

July 1, 2010

Investment Strategy | Australia

Australian Housing Market

- Within the JBWere Investment Strategy Group we do not advise on, or proclaim specific expertise on Australian housing prices. Our interest lies in the impact the housing market has on the broader economy and investment implications for other asset classes. Recent commentary that the Australian housing market, at face value, looks expensive compared to other countries, have drawn interest from investors. Any potential loss in housing value would have a significant impact on the economic outlook.
- Valuation of housing is far from a simple task. There are many unique characteristics to the Australian housing market.
- At present mortgagees are in a relatively good position to service their obligations. This should mean the risk of default is low, limiting downward pressure on prices. Contrasting this, recent interest rate hikes have been passed on to borrowers quickly, and along with the perception that prices have run up too far, buyers may take the market down as clearance rates ebb away.
- The housing investment market appears to be highly dependent on capital gains and tax effective negative gearing as aggregate rental income for all rental properties is some way off covering the net interest cost. Valuation risk is therefore high in our view.
- Household spending contains a degree of consumption of wealth along with income. As asset growth (housing and investments) looks tricky in the near term, households may choose not to spend all of their incremental income from higher wages and tax cuts. This may impact on GDP in 2011.
- The banking sector has benefitted from stable growing demand for mortgages but this has, in turn, held back their margin compared to more profitable business lending. As the cost of funding increases, the sector will be challenged to maintain margins from the already high allocation to housing versus the lack of supply to the business sector. This cautious view from the business sector is in part driven by the higher lending rates and reticence by the banks to extend credit at this time.

Investment conclusion

We believe the housing market is the key domestic risk for the Australia economy over the next few years. Prices are high on most metrics and partially dependent on buyers selling or leveraging existing assets to scale up to a new property. House prices are likely to prove sensitive to rising interest rates designed to cap inflation.

The best outcome, in our view, would be for housing prices to track sideways for some time. The lack of contribution to household wealth, along with the weakness in investment markets may impact on consumer confidence over the coming year. The offset is the rise in income from wages growth, employment and tax cuts. Overall this is expected to temper the otherwise positive outlook for domestic economic growth into 2011.

From an asset allocation perspective we encourage investors to diversify from housing investment. Historic capital gain should not be used to imply that further upside exists. The combination of growth equities and fixed interest assets offer investors liquidity and should be able to exceed the returns from property over time.

JBWere Investment Strategy

Giselle Roux
+61 3 9924 0404
giselle.roux@jbwere.com

Sally Campbell
+61 3 9924 0418
sally.campbell@jbwere.com

Laurie Conheady
+61 3 9679 1250
laurie.conheady@jbwere.com

Duncan Niven
+61 3 9679 1363
duncan.niven@jbwere.com

Yen Koh
+61 3 9679 1787
yen.koh@jbwere.com

James Martin
+61 3 9924 0274
james.martin@jbwere.com

Australian housing: economic impact and valuation

The key factors for the economic outlook and investment markets are:

- Housing valuations as a contributor to confidence and consumer spending
- The impact of housing investment on GDP
- Mortgage funding and mortgage rates as part of the financial market.

Comparative valuation across different countries does require consideration of individual circumstances, but the degree of valuation differential between Australia and other nations should not be lightly dismissed.

In defence of local prices economists cite:

- Urbanised population resulting in a high weight to city house prices
- Relatively high proportion of dual income households which can therefore take on higher risk accompanied with a recent history of solid employment rates
- Willingness of Australians to pay out a high proportion of income towards housing
- Contributions from families towards new home buyers
- Owner occupied housing rates are higher domestically than internationally
- Relatively modest service costs such as rates, state taxes etc, which inflate the costs of occupying homes in other nations
- Larger size of homes and cost of providing land
- Lack of housing supply against population growth

