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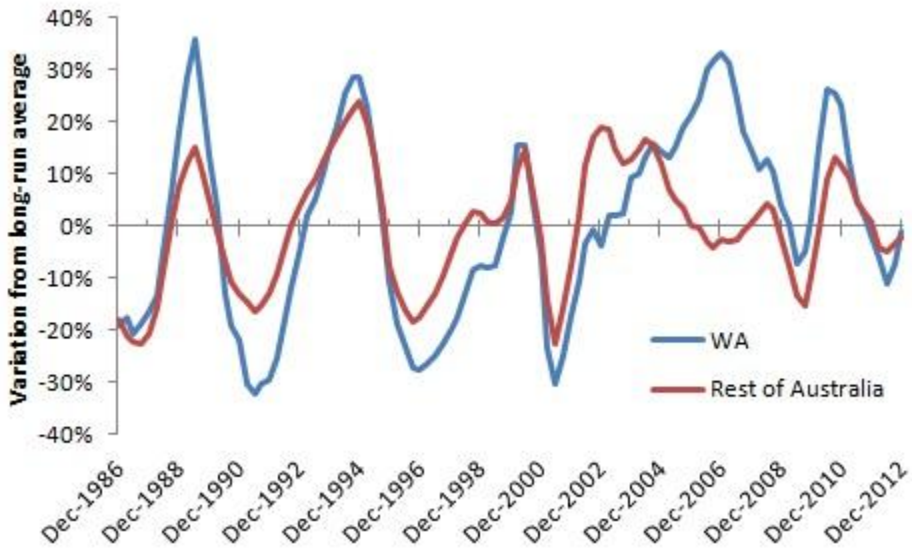
Declining interest rates to drive rebounding residential construction

The latest Housing Industry Forecasting Group report, tabled in Parliament by Minister for Housing Bill Marmion yesterday, has lifted its forecasts for dwelling commencements in Western Australia after residential construction and land market activity grew strongly over the last nine months on the back of declining interest rates

The Housing Industry Forecasting Group, a joint industry and government body which includes UDIA, increased the 2012/13 forecast of dwelling commencements from 21,000 to 22,500 in its latest update. This represents a 27 per cent increase from 2011/12 levels.

Whilst 27 per cent is a significant jump over one year, WA is still at the early stages of a cyclical upswing in residential construction after dwelling commencements in 2011/12 fell to ten-year lows of 17,730 dwellings.

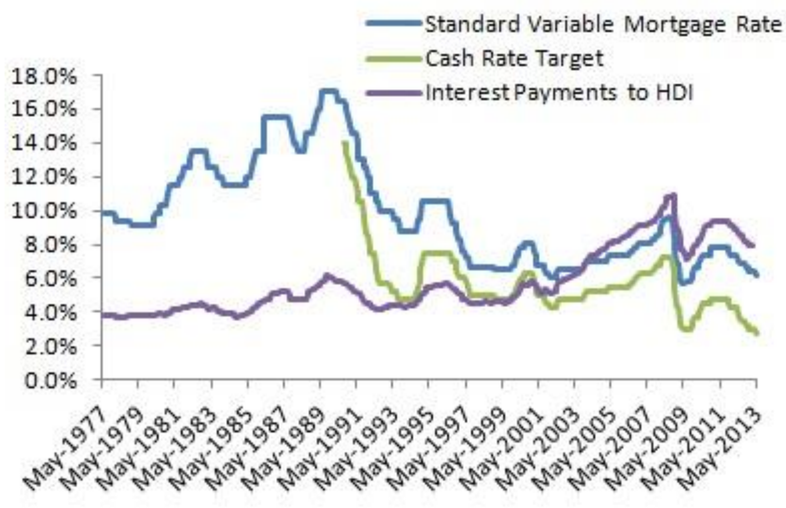
Considering the optimism surrounding property in WA, especially Perth, and pessimism on the East Coast (bar Sydney), you'd expect WA construction to be doing a lot better. It isn't.



Western Australian residential construction starts are going through the same cyclical upswing as the rest of Australia (although some market segments like apartment construction in Melbourne, for example, do not necessarily follow the same pattern). And this upswing is driven to a large extent by declining interest rates.

