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THE BUBBLE THAT WON'T BURST

Despite the housing bears' gloomy predictions proving unfounded time and time again, the property bubble believers aren't ready to back down just yet.

Report: Ben Hurley

Professor Steve Keen, Australia's best-known housing bear, was right after all. House prices have gone up.

In line with his prediction in October last year, the property market has since undergone what Keen calls a "suckers' rally", with lower interest rates pulling nervous buyers out of the woodwork to raise prices to what he says are even more unsustainable levels. As far as suckers' rallies go, mind you, it was a dud. With a 0.1 per cent rise in house prices over the March quarter according to the ABS, it was more like a Claytons suckers' rally, he says.

The next part of his prediction, however, has yet to happen. Keen, known as one of the biggest proponents of the property bubble theory, says that before long, homebuyers will be "living in palaces eating Spam" as they buckle under the weight of their mortgage repayments, as the bubble releases years of hot air, wiping out a lot of wealth as it goes.

For those who believe in Keen's dire housing market predictions, their faith is being sorely tested. The bubble theory just hasn't held true.

Far from following the United States example, as Keen predicted when the financial crisis took hold, much of Australia's housing stock has held its value. It has even attracted international investors seeking a safe haven. Keen now admits he would be "much better off" if he hadn't sold his house in preparation for an imminent property downturn. In fact, he could have cleared his mortgage with the redundancy payment that shortly followed when his employer, the University of Western Sydney, culled its economics school.

There was also that embarrassing bet with former Macquarie banker Rory Robertson about which way the housing market would go, which resulted in Keen trekking to Mount Kosciuszko wearing a T-shirt saying he was "hopelessly wrong". He says he did it to prevent critics like Robertson and another commentator, Christopher Joye, tearing pieces out of him in the media. The exact terms of the bet are still in dispute. "We never actually shook hands on it or wrote down the terms," Keen says.

But he was wrong on a few things, he admits. He expected a massive deleveraging to take place in Australia as nervous homeowners took desperate measures to reduce the country's massive private debt. Mortgage debt was around 84 per cent of GDP last year, compared to around 19 per cent in 1990.

"The weird thing is we haven't delevered," Keen says. "That's what makes us different to the Americans. Our mortgage debt hasn't fallen, it's still rising. I'm quite happy to say I'm wrong on that one."

He puts it down to the widespread use of variable rate mortgages in Australia, compared to the widespread use of fixed rates in America. This means Australian homeowners get an instant reprieve on their mortgage payments when the central bank drops the cash rate.

He also got the speed of the price falls wrong. He anticipated Australia's housing market valuation would fall faster than Japan's slow leak since 1990, but slower than America's plunge during the financial crisis. "In fact, we've been slower than Japan," Keen says. "I got the magnitude wrong. But I never had this idea of a huge drop tomorrow."

But still it will fall, he says, in a kind of "slow bleed" that will leave anyone who was wooed into buying a house by Kevin Rudd's First Home Owner Grant bitterly disappointed. It's only lasted this long due to a series of government interventions and the resources boom, Keen argues.

Misunderstood bears

Keen isn't the only bearish commentator to say he's been painted as more extreme than he really is. Another is Leith van Onselen– former

economist with the federal Treasury and Goldman Sachs who now runs online publication MacroBusiness.

While frequently critical of the housing market valuation and the methodology of data providers like RP Data and Australian Property Monitors, he says he's no Steve Keen. "I'm a bit perplexed at times being painted as the housing bear," Van Onselen says. "I think I'm more of a realist. I have my own house, I don't plan to sell and have owned for the past seven years."

