NEWSLETTER

April 2021

EveryStep
Financial Solutions

Introduction

In recent months we have looked at rising residential property prices and wondered whether the rise is due to an excess of demand over (very low) supply. This month, we look at new data that tells us that supply is rising to meet demand – and prices are staying high.

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The (Residential) Property Market

Last month we brought you the news that median house prices around Australia rose by more than 2% for the month of February – the shortest month of the year. During March, the upward trend for prices showed no sign of abating.

The market also showed other signs that is reacting to the current trend in prices. Last weekend, the last weekend for the month, saw very large numbers of properties offered for auction. Indeed, one market researcher observed that the number of properties offered for auction was the highest it had been since before Easter 2018.

The large number of properties being offered for sale was then accompanied by very high levels of what are known as 'clearance rates.' The clearance rate is the percentage of properties offered for auction that are actually sold on auction day, either at the auction or in the immediate post-auction negotiation period. For all cities for which we have data, last weekend's clearance rates were well above average. For example, in the five eastern mainland cities, including Adelaide, the clearance rates look like this (source: https://www.domain.com.au/auction-results/):

	Sydney	Melbourne	Adelaide	Brisbane	Canberra
Clearance rate	87%	81%	80%	75%	89%
	View details	View details	View details	View details	View details
Auctions scheduled	1230	1593	106	114	80
Auctions reported	972	1280	65	53	73
Sold	844	1042	52	40	65
Withdrawn	82	91	1	2	2
Passed in	46	147	12	11	6

The results in Sydney and Melbourne are particularly influential, as these two markets dominate the national scene, particularly when it comes to auctions. Between them, Melbourne and Sydney accounted for 92% of the total number of properties for which auction results were reported in the five cities shown above. (Our apologies that we do not have data for the other mainland cities and Hobart; due to the Easter long weekend we have prepared this newsletter a little before the end of the month of March and data for all cities is typically released on the last day of the month). As a result of this dominance, the average clearance rate for the five cities shown above was 83.6%.

Until quite recently, any analysis of residential property price movements needed to be adjusted for the fact that the volume of properties being offered to the market for sale was relatively low. For example, in mid-November, the auction and auction clearance rates for the five cities shown above were as follows (source: https://www.domain.com.au/auction-results/national/2020-11-14):

	Sydney	Melbourne	Adelaide	Brisbane	Canberra
Clearance rate	73%	70%	82%	50%	92%
	View details	View details	View details	View details	View details
Auctions scheduled	760	494	51	52	60
Auctions reported	679	421	39	30	52
Sold	498	293	32	15	48
Withdrawn	82	50	2	10	0
Passed in	99	78	5	5	4

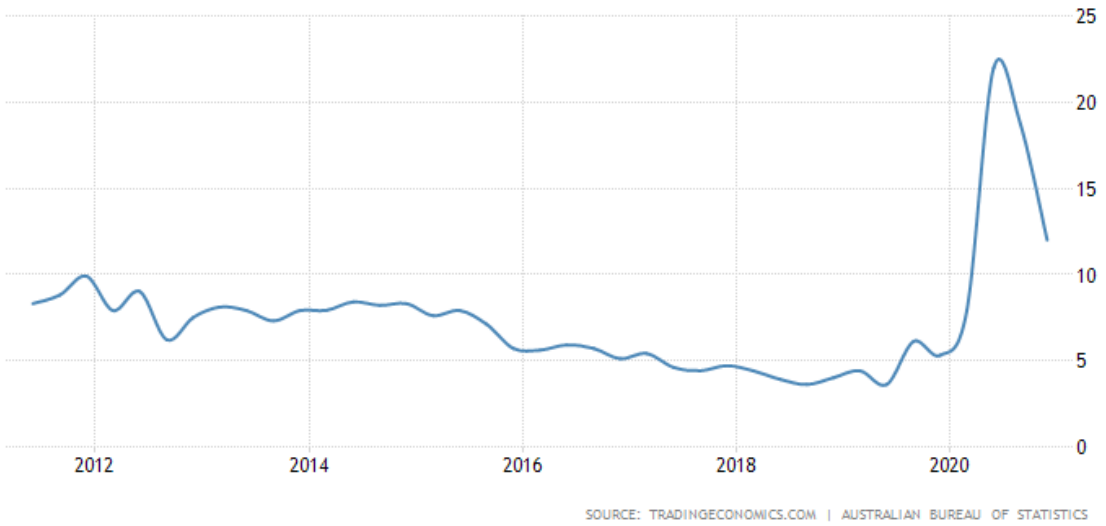
As you can see, all cities except Adelaide and Canberra had substantially lower clearance rates. But the most important figure is the fourth row which shows the number of auction sales reported. In Melbourne in mid-November, only 293 properties were reported as sold at auction. Last weekend, that figure had grown to 1042 - a more than 300% increase.

When we combine the data about escalating median house prices with the fact that the volume of houses being bought and sold is now also very high, there can be no doubt that we are in the midst of a housing boom. Whether that boom continues will be affected by a range of things, mostly in the hands of the Commonwealth Government and the Reserve Bank.