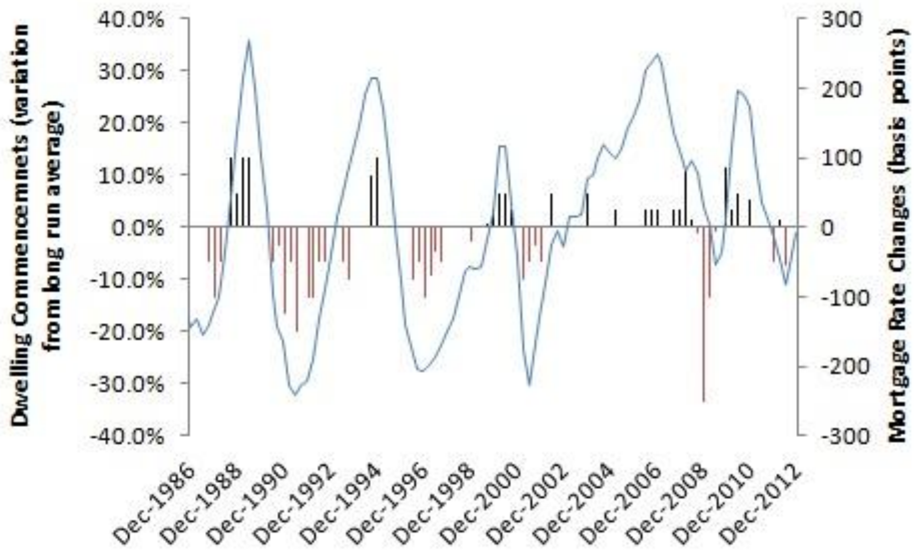
On the interest rate front, the Reserve Bank has aggressively been cutting rates since November 2011 and on Tuesday the RBA Board went against the forecasts of 21 of 29 economists surveyed by Bloomberg and cut rates by a further 25 basis points to 2.75 per cent.

The decline in the cash rate target from 4.75 to 2.75 per cent over the last 18 months has translated into declining mortgage costs. The standard variable mortgage rate has declined from 7.8 to 6.2 per cent, with the majority of mortgage holders paying less. Also, Australian banks are expecting the low rate environment to continue in the short-term, offering 2-year fixed rates of 5 per cent.



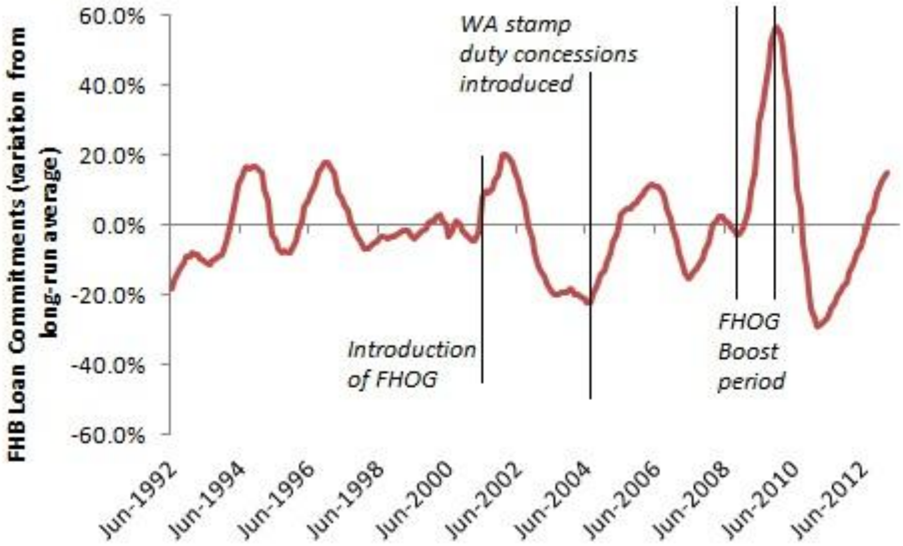
Except lower interest rates do not have an immediate effect on construction levels.

Over the last five residential construction cycles in WA, it has taken, on average, nine months from the first rate cut until the upswing in construction, and interest rates have typically continued to decline for several months after the initial upswing in construction volumes.



The relationship between interest rates and residential construction volumes is not, however, straight forward. To gain the best understanding of future housing demand, an integrated analysis of myriad factors is necessary. I will cover the majority of these drivers below.

