Housing

What's really going on?

Sydney home prices are, by some measures, in their worst slump since 1992 – of course, this comes after outsized gains.

Statistics for housing are among the least reliable of all measures.

Drivers

Over the long term, rental growth of residential property should be a function of ***wages less obsolescence***. The ability to pay should rise with real wages, but as properties age they become comparatively less desirable. Eventually, they require complete new fitout to remain viable on the rental market.

Of course, renovation boosts statistics on median rental and price, well before the owner has achieved any return.

If rents grow faster, this reflects a scarcity factor, and ultimately causes resentment as rental consumes a greater proportion of wages.

Cashflows should ultimately also determine prices.

Site Usage

But consider a district that becomes **rezoned** and redeveloped for high density use. Land prices would rise faster than inflation, representing the potential for higher use. There would appear to be a "bubble" as yields compress, and prices rise far beyond what is appropriate for the ability to generate rental.

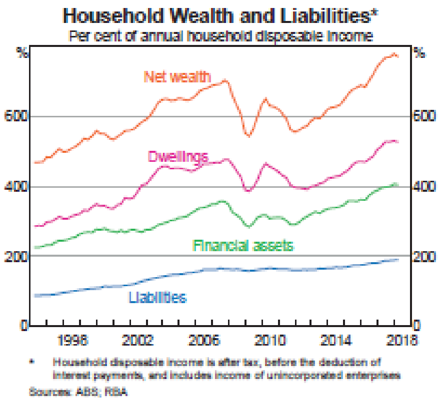
The development approvals sees the site price shoot up vertically. What might have once been 4 houses could now be a $40m site for a tower of 150 units. "*Average House Hits $10m!*" is statistically true, but says little about value – especially when the day after completion the headline reads "*Average Dwelling Price Down 93% to $700k!*"

While an extreme example, we caution readers to consider:

- The distortion to rising "median" prices in areas with heavy renovation activity – this isn't profit

- "*House sells for $millions*" headlines – it is almost certain that outlier prices reflect development sites.

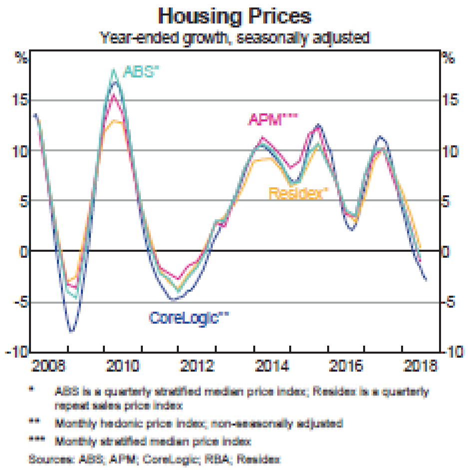
So what's really happening? Are Australians destroying wealth for generations by paying absurd bubble prices for homes? Or are they becoming extraordinarily wealthy from redevelopment of modest family homes?



There are people in both categories. Struggling family farms south of Liverpool are increasingly on motorway / rail / airport corridors, and delivering windfalls to patient owners.

At the other extremes, people are certainly paying prices that they will find it difficult to service – these are the people concerning bank analysts, and **increasingly being described as a systemic risk**.

At a national level, **we have never been wealthier**. Household assets have risen, faster than debts. Some of this is locked in; some rises and falls with market cycles. But the current state of balance sheets is **sound, <u>on average</u>.**

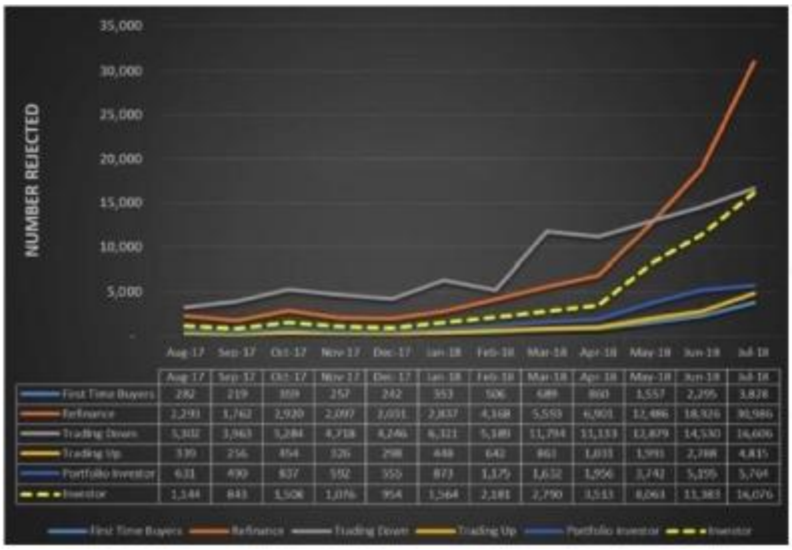


The cycle has clearly turned – property owners are no longer receiving growth of 5% in a quiet year / 12% in a good year. They cannot – not with wages growing below 3%. Visually, 5% is closer to the mark – and even that number is distorted upwards by renovation / replacement / rezoning.

