Why Melbourne's properties will keep on rising

The television and newspaper media deserve a lot of criticism for the way they journalise "the news". It is generally knee-jerk comments based on some latest piece of information they have picked up (whether accurate or not) and sensationalised out of all proportion to reality.

Their efforts are a great disservice to first-time, would be investors. And they are never held responsible to compensate their readers for the opportunity cost of not having invested when they otherwise would have.

Let's look at the facts about property markets.

England
England has by far the longest uninterrupted collection of price statistics on land and property compared to any other country on earth. This is because, when the Normans conquered the Saxons in 1066 A.D., they introduced a method of governing England through a unique collection of statistics in every parish.

The Doomsday Book, maintained in every parish in England since 1088 a.d., has collected meticulously accurate statistics on every birth, death, marriage and sale of land. Because of this unique and accurate history of land prices, researchers have done much study on property prices in England.

The result is that, for 919 years, property prices have risen at a compound rate of increase of 10.2% per annum. The Rule of 72 states that any number which increases at 10% p.a. compound, doubles every 7.2 years. So, for over 900 years, property prices in England have been doubling, on average, every 7 years.

Australia
In Australia, over some 120 years or so of not quite so accurate statistics, property prices have risen at an average compound rate of 10.4%, very slightly ahead of England. Again, property prices have doubled every 7 years or so despite droughts, wars, changes of government, interstate and overseas migration, interest rate movements, exchange rate movements, changing rates of unemployment, CPI movements, etc etc.

Property cycles
When one takes a short-term view of property price movements, one can get confused by apparently contradictory statistics. However, if you understand that property prices move in 7-10 year cycles, the picture becomes a lot clearer.

Let's take one obvious example. The movement in NSW and Victorian property prices tend to be counter-cyclical to Queensland prices (especially South East Queensland). This is heavily influenced by what is happening in the NSW & Victorian economics which encourages migration to Queensland, and at other times in the cycle, people returning to NSW and Victoria.

So, when Queensland prices are moving ahead strongly (because of this additional demand from interstate migration), prices in NSW and Victoria exhibit slower growth, and vice versa.

A study of cycles shows that the Sydney market is much more volatile than, for example, the Melbourne market. Sydney prices rise faster but can also experience significant falls in each cycle - Melbourne prices tend to rise rapidly (+25%, +20%) in the first two years of an upturn and then more moderate increases of 3-7% in the remaining years of the cycle till growth spurts again.

Relative prices in each capital city
Over the last 100+ years in Australia, each of the six State and Territory capitals have established a fairly stable ranking with each other in terms of their median house and apartment prices.

Traditionally, Sydney has always been the most expensive followed by Melbourne, Canberra, Brisbane, Perth, Adelaide, Darwin & Hobart. Increases in prices in each of these markets, for whatever reasons (mining booms, economic recessions, rural booms and droughts etc) can cause some temporary shifts in the relative standing of each of these cities. But these are normally temporary shifts and the long-term standings re-assert themselves as the various cycles evolve.

In the last 3-4 years, Perth & Darwin prices (and to a lesser extent Adelaide and Brisbane prices) have increased dramatically due to the boom in mining and oil company revenues and increased demand for labour (and therefore housing) in those cities. Sydney and Melbourne prices, while still rising, have slipped behind these other cities in terms of relative price increases.

Basic demand & supply
The ever-increasing need for housing in Melbourne and Sydney is not based on temporary boom factors but on underlying (substantial and permanent) shifts in population. Each city has a strong underlying economy, which is not dependent on one particular industry. In addition, estimates of Melbourne's population for 2020 is over four million people (an approximate increase of 25% in 13 years). This is huge in terms of population increase and the need to accommodate these extra people.

The reality is that Melbourne's building industry cannot build more than about 140,000 accommodation units (houses and apartments) per annum due to shortages of qualified tradespeople of all types and shortage of suitably zoned land and the building permit process. Demand, on the other hand, is estimated at approximately 170,000 accommodation units per annum. Added to this, State and Federal governments have all but completely removed themselves from supply of affordable housing.

The inevitable consequence is that house and apartment prices will continue to rise (quickly over the next 2-3 years and then more moderately). And rentals, which are already moving up quickly, will continue to rise ahead of CPI. Relativities with other capital cities will be restored by above average price increases in Melbourne and then Sydney.

Interest rates
The spectre of a return to 16-17% interest rates (experienced only once in Australia's history and then only for a few months in 1990) has loomed large in many would-be investors' minds. This fear is understandable but not justified.

Interest rates are now approximately 1-1.5% above the lowest they have been in the last 40 years. From an economist's viewpoint, they are currently above the theoretical long-term

average that they should be (arrived at by adding the present CPI increase and the additional incentive needed to be offered for people to save and lend their money to others - historically 1.5-2.0%).

Currently rates are above their theoretically justified level. This is not to say that the Reserve Bank will not use one or even two more 0.25 per cent interest rate rises to send a message to the market not to get "overheated". Even two such increases will leave interest rates within 2% of their 40-year lows. A 0.25% per cent increase in the average mortgage of around $220,000 is equivalent to an extra $10.60 per week ($45.80 per month) in repayments.

By comparison, a 10% increase in the median house price in Melbourne is equivalent to an $817 per week ($3542 per month) increase in the owner's wealth.

Rents

The level of rents (determined by supply & demand) and the value of the properties to which they relate establish the rental return per annum. The rental return rises and falls at different times in the cycle as real rents and property prices move up at different rates. Rental returns on residential property tend to vary between about 3.5-4.0% and 5.5-6.0%.

Melbourne's rental returns have moved very close to the top end of this range and are showing every sign of continuing to rise further as vacancy rates continue to show a decline from over 4% to a little over 1.1% in most parts of Melbourne. The city's long-term imbalance between the new accommodation that can be supplied and the level demanded by increased population/increased member of new household formations noted above, allows the actual level of rents to continue to rise quite quickly. This will attract new investors into the residential house and apartment markets, which will, in turn, keep pushing prices up.

Housing affordability

There is much debate about whether houses have become "unaffordable" for young couples. Much research has been done on the number of years' salary it takes to buy the "average" house, and the proportion of income taken up by mortgage repayments.

This is a very complicated issue, which has received a lot of publicity during this faux election campaign. Despite all the rhetoric I have seen no viable recommendations come forward and even less political commitment to solving the problem.

My view is that Australia (which has enjoyed the highest rate of home ownership in the world) will slip in the world rankings. Those who have parents who can help them will still be able to buy a home (especially with abundant bank credit persisting) while those who don't may be consigned to a life of renting. This will further stratify Australian society with the rich getting richer and the poor getting comparatively poorer. This, combined with governments removing themselves from constructing accommodation, will put more reliance on a healthy private rental market and make it suicidal for governments to remove or reduce investment incentives.

Source:
http://www.aabglobal.com/blogs/michael_keating/archive/2008/01/24/why-melbourne-s-properties-will-keep-on-rising.aspx