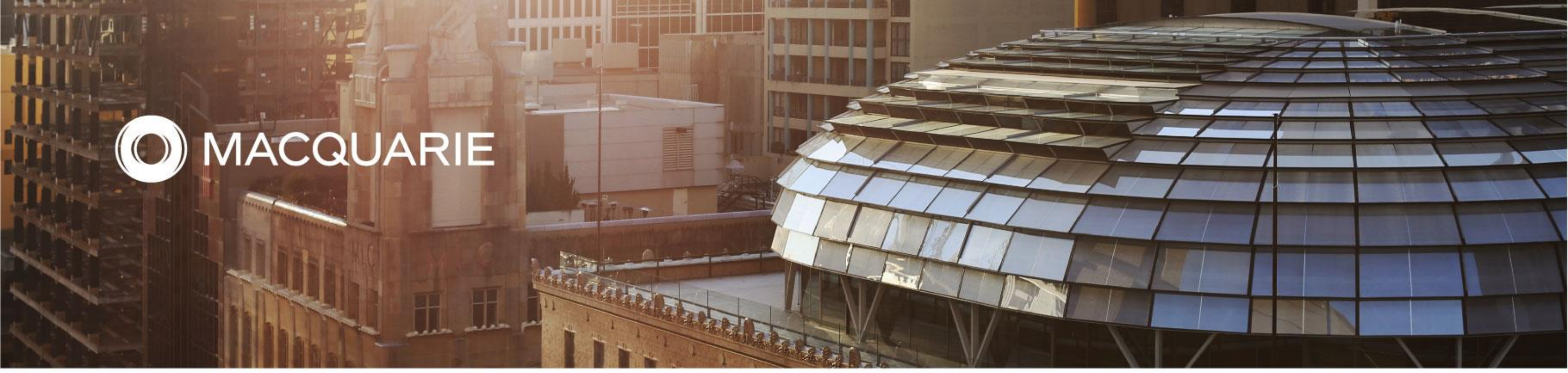


Investment Strategy Update #141

Australian Residential Property: Prices appear to have bottomed but the pace of the upswing remains uncertain

- The Australian housing market appears to have weathered the storm of the RBA's tightening campaign. Housing prices across the five major cities are picking up again, led by Sydney, despite the 375bp increase in the cash rate over the past 12 months.

- A combination of factors has likely contributed to the surprise turnaround: 1) the RBA has flagged that only a few more interest rate rises are likely, 2) the rental market is extremely tight, raising the relative attractiveness of ownership, 3) household formation has fallen to its lowest ever level (raising housing demand), 4) the volume of properties listed for sale is at historically low levels, and 5) government initiatives designed to encourage home ownership, for example, the introduction of the option for first home buyers to pay land tax over stamp duty in NSW.

- Macquarie's base case is for nationwide dwelling prices to now rise modestly by ~2% over the remainder of 2023 before increasing by ~7% over 2024. This implies that we have now seen the worst for house prices and that recent price declines will be largely recouped by mid-2024.

- Despite the recent bounce and expectations for prices to recover towards the end of 2023 and beyond, there remains some headwinds that will linger for a while longer. In particular, inflation is still well above the RBA's target band, and the path back to 2-3% may need further tightening. Government supports have also toned down more recently, with the change of government in NSW resulting in the removal of the land tax option by 1 July. In Victoria, the government decided to lift land tax on investment properties in its state budget, which could add to the headwinds if accompanied by further interest rate hikes.

- By early 2024, Macquarie is forecasting the RBA to begin lowering rates, but this is contingent on the inflationary backdrop. However, with the prospect of lower borrowing rates coupled with supply shortfalls and improving demand as consumer confidence returns, we think the medium-term price outlook is positive with the worst now in the rear vision mirror.

Dwelling prices are on the rise again

Since the commencement of the RBA's rate hike cycle in May 2022, Australian housing prices ~9.1% peak to trough. However, just ten months after the first rate hike, housing prices are rising once again. The national home value index increased over March and April, led by Sydney, which saw dwelling values increase by ~3% over the quarter to April, and dwelling values rising ~1% overall on a national basis.

