Bubble, bubble, housing trouble?

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Want to know the source of wealth for most Australians? Well, look around you. As a share of wealth, property tops the list at 60% of an average individual's overall wealth. According to Citi, surging house prices in Sydney and Melbourne have been a prime contributor to the 30% increase in household wealth over the past three years.

The recent price rises in these cities and widespread media coverage of a looming crash, the surge in apartment building along the east coast and very low rental yields across the country, have many investors wondering whether residential property really is as safe as houses. And that was before Philip Parker of Altair Asset Management announced he would liquidate the company's Australian shares fund and return the proceeds to investors, citing an impending property market "calamity".

Let's walk through the most common questions residential and commercial property investors are asking.

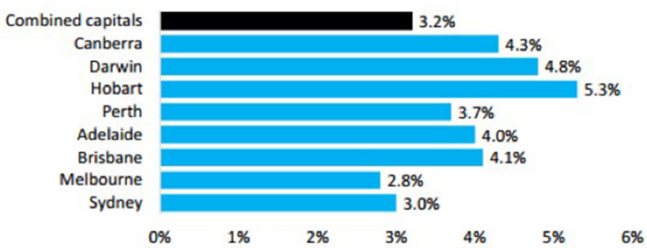
1. Is residential property over-priced?

When a tin shed in Glebe, an inner west suburb of Sydney, sells for \$1.69m[1] and 50sqm roof space sells for \$1m in Elizabeth Bay[2], it's a fair question. The minutes from the Reserve Bank's latest meeting note that growth in rents is the slowest rate in two decades. That's a subtle way of suggesting that current house prices are inconsistent with the fundamental drivers of value in the housing market.

With Sydney's median house price smashing the \$1 million mark and Melbourne's not far behind at \$860,000, CoreLogic's findings that the combined values of residential property in Australia's capital cities is now \$3.52 trillion shouldn't be a huge surprise. But is it a bubble?

While the price rises have been staggering, rental yields have fallen to record low levels, hovering around 3.0% in Sydney and 2.8% in Melbourne.

Current gross rental yields



Source: Corelogic, June 2017[3]

Gross rental yields from commercial property meanwhile stand at 5.0% and 7.5% respectively. And in Perth, residential property values have fallen from their 2007 peak, leaving many investors in a negative equity position in a low-to-no growth environment. If there is a bubble, it's very much driven by Sydney and Melbourne, as this chart shows.

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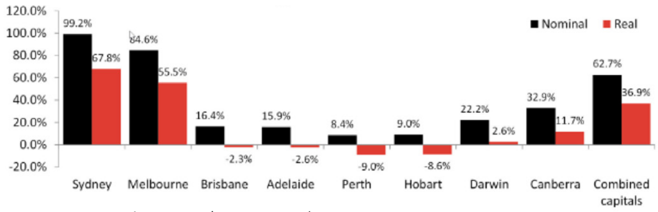
Real vs nominal change in home values - Dec 2008 to Dec 2016



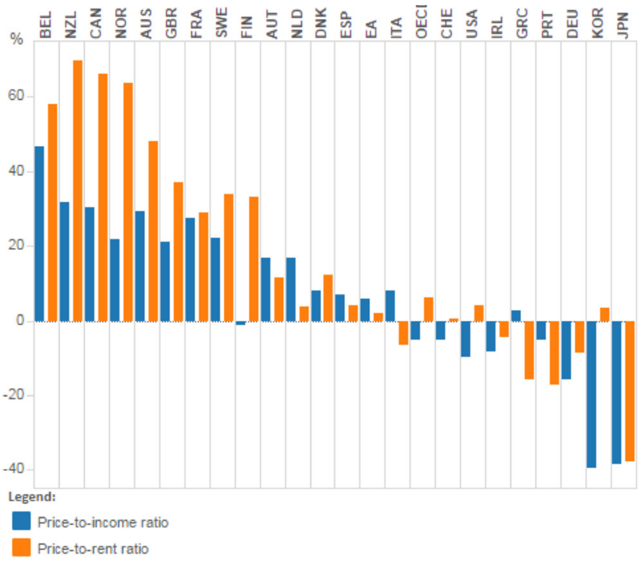
Source: CoreLogic, ABS, February 2017[4]

Nevertheless, the RBA point stands. Residential property prices are a function of many factors. But if investors are throwing money at a sector where net yields are not much more than bank term deposits, and yet the risk is far greater, they must be doing so with an expectation of high future capital growth to compensate for the low yield. That doesn't mean there is a bubble but it does meet one of the criteria for it.

Household debt is another worrying factor. Homeowners and investors are more reliant on credit and more sensitive to a rise in interest rates than ever. Housing credit has increased by over 400% in the last 17 years, from \$400bn in 2000 to \$1.6trn in 2017. Household debt is at record levels, high even by the standards of countries that have also experienced rapid house price inflation, as this chart shows.

House prices across the OECD

Percentage over or under valuation relative to long term averages



Source: OECD, June 2017[5]

In fact, once you adjust for inflation, the ratio of house prices-to-rents is currently 48% above its long term average[5]. In the recent 2017 Demographia International Housing Affordability Survey, Australian housing was deemed "severely unaffordable", with Sydney and Melbourne ranked the 2nd and sixth least affordable cities is the world. Without the growing use of debt it's unlikely this increase would have occurred. Investors with a high concentration of residential property within their portfolio may feel the brunt of a pullback.

