BULLETIN

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Spring looms as a big test for housing market's 'orderly' correction

Australia's housing market correction is gaining momentum. With another batch of data updates due next week and the Spring selling season just around the corner, what are the latest updates telling us and how are things expected to unfold from here?

We are now very clearly into a market correction phase for Australian housing with prices nationally down for a third month in a row in July and the detail showing the pace of falls accelerating and spreading to more markets. The CoreLogic home value index, covering the eight major capital cities, has gone from a 0.4% fall in May to a 0.9% fall in June and a 1.4% drop in July with the daily data point to something similar in August.

The detail shows: deepening falls in Sydney, which is clocking monthly declines of more than 2%; Melbourne pacing the national story but a few more markets now tipping into correction, most notably Brisbane but also Hobart, Canberra and regional areas of NSW, Vic and Qld; and price gains stalling in Adelaide and Perth.

Sales volumes have also fallen sharply, down about 20% since the start of the year, albeit from a very high starting point. Notably, sales in July were broadly in line with the volume of new listings nationally, having run well ahead over the previous 12 months. While we are not yet seeing a substantial overhang of unsold stock, buyers are clearly gaining the upper hand. This is happening more quickly in Sydney and Melbourne where sales are already running well below new listings and the stock of listings is rising quickly.

This shift is likely to become more apparent as we head into the Spring selling season. We typically see a 20% seasonal lift in new listings through September-October that also tends to run ahead of a lift in sales. Sellers may be less prevalent this year given market conditions. Even so, this period will clearly test the depth of demand and the extent to which it has become a buyer's market, seasonal factors also likely to accentuate any price weakness.

Buyers may be gaining the upper hand but they do not look keen. Interest rate rises are still the dominant force for buyer sentiment. Our Consumer Sentiment survey's 'time to buy a dwelling' index, which has a remarkable track record in picking turning points historically, is still languishing around cyclical lows. While the August update shows it holding there rather than weakening further, it is very unlikely to stage a revival until interest rates stop moving higher – and even then may continue to languish until the potential for rate cuts comes back onto the table.

Meanwhile price expectations are now outright pessimistic – those expecting falls outnumbering those expecting gains nationally and with pessimism now looking firmly entrenched in markets that have seen more material declines to date. In contrast to views on 'time to buy', consumer house price expectations are still well above previous cycle lows. As such, further weakening looks very likely.

So are there any positives in this bleak picture?

The downturn clearly has further to run and the peak to trough price decline is already on track to be material, but the correction still looks likely to be reasonably 'orderly'.

So far this has been a 'demand-driven' rather than a 'distress-driven' correction. That is, the prime mover is rising interest rates reducing the volume of demand and the borrowing capacity of buyers, rather than a sharp rise in urgent or distressed sellers. The latter is what would happen if we had a combination of high interest rates and a weakening labour market; if there was a large overhang of unsold and/or vacant stock; or if we were dealing with an unwinding investor-led boom. None of this appears to be a factor in the market right now.

And while we will surely see an increase in stress across the mortgage belt, this will be slow to show through with mortgage arrears coming from an exceptionally low starting point.

The strong labour market is an important factor likely to provide ongoing support here. Job loss is often a trigger for the sort of mortgage distress that can lead owners to sell into a weak market. Job security can also be a big factor on the demand side too – a sudden loss of confidence around jobs could see more buyers hang back. With job vacancies currently outpacing unemployed, risks of a large round of layoffs would appear to be low.

The physical supply-demand balance also looks relatively supportive. Rental vacancy rates are very low in most capital cities and tightening in Sydney and Melbourne with no obvious overhang of physical oversupply. The completion of a large backlog of new dwellings will see some shift in the balance across the wider market but a lift in net migration inflows will also drive up demand, for rental accommodation in particular.

Risks of 'negative equity' compounding the situation also look to be fairly contained. The price declines coming through now – big as they are – follow an extraordinary run-up over the previous two years. In fact, across the fifty sub-segments we follow (city/region by houses/units and by price tier), every single one has still seen net price gains since late 2020 – three quarters have seen net price gains of over 20%, with 46 of the 50 having seen net price gains of more than 10%. The correction to date is still just unwinding some of the earlier gains.

There is also a degree of symmetry: most of the markets now recording the biggest price declines are also coming off bigger gains through the upturn. As we touch on in our most recent Housing Pulse report, this limits the risk of price declines pushing recent buyers into 'negative equity' – where the value of a property drops below the outstanding value of loans secured against it. RBA research shows the presence of negative equity greatly increases both the default risk of mortgages in arrears and the losses on these loans.

Note that this picture around price-driven gains in equity also helps recent borrowers looking to refinance, offsetting, to some extent, the impact of higher interest rates and rising costs on loan serviceability assessments.

Conclusion

While there are valid reasons to expect a continued 'orderly' correction, there is no getting away from the bleak situation right now – markets are locked into a material price correction that has further to run. The RBA is poised to deliver another 50bp rate rise in early September with rate rises expected to continue, albeit at a slower 25bp per meeting pace, through to February, and 'tight' settings maintained throughout 2023. Westpac expects prices nationally to decline 16% from peak to trough, closer to 18% for Sydney and Melbourne. We look to be about a quarter of the way through that adjustment nationally and about 40% through in the case of the Sydney market.

From a buyer's perspective, opportunities may start to emerge next year but a lot needs to happen before then. Most importantly, inflation will need to be firmly back under control. That still looks to be some way off with inflation yet to pass its peak locally and only expected to return to the top of the RBA's 2-3% target band by the end of 2023. As such, the RBA is not expected to relax rate settings until 2024. That said, housing-related sentiment could turn well before then if markets get a sense that the rate cycle may be starting to turn.

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