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FEATURE ARTICLE:

ARE GLOBAL PROPERTY MARKETS SHOWING SIGNS OF SOFTENING?

The Softening of Global Property Markets

In the years following the global financial crisis (GFC), property markets in several key developed market countries were the posterchildren for the strength and the extent of the post-crisis economic recovery. Countries such as Australia, Canada, New Zealand and the United Kingdom saw their residential property markets undergo massive price appreciations. Given that some of these markets only faced a relatively minor blip during the GFC, the price appreciations compounded years of solid returns prior to the crisis. This has led to very expensive property markets in many developed market countries based on mean dwelling prices, but also on a variety of affordability measures, such as the ratio of house prices to household disposable income and mortgage repayments as a proportion of household income.

Headline news in 2018, however, has been that house prices in several property markets around the world are starting to show signs of softening. Lower sale prices have been paired with lower turnover in property markets, a higher volume of homes for sale on the market and auction clearance rates reaching multi-year lows.

So far, the slowdown in property markets has been predominantly contained to major cities. Nevertheless, homeowners and investors alike are worried because the simultaneous run-up in house prices in many countries parallels that in the lead-up to the GFC. Furthermore, the house price appreciation over the past decade has been in part because of the incredibly loose monetary policy conditions, which appear to be coming to an end in several countries. Finally, extreme levels of household debt have raised concerns about the resilience of households and banks should there be a negative shock to housing markets.

In this month's feature article, we discuss the signs emerging that the residential property markets in several key developed market countries are starting to soften after several strong years. We delve into why and how the global backdrop is changing, which has made investment in property markets less attractive. In the latter half, we discuss the synchronicity and interconnectedness of global property markets – when one property market falls, is it likely to coincide with falls in other property markets? Finally, property markets are an important factor in general economic stability. Thus, monitoring the extent to which the softening property markets lead to a soft landing or a broader property market crash is of utmost importance.

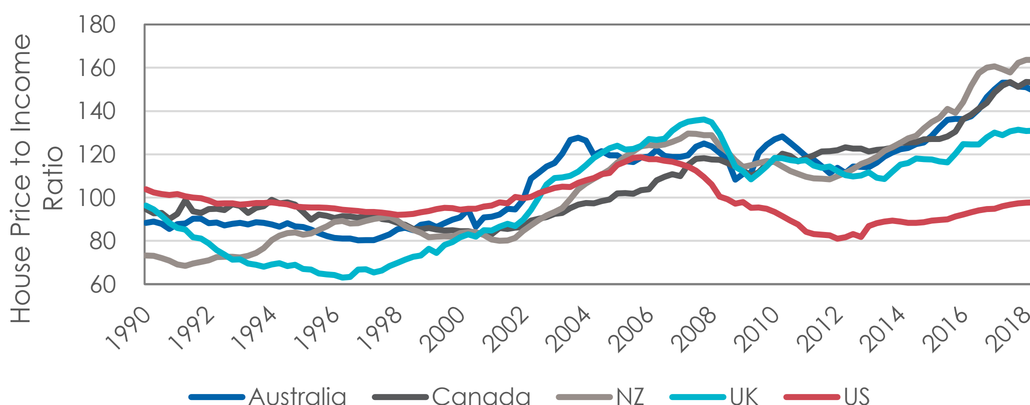
THE SIGNS POINT TO SOFTER PROPERTY MARKETS

In the early 2000s, housing markets in many developed market countries experienced hefty price appreciations. Following the bursting of the dotcom bubble in 2001, nominal interest rates were low compared to what they had been throughout much of the 1990s. This, paired with deregulation of the financial sectors of many developed market nations, allowed households to have much easier access to credit and financing. These conditions led to property markets being a highly attractive asset class. Population growth in many countries, notably in the largest cities, also fuelled the demand for housing, which contributed to the strong price appreciation.

The GFC was the most significant event to impact housing markets in recent history. House prices in many countries experienced serious corrections, however the most dramatic correction occurred in the United States. For many other developed market countries, the extent of the corrections was more limited, and house prices quickly picked up where they left off before the onset of the GFC. This is shown via house price to income ratios presented in Chart 1 below. The United States saw the most significant correction, however prices have been rising again over the past five years. For Australia, Canada, New Zealand and the UK, the GFC corrections were relatively minimal and house price growth has been incredibly strong for the past seven to eight years.

