Housing Affordability in Australia

Data released early in 2014 highlighted that the average Australian house price had risen by 10% in 2013, and by closer to 15% in Sydney. With results like that, expect the debate about housing affordability to hot up as 2014 unfolds.

Indeed with First Home Buyers accounting for the lowest level of overall demand in many years, there are many now talking about the fact that housing may represent an intergenerational equity issue, with calls to scrap negative gearing and the like.

What is hard to dispute is that the current climate of low interest rates and constricted supply provide the perfect environment for investors, whilst younger Australians, who are facing lower rates of income growth, higher levels of unemployment and a more uncertain job market in general are effectively being priced out of the market, finding it impossible to save a deposit in the first place, let alone service a mortgage.

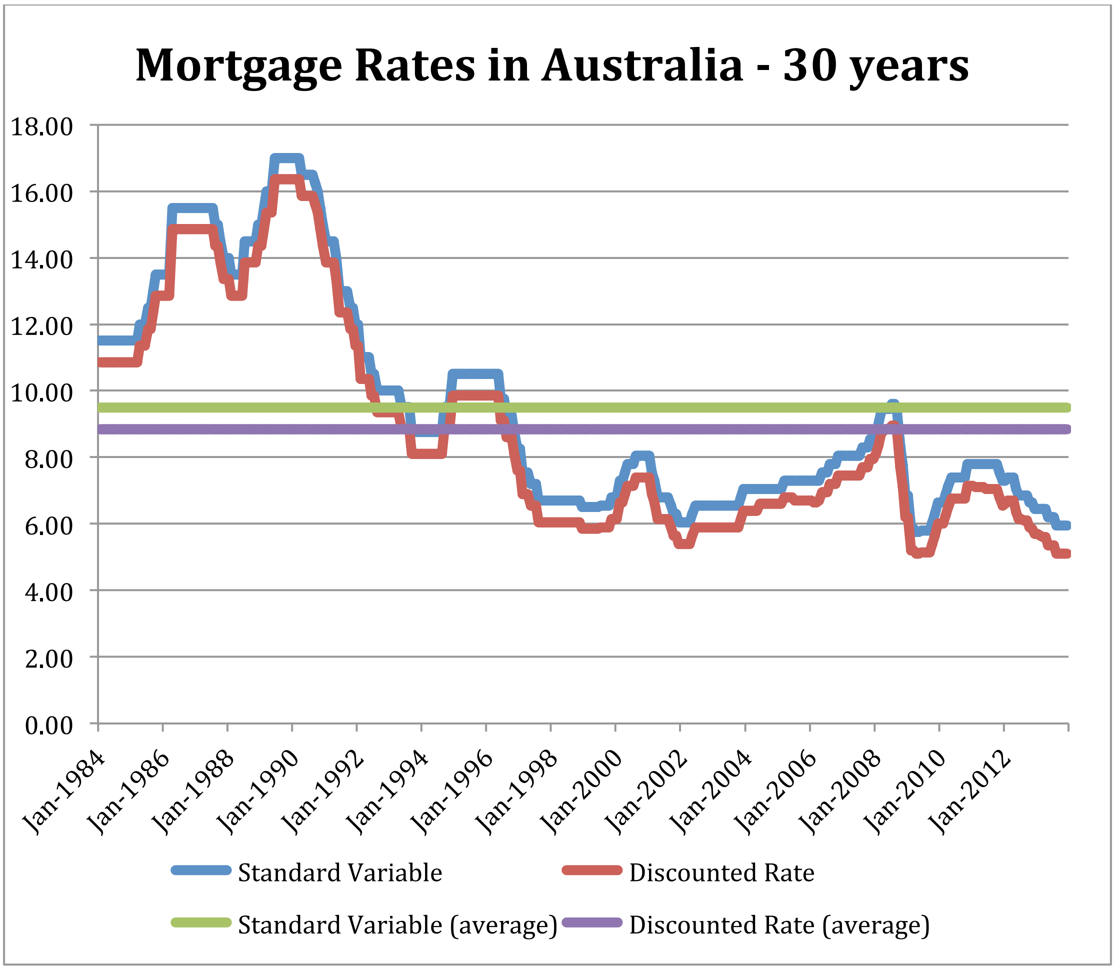
Despite this, there are many that claim that housing 'has never been more affordable', pointing to record low interest rates which imply that servicing a mortgage is easy.

Whilst it's impossible to argue with the fact that lower rates improve mortgage serviceability, it's a mistake to just look at today's interest rates, as mortgages are typically taken out for 25-30 years.

With that in mind, let's look at how affordable housing really is, using 30 years on interest rate data from the Reserve Bank of Australia (codes FILRHLBVS and FILRHLBVD), starting in January 1984 and ending in December 2013.

The following graph shows the monthly changes in the standard variable home lending rate, as well as the discounted rate. Note that the discounted rate has only been published since June 2004 by the looks of things, but since then, the average gap between it and the standard variable rate has been 0.65%.

With that in mind, we've used an average gap of 0.65% all the way back to 1984 as a way of estimating a discounted rate over the entire 30 year time period.



As is evident from the above chart, after spiking in the late 1980's, interest rates have been in a downward trend for over two decades, helping facilitate the huge explosion in private sector debt and subsequent increase in Australian housing prices across this period.