As we told you in our article last week, the Government's main stimulus response to the Covid pandemic, its Jobkeeper payment, ended on March 28. Almost certainly, this will see a substantial number of people registering for unemployment benefits for the first time since the pandemic struck. Recently, the Secretary of the Commonwealth Treasury, Dr Steven Kennedy, told a Senate estimates committee that his Department expected that between 100,000 and 150,000 people may become unemployed when the supplement ends. This is out of a group of approximately 1 million people receiving the benefit immediately before it was ended. Those 1 million people were receiving the benefit through the agency of approximately 370,000 affected businesses. (Source: The New Daily).

So, it may be that we are about to see some negative economic effects attributable to the pandemic but which have been delayed by the Commonwealth stimulus package. That said, the fact that the stimulus package was ending on March 28 was announced back in 2020. It is unlikely, therefore, that people who remained reliant on Jobkeeper up until last weekend are also in the residential property market in any great numbers. That is, the demand for residential property is probably being driven by people who weren't on Jobkeeper.

Much more likely, the residential property boom is being driven by a combination of increased savings and very low interest rates. While in hindsight it makes perfect sense, in the early days of the covert pandemic few people would have expected that many Australians would become wealthier through the simple process of saving money. But 2020 was a year of record high personal savings. The following graph shows the average percentage of household income being saved over the last 10 years (source: ABS and Trading Economics):



During the main lockdown months, Australians were saving an extraordinarily high percentage of household income - well over 20%. There were two main reasons for this. Firstly, the Jobkeeper stimulus and other Commonwealth responses meant that a majority of people maintained at least some income during this period. Secondly, the lockdown meant that things upon which income would normally be spent, such as entertainment and travel, were simply not available.

And, of course, as we have reported several times recently, interest rates are historically very low and the Reserve Bank has repeatedly stated that it will act to keep rates low until at least the end of 2023. So, people are able to combine relatively large levels of their own savings with relatively cheap debt, allowing them to 'bid up' the prices of residential property.

A simple way to slow down demand in the property market would be, of course, to raise interest rates. However, the Reserve Bank doesn't want to do this, particularly because allowing interest rates to increase is likely to have negative effects on business investment and Australia's export industries. Accordingly, some commentators are calling for other policy initiatives that would specifically reduce the extent to which people can borrow to buy houses, while, hopefully, not having any negative effect on other parts of the economy.

Such measures are known as 'macro prudential regulations' and they allow regulators to target specific parts of the economy. In Australia, we have had a recent example of macro prudential regulation when the Reserve Bank restricted the extent to which lenders could make 'interest only' loans. These restrictions were in place between 2017 and 2019, and were associated with a fall in residential property prices. Now, people are calling for a new round of macro prudential activity. As an example, as recently as Tuesday of this week, the International Monetary Fund argued for a tightening of lending standards in Australia.

Almost certainly, we will see some move towards greater restrictions on bank lending for residential property purchases in the coming months. It remains to be seen the extent to which such restrictions will slow the growth in residential property prices. Some slowing is necessary, however, because skyrocketing house prices are seeing an increasing number of Australians simply unable to afford to purchase property in their preferred capital city.

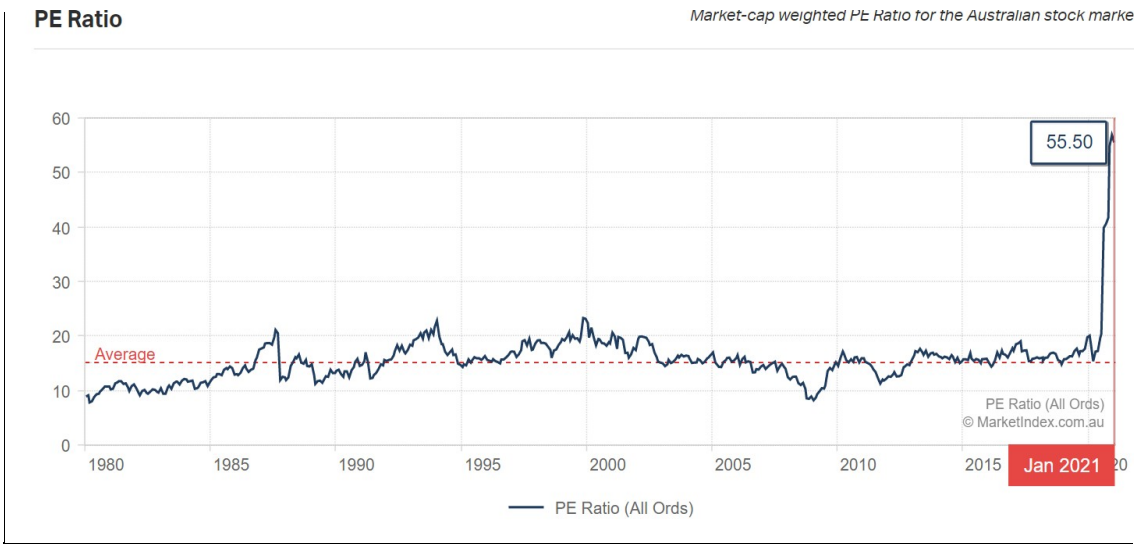
The Share Market

While the residential property market is creating much interest, the same cannot be said for Australia's share market. For the second straight month, the market basically tracked sideways in March. In fact, the sideways movement was almost literal, as the market (as measured by the ASX 200) closed the month just 1.1 points higher than it had been on March 1. That's a change of just 0.016%.

