

Open partnerships
Open possibilities

Australia's Residential Mortgage Market: Where are We Heading

**Presentation to IQPC Mortgage Processing
Conference**

Harbour's Edge Events Centre
Darling Harbour, Sydney
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Much talk of Armageddon, but the broad outlook remains positive

Despite risks, the economic backdrop will remain supportive

- Global growth to remain solid, despite US slowdown
- China/Asia – voracious appetite for commodities

But, the ongoing strength of the Australian economy will prompt further RBA interest rate hikes in 2008

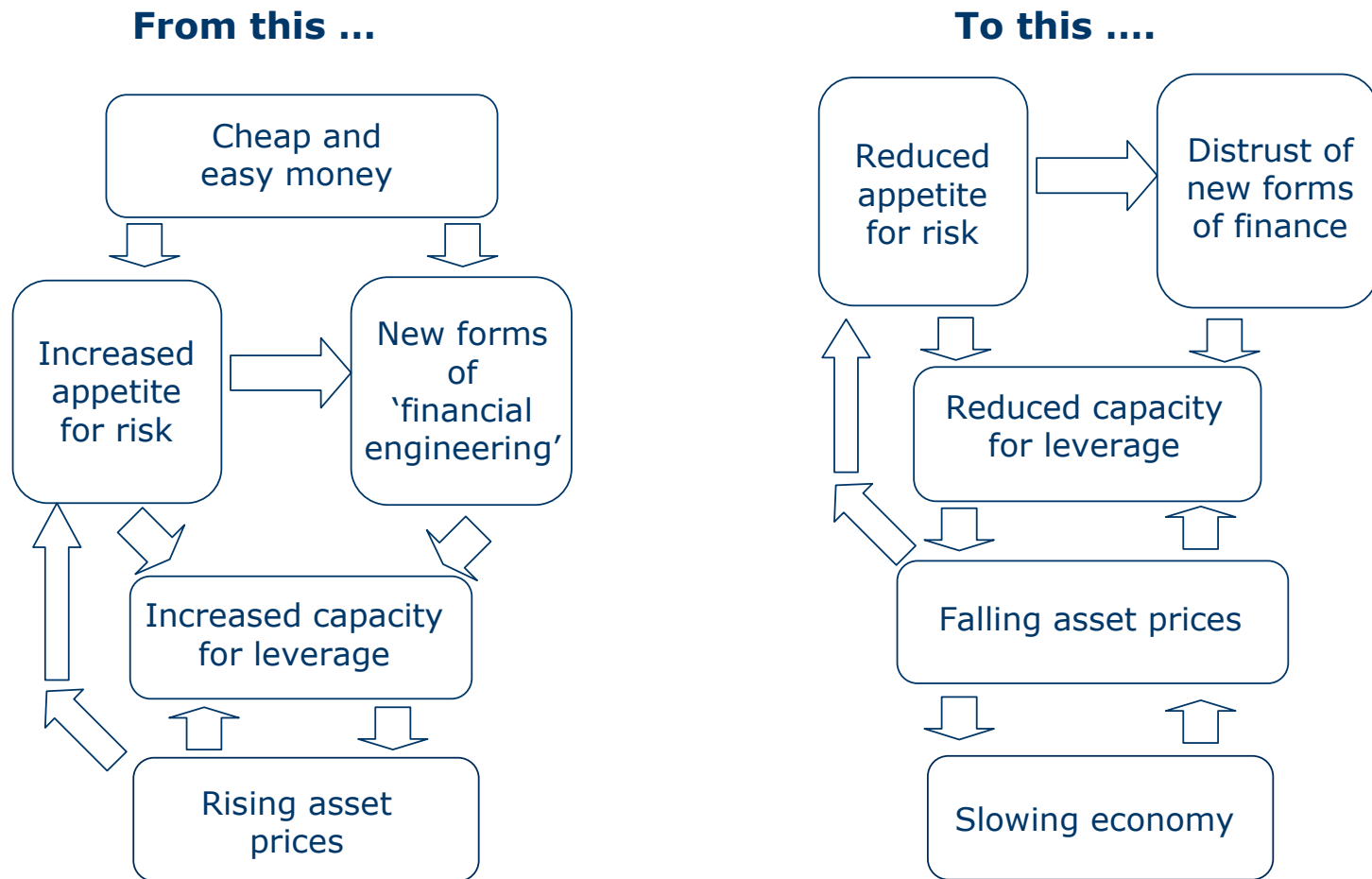
- Which will weigh on buyer/developer sentiment & sales
- And further reduce housing affordability

But housing markets continue to tighten rapidly

- Rental vacancies already well below long term averages...
- ...and supply is now *well* short of demand...
- ...driving vacancies lower & rents and prices higher

Bottom line: Housing markets will remain well supported as underlying fundamentals tighten dramatically - but risks posed by higher interest rates

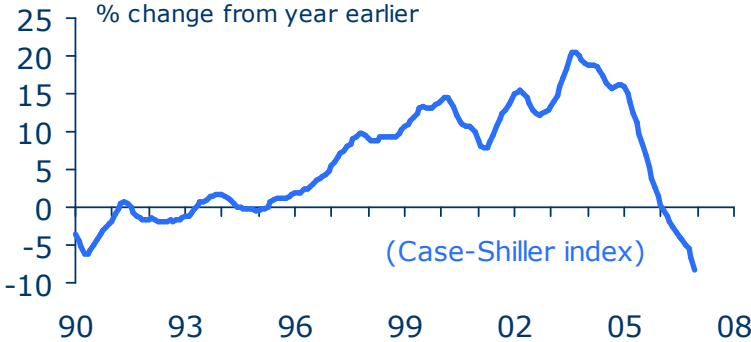
The current global financial crisis stems from the bursting of a 'credit market bubble'



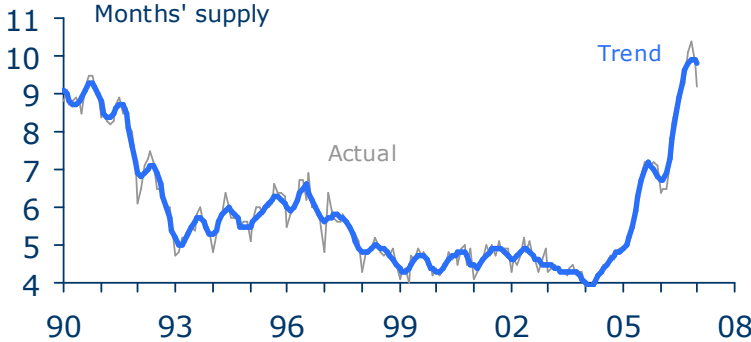
The current financial market crisis has its origins in the US housing market

US housing market

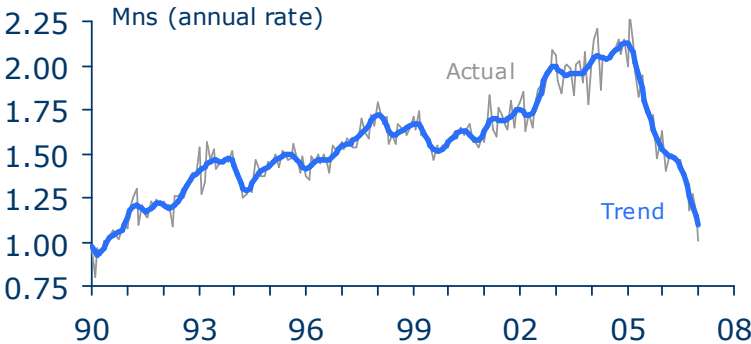
US house prices



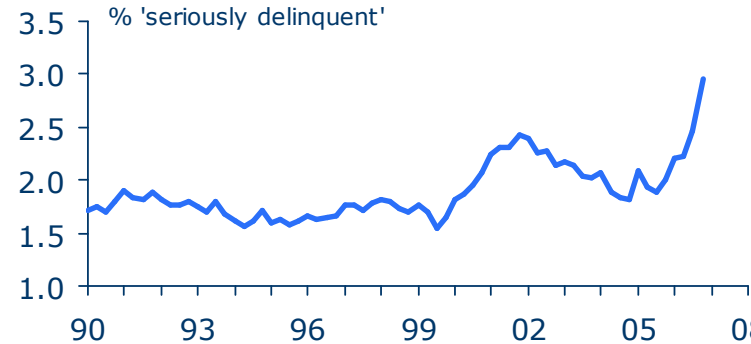
US unsold homes



US housing starts



US mortgage delinquencies

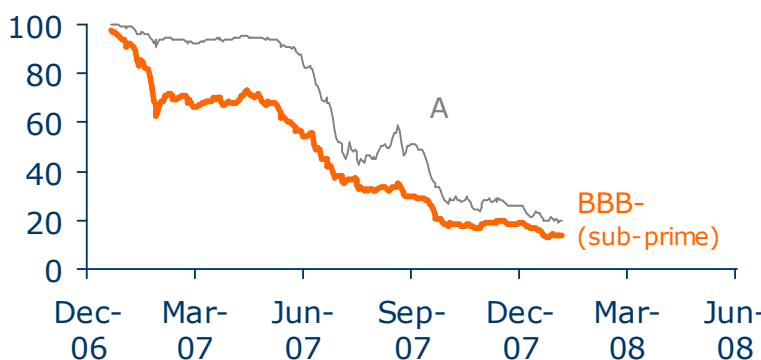


Sources: S&P; US Commerce Department; US National Association of Realtors; US Mortgage Bankers' Association.



Dramatic declines in the value of mortgage-backed securities have led to substantial losses incurred by big global banks

ABX index of prices of US mortgage-backed securities



Source: Bloomberg.

Losses announced by major banks since mid-2007

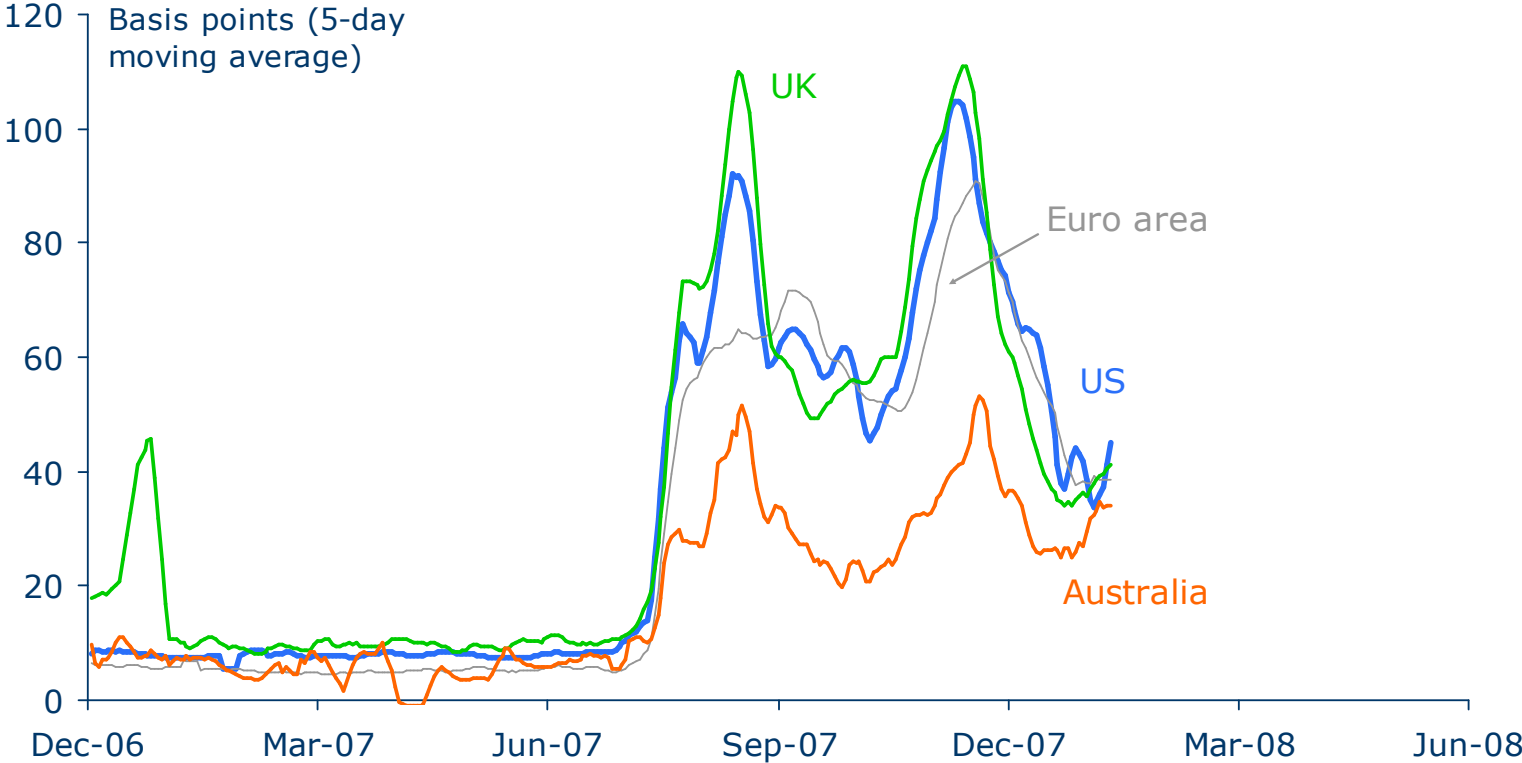
Bank	Total (US\$ bn)
Merrill Lynch	24.5
Citigroup	22.1
UBS	14.4
HSBC	10.7
Morgan Stanley	9.4
Bank of America	7.9
Washington Mutual	6.5
Credit Agricole	4.9
Wachovia	4.7
JPMorgan Chase	3.2
Canadian Imperial (CIBC)	3.2
Barclays	2.7
Bear Sterns	2.6
Royal Bank of Scotland	2.5
Deutsche Bank	2.3
Wells Fargo	1.7
TOTAL*	133.0

* incl. smaller banks not shown separately.



These losses (and fears of more to come) have made banks reluctant to lend to one another

Spreads between short-term (90-day) inter-bank borrowing rates and expected official cash rates



Sources: Thomson Financial; Bloomberg.



