HOUSING UPDATE AND OUTLOOK

Do the Green Shoots Have Roots?

Monday. 9 January 2012

- **The past year has been challenging for the residential housing market. House prices have weakened and building approvals and construction activity has remained soft.**
- **But more recently there have been some signs that the housing market could have bottomed and indeed be showing some green shoots. The Reserve Bank has delivered two rate cuts in late 2011. Further, the latest data shows house prices have risen for the first time in eleven months, first-home buyer demand is recovering and the demand for housing loans is lifting.**
- **However, the housing market is still vulnerable. Housing affordability remains low, buyer confidence is still fragile and worries about the world economic outlook is likely prolonging caution among potential buyers.**
- **We believe housing prices will begin to witness a sustained recovery in the second half of this year and that dwelling construction will lift in 2012-13. This view assumes no significant further fallout from Europe.**
- **Tightness in rental markets is likely to be maintained until the house price recovery begins.**
- **Further rate cuts from the Reserve Bank in the next few months cannot be ruled out, especially given the heightened downside risks emanating from Europe. We expect the RBA to cut the cash rate again when it next meets in February.**

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1. **House Prices:**

Median house prices in most capital cities have declined through 2011 on the back of an interest rate rise at the end of 2010, strong growth in house prices over 2010 and low housing affordability.

Nationwide housing prices dropped by 1.2% in the September quarter and by 2.2% over the year, according to the Australian Bureau of Statistics (ABS) measure.

The weakest housing markets are those that have had the largest run up over the preceding few years. Brisbane and Perth have been the weakest markets over the year.

In Sydney, house prices are down only 0.3% on a year ago (equal with Hobart to be the best performing capital city over the past year in terms of house price growth).

However, there is some possible early evidence that the national decline in housing has now bottomed or is close to bottoming.

RP-Data-Rismark house prices data is released monthly compared with the less frequent ABS data. According to the latest RP-Data-Rismark data, Australian capital city home values rose by 0.1% in November. It is the first increase in home values since December 2010. The annual rate of decline in home values improved from 3.9% in October to 3.5% in November.

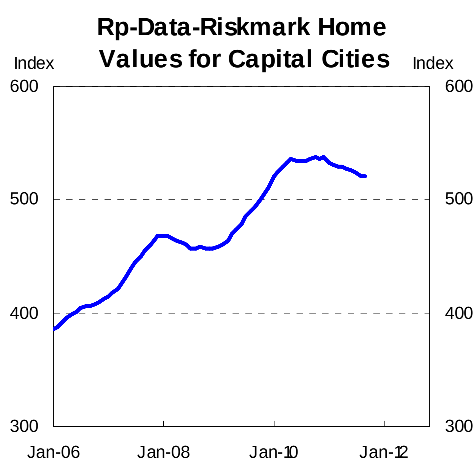
Meanwhile, regional house values recorded a 0.3% rise in November, which was also the biggest increase since December 2010. The annual rate of decline in home values across regional areas improved from 3.1% in October to 2.5% in November.

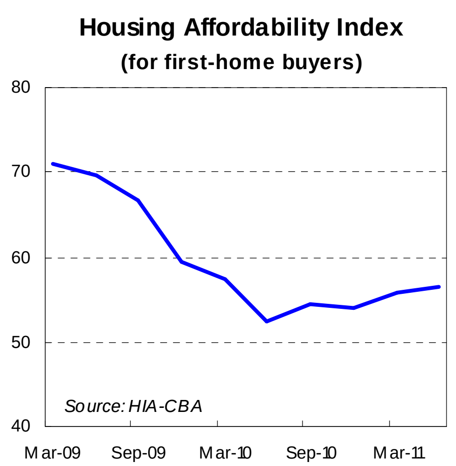
First-home buyer demand is showing early signs of recovery in most States, while dwelling shortages are building up in some States, notably NSW.

The reduction in interest rates and the general expectation of further easing from the Reserve Bank (RBA) should underpin improved housing turnover and result in a stabilisation of prices in the first half of 2012.

We expect a modest price recovery to come through to housing prices later in 2012 and continue through 2013.

The tight rental market will help set the conditions necessary for this house price recovery to come through. However, the price outlook will differ across the capitals.





