Stakeholder Update

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Brook Monahan
Founder & Managing Director
Mosaic Property Group

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We're just emerging from the tail end of a pandemic and now we've been plunged headlong into the middle of a federal election campaign. Caught in the centre of an extreme spin cycle that seems to endlessly drift from one 'potential catastrophe' to another.

In this context, the RBA's much-anticipated decision to increase interest rates two weeks ago to counter inflationary pressure has been used as the latest tool designed to create fear about the cost of living and the future of the property market.

It's at times like these – where emotions are heightened and politics is driving the narrative to fan the flames of extreme uncertainty – that we try to bring some balance and perspective to the issues of the day. Research is part of our DNA at Mosaic, so we step in during these times to provide information to our key stakeholders and loyal customers to help cut a swathe through the fever pitch back and forth created during these periods to hopefully bring a sense of balanced perspective to the 'commoditised' thinking that the average punter happily digests in droves on a daily basis.

As you may well know, Mosaic Property Group has its own internal research department whose sole job is to constantly assess the state of play in the market. To cut through the headlines and ever-persistent white noise, to analyse the market's performance, review what the various experts of different backgrounds and biases are saying and most importantly, to evaluate each new nuance in the market or developing trend, with the backdrop and context of having carefully studied historical cycles and trends; in order to hopefully understand what is really going on.This helps us navigate our way through the market and has served us well in terms of the well-researched and considered business decisions that we make on a daily basis.

And whilst we do not for one moment hold our own view in any higher regard than anyone else's, particularly when they diverge, we are mostly sceptical when the majority of participants and observers in any market begin to hold the same or similar view on mass (and even more so when those views are reactionary or based in fear).

This short piece aims to share the findings of our research with you to help ensure you have the key information you need to help understand the forces at play in relation to interest rates and inflation, and the likely potential impacts on the residential property market in the years ahead.

So, is all of the doom and gloom we've been hearing over the past two weeks since the RBA made its decision to lift interest rates based on substance or is it just sensationalised headlines and commoditised thinking at play again?

While we don't profess to get everything right, we certainly live and die based on the views we form and the subsequent decisions we make, and fortunately, this has served us and our stakeholders well in the past. So, this is our perspective based on all of the facts at hand and the experience we have gained through an intimate understanding of past property cycles.

Firstly, when we look historically at market performance, increased interest rates don't correlate well with a negative impact on property prices. Add to this the fact that the pandemic has resulted in a strong positive surge in household savings, combined with increased lending regulations since the GFC, record-breaking strong employment with wages growth imminent, rapidly rising rents, along with interest rates that will still remain substantially below the historical average for a sustained period of time – we feel there's much less to be fearful of than current media headlines would suggest.

And then if you look at how this will play out in the property market, South East Queensland (SEQ) and the apartment market in particular, will be further insulated to some extent, from the impact of interest rate increases due to the comparative affordability with its Sydney and Melbourne counterparts, strong interstate migration and population growth coupled with high levels of returning overseas migration, record infrastructure spend, rapidly rising rents and severely constrained supply.

Now I know these details don't necessarily make for exciting headlines during the cut and thrust of a federal election campaign, that's pretty much it in a nutshell. Now let's unpack this in more detail.

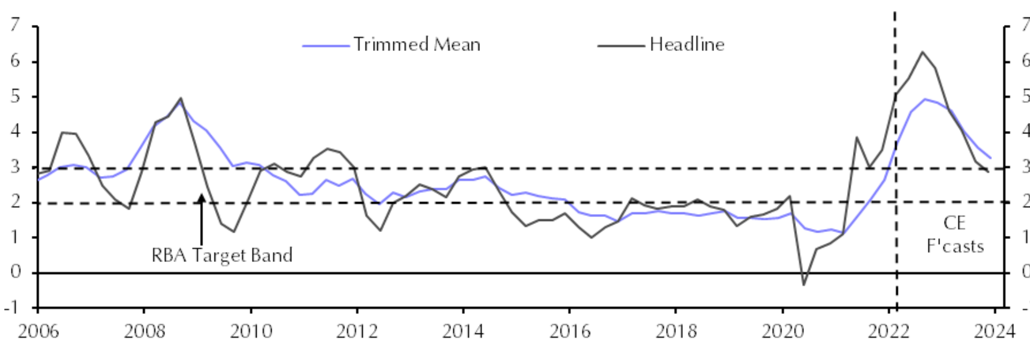
Let's get some perspective around interest rates and inflation…

Firstly, global forces have had a significant impact on prices of most things. The war in Ukraine and the subsequent rapid rise in commodity pricing (energy and food), combined with restricted supply chains and labour shortages resulting from COVID (including China's increasingly committed stance towards its 'Zero Covid' policy) have caused prices and supply bottleneck challenges to persist, with predictions inflation could reach up to 6% in Australia by later this year; and much higher in the UK and US. This is outside the RBA comfort zone of an inflation targeting in the 2-3% range. As a consequence, the cash rate just moved from a record low emergency setting of 0.1% to 0.35% with predictions from the likes of ANZ that it may reach 2% by early next year.