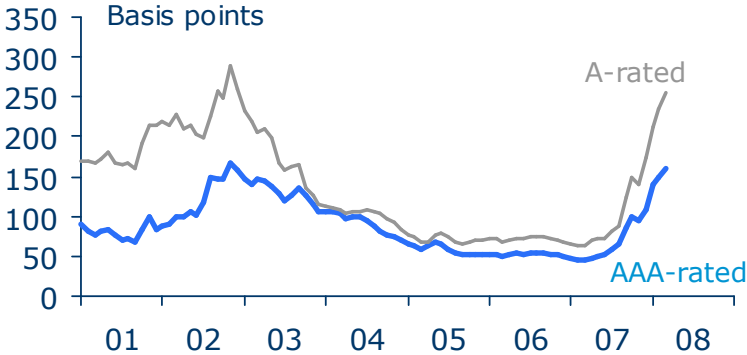
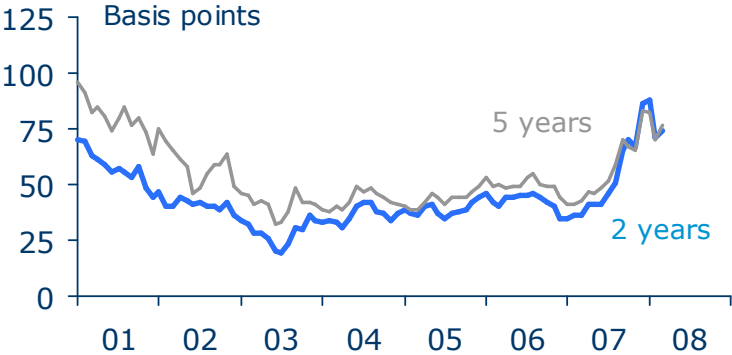
However longer-term borrowing spreads for both banks and corporates remain wide by historical standards

Swap spreads

Corporate bond yield spreads

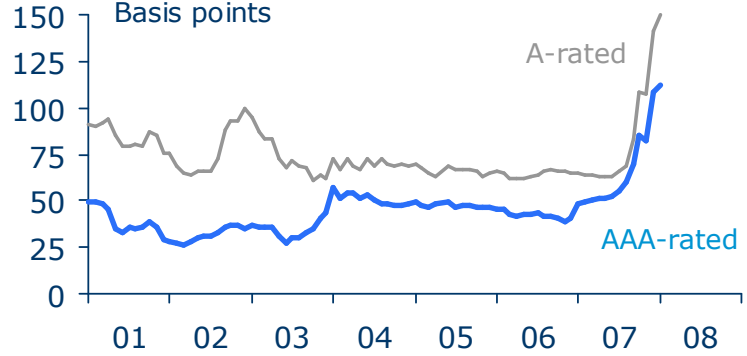
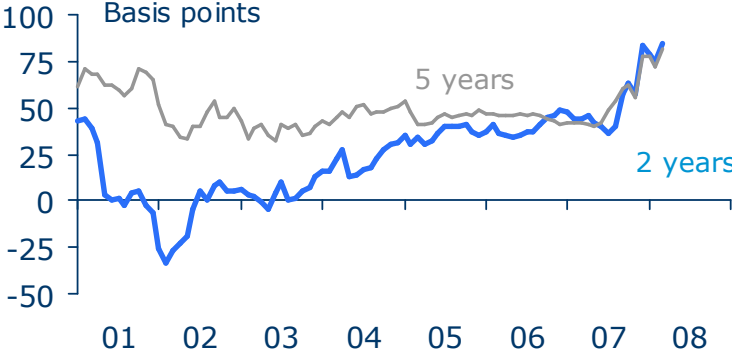
United States

United States



Australia

Australia



Note: spreads are to government bond yields of comparable maturities.
Sources: Thomson Financial; Bloomberg; Reserve Bank of Australia.

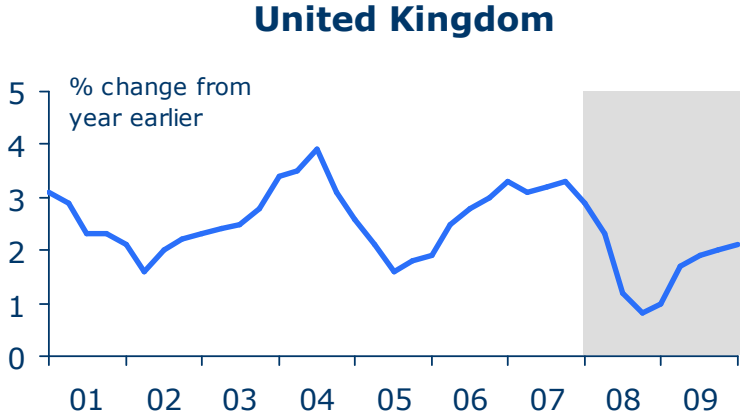
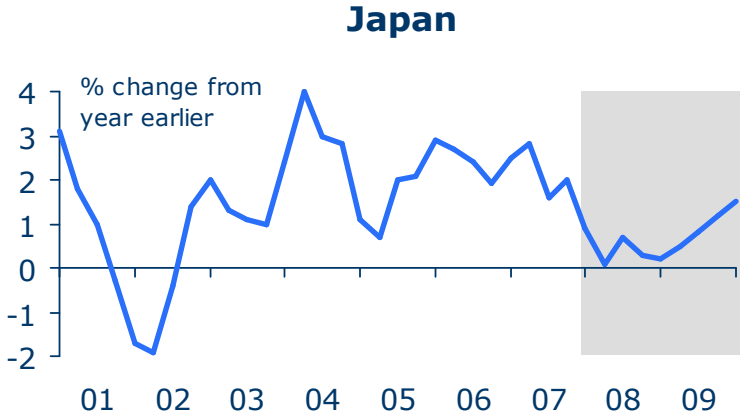
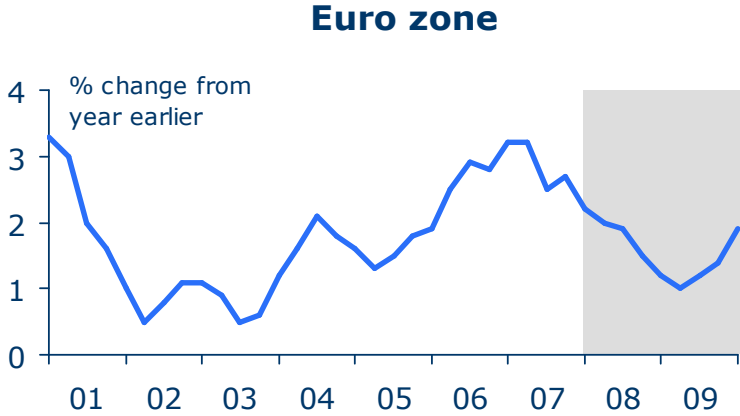
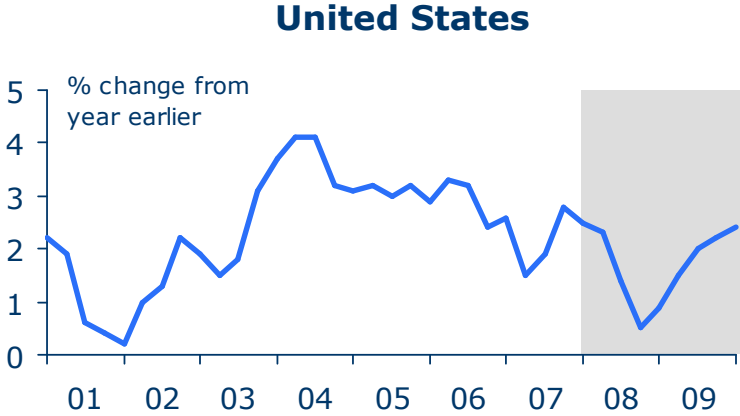


There are still plenty of downside risks facing the global financial system ⁸

- Further write-downs in the value of mortgage-backed securities as a result of on-going defaults and falling house prices
 - Another 1½mn variable-rate sub-prime mortgages face interest-rate resets this year (more than in 2007), and a further ½mn in 2009
 - estimates of eventual total losses are in the range US\$200-500bn (cf. \$133bn written off to date)
- Write-downs in the value of other securities 'guaranteed' by 'monoline' bond insurers whose credit ratings seem likely to be downgraded
 - these institutions have 'guaranteed' US\$2.4trn of municipal and consumer debt (of which \$900bn is structured finance debt (CDOs etc))
- Potential losses arising on other types of securities
 - such as those backed by commercial mortgages, leveraged loans, private equity buy-outs
 - 'credit default swaps' (derivatives intended to provide insurance to investors in debt securities against the risk of default)
- On-going pressure on banks' capital from having to expand balance sheets to meet needs of customers unable to debt issue securities, and from further write-downs
 - which in the most extreme case could result in banks being forced to ration credit

All of the world's major advanced economies will experience sharply slower growth, or possibly even recession, in 2008

Major advanced economies – real GDP growth



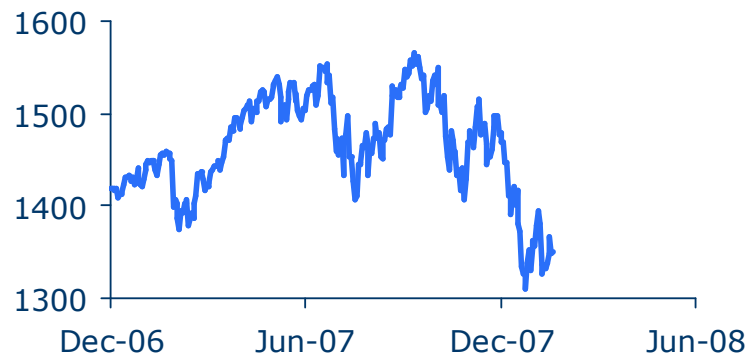
Sources: national statistical agencies; ANZ.



January's panic selling has ceased, but equity markets remain vulnerable to earnings downgrades and other shocks

Equity markets

US – S&P 500



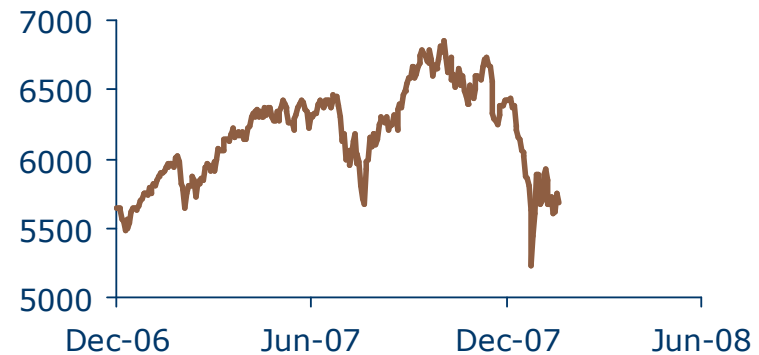
UK – FTSE 100



Japan - Nikkei



Australia – ASX All Ords



Source: Thomson Financial.



Australia is exposed to the global financial crisis, but our circumstances also differ from most other Western economies

Australia's exposure to the global financial crisis

- Large current account deficit, predominantly financed by overseas borrowings by banks (in the same capital markets as their Northern Hemisphere counterparts)
- Share market heavily weighted towards financial and materials sectors, which have been among the hardest hit globally
- Business confidence more directly linked to trends in US and Europe than implied by their relative importance to Australia's trade
- Minority of households with very high levels of debt

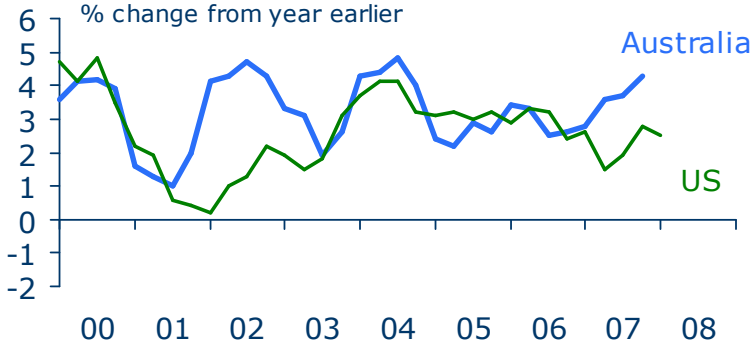
Differences between Australia and other major economies

- Elevated commodity prices add to, rather than subtract from, national income
- Business cycle more closely aligned with that of developing economies than other industrialized economies
- Inflation rising rather than falling
- Smaller extent of high-risk mortgage lending than in US
- Underlying demand for housing remains in excess of supply, providing support to house prices

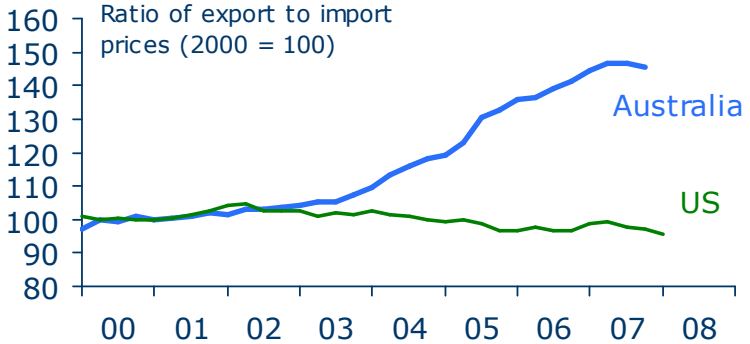
Australian and US economic cycles have not been closely correlated this decade, and are diverging further now

Australian and US economic indicators

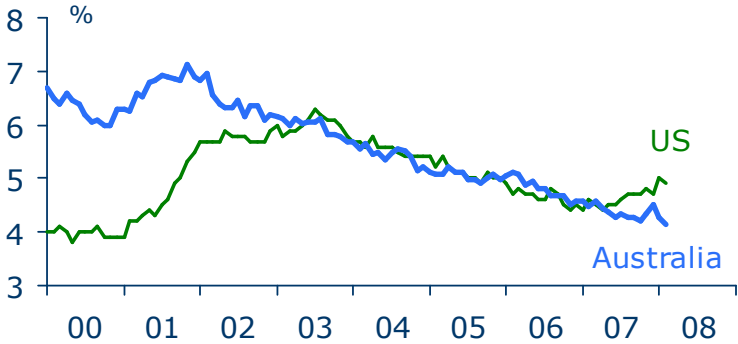
Real GDP growth



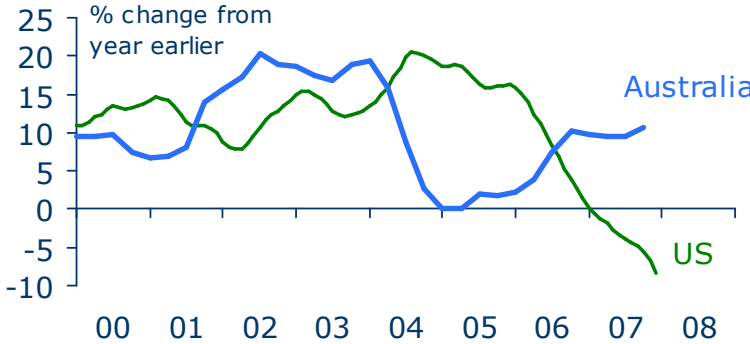
Terms of trade



Unemployment



House prices

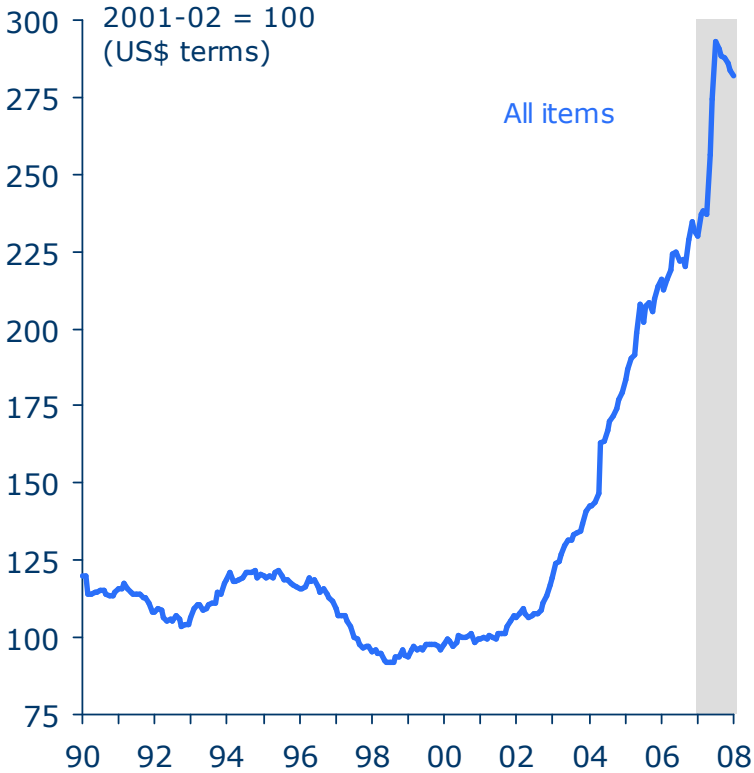


Sources: Australian Bureau of Statistics; US Bureau of Economic Analysis; US Bureau of Labor Statistics; S&P.