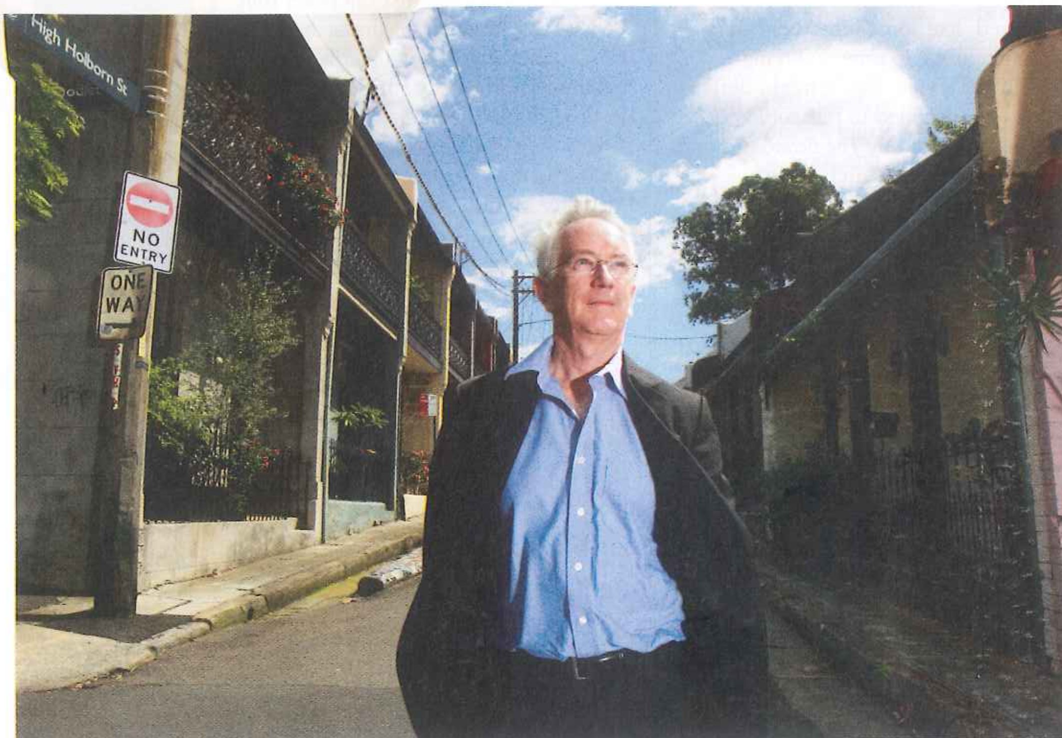
Still, his website has become something of a rallying point for housing bears, attracted by headlines such as "Safe as (straw) houses", "Nailing up the Oz real estate coffin" and "Property risk highest in a long time". And van Onselen's outlook shows some similarity to Keen's. He doesn't rule out a steep correction, although says it would take a major shock like a larger-than-expected downturn in commodity prices and mining capital expenditure. The more likely scenario is a "slow melt".

"I don't see much upside at all to the housing market," he says. "I've for the past few years said Australian house prices are going to have a slow melt, whereby values slowly decline back to pre-boom levels relative to incomes and GDP. It could take a decade."

Another misunderstood bear is AMP chief economist Shane Oliver, who thought things were getting frothy around 2003. Speculators dominated the Sydney market and property shows got the TV ratings. Now, like Keen and van Onselen, Oliver thinks the over-valuation will be ground down over time. But he's no Steve Keen, he says.

"At times I have been lumped in with Steve Keen and Gerard Minack on the property front," Oliver says. "It was a misunderstanding. I thought we would spend 10 years spinning our wheels. There was a vulnerability to a sharp fall. But what I thought was more likely, in the absence of high interest rates or a collapse in China, was an extended period where house prices were range-bound."

He puts the over-valuation at about 15 per cent, and thinks property isn't a good investment as things stand, but the euphoria that would suggest a bubble has eased. "I think we're more sceptical, and the high-rating shows on TV are back to cooking shows," he says.



Minack, too, thinks things aren't as bad as they were, and says a sharp drop is unlikely. "It seems the degree of over-valuation has moderated, but [is] still above fair value," the now retired Morgan Stanley economist says in an email. "So there's a degree of vulnerability there. However, to see quick or disorderly adjustment you need to see broad-based job losses. It won't happen spontaneously."

The new normal

It's been a popular overseas view that Australia's housing market is on the verge of collapse, leading a range of US hedge funds to take short positions on Australia's banks. A compelling CLSA report co-authored by Keen and economist Brian Johnson in 2010, *Hand of Gov: The housing bubble – fact or fiction*, probably played a role in forming that view.