Readers should be aware that **CoreLogic is not the only dataset**. Other indices show less pronounced falls (and therefore are ignored in media reporting, as not sensational enough).

Previous cycles **broke with high interest rates** – always. They were rescued by falling rates – indeed, the Lehman bankruptcy was fantastic for the Australian mortgage belts.

So, on the bright side **deep falls are not consistent with 30 years of history tying residential property to interest rates**. On the downside, there is **minimal scope for rate cuts to cushion the market from here**. If a disorderly crisis began, banks would report higher cost of capital and **absorb RBA cuts**.



What's different about an old story that we've all heard for at least 7 years?

Loan application rejections are spiking – particularly amongst refinancers. Some are shopping for a better deal. But others are genuinely in distress and <u>need</u> to avoid large step-ups as their interest only mortgages reset to P&I. **After 5 years, they have substantial profits, though.**

Leading Markets

Stocks plunged globally. VP Pence's speech escalated the US-China trade dispute ahead of a close US midterm election. Global indices typically dived 6-8%. The Dow Jones finished -5.0%, the S&P500 –6.8% and NASDAQ -9.2%. The MSCI World ex-AUS fell -5.4% in $A.

Similar falls in Emerging Markets (-8.7% in $US) followed double digit falls in Chinese, Korean, Latin American and South African indices. +7.4% in Qatar and a post-election +17.8% in Brazil were rare highlights.

US 10-year bonds reached a 7-year high before closing at 3.15% (+9bp).

Other Highlights

Jair Bolsonaro overcame the campaigning disadvantage of being stabbed (almost fatally) to easily win election. Markets cheered anti-corruption, pro-business liberalisation and privatisation aspects of his platform, amid controversial views.

After September's +25bp, Pres Trump criticised the Fed, prompting Congressional support for Chair Powell.

US GDP reached 3% YoY with a +3.5% p.a. Q3 estimate. CPI fell to 2.3% (-0.4%) in September. Unemployment fell to 6m (-0.8m YoY), a 49-year low rate of 3.7%, after an August revision to +270k offset hurricane-affected September nonfarm payrolls (+135k).

EU growth of +0.2% in Q3 saw YoY GDP at +1.7% - spooking markets. Unemployment was steady on headline (8.1%), youth (16.8%) and L/T (4.1%). The current account surplus hit a record +3.5% of GDP.

China reported +6.5% growth, despite some pressure on corporate earnings. Emerging market data has held up better than their markets.

The UK made further preparations for an EU departure if supply is interrupted.

Domestic

The ASX200 fell -6.1%, with Smallcaps diving -9.6%. Both price indices are marginally below a year earlier.

Australian 10-year bonds rallied despite negative offshore leads, with yields -4bp to 2.63%; the spread to US 10Y bonds exceeded 50bp.

The RBA kept the cash rate at 1.5% in October. Further falls in the headline CPI to 1.9% and trimmed mean to 1.8% gave them the time they wanted to stabilise residential property. New childcare subsidies contributed.

CoreLogic estimated home prices fell -0.5% in October to be -3.5% YoY, with Sydney -7.4% and Melbourne -4.7%. However, this is concentrated in top-end property, with the lowest quartile +0.5% YoY. Economists are routinely forecasting a 15-20% cyclical fall.

Male life expectancy reached 80 years in ALT2015-17, +1.5 over 2005-7. Life expectancy at 65 (19.7 years) is the longest in the world.

Building approvals (+3.3% in September) pared back YoY to -12.9%. Units are -21.9%.

Labour force participation fell -0.2%, reversing August and pushing headline unemployment to 5.0% despite just +5,600 jobs. That was a level the RBA expected to hit in a "*couple of years*."

Retail sales were +0.3%.

The trade surplus reached $3bn (+29%) in September.

Commodities and Currency

WTI oil slumped to $65/bbl (-11.2%) while Gold closed $1,212/oz (+2.5%) and Iron Ore rose to $74/t (+8.6%).

Base metals were mixed with Zinc and Tin experienced small gains but Copper, Aluminium and Nickel fell -1.7%, -3.3% and -6.8% respectively.

The $A finished at US70.5c (-2%).

KEY FINANCIAL MARKET DATA – AS AT 31ST OCTOBER 2018 (UNLESS SPECIFIED)

Interest Rate Markets

Index Performance	1 month	3 months	6 months	1 year	2 year p.a.	3 year p.a.	5 year p.a.
AustBond Bank Bill Index	0.17%	0.49%	1.01%	1.89%	1.83%	1.93%	2.18%

Key Rates	Oct-18	Sep-18	Aug-18
Australian Cash Rate	1.50%	1.50%	1.50%
90 day BBSW	1.91%	1.94%	1.95%
3 Yr Commonwealth Bonds	2.03%	2.08%	2.00%
10 Yr Commonwealth Bonds	2.63%	2.67%	2.52%
CDX North American 5 Yr CDS	68bp	60bp	60bp
iTraxx Europe 5 Yr CDS	74bp	68bp	68bp
iTraxx Australia 5 Yr CDS	82bp	75bp	73bp
US Fed Funds Rate	2.00%-2.25%	2.00%-2.25%	1.75%-2.00%
US 10 Yr Bond Rate	3.15%	3.05%	2.86%

