



Westpac Property Analysis

Housing affordability continues to improve in 2009, but is it sustainable?

- National home loan affordability has improved to around 2003 levels and above the 10-yr rolling average.
- Improvement in affordability has largely been driven by interest rate cuts rather than falling housing prices.
- For affordability to remain at average by end 2011, once the economy recovers and mortgage rates rise, the national average loan size is required to fall 10% or median family income will need to grow 15%.
- While possible, particularly as further job losses occur, Westpac Property does not expect prices to fall by levels required to bring affordability above average, however downward price pressures will exist from late 2009 into 2010, should the recession worsen.

National home loan affordability hit its worst level in 2008, however improvement has since occurred

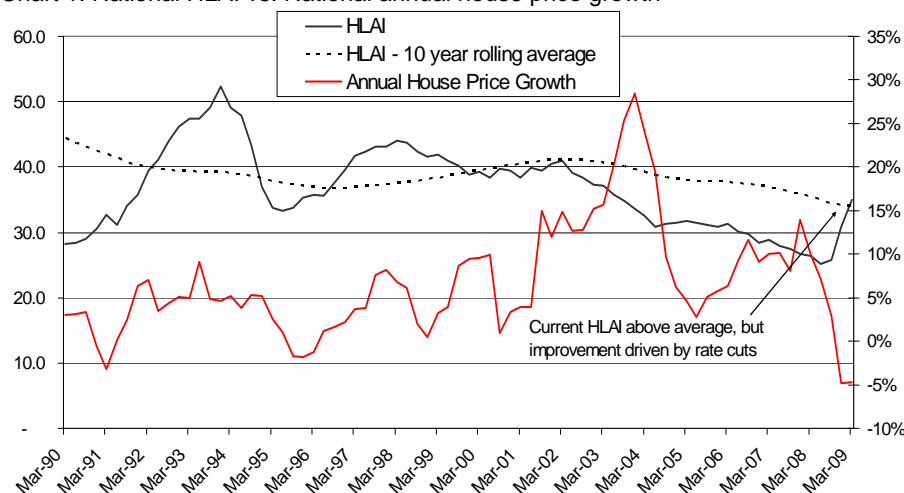
The March 2009 Housing Affordability Report released by the Real Estate Institute of Australia (REIA) indicates that nationally, housing is at its most affordable since late 2003. This is a rapid recovery from the record low affordability of June 2008, but has been driven more by an almost halving of interest rates, rather than by prices falling.

For the purpose of this paper, the 10-year rolling average affordability indicator of 34.1 has been used in our analysis. Long term affordability over the past 30 years averages 39.4. To achieve the long term affordability, higher value falls/income increases would be required than suggested below.

Affordability – Back to 2003 levels but still below average

Affordability has been an issue since 2002, sitting below the 10-year rolling average, as indicated in chart 1 below. National affordability has improved recently and is now above the 10-year rolling average by 2.5%, to be around September 2003 levels. The driving factor behind the recent improvement in affordability has been the decline in interest rates, which are now at their lowest levels in over forty years.

Chart 1: National HLAI vs. National annual house price growth



Source: REIA; Analysis: Westpac Property

Although back to 2003 levels, improvement in affordability has been driven by falling interest rates

Since the improvement in affordability has largely been driven by aggressive interest rate cuts, the indicator suggests that dwelling prices, or rather the debt required to purchase a dwelling, in Australia continues to appear too high. This poses two questions:

1. What will happen to affordability once the economy recovers and interest rates increase to a more neutral level; and
2. What will it take to bring affordability back to average on a national basis by the time the economy recovers in 2011?

Affordability and future interest rate rises

To assess what is likely to occur to national affordability if interest rates rise by 2011, the following assumptions were made:

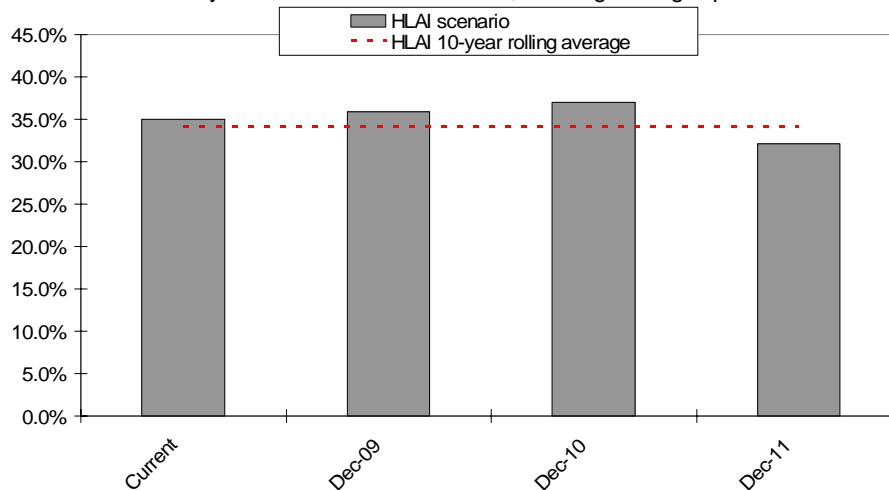
Rising interest rates in 2011 pose a threat to affordability