2, Housing Affordability:

There are a number of key factors that influence home loan affordability:

- The amount to be borrowed, which reflects the price of the property being bought and the borrower's equity situation.
- The average loan repayment, which is determined by the size of the loan, interest rates and the period of the loan.
- Ability to repay the mortgage, which depends on household income (and wealth).

Affordability issues are near or at the top of the agenda when it comes to Australia's property markets. Nationwide housing affordability remains low, although there has been some slight improvement since the middle of 2010. Relatively high interest rates until recently limited the improvement in affordability.

The proportion of income required nationally to meet loan repayments was 33.6% in the September quarter.

According to the REIA's Q3 housing affordability report, NSW remains the least affordable State or territory in which to buy a home. The proportion of income to meet loan repayments sits at 37.1% in NSW. NSW is also the least affordable State or territory along with Tasmania in which to rent a property with 26.4% of family income required to meet rent payments.

Meanwhile, ACT is the most affordable State or territory. The proportion of income to meet loan repayments was 17.9% in the September quarter. ACT is also the most affordable State or territory in which to rent a property with 16.4% of family income required to meet rent payments.

3. Housing Finance

- Number of Loans to Owner Occupiers

Housing finance to owner-occupiers nationally returned to growth seven months ago. The latest data shows that in the year to October, the number of housing loans to owner-occupiers increased by 6.3%. This data pre dates the RBA rate cuts in November and December.

The recent rate cuts from the RBA should give housing finance another lift higher. But more broadly, the sector faces a number of headwinds: interest rates, stretched affordability and household's desire to pay down debt. These factors are offsetting the positives of rising household incomes, relatively low unemployment and a shortage of housing stock.

While the growth in total loans to owner-occupiers has been positive over the last seven months, it is being driven primarily refinancing activity. Loans for established dwellings have also made a positive contribution, but a mild one. Demand remains weak for loans to construct a home and for loans to buy a new home.

Excluding refinancing, owner-occupier home loans has been weak since January 2010 and has only recently started to turn around. In the year to October, loans to owner-occupiers excluding refinancing lifted by 1.2% (compared with growth of 6.3% when including refinancing activity).

Loans for refinancing are growing at an annual rate of nearly 18%. Further, the growth in refinancing loans has been growing at a double-digit pace for seven consecutive months now. Refinancing activity has been spurred on by lower and more attractive fixed mortgage rates in recent months. Indeed, the proportion of borrowers fixing their loans has risen from 5.6% in August to 9.9% in October - the highest proportion since June 2008.

In terms of other loans, loans for the construction of dwellings fell 1.8% in October and on a year ago are down 3.8%. The last time the annual rate grew for the construction of dwellings was February 2010. And loans for new dwellings rose by only 0.1% in October to be down 5% on a year ago.

Just as there is a divergence within loans, there is also a divergence across States. Growth in housing demand is not felt across the country as a whole.

WA is the State where housing finance is growing the fastest – at 15.8% per annum in October. Indeed, there has been double-digit growth in WA for six consecutive months.

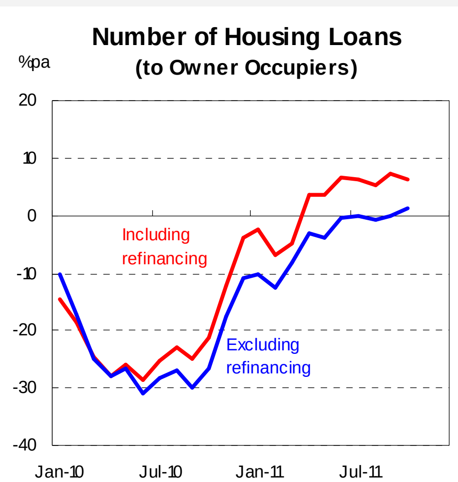
NSW is also one of the few States sharing in the improvement for housing finance. According to the latest data, loans to owner-occupiers in NSW grew by 15.1% in the year to October – the fastest annual pace in two years. The acute shortage of housing in NSW and the tight rental market are likely encouraging buyers back in the NSW housing market. The strength in NSW also likely reflects first-home buyers bringing forward house purchases, after the NSW State government announced the end to the stamp duty exemptions on the purchase of existing homes for first homebuyers from 1 January 2012.