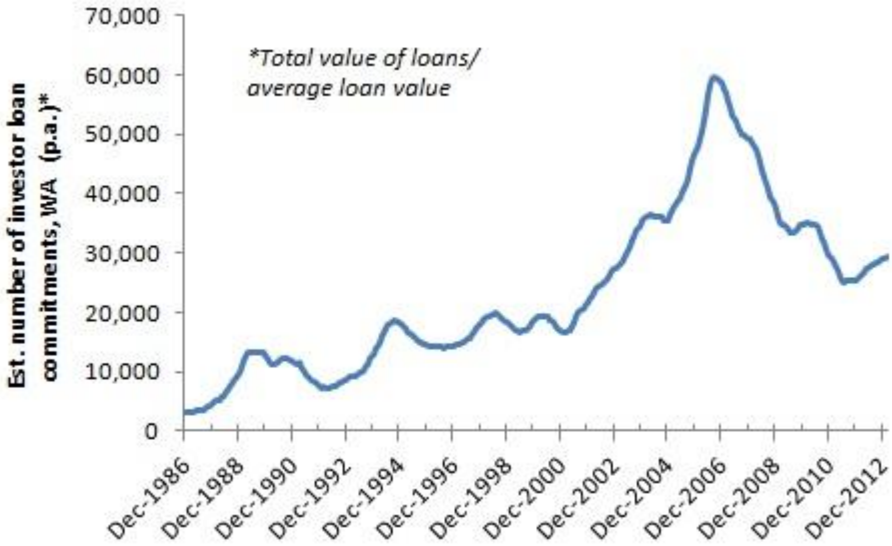
Typically, the most responsive sector to declines in mortgage rates is the first home buyer (FHB) market. Declining mortgage rates reduce the cost of becoming a home owner, especially given that FHBs are at maximum leverage (i.e. high loan to asset price) just after they purchase their first home.



Other stimuli also encourage more FHBs to enter the property market. For example, the recent First Home Owner Grant Boost, which provided first home buyers who purchased an established property an additional $7,000 grant and an extra $14,000 for purchasing a new home, brought forward a lot of FHBs who may not have become home owners for another couple of years.

As you would expect, the decision whether to rent or to buy will be influenced by the relative cost and availability of rental properties and properties for sale. The current tightness in the rental market has driven an 11.9 per cent increase in median rents in Perth, and this was one factor that led to upward revisions of housing construction forecasts in the latest HIFG report.

Increasing rents and declining mortgage costs are also encouraging investors to enter the market. Investor loan levels in WA reached a low point in mid-2011 but have since then increased 17 per cent.



However, with two-thirds of property investors in Australia negatively geared, capital appreciation has become the greatest driver of property investment decisions rather than rental returns.

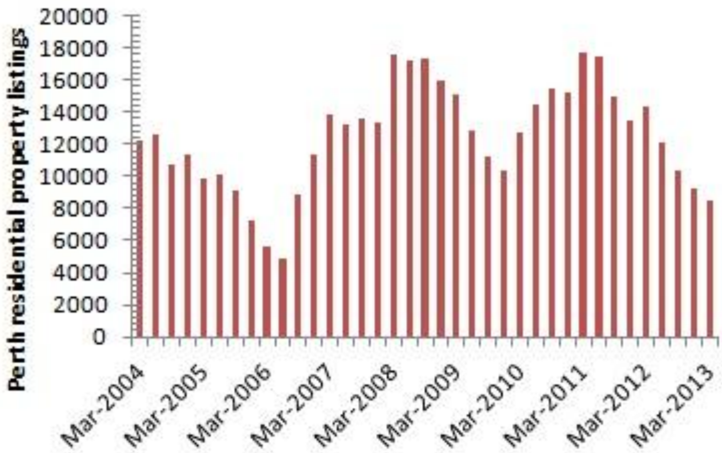
A Westpac survey of consumer house price expectations showed that after an extended period of uncertainty Western Australian consumers look to be much more convinced that house prices are on the way up. Just over 84 per cent of respondents expected prices to rise.

The Australian Property Monitors, a Fairfax-owned property sales information provider, has joined a suite of others by predicting stronger capital growth in the Perth residential property market over the next few years. APM predict the growth in Perth's property market will be the biggest of all capital cities this year, with its median house price expected to jump 5 to 7 per cent.