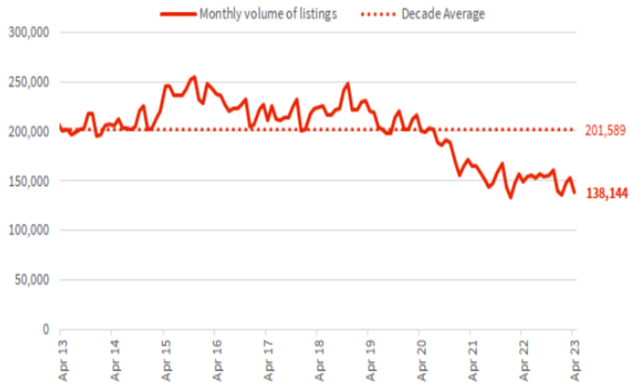
National dwelling prices are up ~1%

Source: CoreLogic, MWM Research, May 2023

We believe the anticipated pause in rising interest rates as the RBA nears the end of their rate hike cycle has been a key driver for the recent rebound. The expectation that interest rates would not rise much further (with the RBA pausing in April), has contributed to a broader perception that the cost of borrowing may soon peak and the housing market has bottomed, signalling a time to re-enter.

Tight supply has also provided a timely backstop for the market in the face of rising interest rates. The volume of total housing listings nationally has remained well below pre-Covid levels and is likely to trend seasonally lower through the cooler months of the year, putting upward pressure on housing prices.

Total volume of dwellings for sale are at decade lows

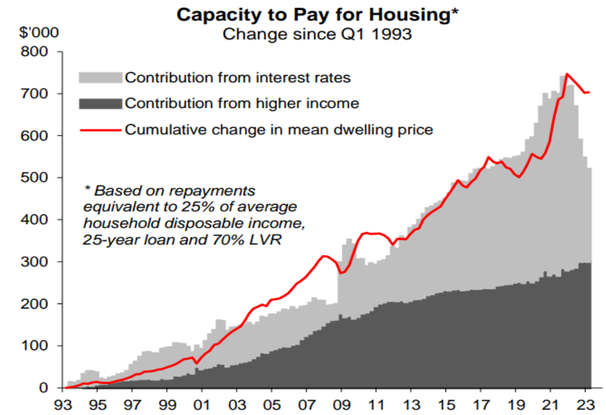


Source: CoreLogic, May 2023

An improving outlook but some headwinds linger

Despite the recent turnaround, there are still some lingering downside risks. Housing affordability has been severely constrained following 375bps of interest rate hikes which has reduced capacity to pay for housing by more than 20%, and the delay in passing through rate hikes points towards some more pain. Furthermore, sentiment toward buying remains at low levels, and this is likely to persist until interest rates begin to fall. High debt servicing costs, high debt levels and cost of living pressures have made it difficult for repeat or new buyers to enter the market.

Capacity to pay for housing constrained by rising rates



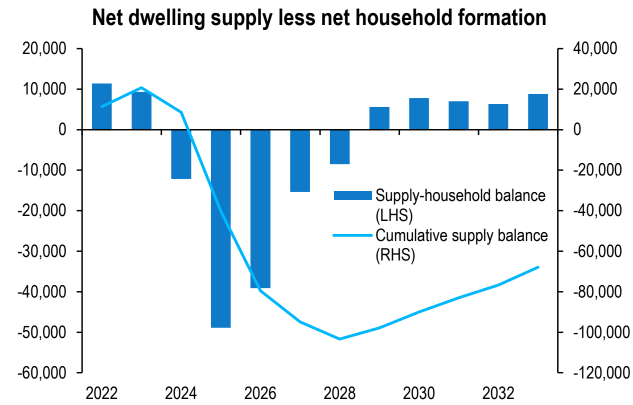
Source: ABS, CoreLogic, Macrobond, Macquarie Macro Strategy, May 2023

But longer-term tailwinds remain

Nevertheless, over the medium to longer term, we see several tailwinds and opportunities for residential property:

1. **Structural demand supply imbalances which are likely to continue to support price increases:** The National Housing Finance and Investment Corporation (NHFIC) expects a cumulative dwelling shortfall of 106,300 over the next four years through to 2027. Construction activity reached record highs in mid-2022 and remains at high levels due to the constraints in the supply of both materials and labour. Poor weather in 2021 and 2022 has delayed the completion of many projects, while availability of serviceable land and the increased time for development approvals is also inhibiting the timely delivery of new housing supply. A decline in average household size across the nation (and an increased number of total households) during the pandemic has further added to upward pressure on demand.