They've been disappointed, Johnson now admits. "There's been a lot of money lost on establishing short positions." He says low interest rates have taken the pressure off households, greatly reducing the risk of a blow-up. But house prices are still "absolutely ridiculous" on the metrics he looks at. "If you ask me is there a bubble, my answer is yes, but if you ask me how it resolves itself, I think it grinds down more like Japan than North America."

He admits he's been wrong before, but Steven Keen says the property market's still going to fall in a 'slow bleed'.

Values would have plunged without stimulus, he says – the so-called Hand of Gov. "There is this view that Australia's house prices never go down," Johnson says. "They were going down at the start of the GFC and they were going to go down a lot. But what the Reserve Bank did was chop interest rates from 7¼ to 3 per cent, save most households 1400 bucks in cash, and buy about $14 billion of RMBS [residential mortgage-backed securities] paper. The stimulus went in one direction, which was into housing."

The shorters probably also felt encouraged by Jeremy Grantham, the US-based economist who famously quipped in 2011 that the Australian housing bubble would be the first he

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had ever seen that didn't pop. He later appeared, like some other bearish commentators, to tone down his position to a view that it might deflate slowly. He declined to talk to*BRW*.

Measures used by *The Economist* and urban planning research group Demographia continue to find Australia's housing market is grossly overvalued. Australia has the third least affordable market in the world, behind Hong Kong and Canada, the latest Demographia survey has found. Global indexes like these offer a transparent way of comparing countries, but are criticised for missing key factors like interest rates. Owing to changes including the deregulation of banks, mortgage rates are now structurally 41 per cent lower than they were in the late '80s and early '90s, meaning Australians can afford to maintain a much higher level of debt.

Macquarie Capital uses a more complex affordability measure, which calculates the proportion of household income needed to meet mortgage repayments. It also factors in interest rates (as around 90 per cent of Australia's mortgages are variable), house prices, wages by capital city, and the increase in dual income purchasers over time, which wasn't necessary in the 1980s. Housing is still much more expensive in each capital compared to the 1990s, it finds. And this is having side effects, says Macquarie real estate strategist Rod Cornish, like a long-term decline in sales volumes and a preference to renovate rather than trade up.

But for the past decade affordability has risen and fallen to a steady tune. In other words, this new normal appears to have staying power. "Our housing market is expensive, but we have been able to manage that by changing interest rates successfully," Cornish says.

Cornish chooses his words carefully. He says that, at some stage, interest rates will have to rise again, worsening affordability. But the impact won't be the same as it was in the late '80s when soaring interest rates sent the housing market off a cliff. He expects a more "moderate cycle" this time.

I'm no bull

Interestingly, it's not just the bears that believe they've been misunderstood. Christopher Joye, now a Fairfax columnist who was staunchly involved in the debate a few years ago, says he was "viciously defamed" on a range of online forums, together with Australian Property Monitors' senior economist Andrew Wilson. Critics were questioning his integrity as well as the RP Data-Rismark house price measures he helped formulate. Contrary to popular perception, he's not a housing bull, he says.

HOW TO TACKLE THE MARKET

Monique Sasson Wakelin

Wakelin Property Advisory director Monique Sasson Wakelin is advising her clients to be particularly wary of Melbourne's new apartment sector, which is widely thought to be over-supplied. There has been a surge of spruiking and property investment seminars, she says, much of it targeted at self-managed super funds.

"Investors need to be exceptionally wary," she says. "It is cloaked very cleverly in what looks like advice. But really it is just clever sales technique."

The downward slide in buyer confidence and home prices has slowed, she says, and auction clearance rates in Sydney and Melbourne are higher than last year. But buyers remain cautious.

With the market weak, she advises investing in safe properties and taking a long-term view. Houses in desirable areas are the safest. If the buyer can't afford a house, established apartments (not new) in small blocks (not high-rise), are most likely to hold their value.

"It's never a case of categorically staying out of the market," she says. "It's not about picking your time, it's about picking your asset."

CLSA banking analyst Brian Johnson thinks there is still a bubble, but it is going to resolve itself by 'grinding down'.

"The only way I can be characterised as being bullish is relative to Steve Keen," Joye says. "The people who are regarded as housing bulls actually have quite moderate views."

