"No property bubble" case lacks substance

Dominic McCormick | Select Asset Management | 11 June 2015

Last week, new Australian Treasury secretary John Fraser stated that "it's unequivocal that property in Sydney and parts of Melbourne are in a bubble" driven by "perceptions of a never-ending increase in housing prices". This week Reserve Bank of Australia Governor, Glenn Stephens, called some of the Sydney market "crazy". These are unusual comments for people so prominent in public policy who are usually guarded on such issues.

These comments and remarks of various politicians have generated a storm of media coverage, much of it focused on playing down the possibility of a property bubble. However, what strikes me is how feeble or poorly thought out many of the arguments downplaying a property bubble are.

A key lesson of my 30 years in finance is to never be unequivocal about anything when it comes to the vagaries of markets and investments. Still, we need to develop views after properly weighing up robust arguments on both sides of an issue.

If the "no bubble" camp is to gain credibility against some of the most important, well researched, resourced and respected economic policy makers in the country, they need to develop much stronger arguments than many that have been trotted out recently.

Let's have a look at these:

1. **There has been no major pick-up in loan arrears** – In a June 6 article in *The Australian* titled "Don't confuse price rise with bubble, say property analysts", insolvency expert Peter Barnes said there was no proeprty bubble because "we would expect there to be an increase in (insolvency) work if there was a bubble". Wouldn't the insolvency work come as and after the bubble has burst? For a possible prelude, he could look at what's going on in some of the mining towns like Karratha where loan arrears are definitely growing and prices are off by as much as 50%.

2. **It is only Sydney and Melbourne** – There are two problems with this argument. First, it's not really true. Prices are rising in some other capital cities (e.g. Brisbane and Adelaide) and in plenty of regional areas. Secondly, even if it was just the greater Sydney and Melbourne areas, that's more than one third of the Australian population which is no small issue for the Australian economy.

3. **People have been wrong for years** – In the same *Australian* article referred to above, John Symond was quoted saying there was no property bubble because "people have been talking about a bubble for the last two years. To date, everyone has been wrong". The fact that a bubble goes on longer than expected does not mean it is not

a bubble. In fact, going well beyond many people's expectations is an inherent and necessary element of a bubble.

4. **Prices are growing more slowly compared to 80s, 90s or early 2000s** – Sydney property prices have risen around 40% in the last three years, which is below the gains in some earlier periods of strong price rises. There are several problems with this argument. Firstly, inflation was higher in many of these previous periods, so you would expect price gains to be higher. But secondly – and more importantly – if prices never fully corrected from an earlier level of overvaluation, the fact that they are growing more slowly from that higher plateau in no way means there is no bubble. I think this is the key problem with many arguments that focus only on the last few years of housing price growth. They neglect the fact that the housing boom has actually been a multi-decade phenomenon, coupled with an explosion of household debt through that period.

5. **Sydney housing is affordable. All you need is to get a good job that pays good money** – This from Joe Hockey. It is true that home affordability measures (based on the percentage of household income needed to pay a mortgage on a median-priced home) have been lower in the past. However, when a key driver of this comparison – mortgage interest rates – are currently at their lowest level in history (compared to periods like the late 80s when they were at their highest), it is dangerous to simplistically compare affordability. Indeed, it is somewhat alarming that even with these record low interest rates, Sydney is close to previous levels of low affordability excluding the late 80s and early 90s.

6. **Sydney housing is affordable because people are buying it** – This other comment from Joe Hockey shows a lack of understanding of how markets work and how bubbles in housing can develop. If taken literally, it would suggest that irrational bubbles can never occur because even at the absolute top, before a collapse, there are always some people buying. People are buying property at these prices because interest rates are extremely low, lending policies are loose, investors are optimistic about property prices and perceive little downside risk, and home buyers feel no choice but to get in now, if they can. All of these points are potential elements of a bubble. Moreover, prospective home owners – the focus of the affordability issue – are being crowded out by investors.

7. **It's all due to lack of supply and the so-called "housing deficit"** – While there has been slow growth in the supply of dwellings in the last decade in Sydney in particular, longer term data suggests that housing supply has generally kept pace with population growth. Refer 16 April "Housing shortage not as certain as we think" on the ABC News website. In any case, we are now seeing a strong supply response in Sydney which should offset this price effect over time, suggesting a rush to buy now for this reason alone is misguided. This so-called supply shortfall has been somewhat sensationalised by the Property Council of Australia, which estimated

earlier this year the annual "housing deficit shortfall" at 190,000 dwellings for Sydney. I've always struggled with this concept. Where are the people waiting for these homes? Living on the streets? On their friends couches? Holed away at airport hotels waiting for their homes to be built? If this degree of shortfall really existed, wouldn't rental vacancies be at record lows and annual rents rising in double digits? Neither is happening in Sydney, currently.

While it is hard to be unequivocal about anything to do with markets and investments, this particularly applies to property where discussions can become emotional and heavily driven by vested interests. The last prominent person to be unequivocal about Sydney property definitely being in a bubble due to bust was economist Steve Keen in 2008 (who, having lost a very public bet on the issue, now lives overseas).

Perhaps the onus is on those calling a property bubble to prove it, although clearly defining and proving a bubble in the middle of one is no easy task. Arguably, if this is a bubble, it is a multi-decade one joined at the hip with a multi-decade bubble in household debt. However, only once it has burst and in hindsight will we be able to identify it clearly as such. But the fact that it hasn't burst yet certainly doesn't rule out it being a bubble, despite the claims of some.

If it is a bubble, the obvious catalysts for it to burst are sharp increases in interest rates or unemployment. But these are not the only possibilities. The property supply response is occurring. Banks may further tighten lending arrangements ether voluntarily or in response to APRA or government direction. Taxation arrangements and incentives might change. Foreign support could dry up, spooked by greater scrutiny and restrictions, or in response to a serious economic slowdown in China. Geopolitical or local events could change investors' perception of the risk of property (and possibly all investments) and the current desperate urgency to buy could fade.

In the meantime, the case against a Sydney residential property bubble needs some work. Joe Hockey stated several weeks ago that those suggesting there was a housing bubble were conducting lazy analysis. Arguably however, the lazy analysis is from those rolling out simplistic reasons and platitudes to dismiss a bubble, including Hockey himself.

Dominic McCormick is Chief Investment Officer of Select Investment Partners. Dominic has worked in investment management and financial services for 30 years and co-founded Select Asset Management in 2002. He has overall responsibility for investment strategy and research for Select's range of multi-asset, multi-manager portfolios, investing across the spectrum of traditional and alternative investments

---