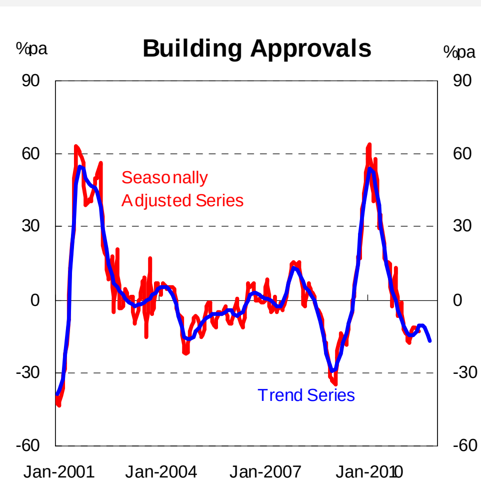
The weakest State is Queensland where home loans contracted by 5.2% in the year to October. However, the degree of contraction has been easing. The annual contraction of housing loans in Queensland was as great as 35.2% in the year to June.

- Value of All Loans (to Owner Occupiers and Investors)

The value of all loans fell by 2.5% in October and by 0.7% in the year to October according to the latest data. There remains a significant divergence between housing credit for investors and that for owner -occupiers. The value of all housing loans to owner-occupiers rose by 3.5% in the year to October. But the value of all housing loans to investors fell by 9.3% in the same time period.

Investor housing loans have been weak since June 2010 while a recovery in owner-occupier housing loans has been in place since April 2011.





4. Building Approvals

Approvals to build both private houses and private other dwellings (i.e. multi-density developments such as townhouses and units) remains subdued. Building approvals continue to remain weak in an uncertain economic environment and with rates only recently moving to a less restrictive stance.

Approvals for multi-density housing (such as apartments) are generally weaker than that of detached housing. One reason for this is that financiers are generally requiring many developers to have a higher proportion of pre-sales and provide more equity in the post-GFC

environment.

According to the latest data, approvals to build a home in the year to October are down nearly 30% on a year ago. It is the weakest annual rate since January 2009.

The underlying health of the Australian economy, strong fundamentals in the residential housing market (which includes a national shortage of housing), recent rate cuts and a low unemployment rate suggests that sentiment should improve. Building approvals should also improve in time. This view assumes no further significant setbacks in the global economy.

Those States with the highest dwelling deficiencies have the strongest potential for a recovery in building approvals over the medium term (refer below for more detail on dwelling deficiencies).

5. Dwelling Commencements

Dwelling commencements weakened moderately over the year to the September quarter to be down 6%. This decline is predominately reflects the loss of government stimulus and restrictive borrowing costs over much of this time.

We see that the balance of risks lie towards further weakness in dwelling starts over the first half of this year. Economic uncertainty stemming from global economic concerns is exacerbating weakness in purchaser confidence, which is restraining activity in residential property and building construction. However, the recent rate cuts and a shortage of dwellings should limit the downside and result in some improvement in the second half of 2012.

6. Alterations & Additions

Alteration and additions approvals remained close to flat over the year to the September quarter. The general weakness prevalent in residential property markets reduced turnover and therefore limited renovation approvals.

We expect renovation activity to be around flat in 2011/12, before returning to growth in 2012/13.

7. Housing Shortage

Nationally, the housing shortage is expected to grow from 120k this year to 141k next year and 163k in 2013 (according to recent BIS Shrapnel estimates). A large chunk of this national housing shortage exists is in NSW. Growth in the dwelling stock in NSW is soft and well below the rate of growth in the population. It is accentuating the acute shortage of housing in NSW. The housing shortage in NSW is expected to grow from 88k this year to 104k next year and 113k in 2013 in NSW.

The Housing Institute of Australia (HIA) "Housing to 2020" report examines the shortage issues at a local government level. The report found that there are some areas of Australia that remain affordable with plenty of dwellings, but a number of factors are increasing the problem dramatically.