Rather than having bullish views on the housing market, he says he has long argued housing got a one-off boost from historical factors in the '80s, '90s and early 2000s and will probably never again charge upwards for such a sustained period.

"We expected house prices to decline moderately in 2008 and 2011, and we consistently have stated that we expected house prices throughout the cycle to only track disposable incomes. Relative to the last 30 years of housing experience in Australia, and relative to forecasts for asset classes like equities, these are very moderate views."

There have been some more notable examples of bullish predictions that turned out to be wrong. Real estate entrepreneur John McGrath at the end of 2010 tipped 7 to 10 per cent growth in house prices through 2011. But ABS figures show capital city house prices ended up 4.4 per cent lower.

This year economist Stephen Koukoulas has called 10 per cent growth over 2013. The latest ABS statistics, which only go up to March, show we've only risen 0.1 per cent. But there's still a lot of time.

So the Australian housing market continues to disappoint, regardless of what side of the debate you're on.

A sense of caution

Oliver believes the bubble debate is ultimately positive because it adds

HOW TO TACKLE THE MARKET

Chris Gray

Property investment adviser Chris Gray says his bank was more than happy to refinance 11 properties he owns through Sydney's eastern suburbs. They had gone up in value by a combined 4.25 per cent in the past 18 months – not bad considering how weak the housing market has been.

He likes median-priced two-bedroom apartments in inner-city areas like Kirribilli and Bondi. In good times they rise in value, and in bad times they fall less than luxury houses or homes on the city fringe or in regional areas.

"They're in areas where there is no more supply of property because it's fully built up," Gray says. "There is plenty of demand from young professionals, and no one is selling because young professionals still have their jobs, so prices are stable."

The same principle applies to the properties he owns in Britain, he says, which have held their value.

"The equivalent on equities is buying BHP and bank stocks.

"They won't double overnight, but they're nice and consistent, and you will never get them cheap."

some circumspection to the buying process. The US and Japan experiences, the crashes in parts of Australia like the Gold Coast, and the ongoing bubble debate all create a sense of caution.

"A degree of realism has crept in," Oliver says. "People know we can't have 10 per cent house price growth forever. It's just not logical when the economy is growing at 5 per cent."

But the national obsession with property means things are often more heated than they need to be. Philip Soos, a masters research candidate at Deakin University, has contributed a lot

HOUSING AFFORDABILITY

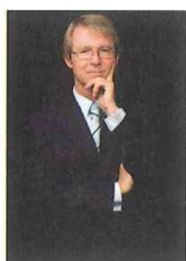
% of household income to meet mortgage payments

Source: Macquarie Capital

HOUSING FINANCE COMMITMENTS

$ billion, monthly

Source: Macquarie Capital



AMP chief economist Shane Oliver says the bubble debate creates a sense of caution.

to the debate with his research into the history of booms and busts in Australia, and their often devastating consequences. We're at the end of the largest boom in recorded Australian history, he says, and a reversion to the long-term average is likely.

But other arguments he makes are murkier – like media outlets such as this one are in bed with industry in a mutual effort to cover up the truth.

"Take, for instance, Andrew Wilson of Australian Property Monitors," Soos says. "He is senior economist of a private research firm that is owned by Fairfax, which is part of a giant media duopoly that obtains over 70 per cent of its funding from advertising revenues. A lot of that is drawn from the government and FIRE (finance, insurance and real estate) sector who have obvious conflicts of interest in denying property has a bubble."

Wilson replies that he just relies on statistical information.

"I'm a classically-trained professional researcher with almost 20 years of experience in government, academia and industry," he says. "I'm just doing my job as an objective analyst."

Oliver finds a bit rich the arguments from Keen, Soos and others that they are better placed to see busts coming because they follow a superior school of economics. Most economists are able to add some perspective to the theories

> *A degree of realism has crept in. People know we can't have 10 per cent house growth forever. It's just not logical when the economy is growing at 5 per cent*
>
> **Shane Oliver, AMP**

they have been taught, he says.

"Some of the super bears have accused me of being a standard neo-classical economist, thinking the free market will fix everything," he says. "But my PhD thesis produced 20 years ago was that markets are frequently irrational, people generally don't follow the rational market that economists assume they do and that sharemarkets and property markets are not efficient."

