

How property prices will withstand rate rises

By **STUART WEMYSS**

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Is it a coincidence? This week the US Federal Reserve raised rates for the first time in three years. Last week, governor Philip Lowe stated that it was “plausible” that the RBA would lift rates this year, which is sooner than his previous estimates of late 2023.

A lot sooner.

Theoretically, higher interest rates should lead to lower asset values in the property market.

First, as it becomes more expensive to borrow money, people become more diligent, demand better value/returns, which means paying less for property. Also, demand for borrowings often falls, resulting in fewer active property buyers.

Second, as interest rates rise, lower-risk investment options such as term deposits become more attractive, compared to higher-risk options such as shares or property, again reducing buyer demand.

However, I believe property buyers are mostly influenced by an affordability assessment, not a valuation assessment, when deciding whether to buy property. As such, financial theory, which proves there is a strong relationship between interest rates and asset values, cannot be used to explain property price movements.

About two-thirds of property buyers are owner-occupiers. When Australians contemplate buying a home, it tends to be a long-term decision – 10 or more years. As such, home buyers tend to focus most of their attention on whether they can service and repay the required mortgage, including factoring in inevitably higher interest rates and any changes in circumstances.

If they conclude that the mortgage is affordable, they know they’ll be better off by buying now, as property prices have always trended higher over the long run.

This explains the weak historic relationship between interest rates and property price growth. I have closely analysed median house prices and interest rate data since 1980 and failed to observe a consistently strong relationship.

For example, between 2011 and 2018, the median house price in Melbourne rose by 1.7 per cent per annum, according to data compiled by the Real Estate Institute of Australia. Over the same period, the average standard variable mortgage interest rate was 6 per cent. Compare that to Sydney. Between 2013 and 2017 the median house price in Sydney appreciated by almost 14 per cent per annum.

The average standard variable mortgage interest rate was 5.7 per cent over this period. Similar interest rates over similar periods produced very different property growth rates. There are more examples I could cite. Looking back over 40 years of property data reveals there is no observable relationship between interest rates and property price growth.

It has been well documented that Australian property prices appreciated by about 20 per cent last year. Most of this price momentum was driven by owner-occupiers.

Owner-occupiers increased mortgage borrowing volumes by about \$10bn per month beginning in May 2020. However, investors did not begin borrowing more until mid-2021, increasing by \$5bn per month, by which time property prices had already risen substantially.

As I predicted in these pages on October 2, 2020, the luxury sector of the housing market outperformed in 2020 and 2021. There were a few reasons.

First, higher-income earners were lucky enough to avoid most of the adverse financial implications of Covid lockdowns, as they were able to work from home. Unfortunately, lower-income earners bore most of the financial brunt of lockdowns.

Second, higher-income earners are more sensitive to lower interest rates, as they tend to borrow more than the average Australian.

And lastly, due to the lockdowns, higher-income earners enjoyed improved savings capacities due to lower spending and travel bans.

It is my view that these three advantages remain intact even if interest rates rise by 1 per cent. Owner-occupier variable mortgage interest rates are about 2 per cent. If mortgage rates increase to 3 per cent, they are still very low by historical standards. For example, according to the RBA,

the average discounted mortgage interest rate since July 2004 (when the dataset began) was 5.6 per cent. Higher-income earners will be able to continue using their improved financial positions and low interest rates to their advantage.

There is no doubt in my mind that some people have overpaid for property over the past couple of years. There have been some mind-boggling transactions. However, the property market this year appears to be more balanced (between buyers and sellers) in many locations. As such, we are unlikely to see that same level of buyer overexuberance that was common last year.

When interest rates do eventually rise, it may further dampen buyer demand and market sentiment. This may culminate in one or two quarters of slightly negative growth, which would be considered immaterial in the context of last year's growth rate.

But I think it is highly unlikely that prices will drop by 15-25 per cent as some of the more bearish commentators are now suggesting.

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