2. Is the housing market over-supplied?

An enduring point, and one that sells newspapers, is that the current rate of apartment construction (particularly in the eastern states) has led to an oversupply and that this could precipitate a more general property crash.

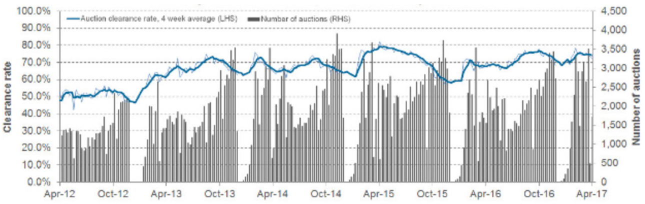
Although a wave of new apartment supply hitting Sydney, Melbourne and Brisbane is placing downward pressure on rents and prices, these concerns look over-stated. Whilst suburbs such as Southbank in Melbourne and Fortitude Valley in Brisbane are facing a flood of apartment developments and are getting plenty of media attention, over the long term this over-supply will be absorbed due to population growth, which remained steady at 1.5% annual growth in the year to March 2017.

Although easing, net overseas migration remains substantial. In Victoria last year, for example, there were 127,500 arrivals and in NSW 109,600. There's still a significant gap between population growth and dwelling approvals, as has been the case for the past decade, but the gap between housing demand and housing supply is narrowing.

Developers, after more than a decade of under-building, have substantially increased construction. Last year ANZ Bank, for example, pointed to a national shortage of 250,000 homes. This convergence, a meeting of demand with additional supply, may take some heat out of the market by easing dwelling prices and rental growth and improving overall affordability.

One further point: if the over-supply of apartments was infecting the entire market, we might expect to see auction clearance rates fall. That doesn't appear to be happening, with Sydney and Melbourne auction clearance rates around the mid to high 70.0% range, as can be seen in the below chart.

Weekly clearance rate, combined capital cities



Source: Corelogic, April 2017[6]

A combination of planning restrictions, high land costs and the absence of infrastructure projects to connect new suburbs with city centres, has meant a bias among developers toward apartments at the expense of family homes. Supply is expected to reach record levels of around 220,000 dwelling completions this year. Thus far, this has been largely absorbed by a historically under-supplied market.

3. What would be the direct impact of apartment oversupply on AREIT investors?

For APN AREIT Fund investors at least, very little. Residential property accounts for less than 2.5% of the Fund's portfolio. Within that, only two stocks – Mirvac and Stockland – only have a portion of their residential exposure to inner city apartments. Even in the very worst case – a scenario we're not expecting – the impact on the Fund would be negligible.

The portfolio allocations tell the story. As of 31 May 2017, 60% of the Fund's assets were allocated to high quality retail assets, 20% to office and 12% to industrial. In each case, we believe more reliable, attractive returns can be found than in residential, which is to say those allocations offer a clue to the answer to the next question.

4. Is residential still a good bet?

With many Australians having most of their wealth tied up in residential property, even if the bubble concerns are overblown there's a good case for diversification. And if we are in a bubble, that case is even stronger.

It's also worth noting that the sector looks expensive on all metrics. House prices are historically high and the yields on offer correspondingly low. The high costs of maintaining a residential property and a likely oversupply of apartments in key markets should prompt a rethink by investors; an examination of the extent of their over-exposure to residential property and possible lower risk alternatives.

Commercial property exposure, for example, offers all the things residential property does not; from sustainable, regular and growing income to low maintenance costs.

Not only is the risk/reward trade-off superior (due to the lower reliance on capital growth versus security of the rental income stream), but the liquidity and diversification, in addition to the lower ongoing costs, can make an AREIT investment attractive. In addition to these benefits, APN's AREIT Fund, for example, currently delivers a yield of 6.11%[7] as at 31 May 2017.

Our suggestion therefore is not to try and pick whether Australia is in the midst of a property bubble or not and think about it in terms of probabilities. If there was, say, a 30% chance that house prices were going to fall 20% and more than half your portfolio was in residential property, would you want to mitigate that risk and if so, how?

That's the question residential property investors should be asking themselves right now, not whether we're in a bubble or not. We'll only find that out if and when it pops. Best to be wise before the event rather than after, even if it doesn't actually happen.

1 http://www.realestate.com.au/news/sydney-shows-no-sign-slowing-after-week-of-more-unbelievable-auctions/news-story/aff6b8a768194022451a913cf5450050
2 http://www.realestate.com.au/news/roof-space-apartment-in-elizabeth-bay-sells-for-1-million/
3 https://www.corelogic.com.au/resources/pdf/indices/chart-pack/2017-06--JunePropertyandEconomicOverview.pdf?language_id=1
4 http://blog.corelogic.com.au/2017/02/since-2008-four-capital-cities-recorded-real-growth-home-values/
5 http://www.oecd.org/eco/outlook/focusonhouseprices.htm
6 http://blog.corelogic.com.au/2017/04/volumes-rise-across-combined-capital-cities-return-clearance-rate-72-1-per-cent/
7 As at date 31 May 2017. Fund inception is 19 January 2009. Returns after all fees and expenses. Investors' tax rates are not taken into account when calculating returns. Past performance is not an indicator of future performance. Distributions may include a capital gain component.

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