So-called neo-classical economists take an equally dim view of Keen's theories. *New York Times* columnist and Nobel Prize-winner Paul Krugman says of Keen: "I'm all for listening to heretics when they offer insights I can use, but I'm not finding that at all in this conversation, just word games and continual insistence that the members of the sect have insights denied to us lesser mortals."

While vitriolic debates play out in places like the Australian Property Forum and Bubblepedia, they rarely gain traction in the mainstream. Online activist group GetUp! decided in 2011 not to go ahead with a campaign to discourage first-home buyers from

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purchasing homes. Only 10 per cent of its members supported the campaign. More than half opposed it.

More than bluster?

Keen is out of the country right now, giving lectures to universities and business schools in Europe, the United States and Asia. His itinerary includes a talk at Harvard Law School – they approached him. He's then flying to Malaysia to be the keynote speaker at an event held by the Central Bank of Malaysia.

"One of the things people in Australia don't realise is I don't just talk about housing," Keen says from a hotel room in Croatia. "I'm an internationally regarded unorthodox economist."

Keen says he has developed software that will address the economic profession's abysmal track record of predicting crashes. They're all a bunch of neo-classical economists, he says, whereas his post-Keynesian modelling can "see things like the financial crisis coming a mile away".

The difficulty with dismissing claims like this as pure bluster is that Keen is sometimes right. In late 2005 he went public with his view that a financial crisis was approaching.

Around the same time, Ben Bernanke, then chairman of the US President's Council of Economic Advisers, was explaining to people why sharp rises in US property values weren't much to worry about: "Price increases largely reflect strong economic fundamentals, including robust growth in jobs and incomes, low mortgage rates, steady rates of household formation, and factors that limit the expansion of housing supply in some areas," Bernanke is on record as saying.

There are other discords in the bubble debate people find hard to understand. Commentators talk about a property under-supply while residential developers are simultaneously doing Asian roadshows because they can't sell enough of their apartments at home.

Among the property-loving masses of Australia, it rouses suspicion towards mainstream economists. It's why the bubble debate never really goes away. Arguments that the bubble theorists like Keen have a poor record of getting things right lose their sheen, given central bankers haven't done much better.

But the claim central bankers are oblivious is problematic, too. The public puts so much weight in the views of the central bank that if a central banker were to call a bubble, it would probably be a self-fulfilling prophecy. They inject caution in more roundabout ways.

Around March 2010 Reserve Bank governor Glenn Stevens warned Australians on television to take it easy on housing and that assuming interest rates would stay low forever could "prove to be unfortunate".

"I think it is a mistake to assume that a riskless, easy guaranteed way to prosperity is just to be leveraged up into property," he said. "It isn't going to be that easy."

No, the property market isn't easy, but it's not as ugly as the bubble believers thought either. BRW.

Leith van Onselen (left) and Philip Soos. Friends...but Soos is far more bearish on property prices.

Arguments that the bubble theorists like Keen have a poor record of getting things right lose their sheen given central bankers haven't done much better.

HOW TO TACKLE THE MARKET

Catherine Cashmore

Catherine Cashmore, a property commentator and buyer's agent with National Property Buyers, says buyers need to adopt a "low-growth mindset", and assume future value gains will be lower than those of the past. This means ensuring they can hold property long term without leveraging to the hilt, rather than buying and assuming they can sell it for more in a few years.

"We really had our golden years of boom growth over the last decade, and that's not likely to continue," Cashmore says.

Property is likely to track inflation or wages growth, she says, making it a good buffer against inflation.

She advises buying established properties and steering clear of high density developments. "Usually new accommodation, particularly units, is poor-quality accommodation built with investors, the rental market and mostly the student market in mind."

City fringe locations are risky because new land releases reduce the scarcity factor, she says.

FEATHERSTONE

NEW LISTINGS RECOVER - THANKS, NEW ZEALAND

The market obsession with dividend yield is having strange effects. Boring utility stocks with reliable yield have rallied, resource companies have paid special dividends and even the troubled initial public offering (IPO) market is showing signs of life thanks to utility and property floats.

