



Market Returns

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Why does residential property seem to defy all the normal investment principles?

The normal key determinants of returns are growth in income and Price Earnings (PE) ratios. But both seem to have little to no relevance when attempting to forecast returns on residential property. For property, the PE ratio is the property value divided by net rents – and on that measure, prices have hovered in the range of 40 to 70 times earnings for years – substantially higher than the average share PEs. What's more, growth of rents over time often seems to bear little or no semblance to growth in prices as shown in Figure 1 on page 3.

The residential property market is not a normal market

In a normal market, investors buy assets that are most likely to give high returns and sell assets that are expected to give low returns. If something appears likely to rise in price, they want to own it; if it looks like it might fall in price, they stampede to the exits.

In contrast, the residential property market is dominated by homeowners, people who primarily want shelter which, along with food, is a basic human need. Think about a pair of home buyers after their first day of house hunting. Invariably, they return home deflated. Talk is along the lines of "Is our dream home really that far out of our range? I can't believe how little we get for our money." And, after that first day, the strategy becomes clear – they work out the maximum they can possibly spend and then go looking for the least worst place they can buy for that amount. What do they spend? Whatever the bank will lend them.

Compare that to a canny sharemarket investor who has spent some time studying the market and concluded that everything seems very expensive. Is it likely this investor would head down to the local bank manager to beg for the biggest loan that the manager is willing to advance, in order that the investor can maximise his/her exposure to the sharemarket? It would be crazy. But that is what happens every day, over and over again, in the residential property market.

So why do housing prices seem so high?

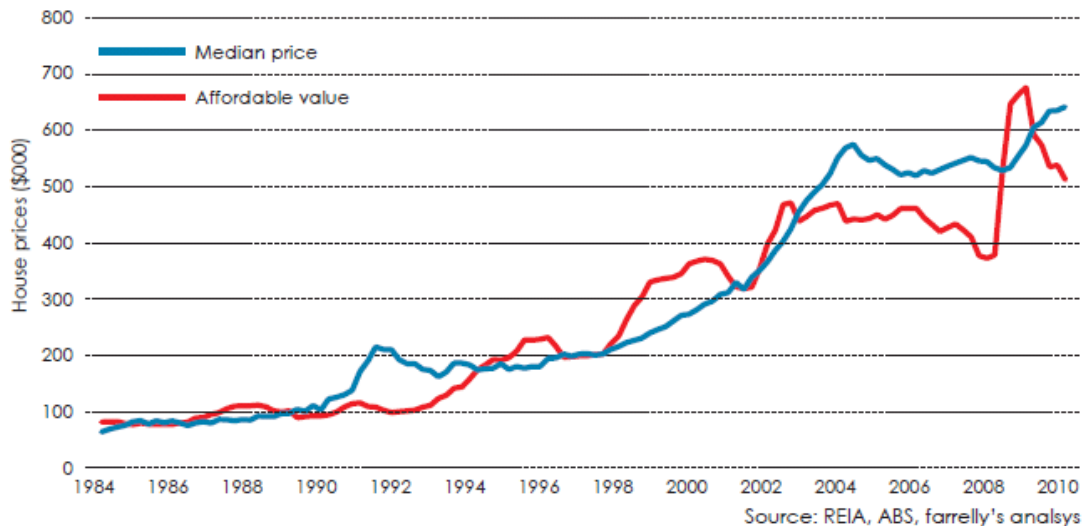
Probably because the demand for housing is greater than the supply. And in such an environment – and when simply staying out of the market is not an option for most – the only thing that limits the price paid is the supply of money, being the amount of money banks are willing to lend. To work that out, the banks look at how much income buyers earn and where current mortgage interest rates are, then use that information to calculate how much debt a potential borrower can safely service. So, when potential buyers' earnings rise or interest rates fall, they can borrow more; similarly, if interest rates rise, the banks reduce the amount they are willing to lend.

Home buyers don't automatically pay more for a given property just because they have had a pay rise. However, in the medium-term, the impact of thousands of buyers, all making similar assessments, will gradually move house prices up when average weekly earnings rise, or if interest rates fall. Similarly, prices should fall, after a suitable lag, when interest rates rise.

Key drivers of housing prices

If this view of the market is correct, over the medium term, prices should move up and down at about the same rate as property affordability. Affordability is proportional to average weekly earnings divided by home loan interest rates. As earnings grow, households can afford to service larger loans and so property becomes more affordable. Similarly, lower interest rates also make property more affordable. Figure 1 shows how Sydney property prices have varied over time compared to affordability. Other states show similar patterns as is shown in Figure 2 on page 4.

Figure 1: Median home prices vs affordability – Sydney



The first thing that stands out is that there is quite a lag between changes to the median and changes in affordability. This makes sense. As noted above, buyers don't all rush out and pay more the first day interest rates fall. It takes a while to work through to prices paid. In the longer term however, affordability has moved much more in line with actual prices than have either rents or inflation as is shown in Figure 2.