However, these same property markets are starting to see a softening in the pricing of global housing markets. This is also shown in Chart 1 above, as the lines for all five countries have all either flattened or kinked downwards in the past year or so. While the flattening of house prices appears to be in the very preliminary stages of broader property market weakness, it is important to address what we have seen so far in case the flattening turns into a more severe downward trend. In the subsections that follow, we provide some colour as to the extent of the softening property prices in Australia, the UK, Canada and the US.

Chart 1: House Price to Income Ratios for Select Developed Market Countries, 1990 - 2018



Source: OECD, Whitehelm Advisers.

AUSTRALIA

Australian home prices have fallen for 11 straight months, however the price falls so far have been concentrated to the largest cities. In the year ending 30 September 2018, the prices for all dwellings (combination of houses and apartments) fell by 6.1% in Sydney, 3.4% in Melbourne and 2.8% in Perth, according to CoreLogic data. House prices in Adelaide and Brisbane increased over the past year, but only very moderately (less than 1%) compared to the increases seen in the past few years. The five capital city aggregate was down 3.9% on the year.

As for the other, smaller capital cities, the residential property market performance has been mixed. Darwin's prices were down by 3.7% over the year, while Canberra's (+2.0%) and Hobart's (+9.3%) saw healthy gains. Hobart's house prices have been the true anomaly, however the significant price gains have been because of predominantly local factors, such as a strong economy which has attracted migrants, a shortage of dwellings and a booming tourism market which has encouraged houses to be turned into short-term accommodation, leaving less stock for owner-occupiers. Thus, aside from Canberra and Hobart, while residential property markets across the country are seeing softer conditions, the biggest falls have been in the cities that have seen the largest run-ups in prices over the past decade.

It is not just prices that are illustrative of the softer property market. Housing credit growth is now just 5.5% per annum, which is the slowest rate in five years. Investor credit growth is just 1.6% year-on-year, which is the slowest rate ever recorded. The annual change in housing finance approvals is shown in Chart 2 below, while the relationship between housing prices and changes in credit is shown in Chart **3**.

UNITED KINGDOM

Similarly, the UK is seeing a patterned fall in house prices, in that the major cities are starting to see softening conditions, while smaller cities and rural areas are continuing to see house price appreciation. Large falls in house prices in London and surrounding areas are offseting continuing house price strength in several smaller cities and more rural areas.

Chart 2: Change in Australian Housing Finance Approvals, 2010 - 2018

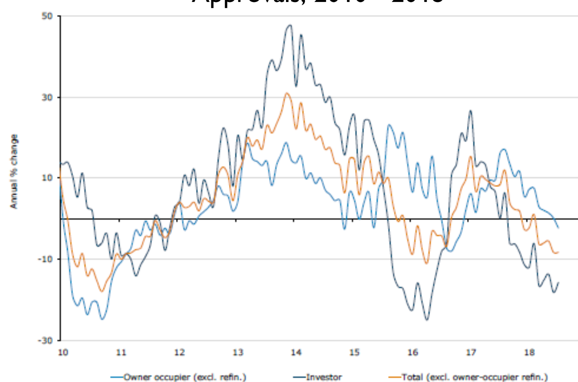
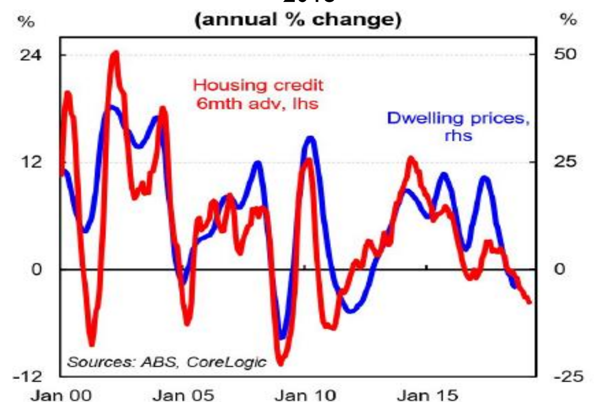


Chart 3: Change in Australian Housing Credit, 2000 - 2018



Source: ANZ, CBA

Turnover in the housing market is notably reduced in several key markets, particularly in London. According to the Financial Times across the country as a whole, the number of housing transactions has stayed roughly the same for the past four years (as shown in Chart 4 below), however turnover in the London market has fallen by 20% over the same time period. There are several smaller cities that continue to see a high volume of transactions, which offset the large fall in London. For example, house price growth (and in turn, the volume of transactions) continues to be strong in both Manchester and Liverpool.