House prices are forecast to grow strongly over the next three years, according to BIS Shrapnel estimates. The LMI Housing Outlook for 2012-2015 forecasts the median house price in Perth will increase by a total of 22.1 per cent between 2013 and 2015. The rosy forecasts predict the median house price in Perth to increase 6.3 per cent in 2012/13. Meanwhile, SQM Research released its forecasts in September 2012, predicting house prices in Perth to increase 6 to 12 per cent in 2013.

To date, the median sales price in Perth has increased over the last year, but at a significantly smaller rate than what was experienced last decade. The median price in Perth increased to $510k in the March quarter, with preliminary settlements data from Landgate showing the rise was largely attributable to increasing sales in the $600-$800k upgrader bracket. Capital growth is harder to gauge, however, liaison suggests that there has been price increases in the sub-$500k market which experienced a strong uplift in sales.

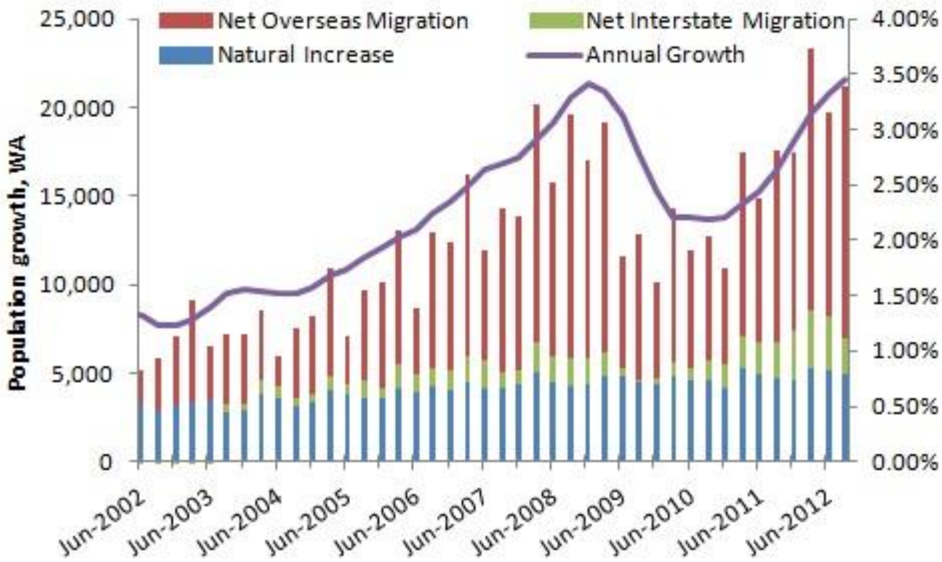
First home buyers and investors are not necessarily buying new properties (75 per cent of FHBs bought established dwellings in 2012 in WA), but they are freeing up existing owners to buy new homes, many of which may have been sitting on their hands since the middle of last decade. The number of listings in Perth has fallen dramatically from 14,000 to 8,500 over the past year – well below the 2010 high of 18,000 listings.



More people, more houses, right?

Western Australia's population grew 3.45 per cent over the year to September 2012, surpassing the previous record growth rate achieved in 2008. The state's population increased by 81,694 persons over the 12 month period, or 1,571 persons per week.

Net overseas migration and net interstate migration accounted for 62 and 13.6 per cent of the state's population growth over the 12 months to September 2012, respectively. Together, net interstate and overseas migration added 61,704 persons in WA, or 1,186 per week.



Population is the most obvious driver of residential construction, but the relationship between population growth and new dwelling construction is not as clear-cut as you'd expect.

Natural population growth, for instance, does not necessarily create the need for additional dwellings and not all migration creates the need for new houses, either (i.e. the reunification of spouses).

The propensity for households to hold more than one dwelling can have both a positive and negative influence on housing construction levels (approx. 5.3 per cent of WA's housing stock is assumed to be unoccupied – although the Census puts this figure a lot higher).

Demolitions that cause the removal of dwellings from the dwelling stock create a requirement for them to be replaced. The National Housing Supply Council uses a demolition rate of 14.4 per cent based on Census figures.

