


Investors must train sights on properties in low supply, proven demand

STUART WEMYSS

By **STUART WEMYSS**

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According to CoreLogic's Home Value Index, housing prices in Melbourne and Sydney showed signs of recovering in June. Observers have suggested this signifies that we are close to (or at) the bottom of the market cycle.

Most people agree that the property market slowdown has been engineered by the banking regulators — through requiring the banks to substantially tighten credit standards. As well, the uncertainty created by the negative gearing and capital gains tax policies that Labor took into its election campaign probably dampened sentiment. Consequently, housing credit growth hit historic lows in the year ended in May.

According to the Real Estate Institute, the median house price in the eastern capital cities of Melbourne, Brisbane and Sydney appreciated by more than 7 per cent a year between March 1980 and December 2018. Assuming an investor received an average rental yield of 3 per cent during this period, the total return from property was in excess of 10 per cent a year over almost four decades.

Of course, we are talking about residential property here, so this growth has not been uniform. In fact, like most asset classes, price growth tends to come in cycles and this recent cycle (of negative capital returns) is unlikely to be any different.

Given the impact that the recent tightening in credit (money) supply has had on property prices, you would be excused for questioning whether historic double-digit returns can repeat themselves. Especially if we assume that access to credit will remain tight for some time.

We need to ask: are house prices really that closely linked to the flow of credit?

Consider the monthly volume of total new housing finance commitments from 2002, when the data set began, and 2019. (I have adjusted the amounts for the impact of inflation. I have compared that to the annualised change in median house values over a rolling three-year period for Melbourne, Sydney, Brisbane and Perth.)

If you compare credit flows to house price movement, the pattern has been relatively volatile — ranging from \$15 billion and \$25bn a month over the period. But there doesn't appear to be a direct relationship between credit flows and property prices (except for maybe the past five years).

For example, credit volumes fell by 21 per cent between September 2009 and March 2012. Over this period, the median house growth rate was only 3.3 per cent a year, according to the REIA — although Melbourne and Sydney did better with growth of 4.7 per cent. This period of growth was still well below trend, but not as bad as the last few years.

More recently, credit volume has fallen by 25 per cent between August 2017 and May this year. However, housing prices have fallen by more than 10 per cent in this period. This suggested that perhaps something else has contributed to the fall in house prices.

Underestimated factor

It is interesting to note that Australia's strong population growth does not seem to have had any - material impact on loan volumes.

In 2002, the population was 19.5 million. Today it is more than 25 million. What else could have contributed to house price falls? Perhaps the credit tightening has dissuaded prospective borrowers. Or maybe predictions of a Labor government hurt sentiment.

Perhaps prospective property investors would be well advised to focus on supply-side drivers. As the saying goes, in a rising tide, all ships rise. However, if the tide is no longer rising (credit flow is being reduced), not all ships will rise.

The problem for investors is that our country is too big, and we have too few taxpayers. This makes infrastructure funding difficult. France, for example, has about 70 taxpayers per square kilometre whereas Australia has 1.5! France can build comprehensive infrastructure, allowing its residents to spread out. In Australia, most of us must live in a capital city to have access to infrastructure and jobs. About 60 per cent of us live in Melbourne, Sydney, Brisbane or Perth, while only 3 per cent of the French live in Paris.

This is an underestimated problem for Australia and I'm not confident a solution will be achieved soon. This means inner-city, blue-chip suburbs will benefit from increasing demand — especially as roads and public transport become congested between the city and outer suburbs. Access to alternative modes of transport such as trains and trams will become more desirable. And these alternatives are mostly found in suburbs close to the CBD.

One way for investors to mitigate the impact that the lower supply of credit might have on growth rates is to level up on quality.

Credit supply affects housing demand. The best way to mitigate a potentially lower level of demand is to invest in locations and property types that are in a finite supply and are proved to benefit from high demand. The increase in population density and lack of infrastructure outside of capital cities will ensure demand for these locations will rise in the next few decades, thereby driving capital.

Stuart Wemyss is a financial adviser and author of Investopoly: The 8 Rules for Mastering the Game of Building Wealth.

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