CANADA

In Canada, the largest price run-ups have been experienced in the two largest cities, Toronto and Vancouver. Per calculations from The Economist based on house prices relative to median household incomes, house prices in Toronto are 49% overvalued, while house prices in Vancouver are 65% overvalued. After a slow decline in Toronto's property prices in the second half of 2017, they have fallen more markedly in the first half of 2018. Vancouver's house prices did not start falling as early as Toronto's did, however they have now joined in on the downward trajectory. This is shown in **Error! Reference source not found.** below from Moody's. The house price correction is not consistent across all major metropolitan areas, which is akin with what has been seen so far in Australia.

Turnover in the Canadian property market continues to be notably lower. For example, home sales in the Greater Toronto Area have plunged by almost 40% from a year earlier, while the total number of active listings has more than doubled.

UNITED STATES

As compared to the three countries that we have already discussed, housing markets in the United States do not appear to be quite as overvalued. This is in part because of the country-wide correction to housing prices that was seen following the GFC. Nevertheless, there are signs emerging that housing prices are starting to turn in some key areas in the United States.

According to Bloomberg, 30 of America's 100 largest cities now have more inventory than they did just a year ago and the supply of homes during the 'all-important' spring market was three times higher in 2018 than it was in 2017. Existing home price growth has fallen over the past few months, to the slowest annual rate since early 2017 and the slowest quarterly rate since 2012. Purchases of new homes are at the lowest level since the end of 2017. Furthermore, per surveys conducted by the University of Michigan, home-buying conditions are the worst since in the middle of the GFC.

Chart 4: UK Residential Property Transactions Above £40,000, 2006 - 2018

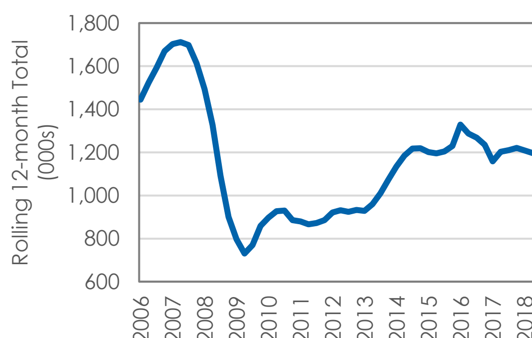
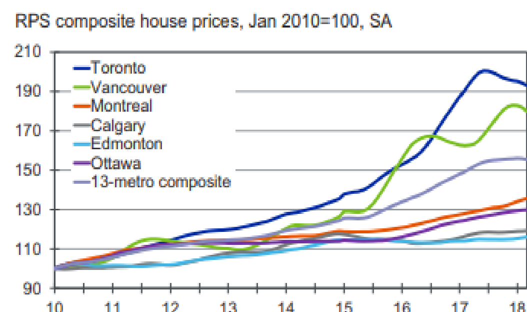


Chart 5: Normalised House Prices in Major Canadian Cities, 2010 - 2018



Source: HM Revenue & Customs, Moody's Analytics Whitehelm Advisers

The Global Backdrop Has Changed

In the previous section, we discussed the reasons why property prices have seen such strength in several different developed market countries over the past decade. However, as apparent from the discussion earlier in this article, conditions appear to have changed so far in 2018. This is largely reflective of a changing global backdrop, in terms of both monetary policy conditions, but also because of changing regulatory landscapes, changing population dynamics and improvements to housing supply. At the global level, the following factors are those that have been most dominant in terms of the changing global backdrop that have influenced property prices.

Monetary Policy Conditions: As central banks tighten monetary policy, servicing a domestic property loan will become more expensive. The US Federal Reserve has raised its federal funds rate from the 0% level that it was at for nearly eight years by 2%, with the first increase implemented in December 2015, and the most recent implemented in September 2018. The Bank of Canada has raised rates from 0.5% to 1.5%. The Bank of England has been taking more tentative steps in its monetary policy normalisation process, having only raised its interest rate by 0.25% from its post-GFC level. The RBA, the most dovish of the collection of central banks discussed in this feature article, continues to hold its cash rate at an all-time low of 1.5%. As central banks increase their respective interest rates, commercial banks typically pass on the interest rate increases to their customers. This makes investing in property more expensive and, in turn, a less attractive asset class. As a result, investors may prefer fixed interest and equity markets over the suddenly less attractive property asset class.

