Are the capital city markets out of reach?

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SMSF Adviser talks to AMP Capital's chief economist Shane Oliver who answers the 'million dollar question' – will prices ever level out in the Australian residential property market?

We've seen a huge run-up in prices in Sydney and Melbourne. Do you think we're ever going to see those drop to affordable levels for middle-income earners?

That's the million dollar question. Most measures show affordability is pretty poor but could improve in two ways. It could either occur because prices literally drop, 30 per cent fall, or alternatively it could occur through time where prices stagnate over many years and income levels catch up. Historically, that's the way in Australia that affordability has improved that after a big run-up, you go through a lengthy period of price fluctuations with incomes growing at a faster rate. That's probably my base case that it would work that way.

So we're not headed for a property crash?

It's hard to see the government or the Reserve Bank wanting to see prices fall 30 per cent because it would probably debilitate the economy in the first place and rather than 2 per cent wage growth, we'd end up with 0 per cent or something and unemployment would rise. The experience in the US and Europe which saw price falls through the GFC warn against that approach and at the moment there's no sign that that a crash is going to happen.

What factors are likely to mitigate one?

The RBA isn't going to raise rates precipitously when they do start raising them. Unemployment's not likely to go shooting higher and yes there's an increase in supply coming through but it's mainly apartments which could indeed fall in price. If you've got an apartment near a crane you probably will have to watch out for a few years but it's hard to see a generalised crash in prices occurring at the moment so I think the more likely scenario is that we get a lengthy period of range about prices. But I've got to be a bit cautious there because I was thinking that five years ago as well and what happened was that prices came down a little bit, there was a run-up in 2010 but then fell through around 2011 into 2012 and of course in the last four years they've taken off again. It certainly hasn't been range about.

In that case, is it fair to see we'll likely see prices level out?

My base case would be at some point in the next couple of years, prices will fall 5 to 10 per cent in Sydney and Melbourne. It probably will require a turn up in the RBA's interest rate cycle. I don't think the banks are enough to do that on their own. NAB and Westpac both did around 25 points the other day for investors, and 3 or 7 [per cent] for owner-occupiers but those figures are probably not

enough to cause a fall in prices. If official interest rates start to rise next year, then we might get 5 to 10 per cent decline.

It could be more where you've got a lot of apartments coming on but on average 5 to 10 per cent. Then if state governments are serious about improving the affordability issue, and particularly expanding supply on a fundamental basis, that should help keep house prices down in the years ahead which should in turn gradually help improve affordability.

What's your medium-term view of those cities?

As Sydney and Melbourne go through a softer patch, particularly as the Reserve Bank raises interest rates from 2018, the other cities will start to look healthier in a relative sense. Perth and Darwin will bottom out and start to see modest growth, and modest growth will continue in the other cities.

There is a risk that the longer this goes on in Sydney and Melbourne, the greater the downside at some point. On one hand, if that did occur, that would be good for owner-occupiers but it could be tearful if the downturn occurs because of a recession and an unwinding of house prices accentuates that recession. That won't be a good outcome for affordability because some people will lose their jobs.

In a way, the housing cycle helped the economy over the last few years because the mining boom has come to an end and other sectors have filled the gap, housing being one of those.

While the housing boom has reinvigorated Sydney and Melbourne economies, it's just that it has gone on for a bit too long, causing all sorts of worries about affordability and financial stability. Australia is losing its iconic status as a land of affordable housing where everyone lives on a one acre block and that's kind of sad in a long-term context but also carries a lot of risk with it.

Housing is like Australia's Achilles' heel. Either it's poorly affordable which is a big worry or at some point something goes wrong and prices come down too quickly, which I don't think will happen but that's where the risk lies and that's why the RBA wants to slow it down.

How have SMSFs and other groups driven demand in these markets?

My understanding is that the SMSF sector is playing a role but it's relatively small at around 5 per cent of the market. The two big groups, however, are owner-occupiers trading up and Australia-based investors getting into the market.

Are foreign buyers having a role?

It really depends on the area you're in. There are some stats showing between 10 and 15 per cent foreign buyer participation but that would be more like 20-25 per cent probably in a suburb like Chatswood, while in the outer lying suburbs of Sydney it's probably close to zero.

Outside of Sydney and Melbourne, how are the other capital cities priced?

There's Sydney and Melbourne and then there's the rest, in a way. Most Australian cities are still expensive by global standards. Sydney and Melbourne are up around double digits in terms of house prices to income ratio, I think Sydney was at around 12 times. The other cities are still relatively expensive but a lot more affordable compared to Sydney in terms of price to income. This is why it's so difficult for the RBA.

In a normal environment where all cities are strong, the economy is strong, but that's not the case in Australia currently. We have a big divergence going on in the Australian property markets. Perth and Darwin are going backwards, reflecting the end of the mining boom. Perth prices are back to where they were in 2007 and Darwin back to 2009. In between those big mining centres and Sydney and Melbourne, you have these other cities which have been seeing relatively moderate growth, ranging from around 3 per cent in Adelaide to the most recent number in Hobart being 8 or 9.

With regard to affordability in an Australia-wide sense, you're probably better off focusing on these other cities. Perth will probably see prices bottom out this year as the mining slump comes to an end, same story in Darwin. Some might say those cities are pretty risky, but you can still have a look at Brisbane or Adelaide or Hobart which have lagged behind Sydney and Melbourne, and affordability is much healthier and rental yields are much higher as well.