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CIO MONTHLY / NOVEMBER 2018

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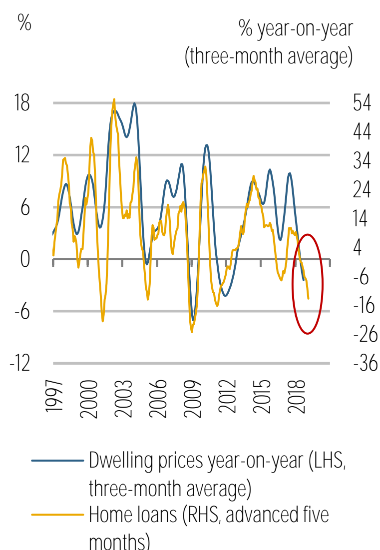
The risk of a more severe downturn in Australian housing and a broader impact on asset markets bears watching over the coming few months

Housing price and loan growth weakness has accelerated



Source: CoreLogic, ABS, UBS

Can Australia weather a housing downturn?

October has proved to be a difficult month for risk assets. Global equities have fallen by over 9% led by the US (-9%) and Europe (-7%), with US technology particularly bearing the brunt of the weakness (-12%). This follows our decision to trim risk last month, cutting our overweight to US equities and moving modestly underweight equities. At the same time, our decision to edge overweight emerging market equities has so far proved premature (down 10%), a risk we flagged, though we continue to favour accumulating positions here as we believe long-term value has emerged.

Unhedged, the fall in global equities is a modestly less significant 7% in Australian dollars. Returns for defensive government bonds have been flat (-0.5%), as US 10-year yields have rallied from a high of 3.23% to 3.12%, while alternative assets are expected to have contributed positively to portfolios.

Where to from here? We viewed the correction in risk markets at the start of this year as a buying opportunity. The typical signals that the global growth cycle was about to end were simply not present. Markets recovered, and risk performed well until the US most recently escalated its trade war with China. With the US Federal Reserve (Fed) threatening to lift interest rates into restrictive territory, and tensions rising in Europe due to another failed Brexit summit and the new Italian government's breach of fiscal rules, this has become a wall of worry too great for risk markets to scale over recent weeks.

Since 1928, US equities have suffered a 5% pullback once every 71 trading days. The drawdown in late October was unfolding 69 trading days since the previous one. It is not unusual for rising markets to experience one or two 10% corrections each year without succumbing to a bear market.

So, is this a buying opportunity? It is true that end-of-cycle macro signals remain scarce. Earnings growth is still strong and valuations following the recent price weakness are also near or below long-run averages. However, global growth is not as robust or synchronised as it was at the start of this year, monetary policy is moving tighter and there are more signs inflation pressures are rising. While we remain cautiously engaged with risk, there are key developments near term that should aid assessments of the outlook. US mid-term elections may influence US-China trade talks; the Fed may step back if growth worries build; it is also likely Brexit and Italian budget worries will drift off the radar over coming weeks.

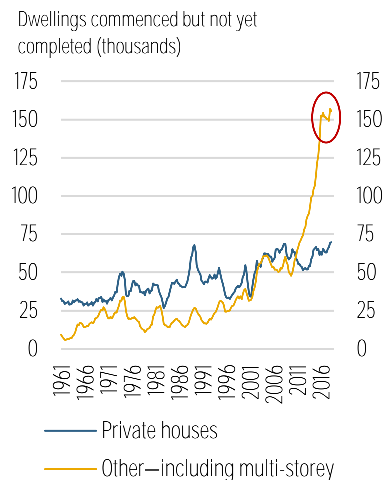
Housing will almost certainly drag on Australia's outlook

Turning to Australia, there seems little doubt that housing will drag on the growth outlook through 2019. Indeed, growth in home lending and building activity has historically been the 'tail that wags the dog' as far as Australia's growth cycle (and sentiment) is concerned.

Yet, much debate rages over whether the unfolding correction in housing is a more familiar periodic headwind to year-ahead growth—or critically, whether it will drive a more sinister (potentially systemic) credit crunch that brings the economy to its knees. Will we see household wealth, housing prices and housing activity correct to multi-decade lows in the year ahead?