Increases to Supply: Because of the drastic increase to property prices over the past decade, property developers have been incentivised to build both single family dwellings and apartment complexes at very fast rates. Given that it can take a few years from the time of building approval to completion, supply is finally starting to catch up to demand.

Regulatory Changes: Several developed market countries have made a slew of regulatory changes over the past couple of years, in part to address very hot and unaffordable property markets. Many of these changes have been focused on disincentivising foreign investment in domestic property markets as well as improvements to lending standards.

AUSTRALIA

The Royal Commission

The Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, while not yet concluded, is already having implications on housing market conditions across Australia. The commission, which spent the lion's share of its time dissecting the conduct of the country's banks, uncovered that broker commission structures, inappropriate estimates for living expenses and inadequate systems in place to verify borrowers' financial standing have led to lax lending standards that has resulted in people receiving loans that are entirely unsuitable for their financial position. The commission has shown the need for tighter lending standards, which will ultimately be up to the government and the relevant regulators to implement.

The effects of the Royal Commission are already being seen in the property market. The negative press as well as the pressure from the regulators have already caused Australian banks to improve their lending standards and compliance processes. The likely medium-term implications are for credit growth to slow and borrowing limits to fall. We have already been seeing Australian credit growth falling in the past few years. Cheap credit has been a significant driver of the house price appreciation that has been seen in Australia over the past several years, and a tightening of credit conditions has been a contributing factor in Australia's softening property market over the past several months. As the government and regulators try to figure out how to deal with the commission's findings and eventual recommendations, we expect these implications to worsen.

APRA's Implementation of Tighter Lending Standards

While credit growth is an indicator of financial system health, one of the Australian Prudential Regulation Authority's (APRA's) key concerns a few years ago was the high rate of credit growth to both individuals and corporations. With the help of the 2014 Financial System Inquiry (FSI) and the global Basel III banking reforms, APRA put in place measures aimed at slowing investment lending growth, ensuring underwriting standards for loans remain prudent and improving banks' financial positions (such as capital ratios and liquidity) to better withstand shocks to the system. Some of the measures introduced were designed to cool down the overheating housing market and contain price growth in a healthier and range, thereby helping to stabilise the housing lending segment of the Australian banking sector.

Two key changes made in 2015 were to put a 10% annual cap on residential investor lending growth (that is, lending to people to buy an investment property, rather than an owner-occupied house) per bank and to increase the capital adequacy requirements for residential mortgage exposures for major banks which use an 'internal ratings-based' approach to determining capital levels. In response, many banks took measures to reprice lending (including out-of-cycle lending rate increases) and tighten credit assessments to stem the growth of investor mortgage loan approvals.

Out-of-Cycle Mortgage Rate Increases

In addition to the tightening of lending conditions in Australia, three of the four major Australian banks have opted to implement out-of-cycle mortgage rate increases so far in 2018, citing an increase in funding costs. So far this year, the spread between the bank bill swap rate and the overnight cash rate has increased to levels not experienced since 2010. The widening spread is hurting banks that are paying more for short-term financing relative to the unchanged level of interest they are receiving from households and businesses. When banks have seen an increase in funding costs in the past, it has led to increases in the spread between the cash and mortgage rates for borrowers. This shows that banks are passing on the increased funding costs to their borrowers in order to help protect their net interest margins.

UNITED KINGDOM

Brexit has wreaked havoc on a variety of aspects of the British economy, with no end in sight in terms of its impacts. The British property market is just one example. While the British property market, on the whole, does not appear to be materially weaker in terms of sale prices so far (although prices are notably down in London), the effect that Brexit has had is more obvious in terms of the difference in the volume of property sales from before Brexit to after Brexit. Sales volumes have decreased by almost 20% in London over the two years since Brexit, with sharp falls in areas around London as well. This is in part because London has been an epicentre for EU nationals, whose future in the UK is now uncertain.