Here is how it looked, thanks to Google and the ASX:

This is the second consecutive month in which prices in the Australian market have not really changed (on average, of course!) In some ways, it is almost as if the market is taking a breath. More formally, the market looks like it is allowing the increased earnings that it had incorporated into prices in the second half of 2020 to come to pass.

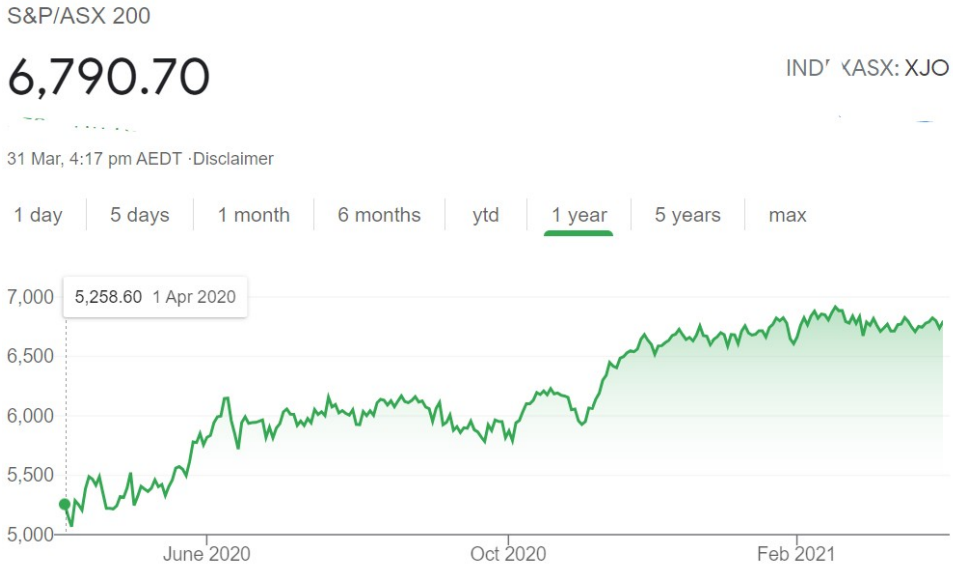
As we have discussed previously, the average PE ratio on the Australian market soared in 2020. Here is how it looks graphically, according to www.marketindex.com.au:



You are not seeing things - that really is how things have been. Having oscillated around the average PE ratio of 16 or so for the previous 40 years, the PE ratio reached more than 56 in December 2020. The level for January, shown above as 55.5, was a slight reduction – but still a much higher figure than the long term average.

The P/E ratio compares current prices in the market to profits (earnings) of companies in the market. This actually means that the ratio is comparing data that relates to two different periods of time. Earnings is an historic piece of information: it is the profit the company has *already made*, albeit very recently in the most recent reporting period. Price is based on the general market perception about a company's *future performance*. Put simply, prices will be higher where investors predict that a company will perform well in the future. As a result, the P/E ratio is comparing recent past performance with likely future performance.

The P/E ratio reported by Market Index in the graph above demonstrates this relationship beautifully. In the second half of 2020, many companies reported either much lower profits or, in a lot of cases, absolute losses. So, the E in the P/E ratio was very low. At the same time, most participants in the market believed that the loss of earnings was temporary, and that the economy would bounce back to pre-pandemic levels quite successfully. This optimism pushed prices higher, as shown by this graph of average share prices over the last 12 months (again, thanks to Google and the ASX):



Bear in mind that March 2020 represented the absolute nadir in terms of share market prices for the pandemic period. From there, we can see the increasing confidence with which investors viewed the future, as investors generally approved of the way in which central banks such as our own Reserve Bank, and governments such as our own Commonwealth Government responded to Covid with compensation and stimulus.

With a small dip in November 2020, around the time of the US presidential election, after March 2020 there was a very steady upward progression in confidence about the future, with this confidence being reflected in a more or less constant increase in prices. Now, in 2021, it seems almost as if the expected future has arrived. We have just finished the February reporting period, and earnings held up quite well. These earnings have not been factored into graphs such as the one above from market index yet, but when they do we will see the average P/E ratio once again falling back towards its long-term average. Almost certainly, December 2020 saw the peak in the average P/E ratio. From now, we can expect that profits reverting to normal will increase the 'E' component of the ratio and see the overall figure reduce.

Put simply, the sharemarket is acting as if it is waiting for earnings to catch up to prices.

The Legal Stuff

General Advice Warning

The above suggestions may not be suitable to you. They contain general advice which does not take into consideration any of your personal circumstances. All strategies and information provided on this website are general advice only.

We recommend you seek personal financial, legal, credit and/or taxation advice prior to acting on anything you see on this website.

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