Remarkably, this year could see one of the stronger IPO markets in the past decade, by capital raised, if current and mooted floats get off the ground. The partial privatisation and dual listing of New Zealand electricity provider Mighty River Power in a $1.9 billion float in May has already eclipsed last year's entire IPO market.

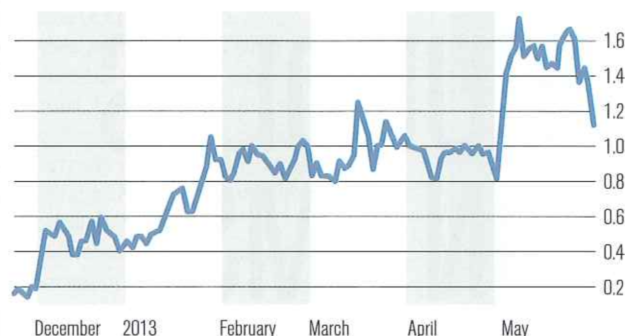
That was not hard. The 2012 float market was a basket case: only 44 companies raised about $1.3 billion between them – the lowest in more than a decade.

The first-quarter 2013 IPO market was just as dismal, despite the rally by the Australian sharemarket. A handful of companies listed, most of them tiny. A savage correction in mining stocks was an awful backdrop for junior explorers or mining producers trying to raise capital and list.

Predictably, there has been a long list of mooted floats, with investment bankers talking up the IPO market's prospects. But few IPOs materialised because of volatile global sharemarkets, lingering concerns about private equity vended assets and retail investor indifference towards floats.

As *BRW* went to press, the $100 million IPO of Domus US Multifamily Real Estate Fund was expected to be postponed due to the Australian dollar's fall (Domus has US assets) and market volatility. Domus, one of the better looking floats, showed how quickly IPO conditions can turn.

A RARE 2012 IPO: SHOPPING CENTRES AUSTRALASIA



Source: ASX

However, rising demand for reliable yield, the New Zealand government's privatisation program and the strong performance of Australian Real Estate Investment Trusts (A-REITs) – which is encouraging other property floats – are game-changers for this year's IPOs.

Of course, the IPO market's recent recovery could stall if global sharemarkets fall and the local market's recent pull-back extends to a 10 per cent correction. Moreover, the IPO market's recovery is so far based on a few billion-dollar floats; overall listing volumes remain terrible.

Most small companies still find it tough to raise IPO capital, aftermarket support for most IPOs remains weak and floats losers after listing vastly outweigh winners. Junior exploration IPOs, in particular, look more problematic than they have in years.

But for retail investors, it is the handful of big name IPOs that matter. The rest are too small for institutional investors and too speculative for most retail investors. For the first time in a few years, a batch of IPOs and recent listings look interesting for long-term retail investors.

Mighty River Power, 51 per cent owned by the New Zealand government, is trading just below its $2.08 issue price – a mighty effort given it listed during the market correction in May. As the first in a likely series of electricity-asset privatisations, Might River looks reasonably priced. The New Zealand government clearly wants to create solid investor demand for other asset sales.

The Mighty River IPO was well-structured, had a high proportion of retail investors and its implied gross dividend yield (after franking credits) of 6.4 per cent to 7.7 per cent in 2013-14 is attractive. Producing about 17 per cent of New Zealand's electricity, Mighty River looks a solid utility stock for long-term income investors.

The next leg of New Zealand's $5.9 billion privatisation program should be a $2.5 billion IPO for another power generator, Meridian Energy. *The Australian Financial Review* reported in May that the New Zealand government had appointed investment banks to handle the float, likely in October.

Meridian might have to be sold in a few tranches if sharemarkets weaken. But the Mighty River IPO and demand for reliable income from utility stocks should see Meridian proceed.

A third New Zealand power float, Genesis, is a mooted $750 million offer in late 2013 or early 2014.

Among other floats, assisted reproductive services provider Virtus Health has a $126 million IPO, the childcare-focused Arena real estate investment trust is trying to raise $75 million and list in early June and a much-anticipated float of iSelect is expected soon.

Two property IPOs from 2012, Woolworths spin-off Shopping Centres Australasia Property Group and NEXTDC spin-off Asia Pacific Data Centre Group, featured in this column in January, have done well since listing. Shopping Centres Australasia in particular has good long-term prospects. BRW