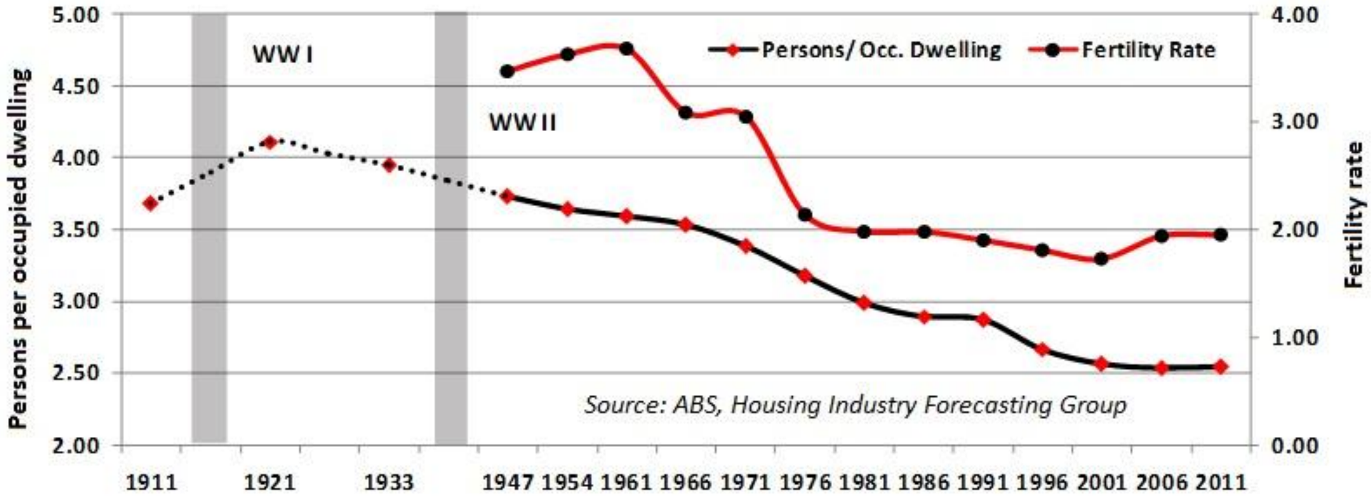
The other major determinant of the number of new households is average household size.

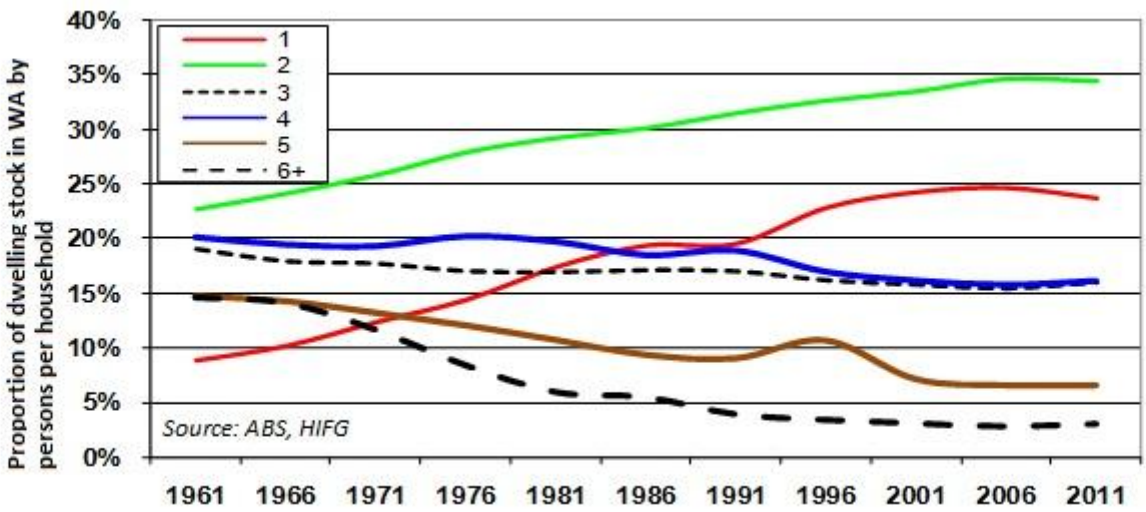
Houses are bigger, but household sizes are small

Australians are building larger homes, much larger. An analysis by the Bureau of Statistics in 2010 found that the average floor size of new houses in Australia grew an impressive 52.7 per cent to 248m^2 over a 24-year period.