Expected rises in coal and iron ore export prices will deliver a final leg upwards in the commodity price cycle this year ...

Australian export commodity prices



Australia's "terms of trade"

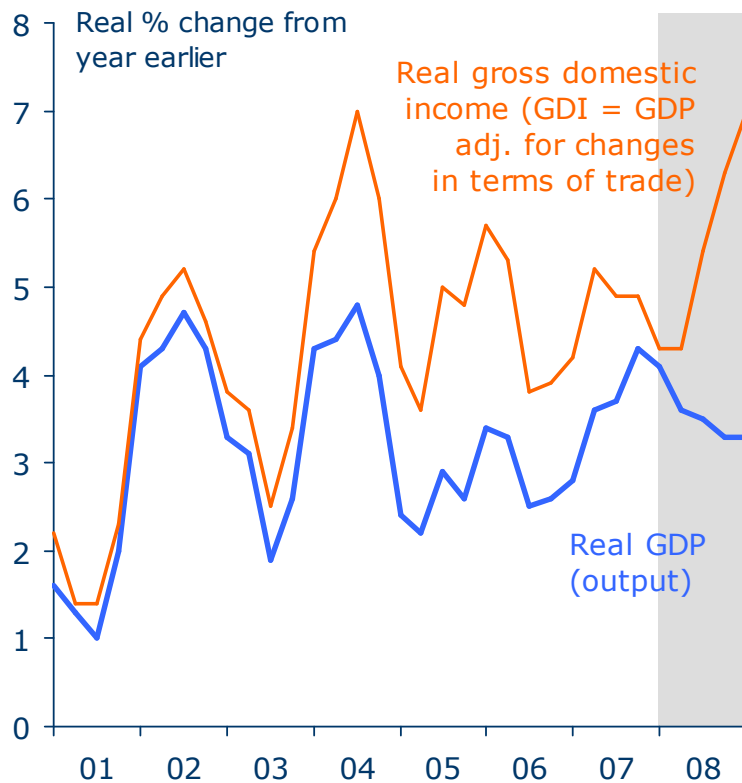


Note: "terms of trade" is the ratio of average export to average import prices.
Sources: Reserve Bank of Australia; ABS; ANZ.

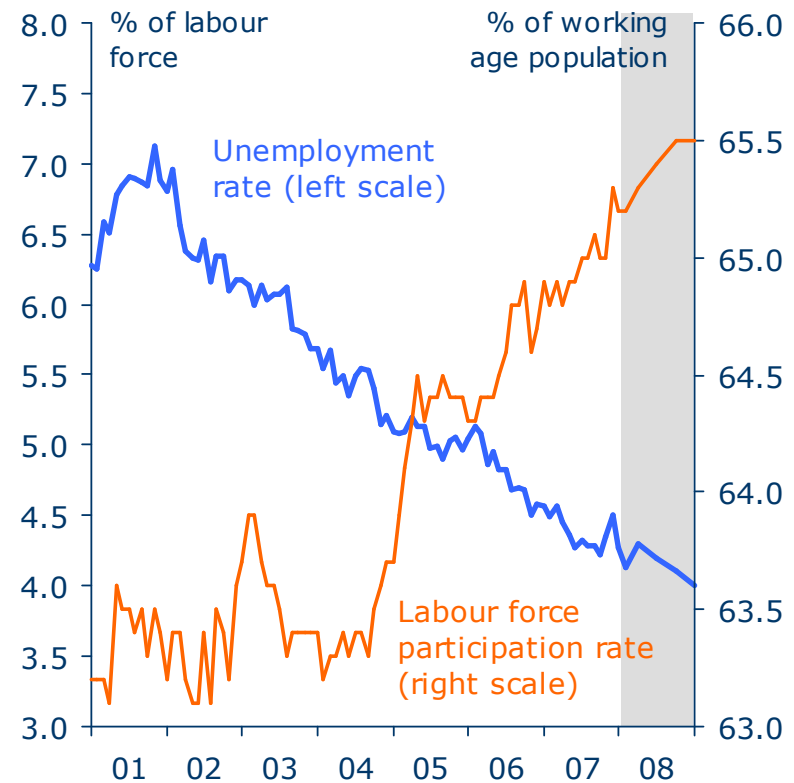


... giving the economy another boost at a time when the labour market is exceptionally tight

National income and output



Labour market

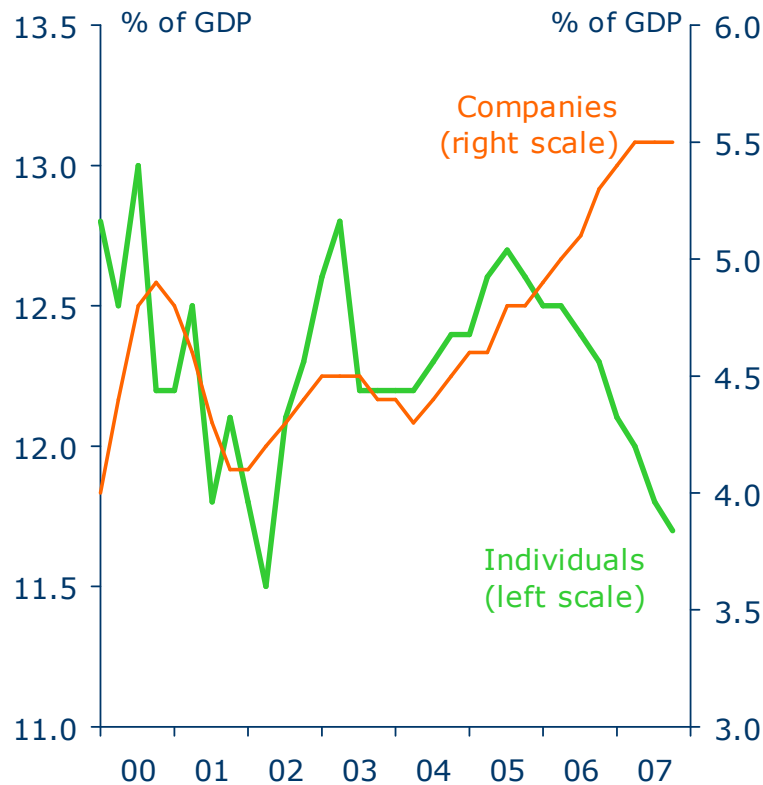


Sources: Australian Bureau of Statistics; ANZ.

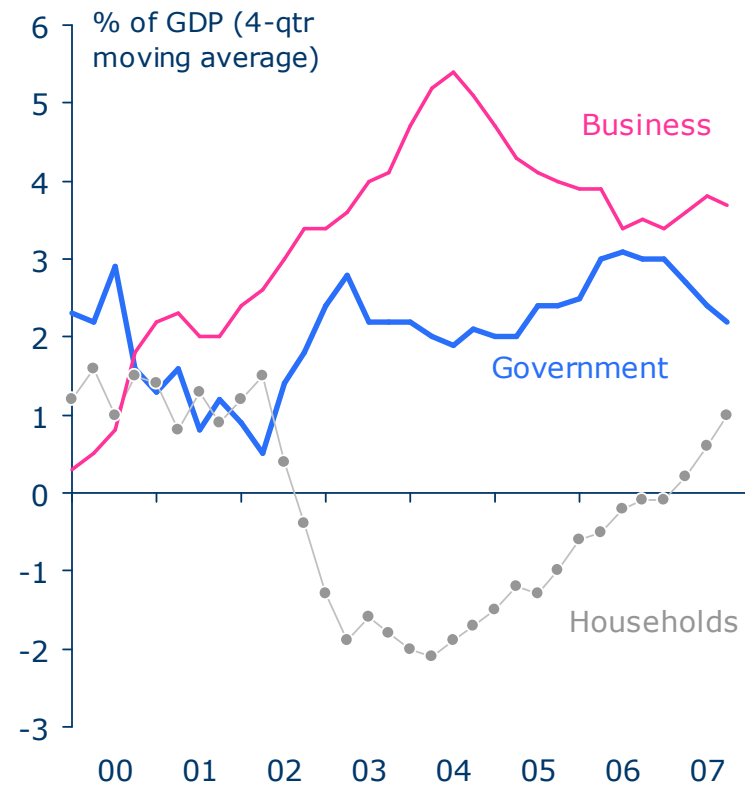


Income will continue to be re-cycled from the business sector to households through the Budget, boosting total spending ... ¹⁵

Australian income tax collections



Net saving by sectors of the Australian economy



Sources: Australian Bureau of Statistics; ANZ.



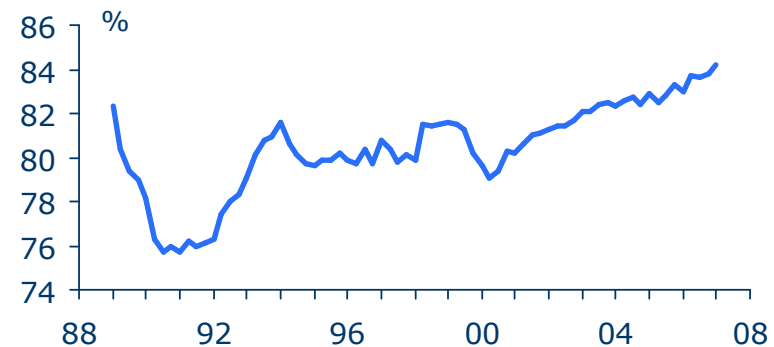
... at a time when, after over 16 years of continuous growth, 'capacity constraints' are becoming increasingly binding

Indicators of 'spare capacity' in the Australian economy

Unemployed persons per job vacancy



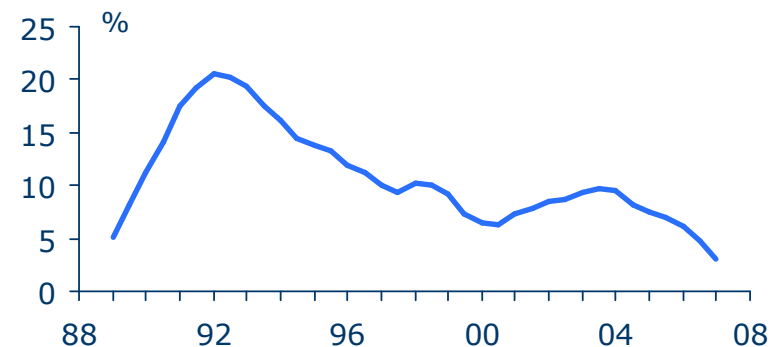
Capacity utilization rate



Businesses reporting labour shortages



Office vacancy rates

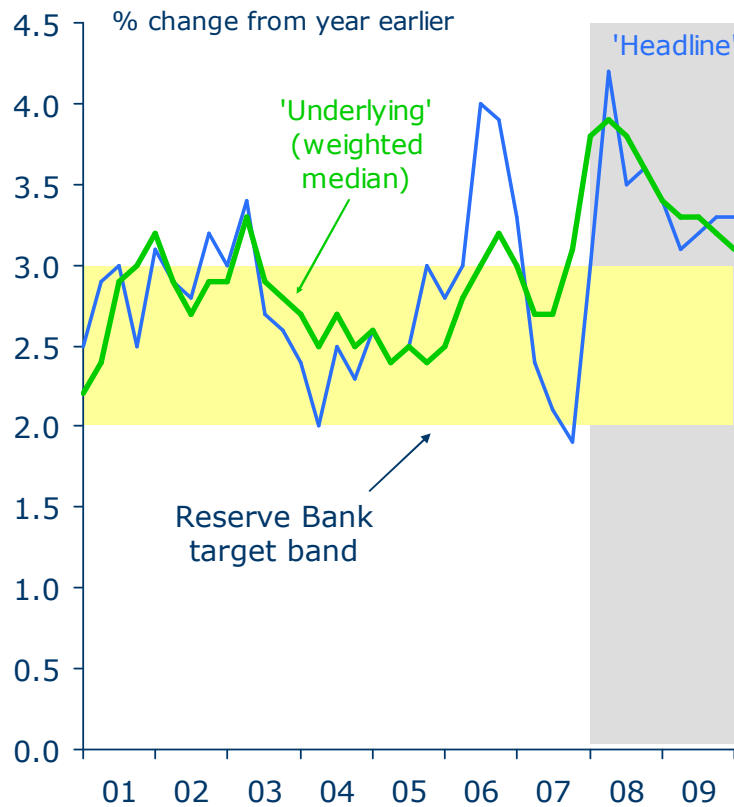


Sources: Australian Bureau of Statistics; nab; Property Council of Australia.

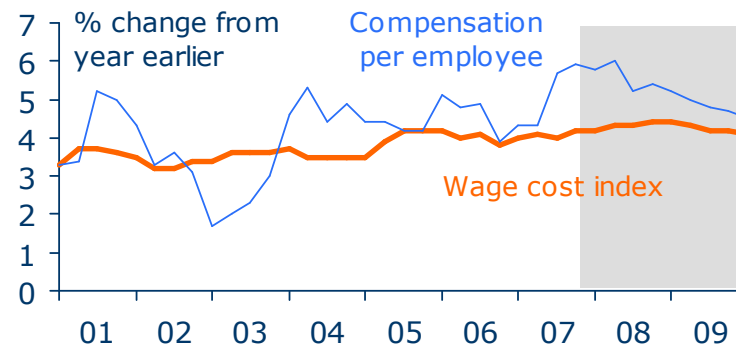


Rising inflation (reflecting demand growth in excess of supply potential as well as global factors) is a serious policy concern

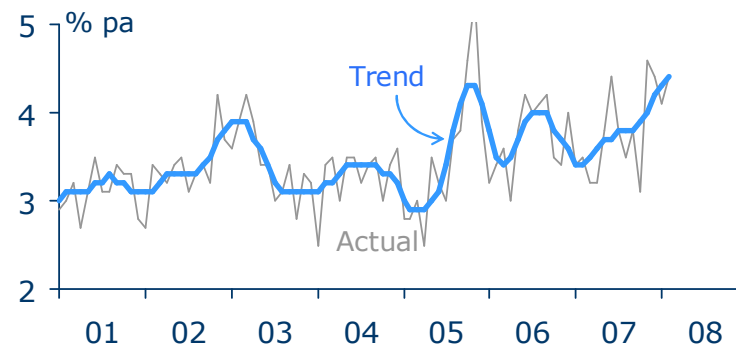
Consumer prices



Measures of labour costs



Household inflation expectations

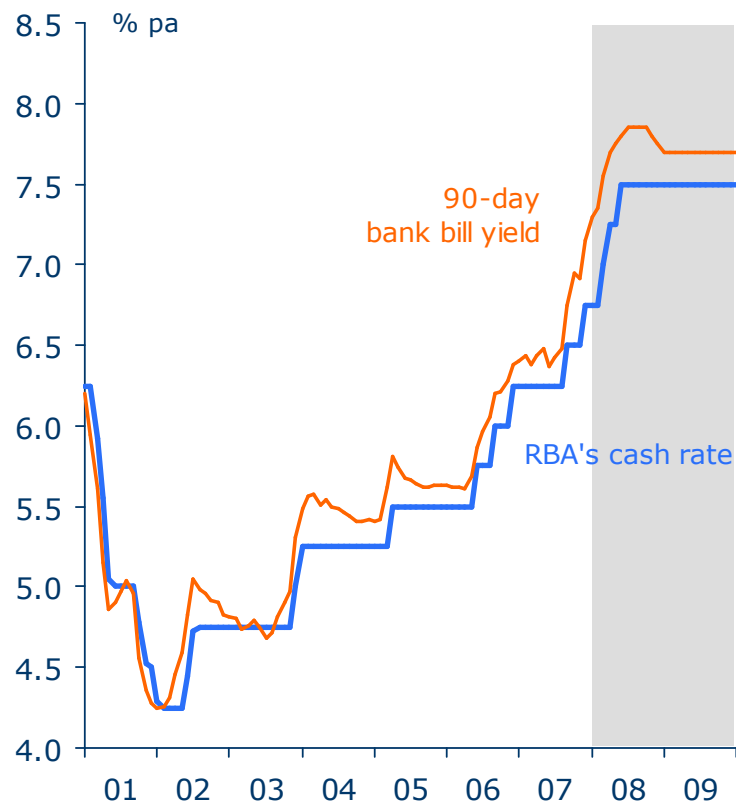


Sources: Australian Bureau of Statistics; Reserve Bank of Australia; Westpac-Melbourne Institute; ANZ.