1. The standard variable mortgage rate remains at current levels of 5.54% before rising to 7.54% in 2011.
2. Average national loan size remains at March 2009 levels (\$266,174) until end 2011.
3. Median family income grows by 8.8% in total until 2011, as forecast by Access Economics (wage growth).

In this scenario, national affordability improves throughout 2009 and 2010 due to income increases. In 2011, as mortgage rates increase, affordability levels are pushed back to 2004 levels, or 6% below the average.

This interest rate scenario is possible, however it should be noted that any growth in loan size (through higher house prices) will push affordability lower than indicated.

Chart 2: Affordability and interest rate increases, all things being equal



Source: Data – REIA; Analysis – Westpac Property

What will it take for national affordability to return to average levels?

There are two key scenarios in which national affordability can return to the 10-year rolling average by the end of 2011, each scenario takes into account the following fixed assumptions:

1. As forecast by Westpac Economics, the cash rate falls by 100bps to 2.0% by end 2009, stabilising in 2010, before rising to 5.0% in 2011. We have assumed the mortgage rate will follow similar movements.
2. Loan repayments are monthly, over 25 years.

Scenario 1a – House prices fall 10% by 2011

Variable assumptions:

1. As job losses mount, average loan size decreases by 10% in 2010, lowering prices by 10%.
2. Median family income increases by 8.8% in total until 2011, as forecast by Access Economics (wage growth).

Scenario 1a
Affordability remains 5% above average if prices fall 10% by 2011

In this scenario, national affordability improves to be above average throughout 2009 as interest rates fall further, as indicated in chart 3 below. National affordability continues to improve in 2010 as the average loan size falls and mortgage rates remain historically low. In 2011, affordability reverts above the long-term average by 4.7% as mortgage rates increase.

As we move further into recession and job losses increase, this scenario is a possibility. However the low interest rate environment suggests the extent of such price falls are unlikely to occur.

Scenario 1b – Median family income increases 15% by 2011

Variable assumptions:

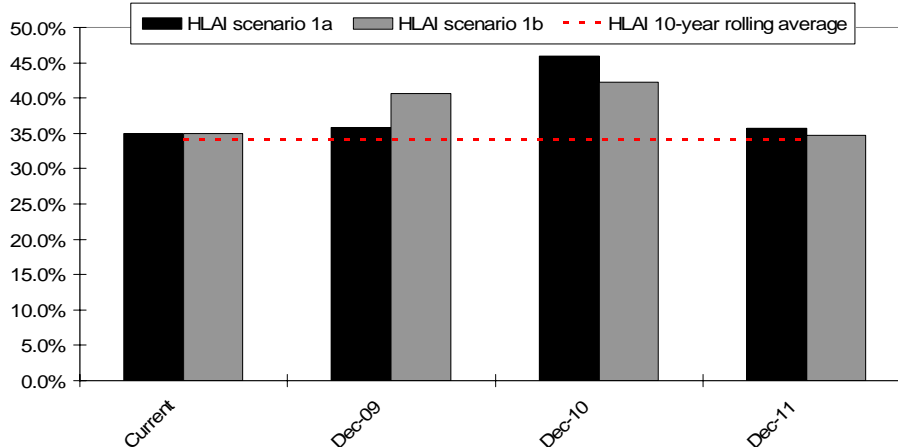
1. Median family income increases 15% by 2011.
2. Average loan remains at current levels (\$266,174).

Scenario 1b
Family income growth of 15% by 2011 is required if affordability is to remain above average

In this scenario, as indicated below in chart 3, national affordability improves throughout 2009 and 2010 to sit above trend as median family income rises in a historically low mortgage rate environment. Despite mortgage rates rising in 2011, strong income growth helps keep housing affordability above the long term trend, but only by 1.8%.

In the current and expected economic climate this scenario is unlikely as unemployment rises and wage growth reverts below average.

