‘Two likely triggers’ for a housing correction

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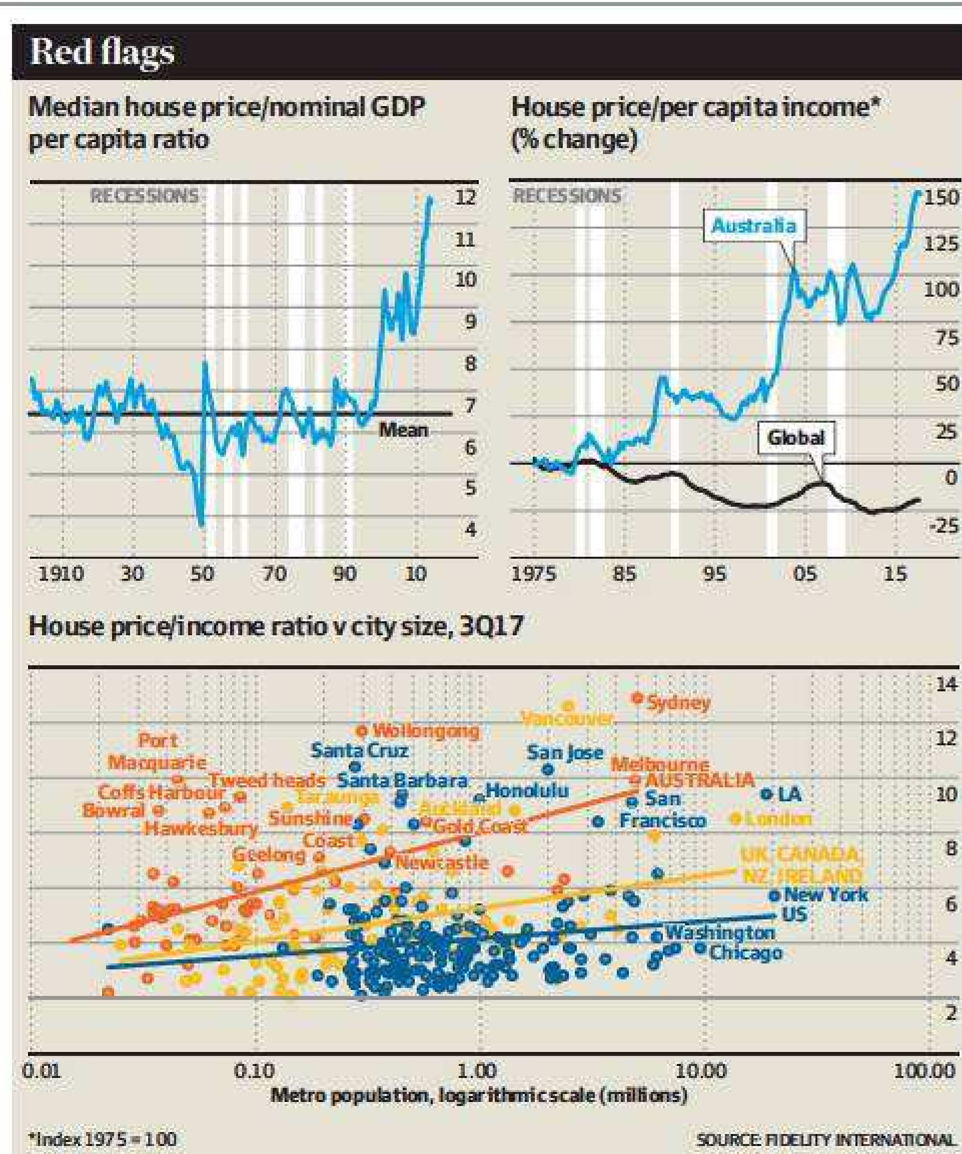

Fidelity Investments says the Australian housing market appears overvalued on three key measures and is a risk for investors, with unemployment and rising interest rates the potential triggers for a correction.

Paul Taylor, the highly rated manager of Fidelity's Australian Equities Fund, said there were two questions investors needed to ask about the housing market – is it fundamentally overvalued and what catalyst would shine a spotlight on that overvaluation and create a market reaction?

He pointed to the global financial crisis in 2007-08 when a liquidity crunch provided the trigger for sharp house price falls in the US and elsewhere. ''It was the catalyst,'' he said.

Mr Taylor evaluated the market on the basis of median house prices compared with gross domestic product per capita – or house prices within a broader economic context.

He noted that from 1900 to 2000, the multiplier was broadly stable but it kicked up from 2000. ''So just looking at the long-term chart you can say ' maybe there's a bit of an issue at the absolute level in Australia',' ' he said.

Other measures appear just as disturbing.

When Mr Taylor examined house prices divided by per capita income relative to the rest of the world, he found Australian house prices had shot up dramatically while the rest of the world hadn't really changed.

''So not only can you say house prices look high in an absolute sense, in a relative sense against the rest of the world they also look high,'' he says.

The final chart Mr Taylor used to illustrate his point at a Fidelity conference on risk in Sydney showed small and large towns and cities around the globe, and indicated ''even the smaller towns in Australia look very expensive''.

Still, while house prices look stretched in terms of valuations, a catalyst to send them lower was not looming, he said.

''While the market does look overvalued, it's hard to see a trigger that's going to cause significant changes. In Australia we typically see prices rises, then the market goes nowhere for seven years,'' he said. ''That's how we adjust.''

Two potential catalysts, however, could be rising unemployment and rising interest rates, with rising unemployment the more likely catalyst, he said.

''There's more likely to be something around jobs,'' he says. ''If unemployment rises, we lose our jobs and people have to sell their homes because they are now a forced seller, then that forces fundamental values down,'' Mr Taylor said.

However, with good jobs growth last year and unemployment still quite low, he said ''I don't think unemployment is an issue in the short term.''

Another catalyst could be interest rates. ''In the short term, maybe that's not going to be a huge issue but in the longer term that could potentially be a trigger,'' he said.

Mr Taylor made the comments on the housing market and interest rates as part of an evaluation on the key risks facing investors.

He took a look at US government interest rates from 1946 to the present, noting there had been two very different cycles, with interest rates advancing from 1946 to 1981 in the ''last great bond bear market''.

Since 1981, those interest rates have declined, he said, but there was an argument that the long-term declining interest rate cycle that started in 1981 bottomed in 2016. He said interest rates had hit a low.

''I'm of the view that we will see a long cycle of interest rate rises but at a much slower increase than we have previously seen,'' he said. ''I think we are in for longer-term higher interest rates but maybe not for the next five to 10 years.

''Maybe it's not really a short-term risk but we think it's one of the key long-term risks.''

A 30-year interest rate increase cycle is extremely bad for bonds, he said, but ''I think it's a bit more nuanced for equity markets''.

''Our own internal research shows that key trigger points are around 5 to 6 per cent interest rates. For the equity market, as interest rates rise to 5-6 per cent, that's still quite a sweet spot,'' he said. ''Typically, as you get rising interest rates, it means that economies are moving ahead and we're getting a little bit of inflation.''

Along with interest rates and the housing market, other risks facing investors in Australia include iron-ore prices driving the Australian dollar higher and making the country more unattractive for tourists, government intervention, the removal of franking credits and a drop-off in population growth. Trade war and China risks are also present, Mr Taylor said.