing costs for consumers. This is the main near-term downside risks to the household consumption outlook in 2023-2024 as fixed mortgage rates roll over.

We ran a simulation to assess the impact of the increase in mortgage repayments on households' balance sheets We project total mortgage payment to reach 10% of disposable income in end-2023. This will be the highest on record. That said, household sector came in this tightening cycle with strong financial buffers, which could potentially mitigate its impact on consumption.

In addition to a sharp rise in living costs, households are yet to fully feel the cumulative 400bps hike in interest rates since May 2022. The full impact is expected to be felt in 3Q-4Q as fixed loans expire.

Estimates of rising mortgage rate on income - We assess the impact of rising mortgage rate on consumption through the change in total mortgage burden, including rising interest and principal payment.

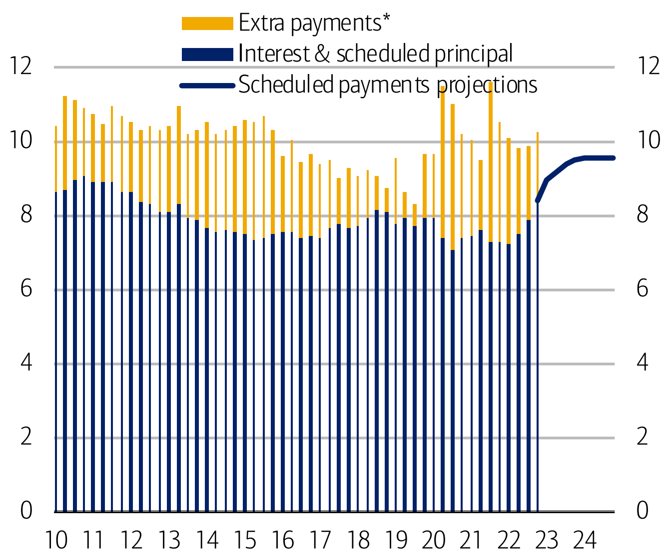
Assumptions:

- We assume the current 4.10% as terminal and expect the cash rate to stay on hold till end-2024.
- All fixed-scheme loans to switch to variable rate upon expiry. As such, variable rate scheme would take up to 80% and 89% of total outstanding mortgage loans in end-2023 and end-2024, respectively. The overall growth in outstanding mortgage loans (0.4% qoq) would be modest.

Outcomes: Our simulation suggests total mortgage payment to rise to 10% of disposable income in end-2023 before stabilizing to 10.1% in 2024, highest in record, eroding household consumption power. Consistent with our estimation, the RBA has noted scheduled mortgage payments as a share of household disposable income increased to 9.4% in the June quarter, which around its historical peak.

Mortgage rates and scheduled mortgage payments will increase further as a high share of fixed-rate loans roll onto higher rates through the rest of 2023 (Exhibit 15) while extra principal repayments into offset accounts is expected to decline further (Exhibit 16), in our view. This is in response to the ongoing pressure on household incomes.

Exhibit 15: Housing mortgage payments
% Share of disposable income, quarterly



Source: Payments into offset and redraw accounts, ABS, APRA, BofA's calculations
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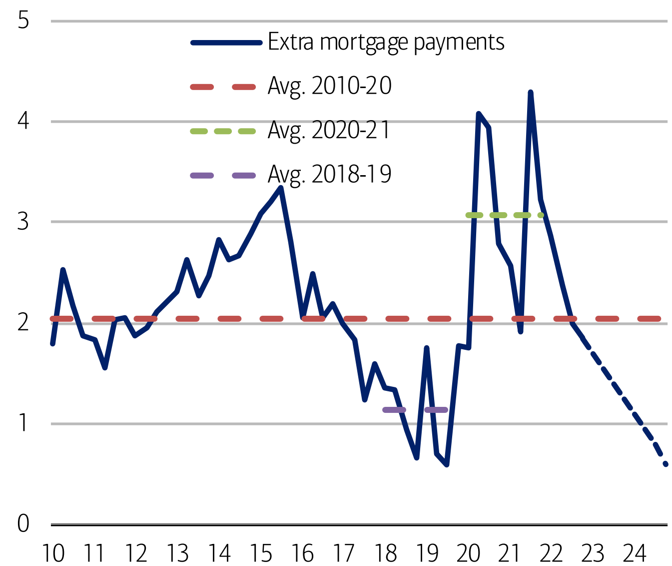
Exhibit 16: Extra mortgage payments
% Share of disposable income,



Source: Payments into offset and redraw accounts, ABS, APRA, BofA's calculations
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The offsets: Stronger savings buffer compared to previous hiking cycle (2005-2008)

In addition to our simulations, the hiking cycle in 2005-08 should shed light on how consumption could evolve through 2024. The cycle started in Mar 2005, lasted for 3 years and saw cumulative 200bps of hikes. Consumption held up well in the first half of the hiking cycle but gradually decelerated the tightening effect kicked in and global momentum softened. Admittedly, the pace of hiking is faster, and the level of change is higher in this cycle. But we see several mitigating factors that could support the outlook for consumption.