Ultimately, the longer-term effects of Brexit on the housing market will likely be indirect, through the effects that Brexit may have on wages and interest rates. If increased trade barriers between the UK and the EU post-Brexit (in the case of a hard Brexit, with a poor outcome for the UK) lead to lower UK economic growth, unemployment could increase and wages could fall. Or if the British pound falls further in the case of a hard Brexit, inflation will increase because of the effect that the weaker pound has on the price of imports. Without commensurate increases in wages, a fall in the pound will cause British people to have a reduced capacity to spend increased amounts on housing. Furthermore, the Bank of England may be required to increase its interest rate to prop up the pound. Higher interest rates will not prove favourable for the British property market. Depending on the nature of the Brexit deal that is struck, EU nationals may be leaving the UK in droves in 2019.

CANADA

The main changes facing the Canadian property market relate to tightening monetary policy conditions and regulatory changes. The Bank of Canada has been raising interest rates, not as fast as the Fed, but faster than many of its developed market peers. It has raised rates by 1% since the start of 2017, from 0.5% to 1.5%. Coinciding with its most recent rate increase in July, all six of Canada's largest banks increased interest rates for their variable-rate mortgages.

At the start of 2018, the Canadian government implemented new guidelines for banks to follow when their customers are applying for a mortgage, or renewing or refinancing an existing one. Stress tests are now required to prove that their customers would still be able to keep up with their mortgage payments if their mortgage rate were to increase substantially. In effect, the stress tests are expected to cause loan-to-value ratios to fall because borrowers will have to reduce the amount they can borrow in order to pass such stress tests.

UNITED STATES

Because the American property market faced a far more significant depreciation in the years following the GFC, and its house prices have not appreciated nearly as much as those in some of the other developed market countries that we have discussed in this feature article, the worry about US house prices falling significantly is reduced. Nevertheless, there have been a few factors coming through in the past year that have been responsible for less strong growth in the US property market.

The very high levels of student debt (which we discussed in our May 2017 feature article, Subprime Lessons Not Learned), and very few listings at the entry level end of the spectrum have created affordability headaches for buyers for a while. However, the strong and growing economy, notably the tight labour market evidenced by the low unemployment rate and reasonable wage growth, has masked some of the housing affordability issues in the United States. However, the interest rate increases being implemented by the Federal Reserve are being passed on to Americans through increases to mortgage rates.

The Interdependence of Global Property Markets

It is well understood that equity and fixed interest markets exhibit a high degree of interdependence, in that when one country's equity market falls, it is likely that equity markets in other countries are all also falling. In other words, global equity and global bond markets often move in tandem. This is in part thanks to the power of globalisation, which has united the investor base and allowed for investor flows, and market sentiment, to transcend physical borders.

There has been less of a consensus on the correlation of global property markets, in part because it has long been believed that domestic property markets are more affected by local conditions than global ones. A house serves a very utilitarian function in that it gives its buyer a place to live. As a result, it is often assumed that housing markets are affected by local factors, such as housing supply in local markets, local population growth and a country's tax policies.

However, the International Monetary Fund (IMF) published a report in April 2018 (refer to *House Price Synchronisation: What Role for Financial Factors?*) which addresses that there has been an increase in the effect that global factors (such as movements in property markets located in other countries) have on domestic property markets, from about 10% of market movements in domestic property prices being explained by global factors, to about 30% over the past 40 years. While this is still low compared to the interdependence of global equity markets, the IMF has found that the correlation between housing markets is particularly pronounced for the urban centres of both emerging and developed economies. The rise in the correlation between distinct property markets means that house prices are starting to behave more like stocks, bonds and other financial assets that are influenced by global investment activity.

WHY HAS IT INCREASED?

Domestic property markets have become 'globalised'. Financial capital can easily move across borders, which results in investors treating property investments as tradeable assets, investing in markets where the yields are most attractive. International capital flows are dictated by where investors believe they can get the most bang for their buck, or where yields are the highest. In the era of loose monetary policy, it is not surprising that yield-hungry investors have looked beyond their own borders, and more traditional asset classes like fixed interest, for attractive investment opportunities. This has caused global property markets to become increasingly dependent on global financial conditions, not just local conditions.

Cross-border flows have been concentrated on the megacities of developed market countries that have been offering up attractive returns on real estate, many of which have been discussed in this feature article – Sydney, Melbourne, London, Vancouver and Toronto, to name a few.

Increased Activity from Institutional Investors

As per the IMF's report, over the past several years, investment in property markets has increased (aside from buying a house for the primary purpose of living

in it). In Australia for example, favourable tax policies have led to individuals buying multiple properties, which has been a major contributor to the increase in housing prices. But the IMF points out that there has also been an increase in investment in global real estate from institutional investors, private equity funds and real estate investment trusts (REITs). Given property's positioning as an attractive asset class from the perspective of global investors, who are affected by global market sentiment, global property markets have become increasingly interwoven.