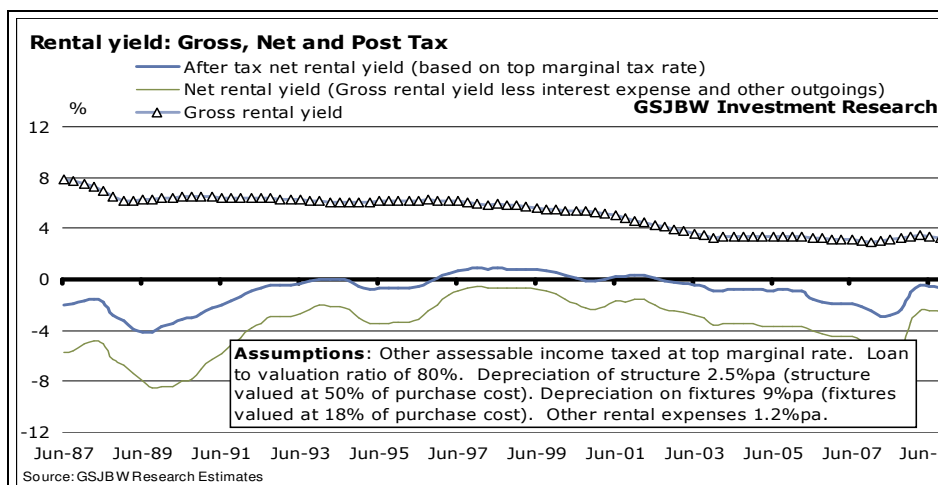
How can one measure whether house prices are elevated or not?

Economic metrics such as rental returns, affordability in terms of household's capability of servicing and repaying capital, multiples of disposable income provide a guide, but as with other assets the real value is difficult to estimate. In particular housing has unique characteristics that distinguish it from other assets the most obvious that is provides a lifestyle over and above its value.

The GSJBW economics team does derive a 'fair value' for Australian house prices based on rental returns and an econometric rental model. On these metrics Australian house prices are currently some 20-25% overvalued having risen strongly in the past year.

A global metric used to compare prices is the average value of a house as a multiple of household income. Australian house prices are high on this basis with median prices 4.2 times median disposable household income (\$380k/\$90k). However in the major cities the prices are around 5.5 times disposable income. This compares to 3 times for most other developed countries. To some extent these figures should be treated with caution as it depends on the average age and therefore income of the home buyer. Australians, due to the first home buyer grant, tend to buy homes at a young age when their incomes are lower than those with more working experience.

For investment housing there is a case for fundamental valuation. With tax advantages in investment property, buyers have been drawn to the rental market. Historic capital gains have in some circumstances been used to create portfolios. For the last available tax year (2007/8), the ATO reports that 1.73m Australians had investment property compared to 1.28m in 2000/1. In FY08 however, investors reported losses of \$8,628m from net rental (gross rental less interest payments less other deductions) compared to income of \$219m in FY01. Rental yields have not kept up with the interest payments and investors therefore are reliant on capital growth.

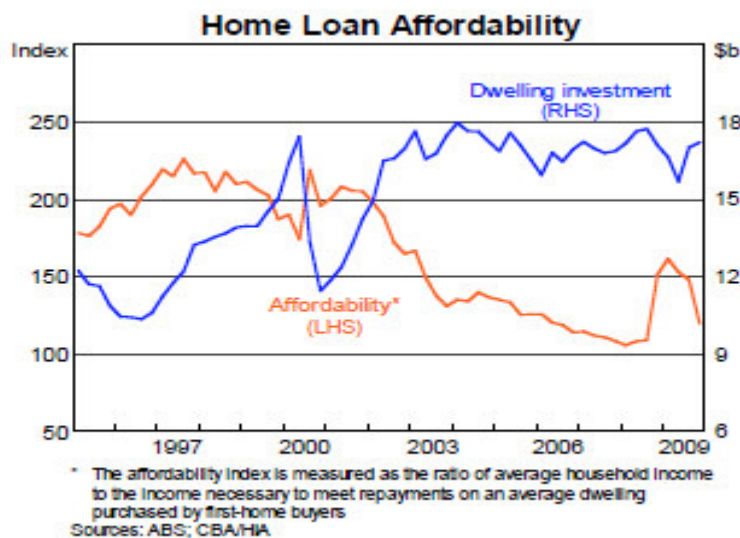


The key to this market will be rental demand versus supply of properties. Analysis of this market is complicated by regional differences and the nature of the demographic that rents.

To the extent buyers of housing units depend on capital gain, this may prove to be disappointing, but the serviceability of the liability remains sound. Unlike other countries experiences, as long as mortgage payments can be sustained, default should remain uncommon due to the recourse nature of our mortgage market.