- **Lower level of rate**: the terminal rate will likely be 300bps lower than that in 2008 (7.25%).
- **Gross saving rate is now higher** while declining, the savings rate is higher than historical levels and continues to help paying additional interest repayments.
- **Previous extra payments into offset/redraw accounts could act as buffer** to the rising total mortgage payment. Accounting for such payment, the total payment could be smaller than historical high (11.3% in 2023f vs 11.5% in 2009, 11.6% in 2021).
- **Wealth effects**: The rise in house prices ahead could also improve consumer sentiment that has been very soft.

Market implications: Housing recovery = wider money market spreads

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While a housing recovery is positive for bank asset growth, stable credit growth and a decline in household savings buffers should add upward pressure to money market spreads.

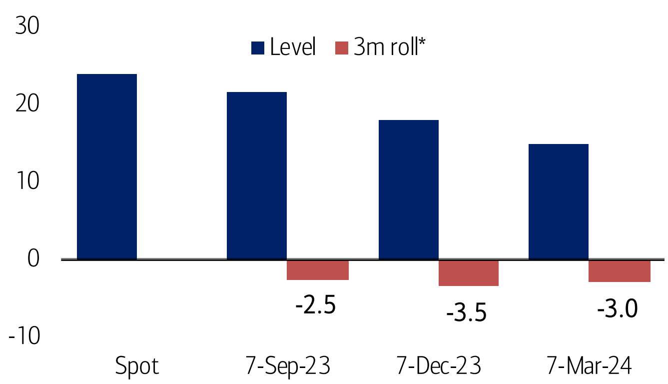
The spread between 6-month (6m) and 3-month (3m) bank bills (6s3s) has widened significantly over the past month and we like to pay 6m 6s3s starting on 7 March 2024 with an entry of 15bps, a target of 27bps, a stop of 9bps and positive roll of ~3bps. Risk to this trade is that excess liquidity means funding markets do not tighten. For a complete list of our open trade recommendations as well as trade recommendations closed over the past 12 months see Global Rates weekly : [BofA - Global FX Weekly (baml.com)](). We see further tightening in funding markets as TFF maturities step up and AU bank funding tasks expand but prefer to pay 6m 6s3s than BOB for 3 reasons:

The cheapening of 6m bank bills to 3m bank bills (i.e.,6s3s) has seen the 6m 6s3s curve flatten aggressively. 6m 6s3s (27bps) is 12bps wider than 6m 6s3s starting on 7 March 2024 (15bps) (Exhibit 17). By paying Mar24-starting 6m 6s3s, we gain exposure to the peak of TFF maturities in May/ June 2024 (Exhibit 18).

The flatness of the curve means the roll on a paid position is positive and will lag tightening in spot positions Even as spot 6m 6s3s has retraced its widest levels over the past few days, forward-starting prices have remained almost unchanged.

Regulatory disclosures suggest the major banks' call on money markets has stepped up in H1 2023 as TFF maturities loom and deposit growth lags credit growth, expanding the major banks' funding task and placing upward pressure on 6m 6s3s.

Exhibit 17: Paying Mar-24 6m 6s3s offers attractive carry/ roll
We like to pay Mar24 6m 6s3s as a wave of TFF maturities loom in mid-2024



Source: BofA Global Research, Bloomberg *roll to fixing for 7 Sep 2023 starting position
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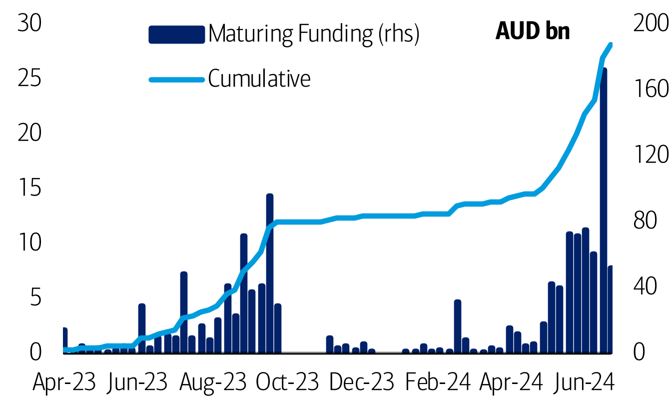
Exhibit 18: TFF maturities peak in mid-2024
Pay 6m 6s3s starting on 7 Mar 2024