Financial Openness of a Country

Countries with a high degree of capital account openness (i.e. how welcoming a country is to foreign direct investment, foreign portfolio flows), have also paved the way for the synchronicity of global property markets. As countries, both developed and emerging, benefit from foreign capital flows, it is not surprising that countries have opened their doors to foreign investors. While some countries are clamping down on the volume of foreign investors flooding into domestic property markets over the past several years, the volume of existing foreign investment that has already taken place means that there is a high degree of property market interconnectedness.

WHY IS THIS CONCERNING?

Property markets being open to international capital flows has meant that there is more liquidity in housing and mortgage markets and more risk-sharing opportunities for households and lenders. However, it also comes with risks. As per the IMF's report:

'At the same time, however, the links across housing markets may transmit or amplify financial and macroeconomic shocks, increasing the exposure of local housing markets to global financial conditions or to shocks affecting foreign investors active in local markets. As a result, policymakers' ability to address imbalances in the housing market through national or local policies may be constrained, particularly if house prices across many countries decline at once. In this case, a decline in external demand may exacerbate the challenges of stabilising household balance sheets, financial markets and economic activity. In this sense, a sharp reversal of the prevailing accommodative global financial conditions could challenge how policymakers address financial and macroeconomic stability should a simultaneous decline in house prices occur.'

As the global financial system grows increasingly integrated, in part because of international capital flows into developed market property markets, it means that domestic property markets are increasingly likely to be affected by the risk sentiment of global investors. Importantly, individuals who are invested in the property market are less likely to liquidate their assets at the earliest note of worry about property markets. This is because they are often tied to their house and its location, because of family, friends and jobs. Global investors who have invested in property markets are far more prone to capital flight in the event of a downturn in global risk sentiment.

This interdependence of global property markets is a cause for concern given that several property markets in key cities in developed market countries are currently experiencing a high degree of softening. Furthermore, there is a slew of other global economic uncertainties currently facing markets and if we are to see any of these risks materialise, investors may become wary of the security of their property investments around the globe. While each property market is facing its own unique domestic-born challenges, they have the potential to cause spill-over effects for other countries, and other property markets. As a result, house prices in domestic markets can deviate from their market fundamentals and can exhibit higher degrees of volatility when global conditions are in flux.

Impact of Housing Markets on Economic and Financial Stability

Past experiences of boom and bust cycles in property markets have highlighted the risks to the economy when frothy house prices are paired with high levels of household debt. The rapid run-up of house prices in countries like the United States, Ireland and Spain in the lead-up to the GFC was followed by a very sharp correction, which led to bank failures, and in turn, poor economic performance and financial market stress. While we are not forecasting that this will happen given recent weakness in property markets, it is important to understand the stages of housing cycles, as well as the importance of housing markets on economic and financial stability.

THE STAGES OF HOUSING CYCLES

A simplistic description of how housing cycles usually progress can be split into three main stages:

Mania: House prices rise at a very rapid rate, as factors like low interest rates, excess central bank liquidity, easy credit, supply not coming onstream fast enough and high levels of foreign direct investment cause house prices to rise, weighing on housing affordability.

Peak: Homeowners and investors alike start to worry about where the top of the cycle is and become jittery about whether the market is approaching bubble territory. Supply has caught up to demand. Increases to interest rates and/or tighter lending conditions can also bring about this stage. Homeowners and investors start to sell out because they think a market sell-off is imminent.

Bust: As transaction volumes and clearance rates fall, housing inventory builds up. Sellers start have to lower prices to try to sell. This is the first step of a downward spiral, because buyers do not want to buy a house when the price might be lower in a week's time. Sellers are forced to lower prices even further.

There can be many different triggers that cause the housing market to move on to the next stage in a cycle. In a feature article we wrote in February 2017 (refer to *An Update on the Australian Property Sector*), we discussed how the Australian property market was very much towards the end of the mania stage. House prices had been increasing almost consistently for nearly twenty years, and housing affordability had become one of the country's most significant problems to grapple with.

The extent to which Australia, and the other countries discussed, fall into the bust stage is still very much uncertain. However, as discussed in the previous section, the interdependence of global property markets adds fuel to the fire, in that if one of these property markets starts to see more serious price corrections than have been seen so far, global risk sentiment could dictate that a housing market collapse could be more severe than previously thought.