The key risk therefore would be further significant increases in interest rates possibly due to higher than expected inflation. In the event of a deterioration in employment or incomes, one would expect the RBA to drop interest rates and dampen the outcome. We would therefore consider the risk of a meaningful fall in house prices to be low at this time.

Financial regulation and sustained low interest rates resulted in households taking on more leverage, but they can afford it.



Contribution to GDP

Housing investment is an important part of GDP. As an aside, many countries include some components of housing as part of consumption spending rather than investment, and we therefore caution against specific metric compared to other nations.

In the Australian accounts, housing investment has made a meaningful 5% contribution to GDP for some time. However instead of adding to housing stock a significant amount has gone into refurbishment and expansion of existing properties, increasing prices rather than supply of new affordable homes.

The impact of housing goes further than just investment. Rising house prices do contribute to consumer spending as households tend to spend part of their wealth not only their income flow. Unsurprisingly rising house prices tend to correlate with high consumer confidence.

GSJBW economic research estimates the marginal propensity to consume from income and assets. The table below shows that households spend 82% of incremental income for example. The propensity to consume wealth might appear low but must be seen in the context of total wealth.

Marginal Propensity to Consume (MPC)	
MPC out of income (ex transfers and income taxes)	82%
MPC out of welfare transfers	94%
MPC out of income tax cuts	73%
MPC out of housing wealth	5%
MPC out of financial wealth	10%
MPC out of total wealth	7%
MPC out of active MEW	22%
MPC out of real interest rates (25bpt cut)	21%

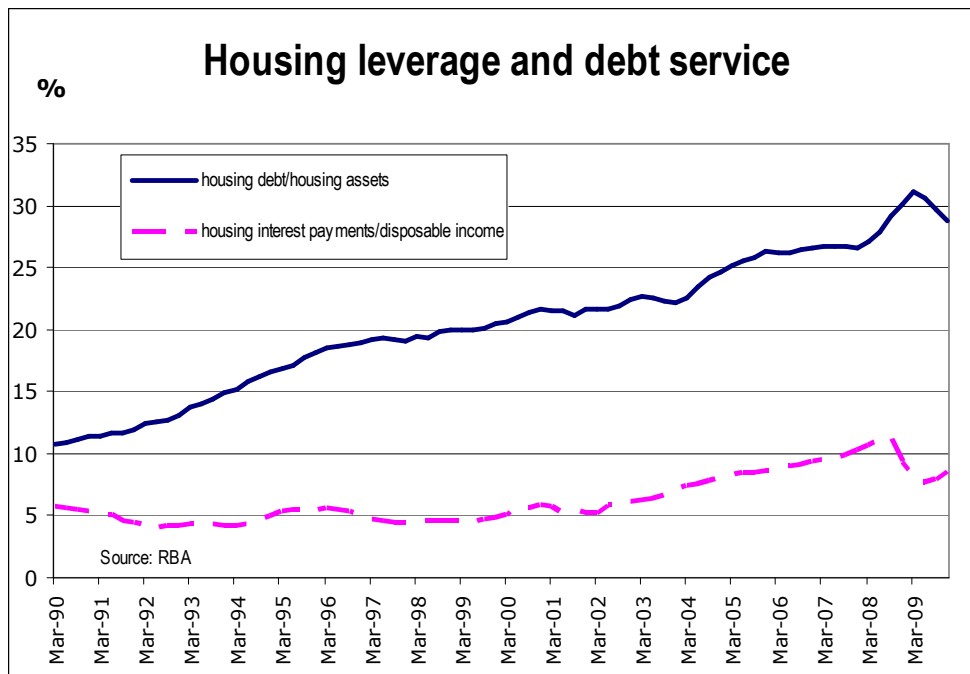
Source: GSJBW Research estimates

With the recent run up in house prices abating, the consumer is more reliant on income growth, which we expect to improve over the next 12 months due to wage increases and tax cuts. The risk is likely to lie with rising interest rates due to inflationary pressures that would further dampen the house price momentum and erode disposable income.