Chart 3: Scenarios 1a & 1b – HLAI reverts to average in 2011



Source: Data – REIA; Analysis – Westpac Property

Alternate scenarios to revert affordability to average beyond 2011

Alternatively, there are two further scenarios which could occur to bring affordability back to average levels however the timeline is much larger, as indicated in chart 4 overleaf. Each scenario assumes the following:

1. Interest rates will follow Westpac Economics' forecasts through to 2014 and the mortgage rate will follow similar trends.
2. Median family income averages annual growth of 3.4% to 2013 (Access Economics).

Scenario 2a
No price growth between 2009 and 2014 will need to occur if affordability is to remain around average

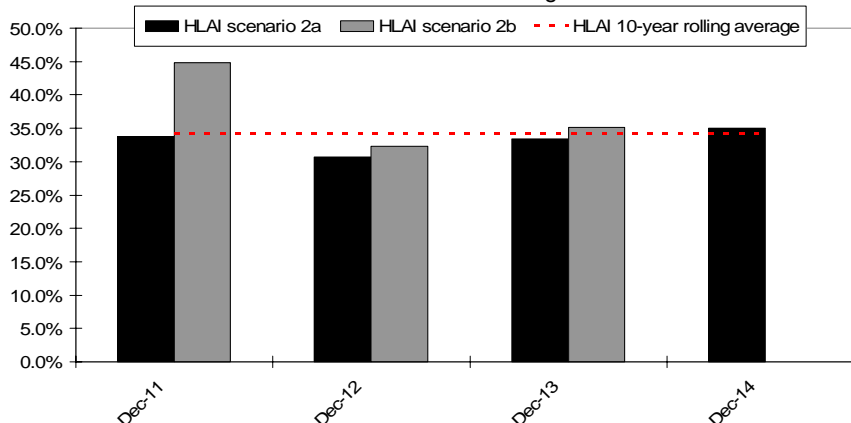
Scenario 2a – Stabilisation in house prices from 2009

In this scenario, it takes six years of stability in house prices from 2009 before affordability reaches the long term average in 2014.

Scenario 2b – Prices fall 5% in 2010 before stabilising beyond 2011

In this scenario, affordability sits above average in 2010 as prices fall. However when rates rise in 2011 affordability worsens to below average. It will then take 2 years of house price stability beyond 2011 before affordability reverts above the long term average end 2013.

Chart 4: Scenarios 2a & 2b – HLAI reverts to average 2013+



Source: Data – REIA; Analysis – Westpac Property

Affordability has been an issue since 2002. However, during this time prices have had periods of strong growth

Affordability will continue to be a problem if interest rates are the main driver of improvement.

Conclusion

Affordability has been an issue since 2002, sitting below the 10-year rolling average, however during this time house prices have still shown periods of strong growth.

The current forecast by Westpac Economics is for interest rates to fall a further 100bps by end 2009. If passed through to mortgages this would help improve affordability further. However the improvement will continue to be driven by interest rates remaining low rather than price falls.

If, as currently expected, job losses accelerate between 2H 2009 and 2H 2010, sentiment and purchasing activity is likely to fall further. Falling sentiment, coupled with a decrease in housing activity and rising job losses, could result in house price falls as forced sales filter through from late 2009. Such a scenario in a historically low interest rate environment would provide further relief to affordability in 2009 and 2010.

However, as the economy improves from 2011 and interest rates begin to rise to a more neutral level, affordability issues will re-emerge if loan size (and thus price?) falls are not high enough between 2009 and 2011. In order for affordability to revert to long-term average levels by end 2011, the average loan to purchase a dwelling needs to fall 10%, nominally.

REIA data from 1980 suggests that national house price falls of 10% have never occurred. Current house prices are down around 5% nationally, which is the highest on REIA records since 1980. Westpac Property are of the view that prices are likely to remain stable until accelerated job losses bring confidence down in late 2009, after which further price falls are likely to occur through to early 2010. However, as the economy and employment numbers recover and interest rates rise in 2011, house prices are likely to enter a period of stabilisation.

Despite the expectation of further house price falls, Westpac Property expects that the declines will not be large enough to assist housing affordability as the economy recovers. As such, affordability will remain constrained well beyond 2011 as interest rates revert to a more neutral level.

There is the possibility that the economy performs better than expected. As such, if job losses are limited this could potentially place upward pressure on prices in an environment of low interest rates and low housing supply. Should this occur, housing affordability would be a much greater issue than suggested above, once interest rates start to rise.

Contact: Westpac Property Markets
Theresa Arnott
tarnott@westpac.com.au