Equity Markets

Domestic	1 month	3 months	6 months	1 year	2 year p.a.	3 year p.a.	5 year p.a.
S&P/ASX 200 Acc. Index	-6.05%	-5.92%	-0.42%	2.94%	9.34%	8.25%	6.02%
S&P/ASX Small Ord Acc. Index	-9.60%	-7.67%	-4.22%	2.59%	8.42%	10.54%	6.00%
A-REIT 200 Acc. Index	-3.11%	-2.25%	3.96%	7.27%	7.59%	7.08%	11.12%

International	1 month	3 months	6 months	1 year	2 year p.a.	3 year p.a.	5 year p.a.
US: S&P 500 ($US)	-6.94%	-3.71%	2.41%	5.30%	12.93%	9.25%	9.07%
US: NASDAQ ($US)	-9.20%	-4.77%	3.39%	8.59%	18.66%	13.07%	13.26%
MSCI World Acc. (Local Currency)	-6.80%	-4.87%	-0.30%	2.06%	11.45%	8.12%	8.46%
MSCI World Acc. (AUD)	-5.41%	-1.06%	4.20%	9.44%	15.47%	8.15%	13.18%
FTSE (£)	-5.09%	-8.01%	-5.08%	-4.87%	1.24%	3.87%	1.15%
MSCI Emerging Markets ($US)	-8.78%	-12.10%	-17.91%	-14.58%	2.77%	4.08%	-1.57%

Fixed Interest Markets

Bonds	1 month	3 months	6 months	1 year	2 year p.a.	3 year p.a.	5 year p.a.
BarCap Global Agg Acc. (AUD)	-0.23%	-0.32%	0.24%	0.19%	1.05%	2.91%	4.36%
AusBond Composite Bond Acc.	0.48%	0.87%	2.21%	3.09%	2.36%	2.92%	4.39%

Data*	Current Period		Previous Period	
Employment Data				
Employment Growth	Sep	56,000	Aug	44,000
Unemployment Rate	Sep	5.00%	Aug	5.30%
Participation Rate	Sep	65.40%	Aug	65.70%
Lending Finance				
Housing Finance	Aug	-2.70%	Jul	1.30%
Personal Finance	Aug	4.80%	Jul	-4.80%
Commercial Finance	Aug	-1.70%	Jul	0.20%
Lease Finance	Aug	-4.70%	Jul	1.90%
Other				
Balance on goods and services	Sep	3017m	Aug	2342m
Retail Sales	Sep	0.20%	Aug	0.30%
Building Approvals	Sep	3.30%	Aug	-9.40%

*All data is seasonally-adjusted.

Median Fund Manager Returns (Morningstar)	1 month	3 month	6 month	1 year	2 year p.a.	3 year p.a.	5 year p.a.
Australian Equity Large Cap	-8.05%	-8.16%	-2.52%	0.86%	8.79%	7.24%	5.07%
Australian Equity Small Cap	-8.09%	-6.52%	-2.45%	4.38%	6.67%	9.16%	7.89%
Global Equity Large Cap	-5.64%	-2.56%	0.74%	6.05%	13.53%	6.46%	11.42%
Global Equity Small Cap	-8.02%	-4.37%	-1.39%	1.78%	13.45%	6.79%	10.88%
Australian Fixed Income	0.40%	0.66%	1.76%	2.61%	1.98%	2.56%	3.73%
Global Fixed Income	-0.31%	-0.50%	-0.38%	-0.42%	0.73%	2.44%	3.95%
Australian Listed Property	-3.65%	-2.66%	2.98%	4.94%	6.22%	6.22%	9.71%
Australian Cash	0.13%	0.39%	0.77%	1.46%	1.46%	1.57%	1.85%
Conservative[1]	-0.82%	-0.57%	0.49%	1.63%	2.49%	2.53%	3.48%
Moderate[2]	-1.66%	-1.36%	0.25%	1.31%	3.24%	2.84%	4.04%
Balanced[3]	-2.87%	-2.38%	-0.14%	1.69%	5.17%	4.29%	5.19%
Growth[4]	-4.13%	-3.52%	-0.71%	1.77%	6.70%	4.94%	5.98%
Aggressive[5]	-5.50%	-4.25%	-0.96%	2.31%	8.74%	6.12%	7.33%

[1] Growth Assets 0% - 20%
[2] Growth Assets 21% - 40%
[3] Growth Assets 41% - 60%
[4] Growth Assets 61% - 80%
[5] Growth Assets 80%+

For any queries, please contact:

Name	Title	Phone	Email
Andrew Vallner	Managing Director	(02) 8246 8800	andrew.vallner@cpgadvisory.com.au
Vipul Gupta	Advisor – Fixed Interest	(0435) 756 721	vipul.gupta@cpgadvisory.com.au
Rick Lu	Senior Analyst	(0425) 567 022	rick.lu@cpgadvisory.com.au