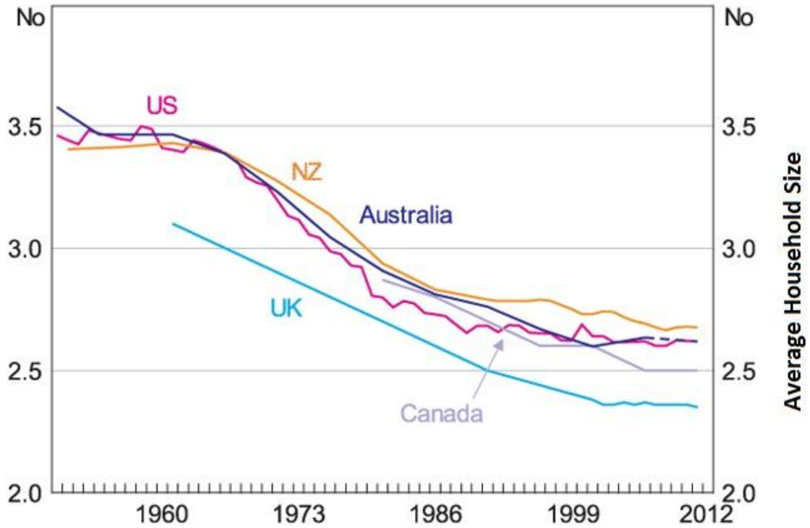
Most commentators have attributed this trend to our increased affluence over the last three decades. I'm not sure if this is the key driver, but it reminds me of an aphorism by Marx. And I digress.

Despite Australians having larger homes, over the 20th century, the average household size declined. This was a reflection of demographic factors, notably a lower birth rate and an increase in the share of single adult households with or without children. However, this long trend decline in average household size came to an end in the early 2000s.





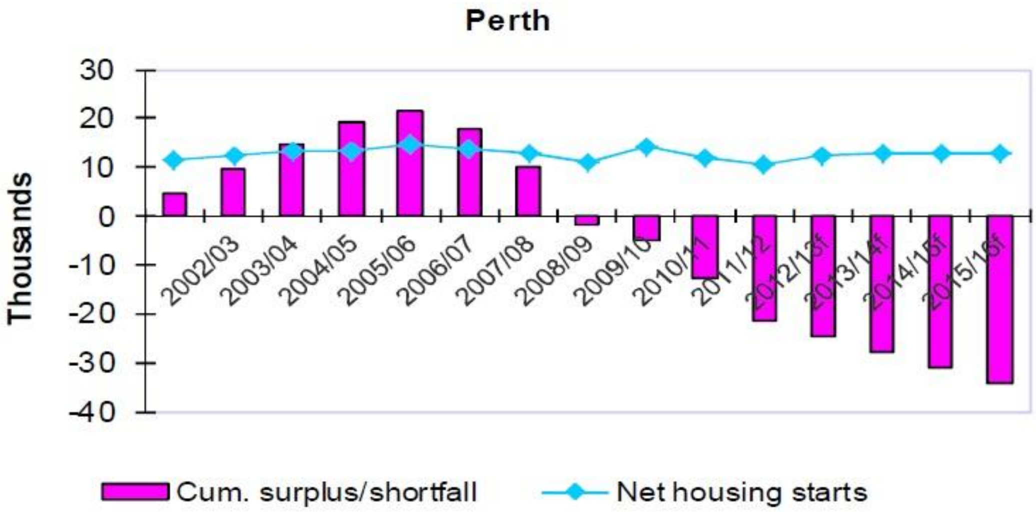
It is interesting to note that Australia was not alone in experiencing a long trend decline in average household size followed by a levelling off in more recent decades. The Reserve Bank's Christopher Kent presented the following graph in 2012, which details consistent declines in house sizes across a number of Anglo-Saxon economies.