Over the most recent five years, outside of the Sydney market, prices have moved much more quickly than the affordability framework would have suggested. This is more than likely due to a variety of factors including the market not yet digesting the interest rate hikes of the past year, and some lingering effects of the First Home Buyers scheme. We believe this outperformance will be given up over time and that, in the long term, affordability gives a good guide to price behaviour both conceptually and in practice.

The affordability model requires demand to exceed supply

This framework is predicated on the idea that there is a shortage in the supply of housing and that home owners will pay whatever they have to so long as the shortage of housing remains. This relies on continued population growth in the major cities, as well as councils continuing to limit the density of dwellings and the release of land for development. Without insufficient supply this model falls down and prices would begin a long slow slide back to more conventional valuation levels.

Figure 2 : Increases in median housing prices, rents and affordability

Component	Sydney	Melbourne	Brisbane	Adelaide	Perth
1985 – 1995					
Price increase (%pa)	7.5	6.4	8.1	3.4	8.9
Affordability increase (%pa)	7.2	7.2	7.2	7.2	7.2
Rental increase (%pa)	2.6	2.3	4.5	2.1	3.9
Inflation (%pa)	5.1	5.1	5.1	5.1	5.1
1995 – 2005					
Price increase	10.0	9.6	9.1	9.8	9.8
Affordability increase (%pa)	8.6	8.7	9.0	8.4	8.7
Rental increase (%pa)	2.2	4.0	3.9	5.1	6.1
Inflation (%pa)	2.4	2.4	2.4	2.4	2.4
2005 – 2010					
Price increase	4.1	10.1	6.9	7.9	8.1
Affordability increase (%pa)	2.1	2.3	4.1	2.6	5.3
Rental increase (%pa)	9.0	7.5	7.0	6.2	10.5
Inflation (%pa)	3.0	3.0	3.0	3.0	3.0

Source: REIA, RBA, farrelly's analysis

This is what happened when the Japanese population stopped growing in the early 1990's – Japanese residential property prices began a slow but steady fall that has them nearly some 60% lower than their peak 20 years ago.

A Big Week of Volatility

Two weeks ago was one of the most turbulent periods in stock market history.

On Monday 8th August, following the S&P downgrade of America, we saw the Dow fall 634.76 points. Even more remarkable was the breadth of the decline. The Elliott Wave financial forecast for Monday 8th August had this to say:

"The ratio of today's NYSE declining versus advancing issues ended at 69:1, with 3033 shares ending the session down and just 44 shares ending the day up. I can readily access this data back to 1984 and today's ratio represents the strongest downside selling pressure-by far- over this entire time frame. The next closest downside day was the crash of 1987, when the ratio closed at 57:1. Calling today's session historic is therefore not hyperbole."

On Tuesday the Federal Open Market Committee (FOMC) stunned the markets with the following statement:

"The Committee currently anticipates that economic conditions...are likely to warrant exceptionally low levels for the federal funds rate at least through mid 2013."

At 2.15 pm EST on Tuesday 9th August 2011 the Fed formally announced that America was "turning Japanese".

Two year U.S Treasury note yields plunged and closed at about 18 basis points. Ten year notes reached a low of 2.03%, matching their previous low on 18th December 2008 amidst the depths of the 2008 crisis.

On four consecutive sessions, between Monday and Thursday, the Dow Jones rose or fell by more than 400 points; a first in the history of the Dow. Not wanting to miss out on a bit of history the Australian stock market staged the biggest intra-day reversal in over 30 years, closing 7.4% above its intra-day low on Tuesday 9th August.

Over in Europe, however, events were even more dramatic. Riots swept across England and European banks experienced a crash of 2008 proportions, with the second largest French bank, Societe Generale, going into freefall. From its recent high on 17 February, Soc Gen fell a stunning 61.8% to its low on 10th August. Across the board European bank stocks collapsed in a heap.

Basically the reason for all this is the mountain of debt in the submerging world of Europe and America. This has now turned into a vicious spiral that will be difficult to escape from.

The possible savior is the emerging economies lead by china, India and Brazil with are now driving world growth.

In the decade that finished in 2010, these economies added around \$8,000 billion to global gross domestic product, equivalent to about 80 per cent of that of the Group of Seven leading economies. They will probably add around \$12,000 billion more over the next decade, double the U.S and Eurozone combined.

The latest retail sales indicators suggest that Chinese consumption is probably rising by around 20 per cent per year. The current size of Chinese consumption is \$2,100 billion. Assuming the level is as low as the 35 per cent of GDP in the official data, then a 20 per cent growth rate translates into an extra \$400 billion a year. The combined rate of consumption growth in the other emerging nations is similar, meaning that these countries alone will add something like \$800 billion to global growth this year alone.

Ultimately, the emerging world will spend more and in so doing soften the blow being dealt by the submerging world, but the submerging nations face a prolonged period of pain.

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