Reserve Bank will hike rates at least twice more to 'slow demand' and bring inflation back within the target range

Short-term interest rates



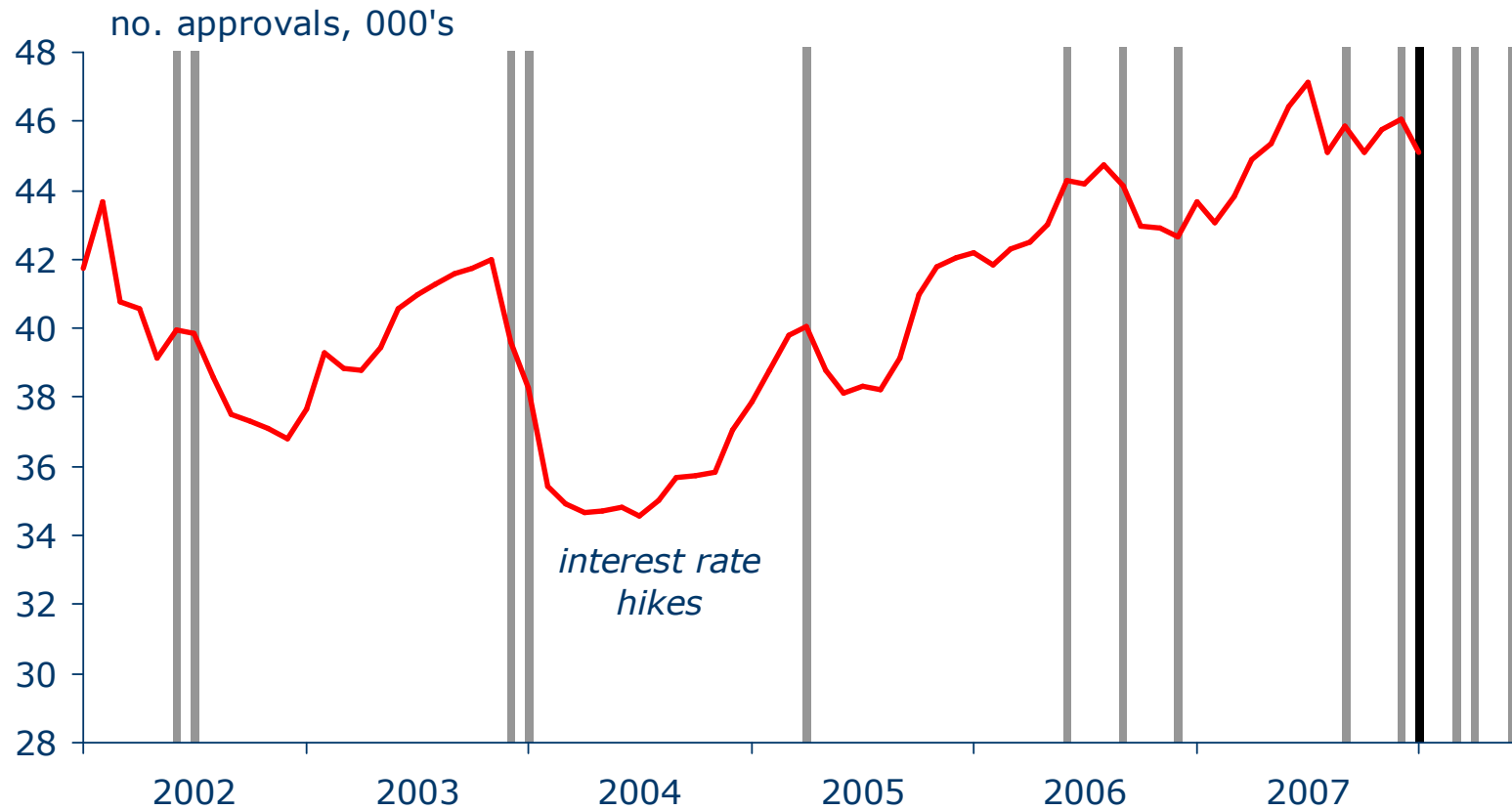
Sources: Thomson Financial; ANZ.

- 10 interest rate increases since mid-2002 have had little lasting impact in restraining growth in domestic demand – largely because they've been offset by commodity-related income gains, repeated rounds of tax cuts etc.
- The RBA now says that 'a significant slowing in domestic demand ... is likely to be necessary to reduce inflation over time' ...
- ... and that 'absent a further shift in economic risks to the downside' (ie, a further deterioration in the global economy and financial markets) ...
- ... 'monetary policy is likely to need to be tighter in the period ahead' (ie, rates will rise some more)
- In other words – there will be a 'significant slowing in demand', what is not clear is how high rates will have to go in order to procure it



Further interest rate hikes will weigh on the demand for housing finance ¹⁹

Owner occupier finance approvals vs. interest rates

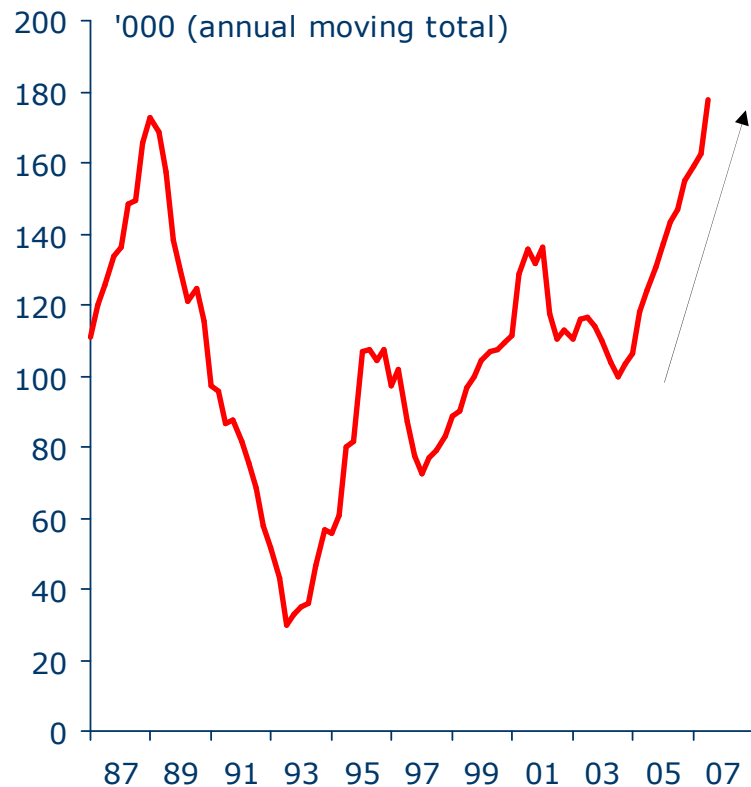


Sources: Australian Bureau of Statistics; ANZ.

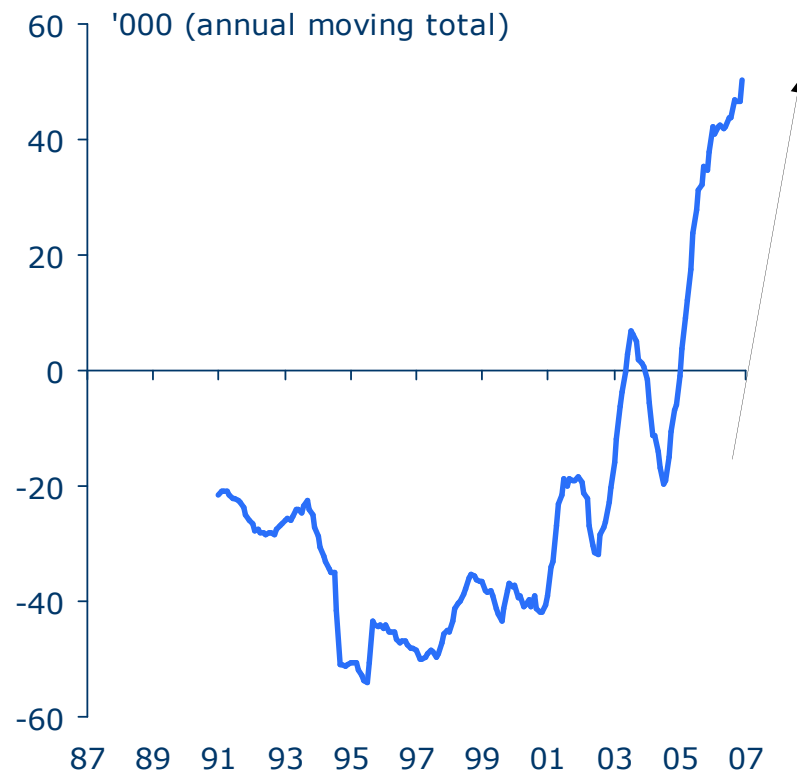


Rising immigration, both permanent and temporary, is boosting housing demand...

Net permanent & long-term settler arrivals



Temporary migration 'for employment'

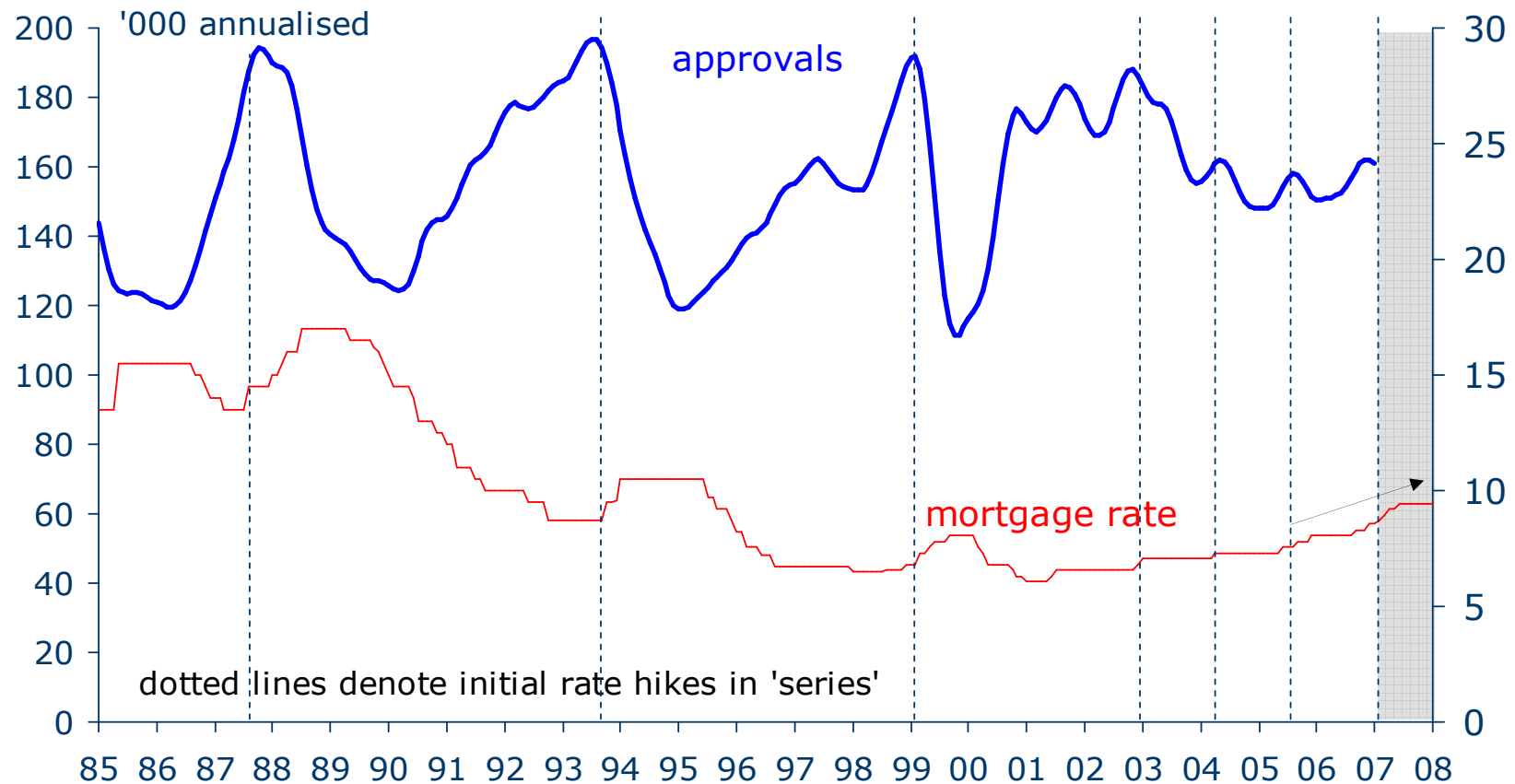


Sources: Australian Bureau of Statistics; Economics@ANZ.



...while rising interest rates continue to stymie any building recovery...