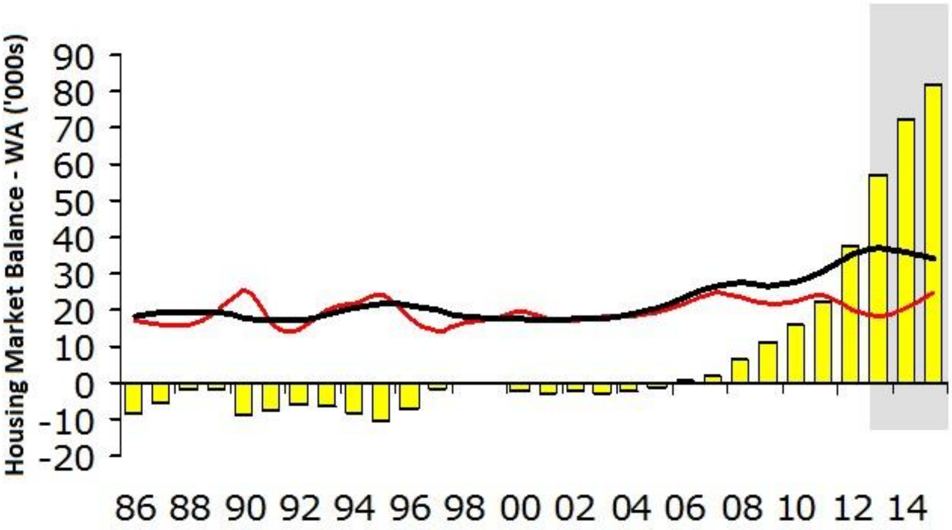
Sources: ABS; Office for National Statistics; RBA; Statistics Canada; Statistics New Zealand; Thomson Reuters; US Census Bureau

Despite the complexity, a number of analysts have tried to model underlying demand based on estimates of these aforementioned factors. This gap is referred to as underlying demand in contrast to effective demand, which is what actually happens in the property market.

Perth is considered to have a cumulative shortfall of dwellings. Estimates, however, vary widely. The Housing Industry Forecasting Group estimated that Perth had an estimated shortfall of 21,500 dwellings at the end of June 2012.



Meanwhile, the ANZ in 2012 presented the following estimates that put Western Australia's undersupply of housing at 40,000 dwellings in 2012, rising to over 80,000 dwellings.



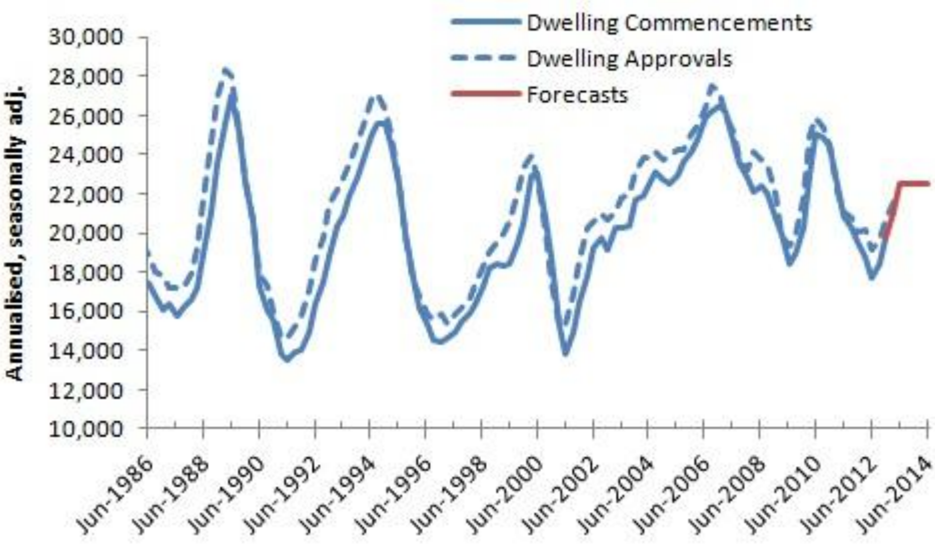
Construction forecasts

Whilst all the aforementioned factors played a part, the effect of declining interest rates has been unambiguous. Since the beginning of the rate cut cycle in November 2011, residential land sales in Perth have more than doubled and we have also seen a substantial decline in the amount of land for sale.

As recently purchased land may still have to receive final subdivision approval and titles before construction can begin, there is a general lag between when the land sales contract is signed and when construction begins. The increased land development activity therefore only started to translate into more dwellings being constructed in the second half of 2012. The Bureau of Statistics reported that total dwelling commencements were up 32.5 per cent over the second half of 2012 to 11,239. (The implementation of the new Building Act in April 2012 led to a decline in building approvals in the June 2012 quarter.)

The Housing Industry Forecasting Group predicts dwelling starts to increase throughout 2013, forecasting 22,500 dwelling starts in 2012/13 and 2013/14.

There is upside potential in 2013/14, however, as construction cycles in WA have typically peaked at between 24,000 and 28,000 dwellings (per annum).



Download the Housing Industry Forecasting Group April 2013 report here.

To view population statistics (inc. forecasts) for the areas you work (or live), download the Institute's Population Tool here.