The report also suggested that many regions and cities in Australia is that affordable and well-located land is not available or abundant. Furthermore, planning restrictions, higher taxation on new housing relative to existing dwellings, labour shortages, and onerous regulation biased toward new housing are adding to the problem.

The report concludes that if there is not a comprehensive supply response to the deteriorating housing shortage then the lack of affordable and appropriately located rental properties will worsen and pressures on existing home prices will likely continue at an undesirable rate.

According to the 2011 National Housing Supply Council, there is little improvement likely for the demand-supply gap in housing. Over the five years to 2015, the Council expects the housing shortage nationally to grow to nearly 329k and by 2030 to 640k.

The shortage in housing suggests that a collapse in housing is less likely and eventually construction activity must recover to try and meet underlying demand.

Housing Shortage (Annual and in '000s) *				
State	**2010**	**2011 (e)**	**2012 (f)**	**2013 (f)**
NSW	75.7	87.9	103.9	113.3
Vic	30.8	20.2	13.5	12.8
QLD	5.6	5.7	14.3	22.9
SA	0.2	-1.7	-2.3	-2.2
WA	8.7	8.3	13.0	17.0
Tas	-0.9	-1.7	-2.1	-2.2
NT	1.7	2.0	2.7	3.5
ACT	1.6	-0.4	-2.3	-2.6
Australia	**123.4**	**120.3**	**140.8**	**162.6**

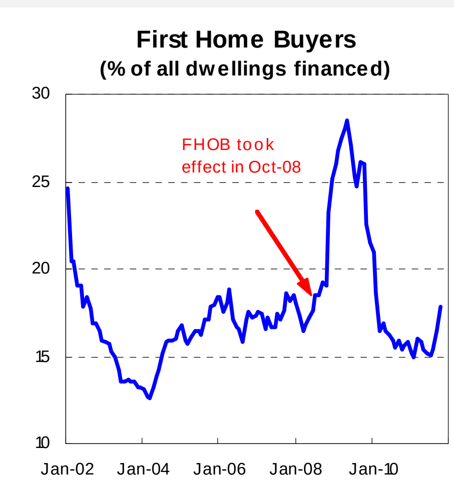
**As at September 2011, Source: ABS, BIS Shrapnel*

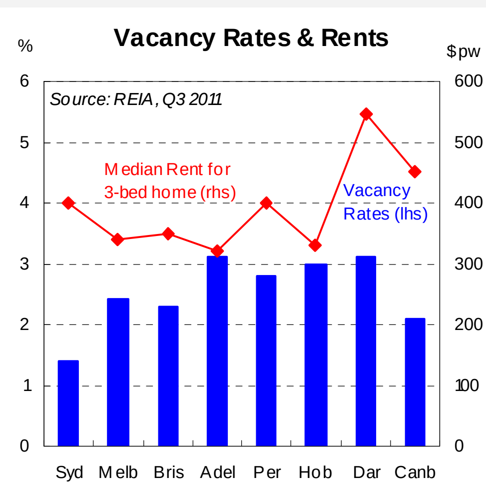
8. Rental Markets

Rental markets are tightening as more and more would-be homebuyers are forced to remain on the tenancy treadmill. Low levels of housing affordability are contributing to this problem.

In most capital cities, the vacancy rate for rental properties is below 3%, indicating tightness in rental markets. In mining-related towns, vacancy rates are generally tighter and rental yields higher. Rental yields of 10-15% are prevalent in some mining-associated towns compared with rental yields of around 4-5% in the capital cities.

Over the September quarter, Sydney, Adelaide and Perth recorded decreases in the vacancy rate. Further, all capital cities have vacancy rates below 3% except for Adelaide, Darwin and Hobart. Vacancy rates below 3% generally indicate strong demand for rental accommodation.





Over the September quarter, REIA data reveals that rents for three-bedroom houses remained unchanged in all capital cities except for Perth and Darwin, which increased by 2.6% and 0.9%, respectively. Rents for three-bedroom houses remain the highest in Darwin at $545 per week and lowest in Adelaide at $320 per week.