Source: BofA Global Research, Bloomberg
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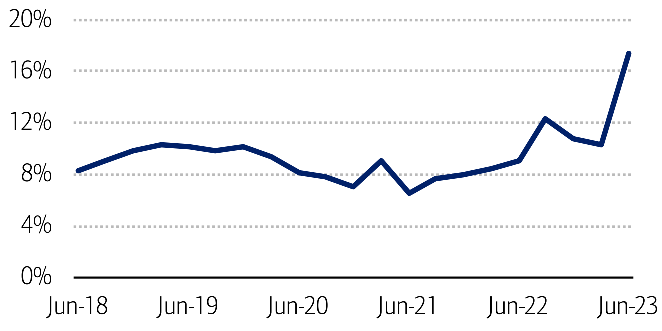
TFF maturities impact issuance patterns

The share of wholesale funding derived from 7-12mth paper (unweighted value) increased substantially last quarter (Exhibit 19, Exhibit 20). In its Pillar 3 regulatory disclosure on Wednesday, the Commonwealth Bank of Australia noted the Term Funding Facility was a factor in its falling net stable funding ratio or NSFR (down from 130% to 124% YoY), which was caused in part by an increase in 7-12mth issuance. Although 6m bank bills do not fall in this bucket, the data confirms the TFF maturity schedule as a likely catalyst for the cheapening of 6m bank bills vs 3m bank bills since July.

In our view, banks have sought to bridge a spike in TFF repayments in September 2023 and we forecast a repeat of this trend in Q1 2024 given a much larger wave of TFF funding matures in June 2024. We see banks as likely to bridge the spike once again in TFF repayments by increasing the supply of longer-dated bills. Mar-24 starting 6m 6s3s should widen materially against this backdrop as the supply of 6m paper increases ahead of TFF maturities.

Exhibit 19: Rising 7-12mth wholesale funding (contribution to ASF)
Major banks stepped up 7-12mth issuance in Q2 as TFF approached



Source: BofA Global Research, Pillar 3 disclosures.

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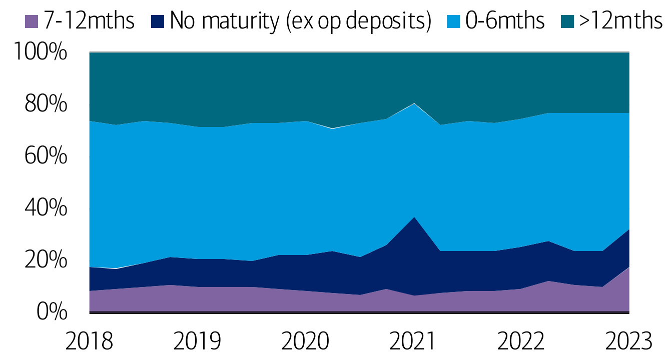
Exhibit 20: 7-12mths issuance rises (unweighted value, ASF)
Sudden change in wholesale funding mix likely caused by TFF unwinds



Source: BofA Global Research, Pillar 3 disclosures.

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After the TFF

While nearly all TFF loans maturing in 2023 will unwind by early October, the funding requirement generated by the unwind of this facility will be generated by early September. For the purposes of calculating major bank LCRs, 60% of the HQLA that will be removed from major banks' balance sheets in 2023 has now been withdrawn and 96% of the HQLA reduction will have occurred by the week of 4 September

Once the impact of TFF repayments in has been fully priced in the BOB curve (i.e., around early September), we will also revisit BOB curve steepeners. At this stage, though, Dec23 remains vulnerable to a sudden spike in 3m BOB and we prefer forward-starting positions on the 6s3s curve.

Analyst Certification

I, Oliver Levingston, hereby certify that the views expressed in this research report accurately reflect my personal views about the subject securities and issuers. I also certify that no part of my compensation was, is, or will be, directly or indirectly, related to the specific recommendations or view expressed in this research report.

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