But, so far in 2018, it appears as though the Australian housing market, notably in Sydney and Melbourne, is in the peak stage. The ongoing Royal Commission can take some of the credit for this, given that tighter lending conditions, and thus credit being hard to come by, are already taking effect.

THE RISKS AT PLAY

Downward movements in house prices can pose risks to households and financial institutions in any given country. This is because of the importance of housing markets to overall economies, particularly given that housing makes up the largest component of wealth in an economy. The majority of households around the world hold the greatest portion of their wealth in their homes, rather than in other financial assets, such as stocks and bonds. Housing is by far the largest asset class on Australian households' balance sheets, accounting for around 60% of total assets.

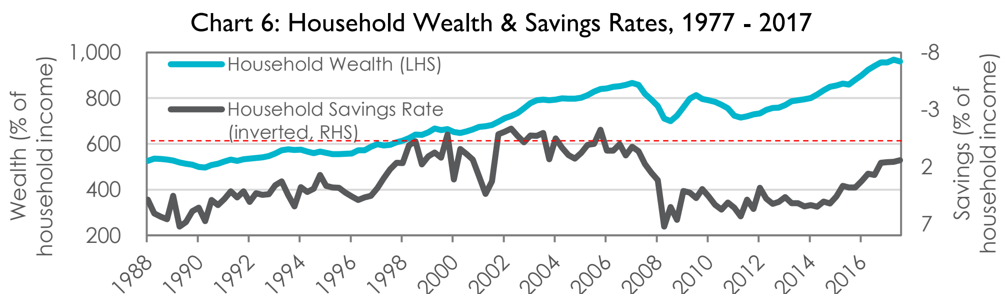
In the boom stage, households, investors and financial institutions alike are likely to engage in excessive risk-taking. But when the boom ends, and households and investors grow jittery of the future value of their houses, there can be a great deal of knock-on implications. Changes in the value of housing can have a large impact on consumer spending due to the 'wealth effect'. The Australian Housing and Urban Research Institute estimates that every $100,000 increase in housing wealth reflects an increase in consumption of between $1,000 to $1,500 in Australia. Chart 6 illustrates the wealth concept in Australia over the past several years. As house prices have increased, so too has household wealth. The additional wealth has caused consumer spending to increase, or the savings rate (inverted in the chart) to fall. The red line indicates a savings rate of 0%.

The impact of falling house prices on any developed economy is likely to be significant, particularly if paired with a severe rationing of credit. If a credit crunch, brought about by higher interest rates or tighter lending standards, is severe enough, it could result in a rise in unemployment, magnifying the likelihood that homeowners will be unable to repay their mortgages. While household debt levels are high, with Australia's among the highest in the world, to date, the ability of households to service their debt has not been greatly tested because of the ultra-low interest rates. However, in an environment of higher interest rates, a rise in unemployment and/or a fall in house prices (a fall in the value of their largest asset), households may have more difficulty in servicing their debts.

Given the run-up in house prices, a rise in interest rates causes the size of mortgage repayments to increase, meaning that mortgage repayments comprise a bigger portion of a household's spending. To offset this increase, a household's disposable income is negatively impacted, meaning that they have less to spend on other goods and services. A fall in consumption can have obvious widespread effects on the broader economy. If households do not change their consumption patterns, their ability to meet their mortgage payments may be strained, leading to an increase in the volume of loans being in arrears.

The risks that come with the high levels of leverage within the property market have often been downplayed by investment professionals.

Chart 6: Household Wealth & Savings Rates, 1977 - 2017



Source: ABS, RBA, UBS, Whitehelm Advisers

An example should help clarify the risks. Typically, investors will not pay a full 20% deposit on purchase of the investment property. For the sake of this example, say the investor paid a 5% deposit on a $500,000 house, so the amount left owing is $475,000. If property values were to fall by 20%, the investor now owns a house worth $400,000, but owes $475,000 on it. They have negative equity at this point and could see serious downside implications should there be even a moderate price correction.