Building approvals vs. interest rates

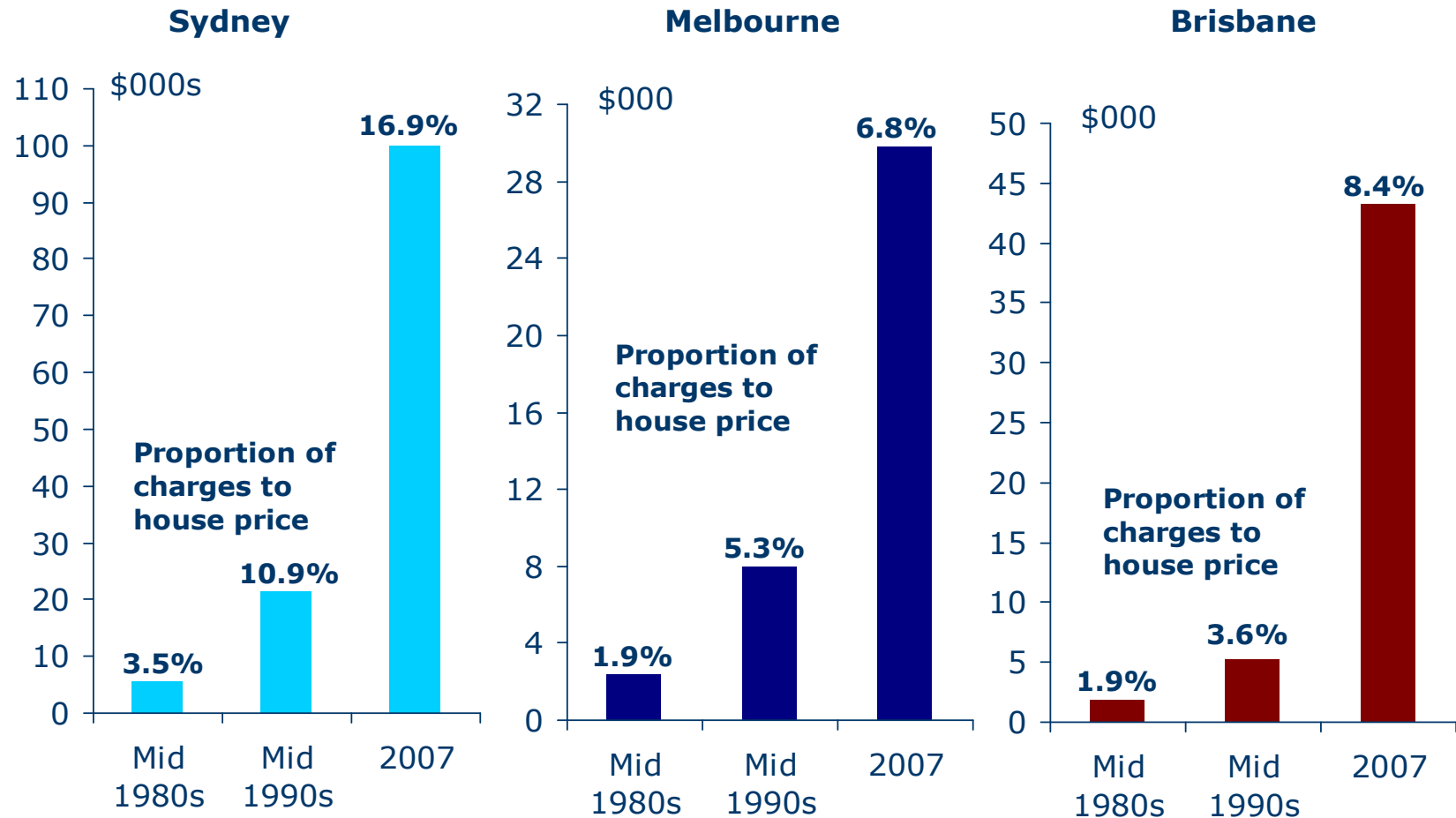


Sources: Australian Bureau of Statistics; RBA; Economics@ANZ



...as do excessive developer charges

Primary charges for lot development

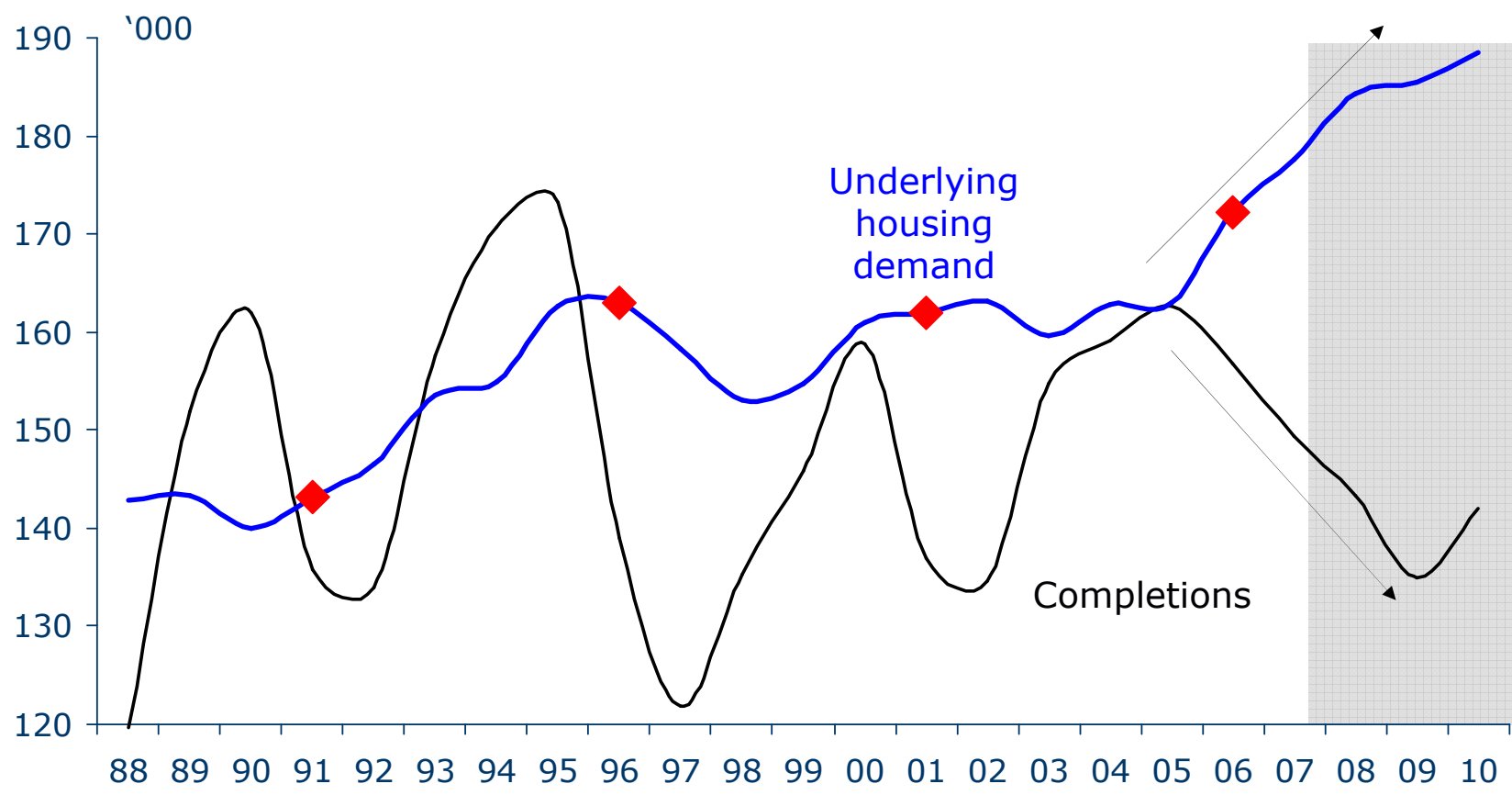


Source: HIA



Underlying housing demand is already outstripping new supply, and the gap is set to widen sharply...