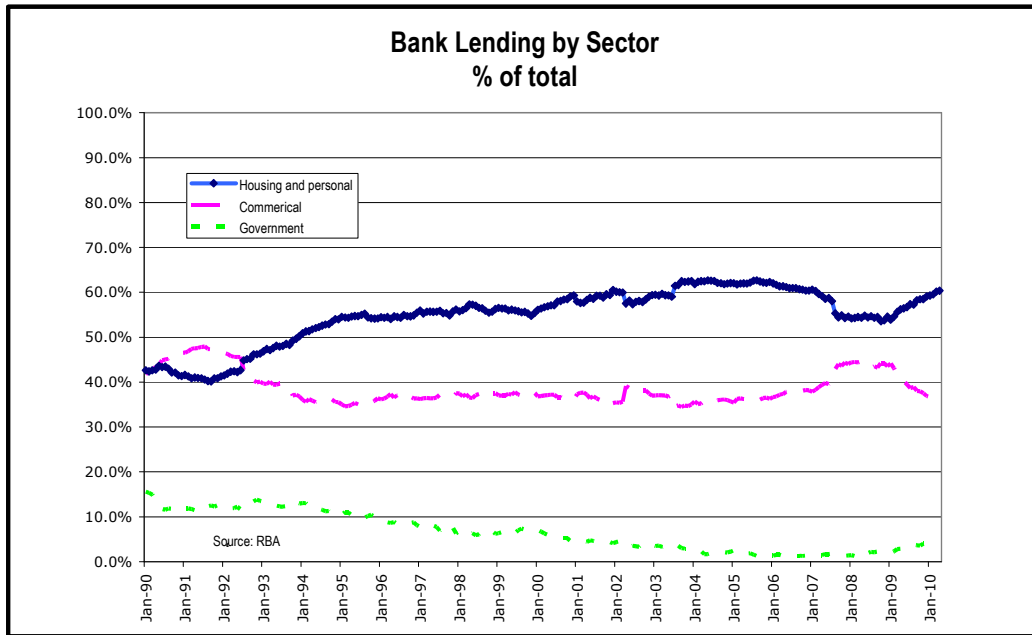
The financial sector and its impact on housing

A very important current consideration is the funding of bank mortgages.

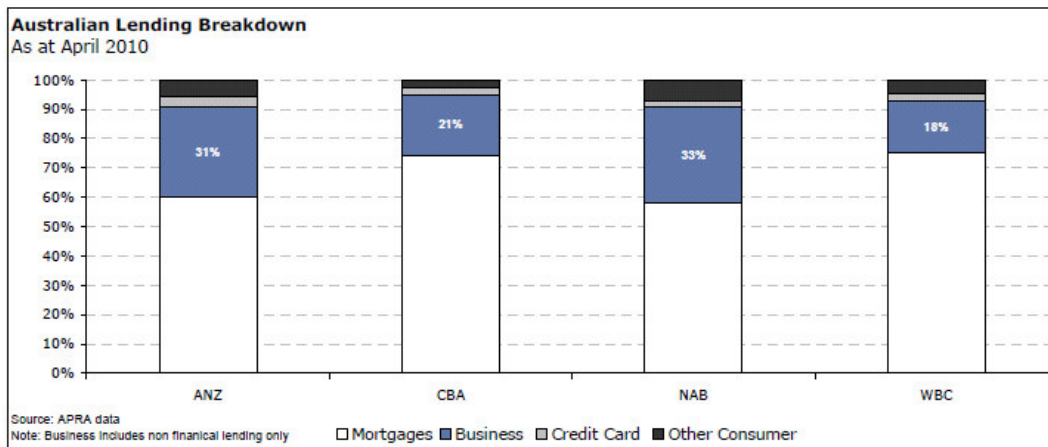
The chart below shows the long term rise in debt to housing values and highlights the interest burden has increased at a much more moderate pace. This reflects the stable interest rate climate, competition for mortgages that has allowed borrowers to manage their interest payments and the shift in debt to higher income households. It is difficult to envisage a continuation of such favourable trends.



For some time the pattern has been towards increased lending to housing as a proportion of the total bank sector's lending book. Banks have sought mortgage lending due to its very low default rate and the capacity for ancillary deposits and charges. Business lending grew sharply in the mid 2000's as credit became freely available while return on assets was high. However with the financial crisis that has quickly unwound.