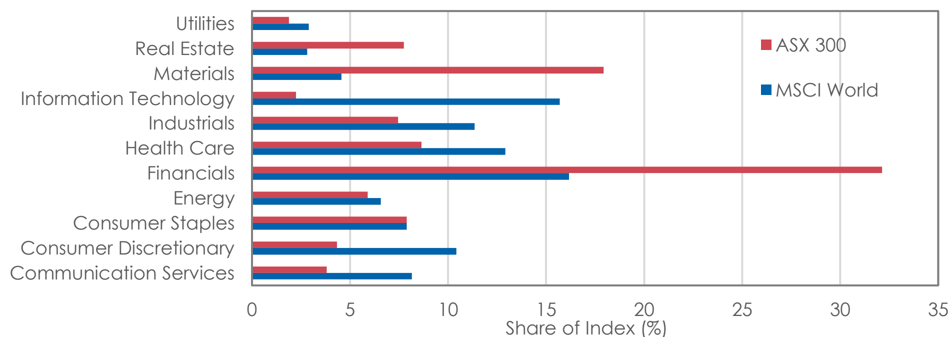
Because of the run-up in house prices, banks are heavily exposed to price movements. In Australia, homeowners cannot walk away from their homes and their mortgages like they could in the US during the GFC (by sending keys to the bank), so falls in house prices can lead to an increase in the volume of loans in arrears or in default. Residential property loans make up 60% of overall lending in Australia. Mortgage lending has been a key source of profitability for the major Australian banks, and they have benefited greatly from rising household leverage.

If a downturn in the Australian property market is caused by a spill-over effect of downturns in global property markets more broadly, the impact on Australia's banking sector will be more severe. Given that the source of the weakness in this case is coming from external markets, there is little that Australian regulators will be able to do to prop up the property market in Australia.

Should the property market experience a sustained downturn, Australian banks are likely be significantly impacted The Australian share market is concentrated in terms of exposure to certain key sectors, with the financial sector being by far the most dominant. As of the end of September, 32% of the ASX 300 Index was made up by financial sector stocks, with the big four banks alone accounting for 22% of the index. The MSCI World Index is also heavily weighted towards the financial sector (16% of the index), shown in Chart 7 below. Therefore, a significant hit to the banks because of pressure in housing markets would have serious implications for investors heavily invested in the Australian and overseas share markets. According to SuperRatings data, Australian superannuation funds have typically maintained a 25-30% exposure to each of Australian equity and developed overseas equity. This means that the average Australian superannuation fund could have between 12-14% of its overall fund comprised of global and domestic financial sector stocks.

We have been recommending our clients maintain a lower exposure to risk assets than peers over the past several years. Should domestic and global property markets face sustained downturns, we expect this positioning to benefit performance, all else equal. We will continue to monitor the allocations to these two asset classes in light of the outlooks for the domestic and overseas property markets.

Chart 7: Sector Breakdown of ASX 300 and MSCI World Index



Source: Bloomberg, Whitehelm Advisers

Conclusion

The perfect storm of market conditions has driven an impressive period of property price appreciation for several developed market countries, in terms of both magnitude and duration. A long period of historically low interest rates, generous tax policies, financial market openness and high rates of immigration and urbanisation have fuelled the demand side of the property boom in major urban centres, while delayed supply and urban consolidation have constricted supply.

Eighteen months ago, we wrote a feature article which concluded by saying that we thought that the Australian property market was in bubble territory, even if it was only localised to Sydney and Melbourne. We noted that the main triggers for bursting the bubble were increases to unemployment or to interest rates. While we have not seen the former, we are seeing the latter, not in interest rate increases from the RBA, but from tightening credit and lending conditions, in part because of the Royal Commission. So far, we have seen prices softening in the major urban centres in Australia, however we are yet to see any sort of major price correction.

This is not a trend unique to Australia. Urban centres in many different developed market countries are experiencing similar softening. This supports the argument for property market synchronisation, but it also raises concerns about the impacts of several different property markets falling at once. Deteriorating investor sentiment could exacerbate property market falls, and exacerbate the knock-on implications given the importance of property markets in maintaining economic and financial stability.

While we try to be optimistic with regards to global property markets undergoing gradual price corrections rather than a large sell-off, we recognise that housing markets are the key risk for many different nations. That said, the key to this risk materialising into a huge problem lies in unemployment, and to a lesser extent, interest rates. A considerable rise in either of these two factors would present the catalyst for the downside scenario to eventuate. While we find it difficult to see a near term catalyst for a sharp rise in unemployment, increasing interest rates are something that, broadly speaking, financial markets are trying to come to terms with. It is a space that will continue to be of great interest.

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