Housing market balance: Australia

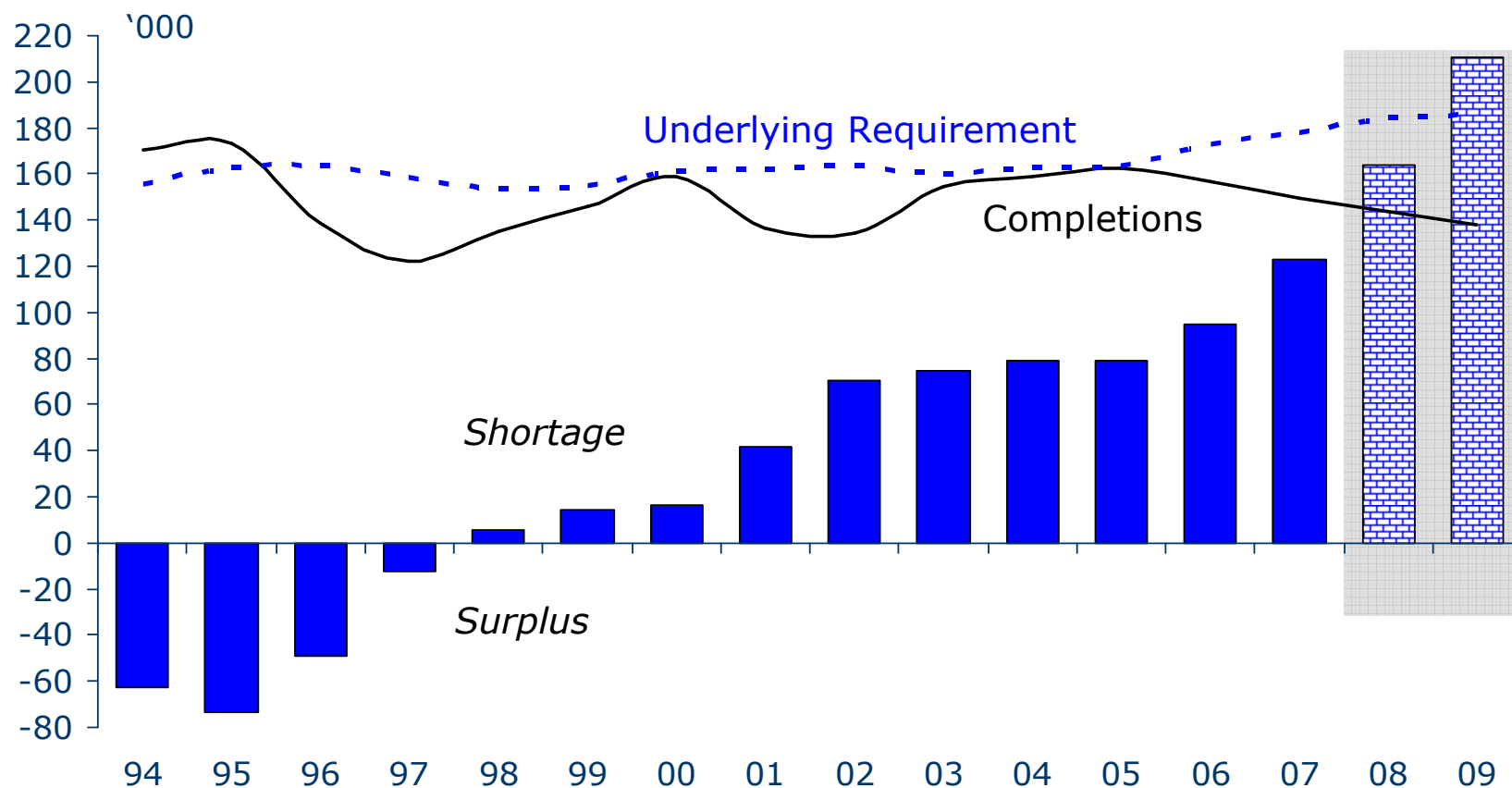


Sources: Australian Bureau of Statistics; Economics@ANZ



...and pent-up demand will rise to record (and *possibly intractable*) levels

Housing market balance: Australia

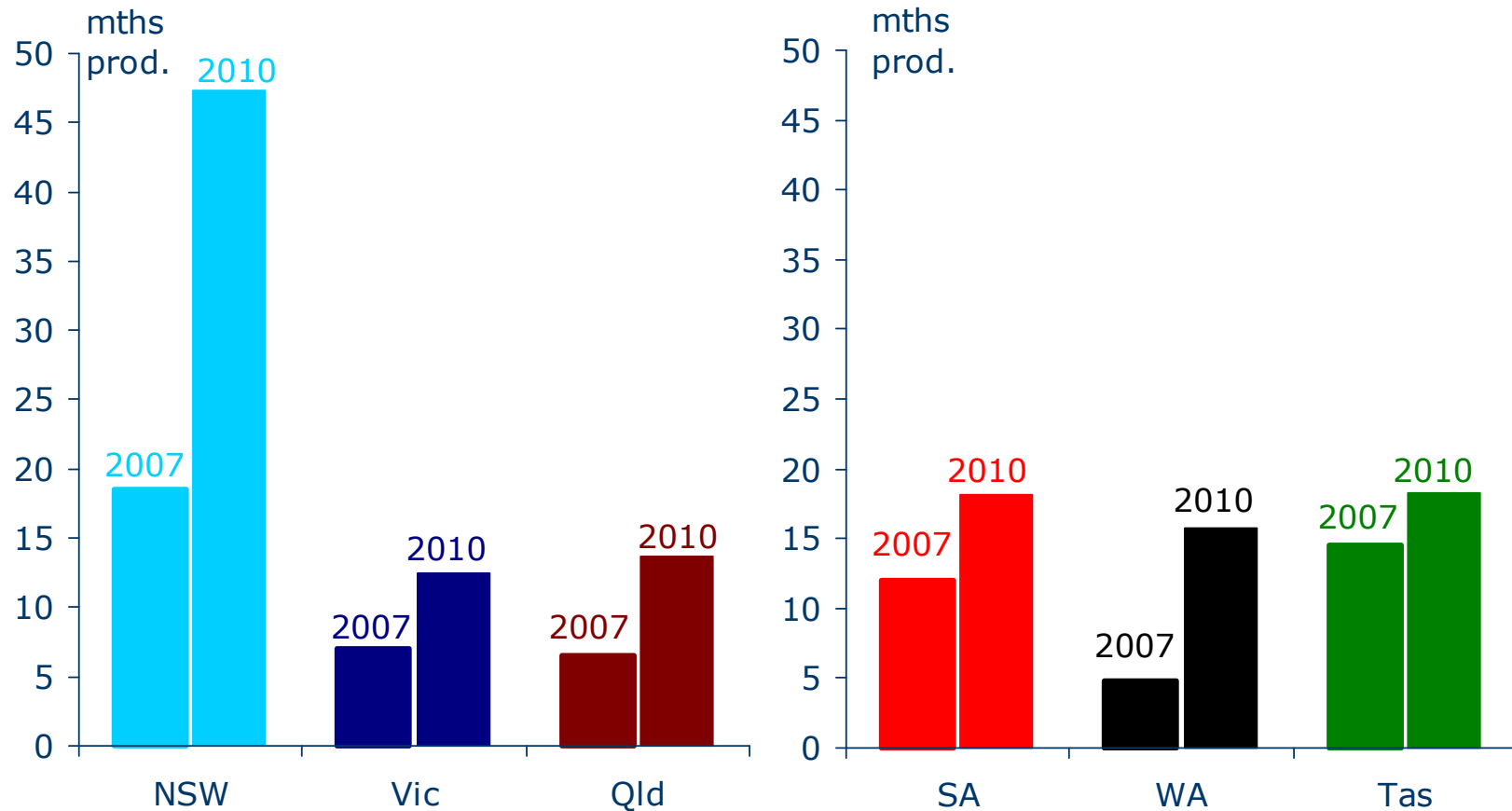


Sources: Australian Bureau of Statistics; Economics@ANZ



...in all states, but particularly in New South Wales

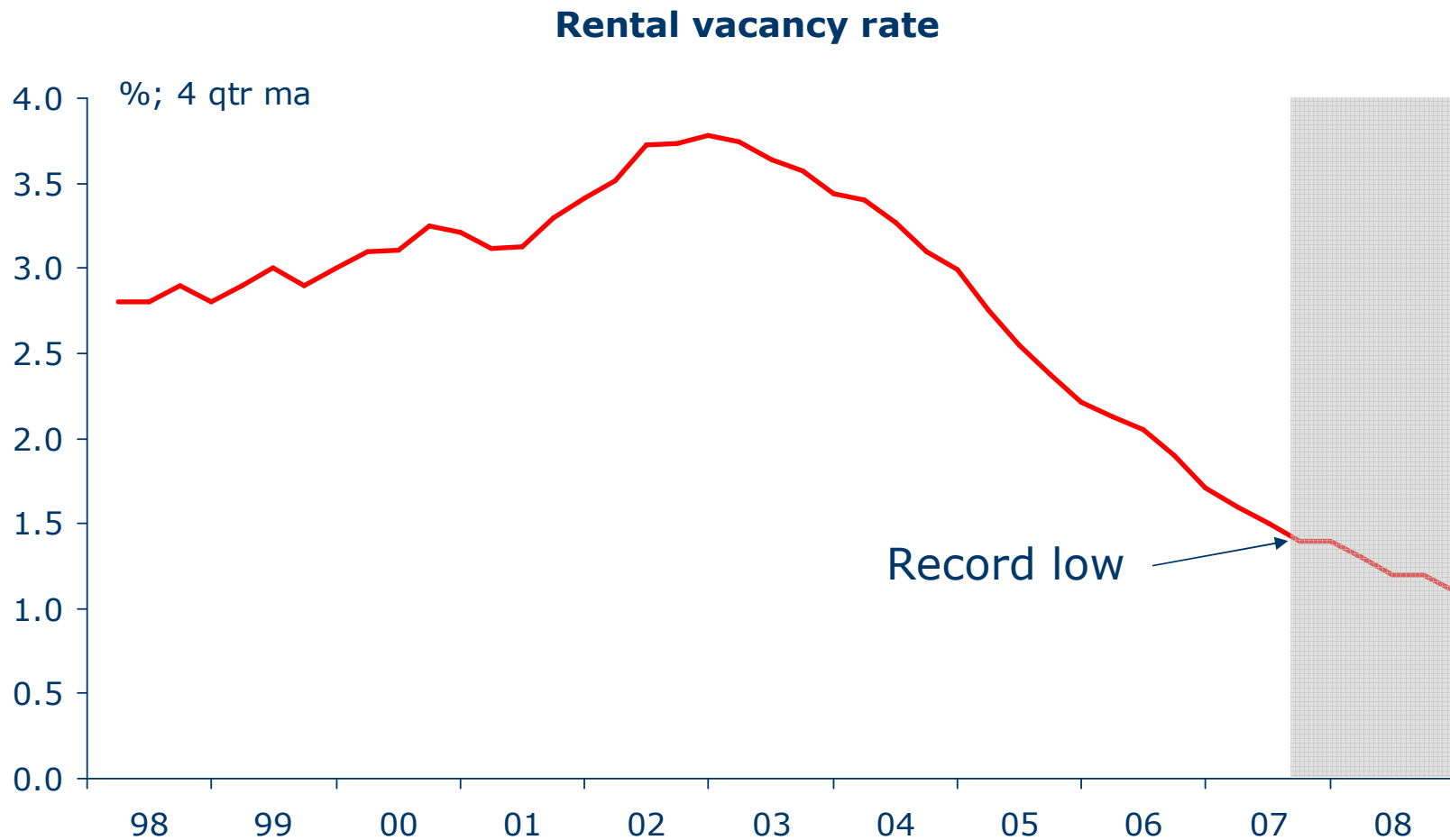
Pent-up housing demand by state



Sources: Australian Bureau of Statistics; Economics@ANZ



The tightening is reflected in sharp falls in rental vacancy rates²⁶
rates...

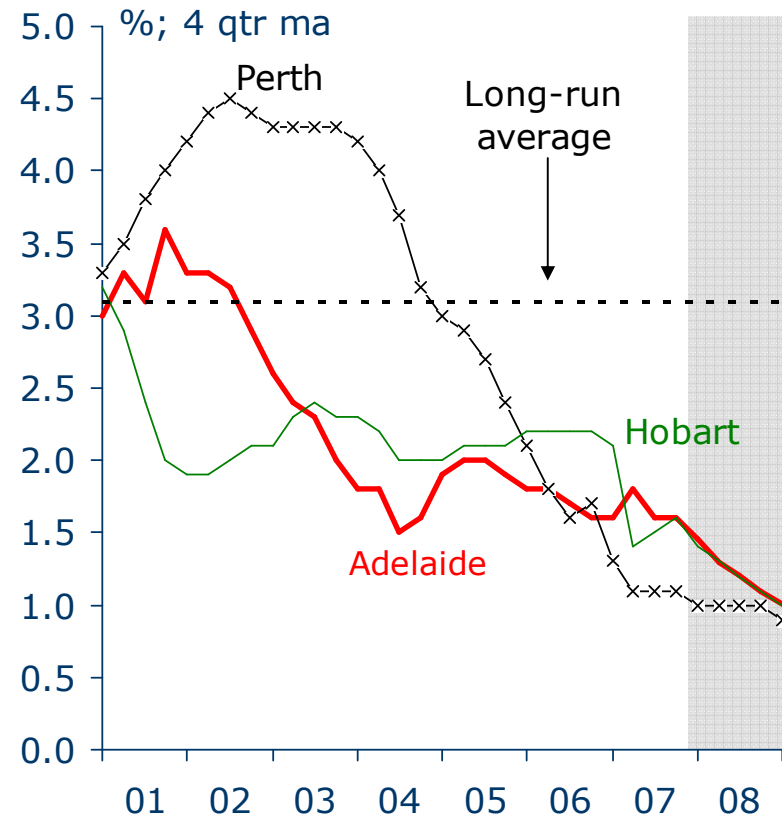
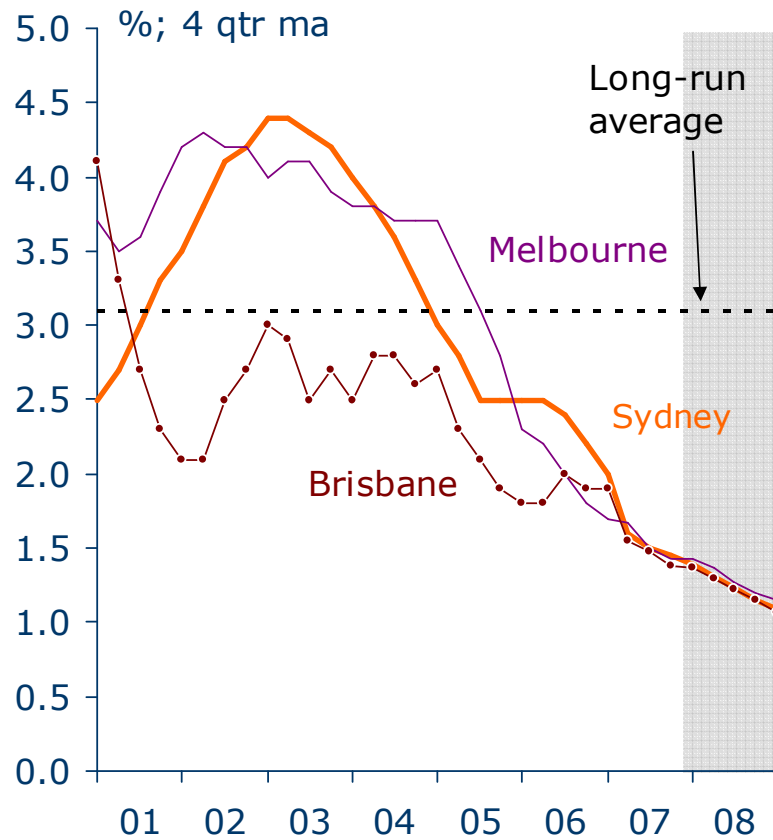


Sources: Economics@ANZ; REIA



...and a *critical* shortage of housing will develop in 2007/08 in *all* capitals

Rental vacancy rate

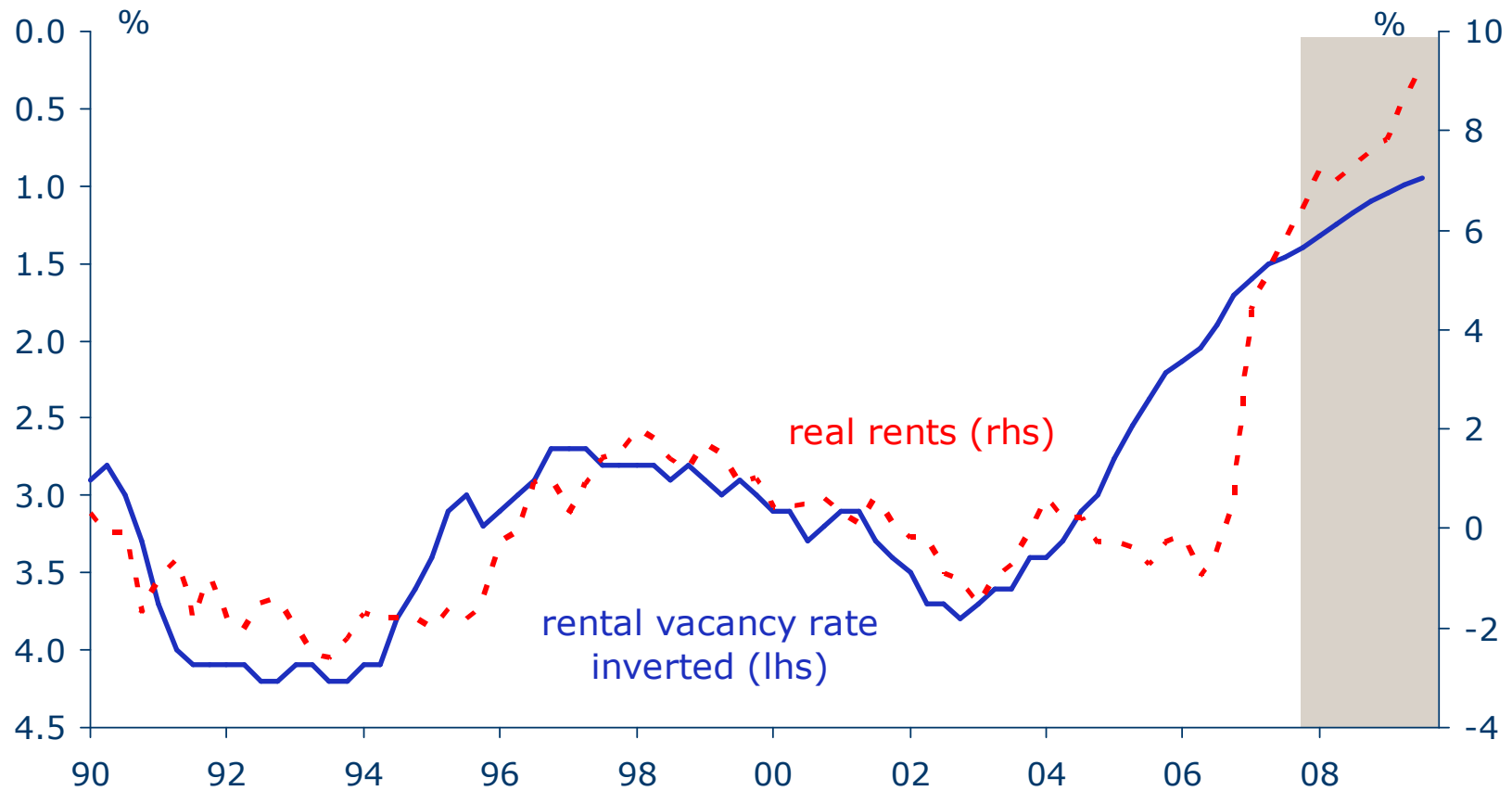


Sources: Economics@ANZ; REIA



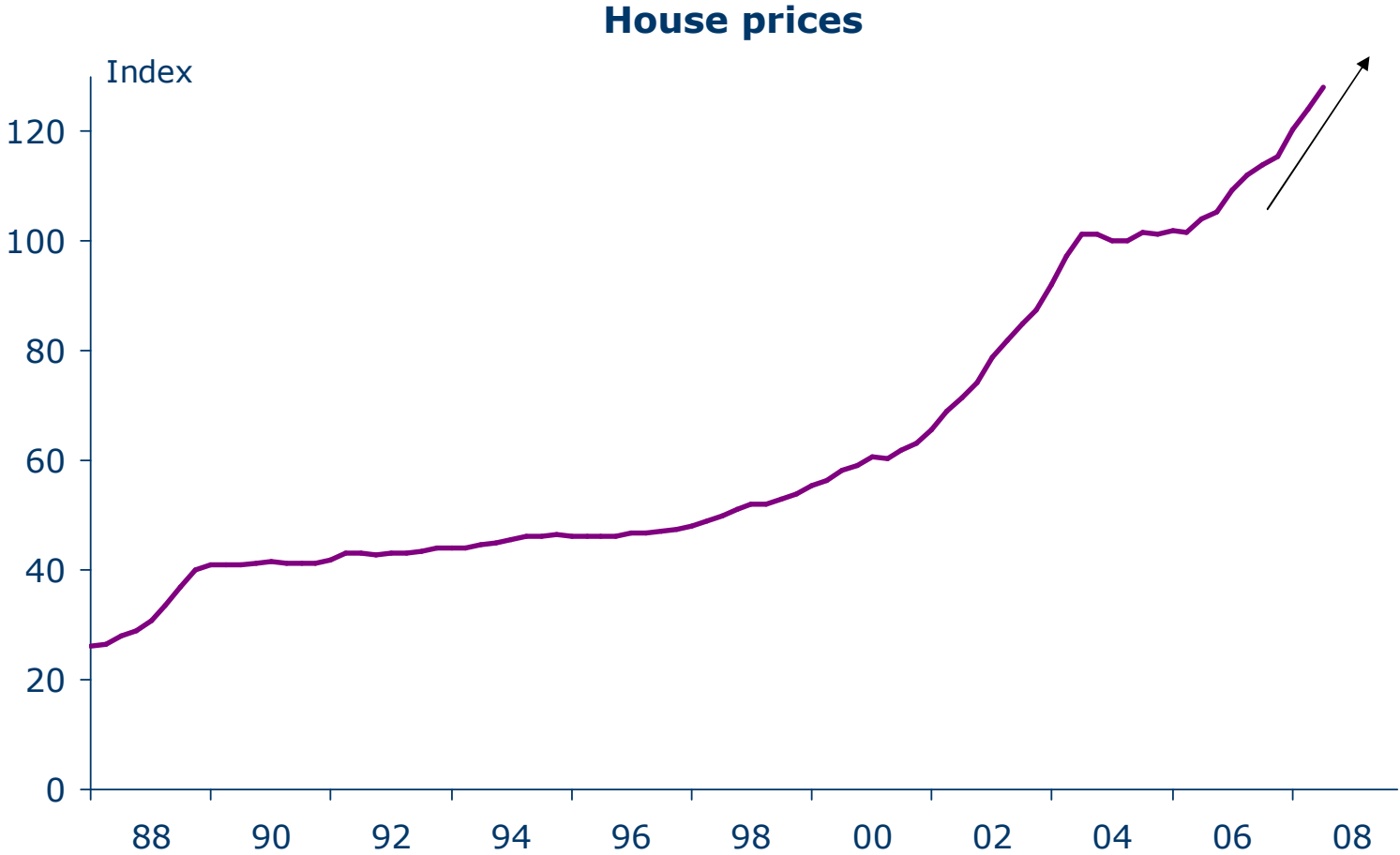
...which is now forcing rents sharply higher