This month, we canvas both the 'sanguine' and more 'bearish' viewpoints on Australia's residential outlook. For the record, we see housing as a potentially long-lived headwind that will constrain Australia's growth to no more than trend

Construction in multi-storey apartments looks set to fall

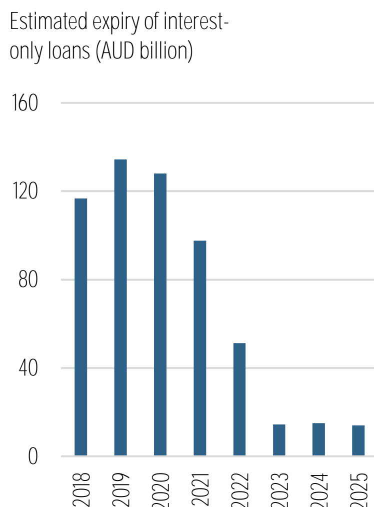


Source: Crestone, ABS.

“We've become even more bearish on housing, and now expect prices to drop 10% peak-to-trough by 2020, skewed to Sydney & Melbourne down ~15%”

UBS, OCTOBER 2018

Expiry of interest-only loans is set to rise in 2019



Source: RBA, UBS, Crestone

over the coming couple of years. Housing asset values may end up as much as 10% lower (having risen 40% over the preceding five years), driving only a cautious Reserve Bank of Australia (RBA) rate hiking cycle ahead.

However, with lending and house price data more recently accelerating to the downside (see chart on previous page), the risk of a more severe downturn and a broader impact on asset markets bears watching over the coming months.

Factors supporting the more ‘bearish’ housing outlook

Under the more bearish housing scenario, prices are forecast to fall by 20% from their peak—they are down less than 4% to date. This is accompanied by a 20-30% fall in new loan growth, a collapse in credit growth to zero, and a significant retracement in household wealth that weighs on the broader economy, potentially tipping the economy into recession.

Housing valuations are expensive and debt levels are high—Prices have risen over recent years to more than six times annual income, well above global comparisons. Australian consumer debt levels have also risen to be among the highest in the world. With the share of income going to mortgage repayments already above average, despite record low interest rates, housing is vulnerable to even a modest rise in interest rates.

Lending standards deteriorated, interest-only loans ballooned—Over the past five years, interest only (IO) loans amounted to AUD 650 billion, 40% of the total. The regulator has now limited this to 30% but it has dropped to 15%. Now around AUD 120 billion of IO loans will revert to principal and interest (PI) each year until 2021 (see chart), with repayments jumping 30-50%. This will limit prospects for price gains and many mortgagors may be tempted to sell. More than half of housing investors own more than one property and more than 60% are negatively geared, which means they are making a loss.

Regulatory pressure will severely constrain credit availability—In the wake of the Hayne banking royal commission, regulators will take a more rigorous interpretation of responsible lending requirements. According to UBS, the inability of lenders to rely on ‘poverty’ level expenditure benchmarks will lower borrowing capacity by as much as 30%. The weakening of the housing cycle has not been driven by higher RBA cash rates (denting demand) but largely reflects reduced credit supply (which will persist).

The RBA is unable to reflate the housing market—According to UBS, “whenever housing weakened, the RBA were willing and able to ease policy to reflate the market”, often lowering mortgage rates by 200-400 basis points (bps). This boosted affordability and increased demand. Faster lending then encouraged residential prices to rise. In this cycle, official interest rates are already at record lows and unlikely to fall further.

Foreign demand has weakened sharply—Demand from foreigners, particularly Chinese nationals, has dropped sharply due to increased costs (foreigners’ taxes) and more limited access. According to UBS, Foreign Investment Review Board data show a 65% collapse in applications in 2016/17, their lowest level since 2012/13 (led by NSW and Victoria).

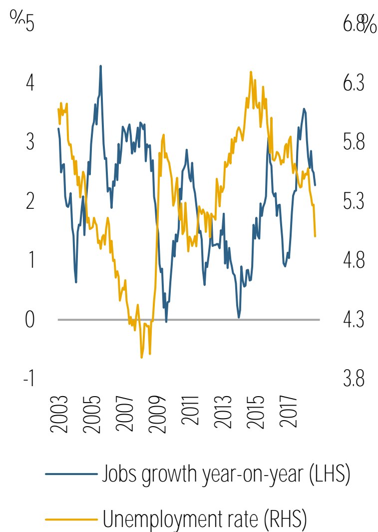
Potential change to tax attractiveness—The opposition Australian Labor Party is currently ahead in voting polls and is threatening to curtail negative gearing from all property to just new building, as well as halve the 50% capital gains tax offset on all assets. In the past, the removal of negative gearing has been associated with a sharp drop in the housing market.