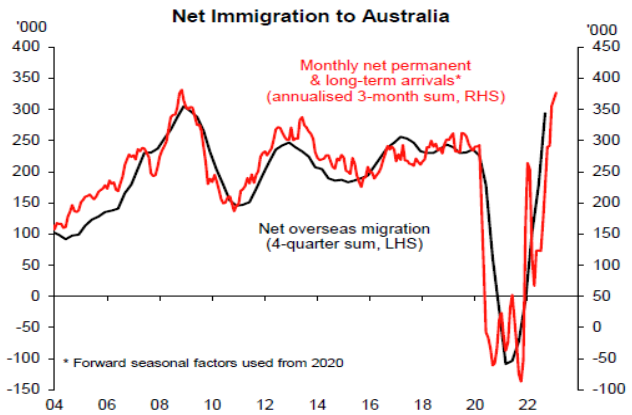
Housing undersupply forecast through 2025 to 2027



Source: CoreLogic, MWM Research, May 2023

2. **Returning migration volumes:** The reopening of Australia's borders has led to a much stronger than anticipated recovery in population growth. At a time when national rental vacancy rates (~1%) are already low, the recovery in migration is likely to keep upward pressure on rents for some time (particularly in the Sydney and Melbourne apartment markets which receive the bulk of overseas workers and students).

Australia's net immigration is bouncing back

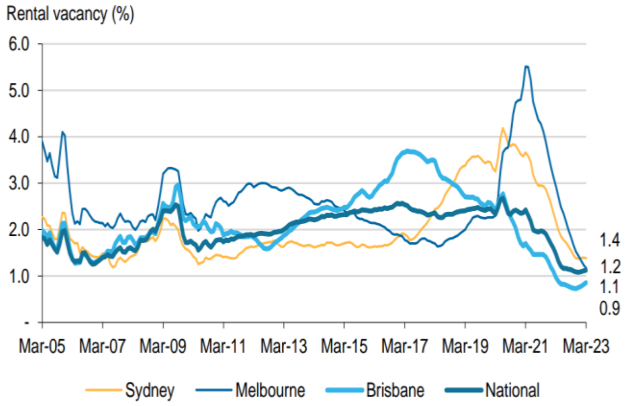


Source: ABS, Department of Home Affairs, Macquarie Macro Strategy, May 2023

3. **Ongoing tightness in the rental market:** Vacancy rates were already low prior to borders reopening due to several factors: 1) frequent lockdowns forced households to rethink their living arrangements (shared housing) resulting in a sharp fall in the household size, and 2) closed borders during the initial

period of the pandemic saw vacancy rates surge, with many investors likely forced to sell their properties to first home buyers, reducing supply in the rental market. The current tight rental market means it is less likely investment properties become listed for sale, which will in turn help keep a lid on the supply of new properties available for purchase.

Historically low rental vacancy to continue to drive rent growth



Source: CoreLogic, Macquarie Research, May 2023

Overall, it appears that the Australian housing market has passed what has been a relatively short (although sharp) downturn and Macquarie's base case now is for nationwide dwelling prices to rise by ~2% over the remainder of 2023 before increasing by ~7% over 2024 as monetary policy is eased. However, the lagged impacts from policy tightening are still impacting household balance sheets and a tight labour market means rate cuts are some way off, even if rate hikes are close to an end. Ultimately, the short-term outlook will rest with the trajectory of interest rates and price increases will gather momentum once the time for interest rate cuts gets closer.

Over the medium to longer-term, we see several tailwinds for the housing market including worsening structural demand supply imbalances, created by strong immigration and population growth, and ongoing tightness of the rental market. We think it would take a US hard landing and/or a much stickier than expected domestic inflation backdrop (that drives policy rates much higher than expected) for house prices to be lower than the current level in 12 months' time.

Macquarie WM Investment Strategy Team

The report was finalised on 29 May 2023.

Recommendation definitions (Macquarie Australia/New Zealand)
Outperform – return >3% in excess of benchmark return
Neutral – return within 3% of benchmark return
Underperform – return >3% below benchmark return

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