Rental vacancy rate vs. real rents



Sources: Economics@ANZ; ABS, REIA

After a brief hiatus, house prices are rising strongly again

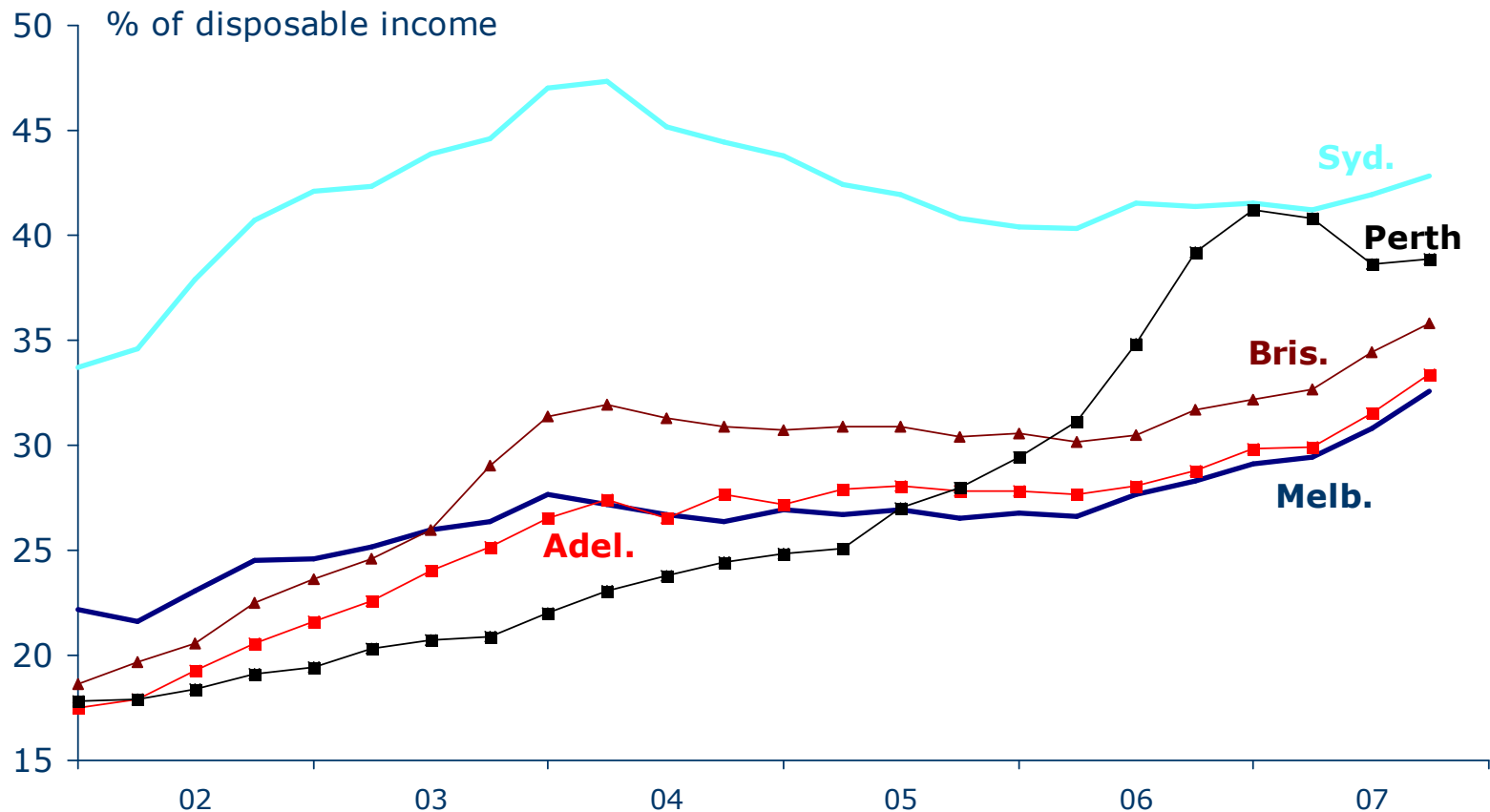


Source: Australian Bureau of Statistics



House prices and interest rates will continue to rise and housing affordability will continue to deteriorate

Housing purchase affordability

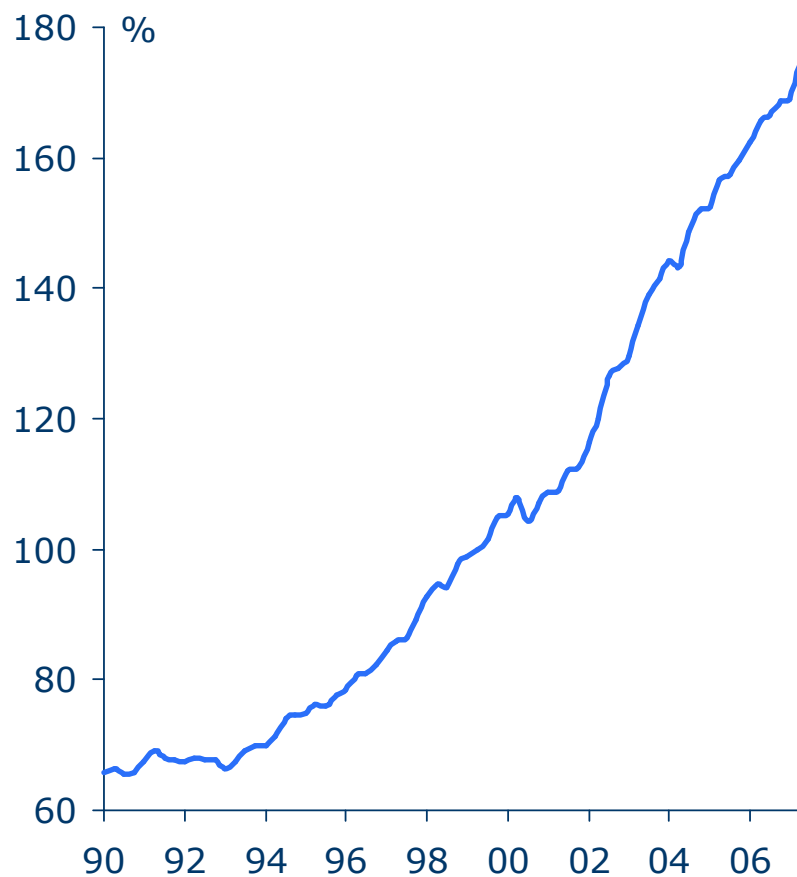


Source: ABS, RBA, Economics@ANZ

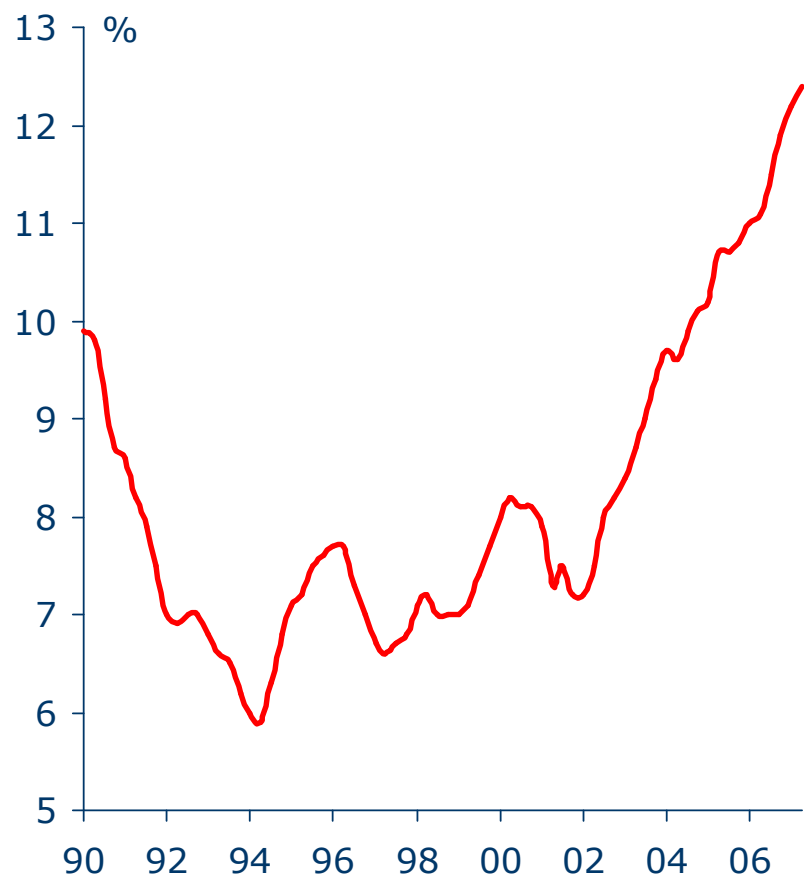


Is rising household debt really a serious issue for the macroeconomy?

Household debt to income ratio



Household debt service ratio

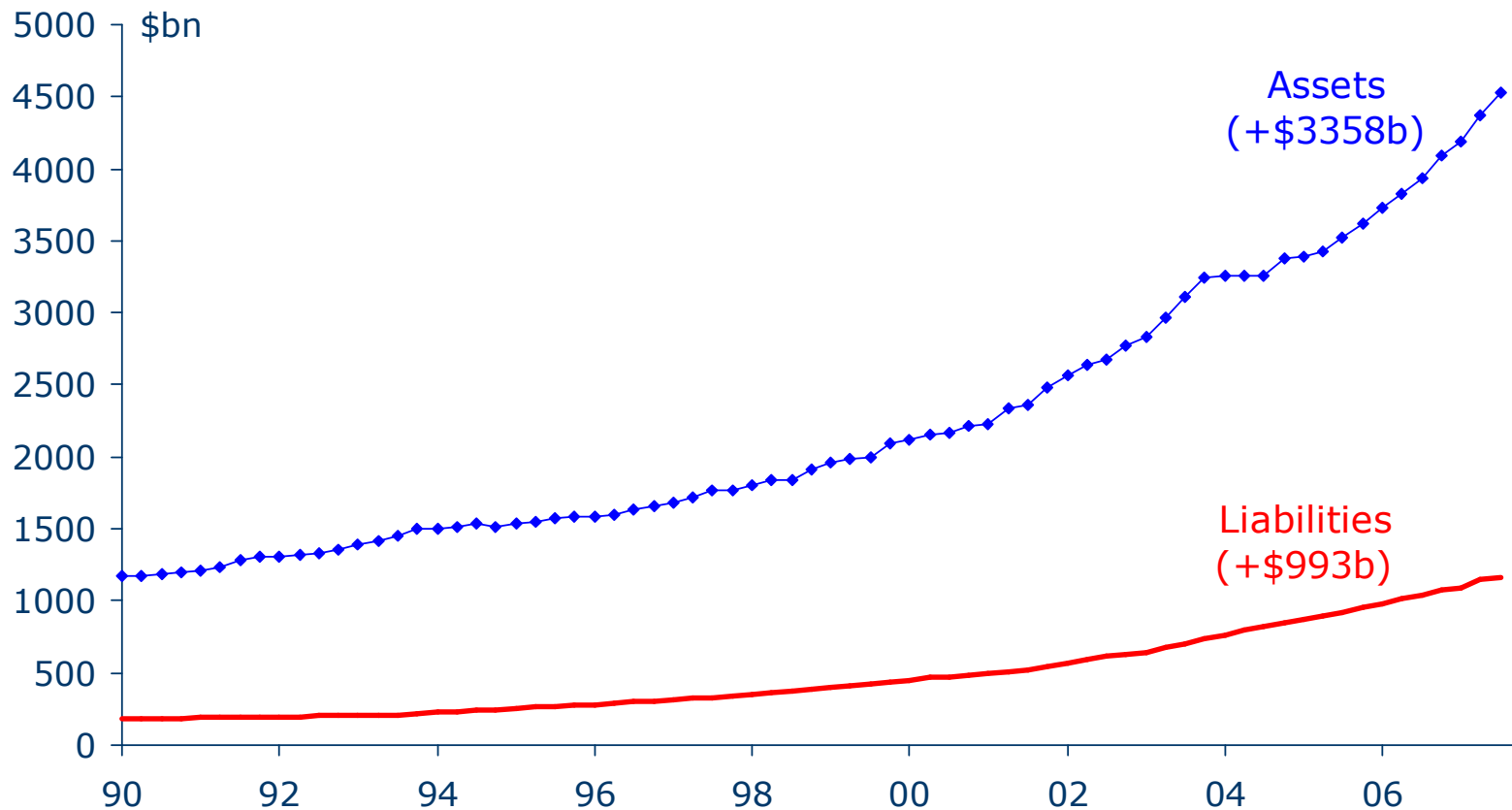


Sources: ABS, RBA, Economics@ANZ



Increased household debt more than offset by growth in net assets ³²

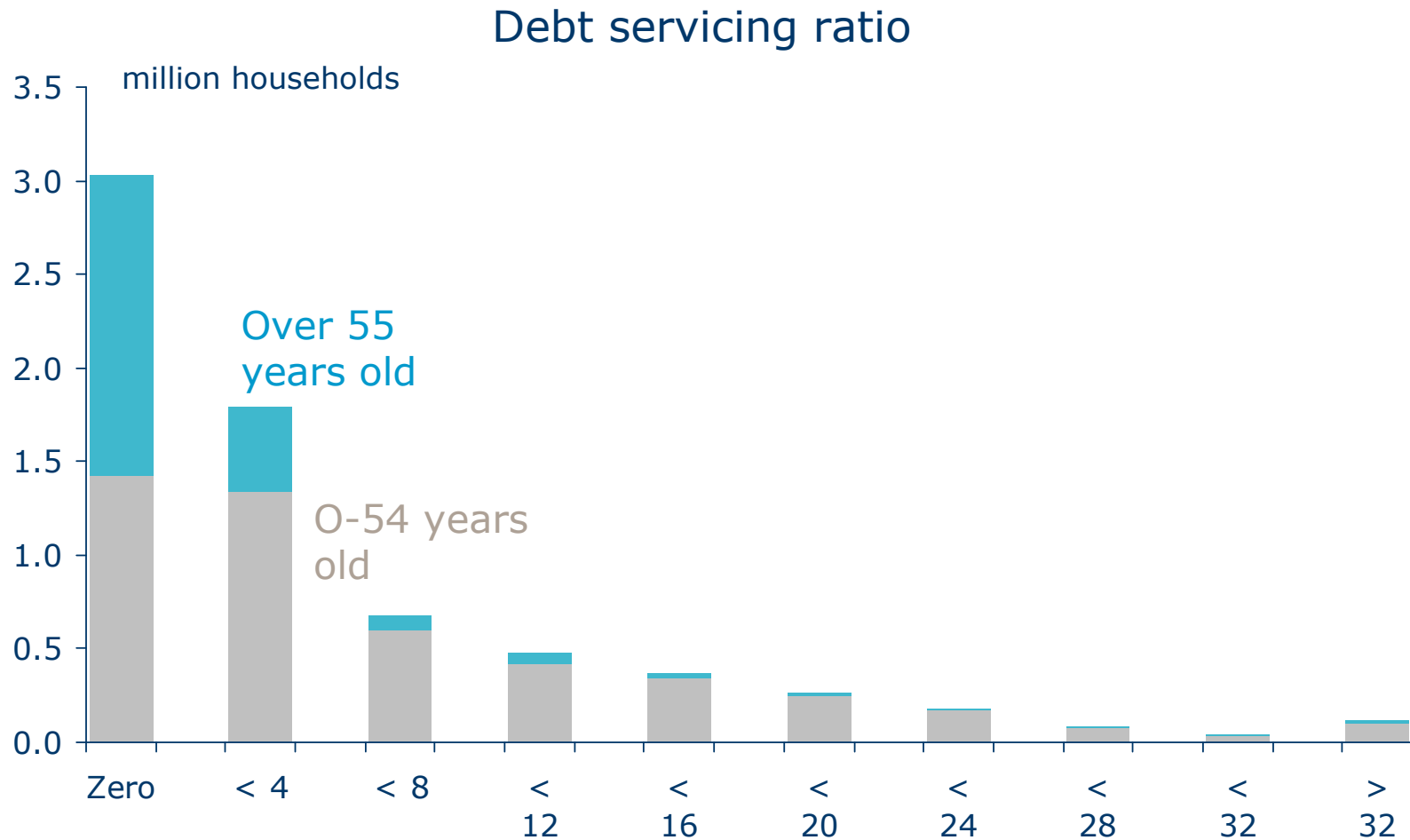
Household assets vs. household liabilities