New building activity is currently in cyclical over-supply—While there is potentially a structural under-supply over the longer term, the flow of new residential homes (particularly multi-storey apartments as seen in the chart opposite) is more than can be absorbed in the near term.

Factors supporting a relatively ‘sanguine’ housing outlook

Under a more sanguine housing scenario, prices fall by up to 10% from their peak, broadly in line with prior cycles. While lending drops 20% (from -14% to date), this is also a familiar cyclical event. Nonetheless, this further slows housing credit growth to around 3-4%, a record low. Negative wealth impacts and slower construction activity are a significant headwind to economy-wide growth but do not deliver a systemic or recessionary event.

A strong jobs market should support the housing sector



Source: ABS, Crestone.

Housing debt is being carried by those most able to afford it—Australia has not been unique in seeing debt-to-income ratios rise significantly, and debt is not as high when buffers in mortgage offset accounts are considered. Moreover, according to the Australian Bureau of Statistics (ABS), around 40% of household debt is held by the top 20% of the income distribution. This share has remained fairly steady for the past 20 years.

The regulator has been tightening lending standards for several years—Focus from the regulator has led banks to already improve underwriting standards, requiring more disclosure and limiting higher risk lending. According to the RBA, lending at high loan-to-valuation ratios has declined as a share of total loans, providing protection against a decline in house prices for both banks and households.

Borrowers don't typically use their full borrowing limits—While loan limits are likely to fall sharply, borrowers do not typically borrow the maximum amount. According to RBA analysis, the impact will be primarily on the riskiest borrowers, and "this is a very small group. Most borrowers will still be able to take out the same sized loan".

Households are well ahead of their mortgage payments—The latest RBA *Financial Stability Review* (October 2018) shows households have made mortgage prepayments equivalent to nearly three years of repayments. Of course, this refers to the average rather than marginal borrower. House prices have risen 40% over the past five years providing a significant equity buffer for most households.

The transition from IO to PI loans has been occurring without stress—Borrowers have been moving from IO to PI loans for the past couple of years without signs of widespread stress. According to RBA analysis, "most borrowers will either be able to meet these higher repayments, refinance their loans with a new lender, or extend their interest-only terms for long enough to enable them to resolve their situation."

Non-major lenders are offsetting some of the credit tightening— Lending from non-major banks and non-banks has risen significantly over the past year supporting credit availability. According to ANZ research, non-bank loans to owner-occupiers have risen 17% in the year to August.

The economy is strong, unemployment is falling—Despite rising interest servicing costs and reduced credit availability, a crisis is likely to require a significant rise in unemployment. An inability to service owner-occupier rather than investor loans will likely need significant forced selling. Unemployment in September fell to 5.0%, a six-year low, while leading indicators of job demand for the year ahead remain strong. Immigration also continues to support population growth and housing demand.

"Lending standards have improved over the past few years...

...resulting in an improvement in the average quality of both banks' and households' balance sheets"

MICHELLE BULLOCK
ASSISTANT GOVERNOR, RBA
SEPTEMBER 2018

Housing remains a key risk to Australia's outlook

We remain tactically underweight domestic equities for a range of reasons, including the risk to domestic growth from a significant slowing in housing. The RBA is also unlikely to be under pressure to move away from a record low interest rate setting given inflation and wage growth remains benign. For now, this should maintain downward pressure on the Australian dollar, particularly if recent gains in commodity prices are somewhat reversed and China's growth comes under further downward pressure as we enter 2019.

The housing outlook warrants significant caution. The high level of household debt remains a vulnerability, particularly in the event of an adverse shock to the economy and the potential for loan defaults and weaker consumer spending to feed back into weak activity. There is some risk that even the most diligent economy-wide analysis still obscures some vulnerabilities across certain types of households, only to be revealed under more stressful conditions. The unfolding transition of a significant cohort of borrowers from IO to PI loans also bears watching in the year ahead.

However, Australian banks have substantially strengthened their capital positions over the past decade. Lending standards have been more strictly applied over recent years (albeit further tightening is anticipated), and loans for high loan-to-value ratios have been reduced. Mortgage arrears, while edging higher, are very low. With the outlook for the jobs market firm and no anticipated sharp rise in unemployment on the horizon, it seems more likely that weakening housing activity will remain a persistent headwind on growth over the coming year or so—with lower house prices and slowing loan growth—rather than developing into a systemic or recession-like event.

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