Over the last two years, growth in lending to housing has tempered the fall in credit demand from businesses thereby sustaining headline growth for the banking system. But while that may have been welcomed, the risk is now that the mortgage market crowds out the business sector. Margins on mortgages are relatively thin and in order to protect their overall margin in the face of higher lending costs, banks have to increase their margin from the business book.



Housing is essentially a lifestyle asset and does little to economic growth longer term. Business credit has a much stronger multiplier effect and should add to productivity over time. From an economic point of view, we should therefore welcome a reduction in the proportion of lending to the housing sector if it leads to an increase in business lending. That is likely to align with moderating house prices.

Australia - Research Important Notice

Ownership and Material Conflicts of Interest

JBWere policy prohibits its research personnel and their respective associates owning listed securities which are the subject of their research.

Research personnel compensation

Research personnel are paid in part based on the profitability of JBWere. This report has been prepared by the JBWere Investment Strategy Group for distribution to clients of JBWere and potentially to clients of other financial advisers. This research is for clients only, as stated above and is based on current public information that we consider reliable, but we do not represent it is accurate or complete, and it should not be relied on as such. We seek to update our research as appropriate, but various regulations may prevent us from doing so. Other than some industry reports published on a periodic basis, the large majority of reports are published at irregular intervals as appropriate in the analyst's judgment.

General Disclosures

Our advisers and other professionals may provide oral or written market commentary or trading strategies to our clients and our proprietary trading desks that reflect opinions that are contrary to the opinions expressed in this research. They may make investment decisions that are inconsistent with the recommendations or views expressed in this research.

We and our officers, directors, and employees, excluding research personnel, may from time to time have long or short positions in, act as principal in, and buy or sell, the securities or derivatives (including options and warrants) thereof of covered companies referred to in this research.

This research is not an offer to sell or the solicitation of an offer to buy any security in any jurisdiction where such an offer or solicitation would be illegal. It does not constitute a personal recommendation or take into account the particular investment objectives, financial situations, or needs of individual clients. Clients should consider whether any advice or recommendation in this research is suitable for their particular circumstances and, if appropriate, seek professional advice, including tax advice. The price and value of the investments referred to in this research and the income from them may fluctuate. Past performance is not a guide to future performance, future returns are not guaranteed, and a loss of original capital may occur. Certain transactions, including those involving futures, options, and other derivatives, give rise to substantial risk and are not suitable for all investors.

In producing research reports, members of JBWere's Strategy Research may attend site visits and other meetings hosted by the issuers the subject of its research reports. In some instances the costs of such site visits or meetings may be met in part or in whole by the issuers concerned if JBWere considers it is appropriate and reasonable in the specific circumstances relating to the site visit or meeting.

Our research is disseminated primarily electronically, and, in some cases, in printed form. Electronic research is simultaneously available to all clients.

Goldman Sachs JBWere (GSJBW)

Certain excerpts contained in this document are sourced from the GSJBW research reports. This document has been prepared by its authors independently of GSJBW or a Goldman Sachs U.S. Group Entity (collectively, the 'Group') and the Group (and each member of the Group) takes no responsibility for its contents. The authors, the Company ISG Group, the Company and the Subsidiary have no authority whatsoever to give any information or make any representation or warranty on behalf of the Group or any director, officer, partner or employee of the Group or any other person in connection therewith. In particular, other than as indicated in the document, the opinions, estimates, and projections expressed in the report are entirely those of the author(s) hereof and are not given as an agent of the Group (or any member of the Group) or any other person in connection therewith.

Disclosures concerning GSJBW's research appear at <http://www.gsjbw.com/?p=Disclosures> Goldman Sachs U.S. makes important disclosures at <http://www2.goldmansachs.com/cgi-bin/disclosure.gscgi>

No part of this material may be (i) copied, photocopied or duplicated in any form by any means or (ii) redistributed without the prior written consent of JBWere.

JBWere Offices

Melbourne

Telephone (03) 9679 1111
Facsimile (03) 9679 1493

Adelaide

Telephone (08) 8407 1111
Facsimile (08) 8407 1112

Sydney

Telephone (02) 9321 8777
Facsimile (02) 9321 8621

Perth

Telephone (08) 9422 3333
Facsimile (08) 9422 3399

Brisbane

Telephone (07) 3258 1111
Facsimile (07) 3258 1112

Canberra

Telephone (02) 6218 2000
Facsimile (02) 6218 2001