Sources: ABS, RBA, Economics@ANZ



Two thirds of all households still have *little or no debt*

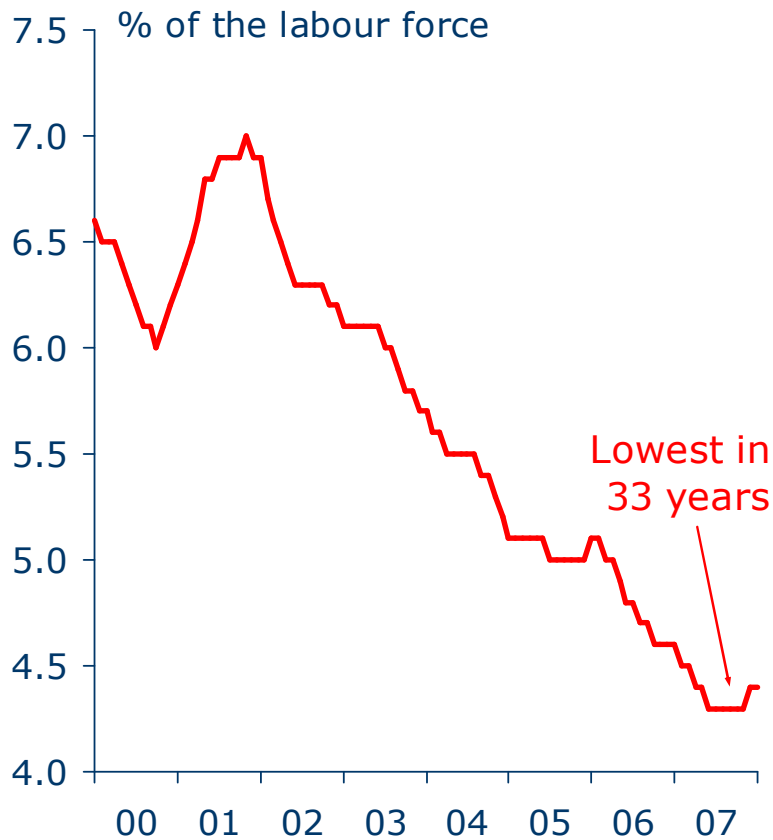


Source: Unpublished ABS HES data 2003/04 surveys, Economics@ANZ

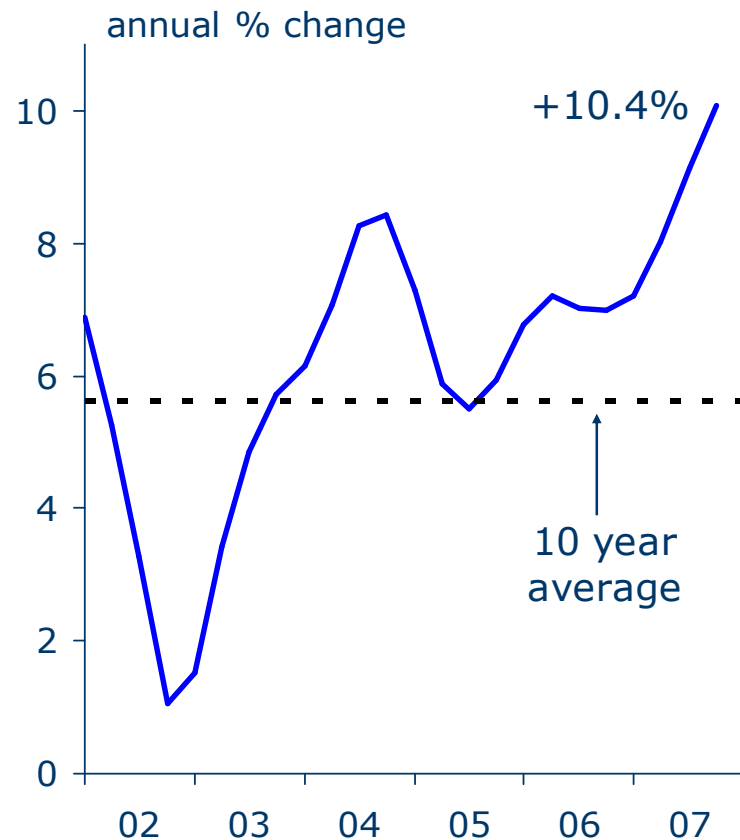


Despite widespread doomsday commentary, households are, in aggregate, in a strong financial position ³⁴

Unemployment rate



HH disposable income

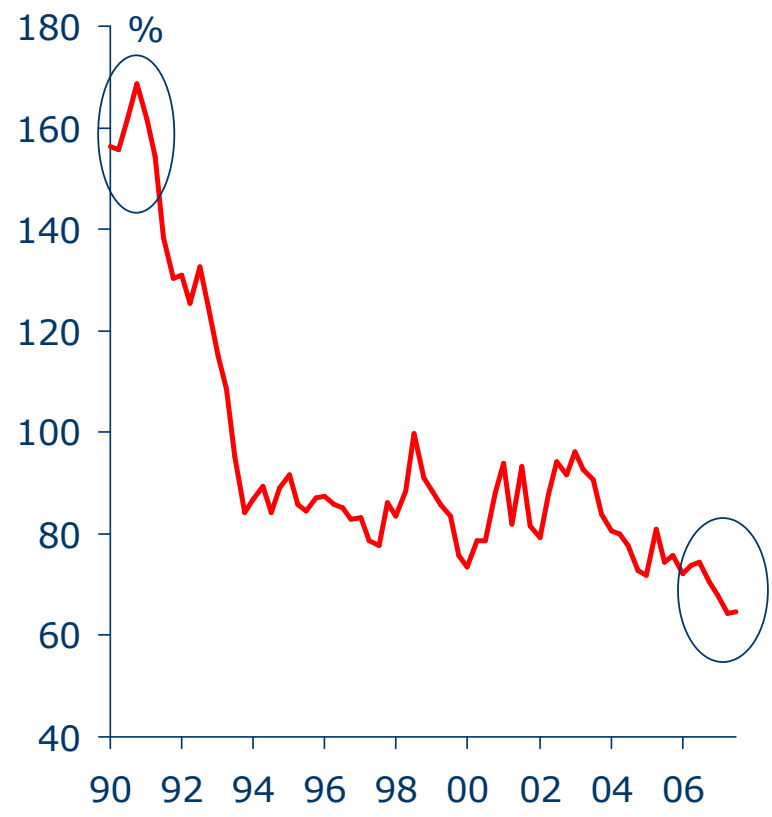


Source: ABS



The corporate sector (and hence employment) is much less vulnerable to rising interest rates than 20 years ago

Corporate gearing Ratio



Corporate interest cover



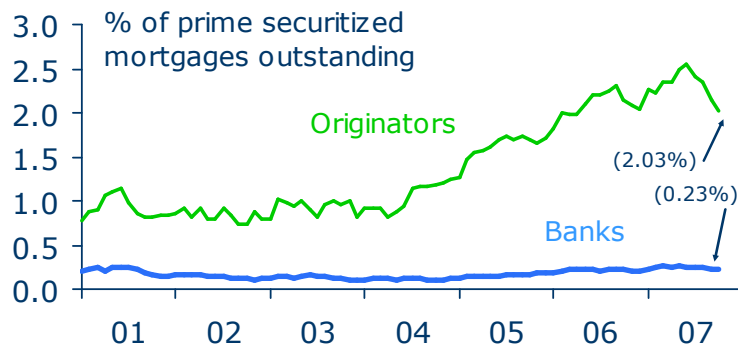
Source: ABS



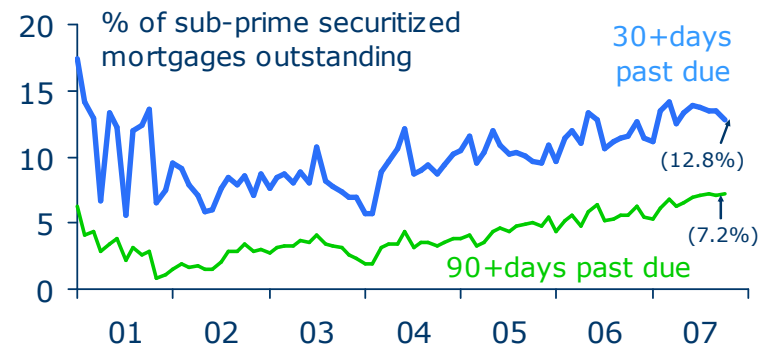
Although mortgage delinquencies have been rising, they remain very low by international standards 36

Mortgage delinquency rates

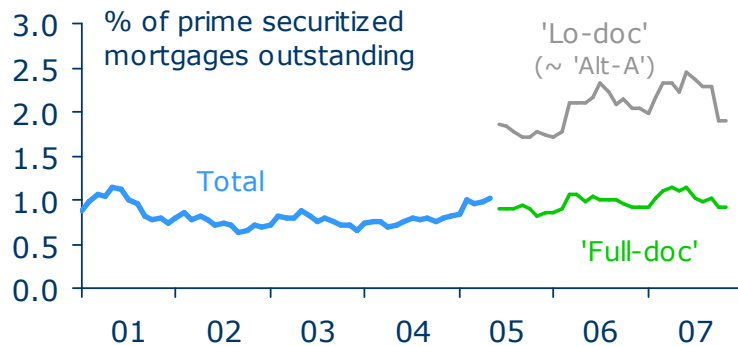
**Prime securitized mortgages
30 days + past due, by lender**



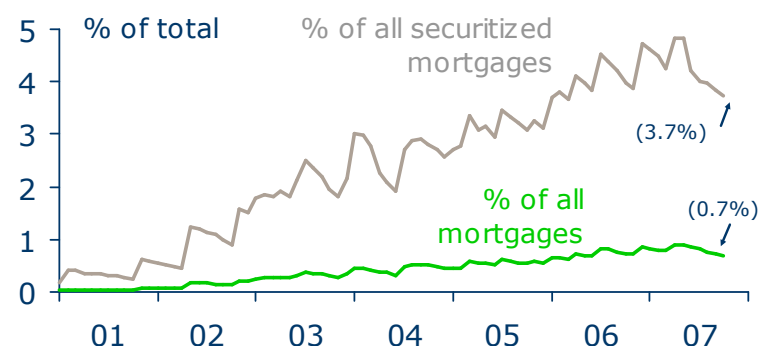
**Sub-prime securitized mortgages
30 days + past due**



**Prime securitized mortgages
30 days + past due, by type of loan**



Sub-prime mortgages as a pc of total mortgages

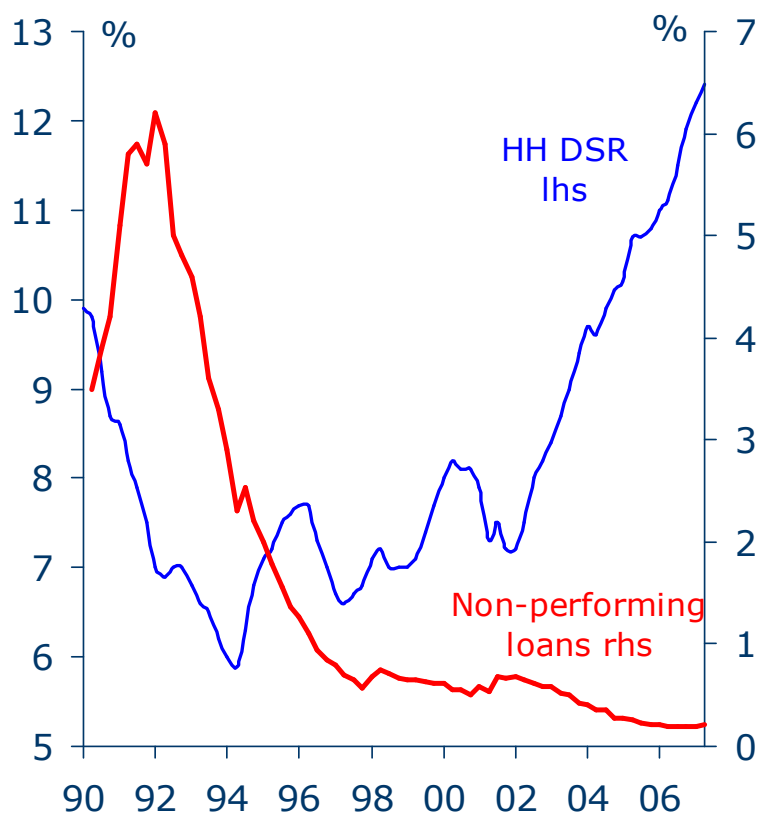


Sources: S&P.

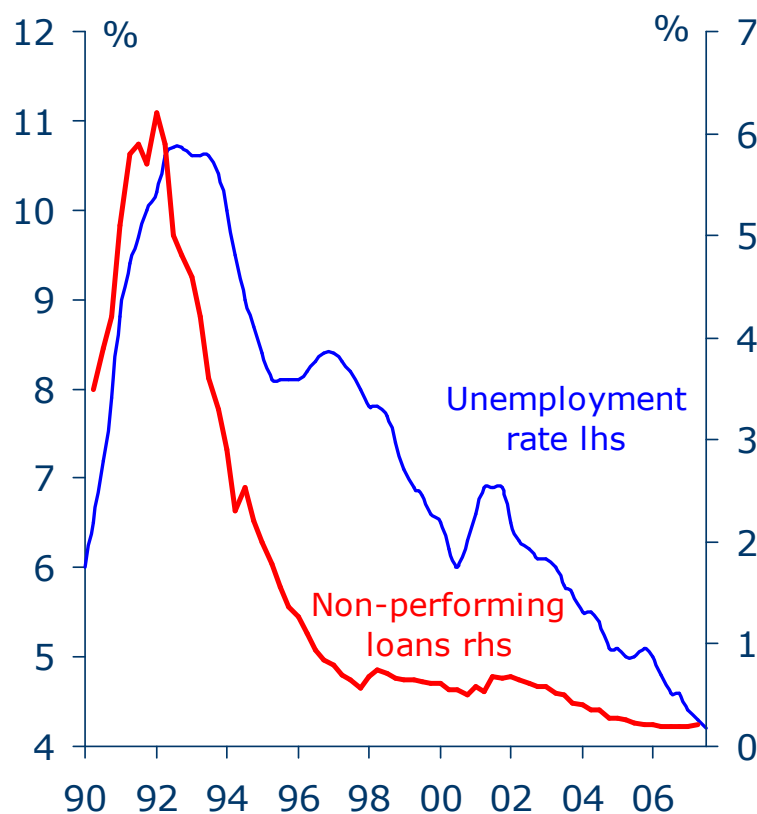


Non-performing loans are more correlated with unemployment than debt-service ratios

Household debt service ratio vs NPLs



Unemployment rate vs NPLs



Sources: ABS, RBA, Economics@ANZ



Summary: Good for investors, ugly for first homebuyers

Economic backdrop supportive

Interest rates *will* rise further

- Economic growth well above potential, labour market already tight
- Inflationary pressures high & rising

Housing affordability *will* deteriorate sharply further

- Rising interest rates & increased house prices and rents

But housing fundamentals *will* tighten dramatically

- Housing demand is rising (migration will push demand to 200K p.a.)
- We are not building enough homes (supply to fall below 140K p.a.)
- Housing market balance to tighten to *record* levels
- A serious supply shortage will be a feature of the market for *at least* the next 5 years (if not decade)

Economics 101 – if demand exceeds supply, prices *will* rise

- Houses no different to bananas
- Opportunities for long-term investors

Rising interest rates will hurt outer suburbs

- Closer to absolute budget constraint