In the September quarter, rents for two-bedroom other dwellings (eg, townhouses, apartments) were flat in Sydney, Melbourne, Brisbane, Adelaide and Hobart. Perth and Darwin registered rental growth of 2.7% and 1.0%, respectively. Rents in Canberra, on the other hand, fell 2.3% during the September quarter. Sydney recorded the highest weekly rent for two-bedroom other dwellings at $450 per week while Adelaide and Hobart recorded the lowest weekly rent at $270.

We expect rental conditions to remain tight over the next six to nine months until there is sustained growth returns to house prices.

9. First-home Buyers

Demand from first-home buyers is recovering from a very low level. The percentage of first homebuyers as a proportion of all dwellings financed picked up to 17.9% in October, the highest ratio in eighteen months. The ratio had been as low as 14.9% in February 2011.

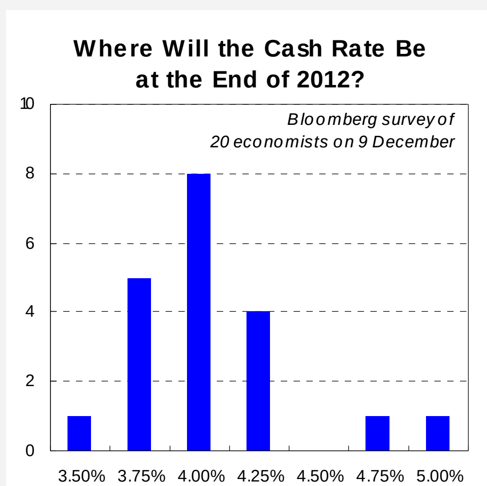
The improvement suggests that the first-home buyer market has mostly unwound the pull-forward effect from the First-Home-Owners-Grant (FHOG) Boost Scheme.

A recovery in first-home buyer numbers will add to overall demand for housing and improve liquidity by providing a larger market for upgraders and downsizers to sell their existing properties. This is an important step in a more broad-based and resilient recovery.

However, some of the improvement in first-home-buyer numbers could be temporary, driven by the stamp duty changes in NSW.

10. Cash Rate Outlook

The RBA cut the cash rate in November and December - each by 25bp - taking the cash rate to 4.25%. This level of the cash rate can be considered near or at neutral – i.e. that level that is neither applying stimulus nor restraint to the economy.



We expect two more rate cuts from the RBA next year with the next one likely in February. Ultimately, how much cutting the RBA does in this easing cycle will depend significantly on European developments. The deeper the European crisis, the more easing the RBA might need to do.

The recent improvement in US economic data and the associated greater optimism over the nearer term outlook for the US economy is offsetting some of the worries about the global economy stemming from Europe. However, uncertainty remains heightened over the world economic outlook, meaning further rate cuts from the RBA cannot be ruled out.

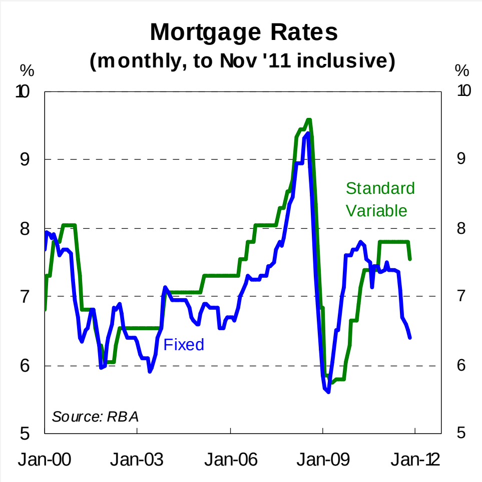
The latest poll of economists (i.e. 25 institutions) in Australia taken on December 9 shows that the median forecast is for the cash rate to fall a further 25bp to 4.00% by the end of next year. The range of forecasts is 3.50% to 5.00%.