The following table below summarises some of the major data points that are highlighted in the above chart

Interest Rate	Current	30 year Average	Lowest	Highest
Standard Variable Rate	5.95%	9.49%	5.75%	17.00%
Discounted Variable Rate	5.10%	8.84%	5.10%	16.35%

As you can see, whilst the Standard Variable Rate has been lower by 0.20% in the past (ever so briefly in 2009), we are near record lows on that front, and we are at a record low of 5.10% for the discounted variable rate. Loans are cheap today!

What's also clear from the table is that there is considerable upside in potential borrowing costs from here, even if interest rates don't overshoot to the upside like they have in the past, which would involve a near tripling from here if looking at the standard variable rate alone.

Indeed, a normalisation of rates would see borrowing costs rise by 60-75% depending on which metric we are referring too, adding 3.54% to 3.74% to the annual costs of a mortgage.

This is important for anyone looking to buy a house today, as whilst current low rates might make the idea of purchasing a home attractive, the reality is that in all likelihood a home loan will have a term of circa 30 years, so this kind of volatility (and higher average cost) should be factored in.

<u>What does this mean to an everyday Australian?</u>

In terms of what this means to an everyday Australian, lets consider say a newlywed couple (Scott and Charlene?) earning the median Australian wage wanting to buy the median Australian home.

According to an article In January of last year (which used ABS data), the median weekly total cash earnings for all full time employees was $65,000 pear year. Admittedly, this was using May 2012 data, so lets be generous and assume a near 10% pay rise for both Scott and Charlene, so that they're now earning $70,000 a year each.

According to the online tax calculator, they're both up for a total of $14,297 in taxes and a $1,050 Medicare levy, meaning they'll each pay a total tax bill of $15,347.

After taxes and Medicare, Scott and Charlene have $109,306 combined to spend each year.

According to RP Data, the capital city aggregate for the median Australian home is now $540,000, equivalent to just shy of 5 times Scott and Charlene's post tax wages.

But before we look at how sensitive they are to rates, and how affordable housing is, we should also work out what they might spend in day-to-day life too.

Standard 'lifestyle' bills, like a mobile phone, private health cover, a train or bus ticket, and maybe a gym membership will probably set each of them back $100 a week. There goes $10,400 per annum.

The electricity, water, and gas bills, plus council rates are probably another $100 a week in total, costing another $5,200 per annum.

Let's say they try to limit their social life to $200 of recreational spending per week each, plus $200 at the supermarket per week, and there goes another $31,200

They also have one child, and as they are a middle-income family, that sets them back $458 a week (or just shy of $24k a year), a cost that has jumped more than 50% since 2007.

Finally, let's assume that once a year they like to get away for a holiday and that costs $5,000 too.

Add all those expenses together and you get to $75,616 in total spending, meaning that their total post tax, post-spending pool of money which can be directed toward a mortgage is $33,690

Lets now take a look at how much an **interest-only loan** will cost them today, using the current discounted standard variable mortgage rates.

I've done two calculations, one assuming that they have to borrow 80% of the value of the property, and one assuming they've only saved a 10% deposit, ignoring lenders mortgage insurance which you need if you borrow more than 80% of the properties value.

The table below summaries the findings!

Mortgage as % of home value	Total amount Borrowed	Borrowing rate (discounted)	Interest only mortgage payment	Residual leftover from income
80% of home value	$432,000	5.10%	$22,032	$11,658
90% of home value	$486,000	5.10%	$24,786	$8,904

As you can see, without even reducing the principal amount they owe on their property, Scott and Charlene will pay between $22,032 and $24,786 a year to 'rent the house' from the bank, in all likelihood leaving only between $9,000 - $12,000 in leftover cash each year.

But if rates normalise to their long-term averages, then the situation is going to get substantially worse, as the next table makes painfully clear.

Mortgage as % of home value	Total amount Borrowed	Borrowing rate (discounted)	Interest only mortgage payment	Residual leftover from income
80% of home value	$432,000	8.84%	$38,189	$-4,499
90% of home value	$486,000	8.84%	$42,962	$-9,272

As you can see, if interest rates went back to their long term averages, then even assuming they were on an interest only loan, and assuming they had only borrowed 80% of the value of the home, they'd have an annual shortfall of somewhere around $4,500.

A higher loan amount would only exacerbate the imbalance, and could see them as much as $9,272 a year short, meaning they'd have to severely tighten their belts elsewhere, or more likely, simply sell the house (possibly at a loss as higher rates will in all likelihood stop the current rate of house price growth) and move back into some kind of rental accommodation.

I think it's fair to say that neither of these are ideal outcomes, and have a range of negative flow through effects on the rest of the economy.

Summary

The bottom line is that housing in Australia is not at all cheap today, and affordability only 'looks good' through the very narrow, and I would say dangerous prism of today's unsustainably low interest rates.

And whilst we can't be sure over the next 30 years that interest rates will display the same volatility and average the same amount they have in the past (many would argue the RBA won't let it happen) none of us can be 100% sure either way.

What's more, we all know that markets move in cycles, indicating that the next major, multi decade move in interest rates in all likelihood will be up.

It is highly unlikely rates will stay low forever, that's for certain

With that in mind, all Australians should be cautious about housing entering 2014 and beyond. First Home Buyers and younger Australians in particular are unsurprisingly finding it harder and harder to get on the property ladder as it stands, and are taking an enormous risk in doing so, especially as potentially higher rates in the future will both reduce mortgage serviceability and potentially lead to capital losses on the value of their home.

Considering that today, an Australian couple could rent the median house for less than or roughly equal to what it would cost them for the interest only payment on the mortgage, even with rates this low, it's no wonder more and more Australians are making that choice.

Warm Regards
Jordan Eliseo

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