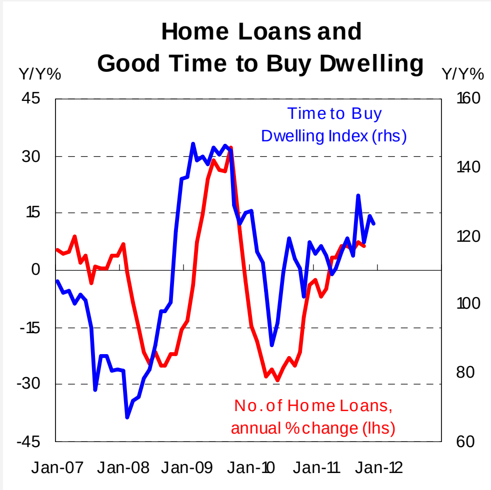
Financial markets (using 30-day interbank cash rate futures as the proxy) are forecasting a cash rate of 3.50% by mid 2012. It implies financial markets are anticipating something almost as nasty as the 'GFC' to transpire. The RBA cut rates to an emergency level of 3% during the GFC but did not leave rates there for long.

11. Mortgage Rates

Rates on the variable mortgage rate have fallen in the wake of the RBA cash rate cuts.

Rates on new fixed-rate mortgages have also fallen and started falling well before the first RBA rate cut on November 1 due to expectations of RBA rate cuts and a fall in global bond and swap rates. Average fixed-mortgage rates have fallen 110bp to 6.4% to November 2011, from the 2011 peak of 7.50% in February 2011.





One can argue that now still offers a good opportunity for borrowers to lock in rates at these sorts of levels. Swap rates, which fixed mortgage rates work off, have fallen a long way.

Australian 3-year and 5-year swap rates have fallen from near 5.40% and 5.45%, respectively, at the end of June this year to around 3.94% and 4.31% at the time of writing. They had been as low as 3.73 and 4.17%, respectively, in mid December. But have recently recovered some ground.

Nevertheless, these swap rates are still not far from the lows recorded during the worst of the GFC; the lows for the 3-year and 5-year swap rates during the height of the GFC were 3.34% and 3.81%, respectively.

There are factors to support the argument that the world financial system and economy should hold up better this time round. These factors are:

- regulation is tighter around the world since the GFC,

- sovereign debt instruments are simpler and more easily understood compared with structured products during the GFC,

- company balance sheets are generally stronger, and

- most banks of any significant size in the advanced economies have gone through stress tests and understand their exposures better unlike during the GFC when exposures were generally poorly understood.

However, in many advanced economies, the hands of policymakers in providing additional stimulus are tied. Traditional policy mechanisms like monetary policy are limited because benchmark cash rates are already very low (UK: 0.50%, US: 0.25%, Eurozone: 1.0% and Japan 0.10%). Meanwhile, fiscal stimulus is limited because governments are grappling with huge levels of debt.

So we cannot fully rule out a scenario as nasty as the GFC playing out, especially given the lack of a co-ordinated swift policy response to the growing crisis to date.

Further, in an environment where conditions in Europe are deteriorating it might be hard for markets to unwind their RBA cash-rate expectations significantly so in the short term.

Whether one entertains a GFC-type scenario being played out or not, swap rates at these levels appear attractive.

Uncertainty remains high about the European sovereign debt crisis, especially as predicting the outcome for Europe involves predicting what the political response will be of its member States. The uncertainty means that while swap rates could revisit the 2009 lows, there is also a good possibility that they will not revisit these lows or breach below these lows. So we believe now is a good opportunity for borrows to consider hedging some of their interest-rate exposure.

12. Fixed Rate Loans

The percentage of fixed rate loans of all dwellings financed jumped from 5.6% in August to 9.9% in October, the highest since June 2008. This likely reflects the recent decline witnessed in fixed-rate loans and the relative attractiveness of the fixed rate versus the variable rate.

13. Employment Outlook

Employment growth has moderated this year and we expect the unemployment to drift higher in coming months.

There is anecdotal evidence of some caution entering into employer hiring plans.

However, the unemployment rate remains low at 5.3%, indicating that the labour market is still a relatively tight one.

We are not forecasting a significant increase in the unemployment rate, which is important in supporting the fundamentals of the residential housing market.

14. Confidence

Consumer confidence for much of the second half of this year has sat under the 100 level, which means on balance consumers are more pessimistic about the outlook (than optimistic). A subset of this survey, published by the Melbourne Institute and Westpac, is whether now is a good time to buy a dwelling. This series has risen 4.3% in the year to December 2011 and suggests some modest upside for the demand for housing loans in the months ahead (please refer to chart).

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