It's the first increase in almost 12 years when the RBA last lifted rates to 4.75%. This means there are a lot of buyers out there who have never seen a rate rise, and who are therefore shocked by it, as well as those who took advantage of a short window in 2020 to fix artificially low rates for 3-4 years who will ultimately face a different rate environment when these fixed rates eventually expire.

This is "new news" for many of them and understandably they question the impact this will have on their lifestyle and consumer spending habits. In our opinion, they needn't worry quite as much as some current media would suggest. I'll go into more detail below to put this into context.

CONSUMER PRICE INDEX- HISTORICAL AND CAPITAL ECONOMICS FORECASTS



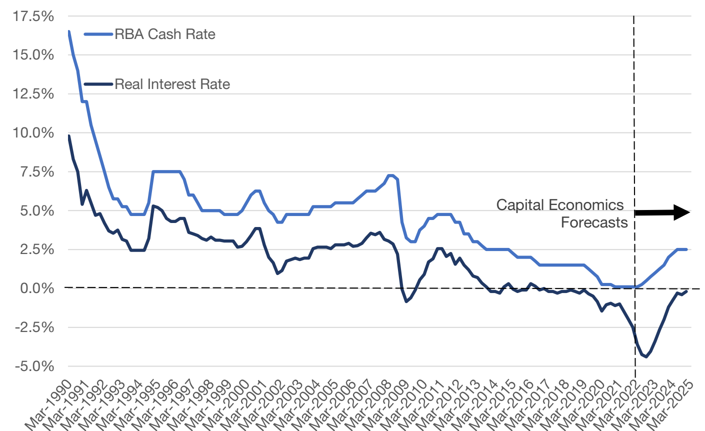
There's also a considerable weight of opinion that interest rate cuts – not increases – will be back on the agenda within 12 to 18 months. Macquarie Bank's respected Global Head of Strategy, Viktor Shvets, says disinflationary outcomes are more likely in 2023 and 2024 with a higher probability of loosening of both fiscal and monetary policies over this period.

The important takeout here is that the RBA cash rates are predicted to remain well below the historical average of 4.7% and in fact, real interest rates (when we take into account the rate of inflation) based on Capital Economics forecasts, will remain negative and sit at around -0.2% at the end of 2024.

So in essence, interest rates have been at historic lows for a decade and will continue to remain low (and even more so when adjusted for inflation) for the foreseeable future, including at the eventual peak of this current tightening cycle.

CASH RATE VS REAL INTEREST RATE- HISTORIC & FORECAST

(Source: Capital Economics, RBA)



There isn't a perfect correlation between interest rate increases and property prices…

History shows that housing prices remain resilient over the longer term despite tightening cycles where we see increases to interest rates. Six months after three of the last four cash-rate tightening cycles, housing prices were higher than at the beginning of the tightening cycle.

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> - Brook Monahan

In fact, over the 2002-2008 tightening cycle, housing prices rose more than 50% - equivalent to an 8% year on year increase. Interest rates rose 22 times during this cycle while the median house price more than doubled in six of the eight capital cities. In Brisbane, it increased by 127%.

Whilst there are some differences to the current tightening cycle in comparison to this most recent prior tightening cycle, including higher average household debt levels this time around, the data is of note nonetheless.

HOUSING IMPACTS OF CASH RATE TIGHTENING CYCLES
(Source: ANZ Research, RBA, CoreLogic)

Cycle begins >	Aug-94	Nov-99	May-02	Nov-09
Cash rate before hikes	4.75	4.75	4.25	3
Cash rate after hikes	7.5	6.25	7.25	4.75
Cash rate ppt increase	2.75	1.75	3	1.75
Hiking cycle length	6mths	10mths	5yr10mths	13mths
Housing price change to 6mths after last rate increase	**-2.70%**	**5.90%**	**52.20%**	**2.10%**

Property prices have never crashed in the history of Australian real estate as a result of interest rate rises alone and we don't expect it will happen this time.

And whilst there are no doubt a collection of headwinds that our property market will face over the next 12 to 18 months, our 'decade view' out to the 2032 Olympics would suggest that SEQ will outperform all other major Australian capital city markets over this time horizon. I will touch on this further below.

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Without the ability to look back over history it's easy to submit to the hysteria and underestimate the economy's ability to absorb higher rates and overestimate the impact of the increases on household finances.

Not to mention the psychology of Australian mortgage holders who have historically made substantial spending sacrifices, when required, in previous much tougher economic climates than the one we are heading into, to ensure they are able to service their mortgage commitments.

The home is central to Australian identity and mortgage holders typically do whatever they can to protect this and with record low unemployment, there is strong reason to believe this will be readily easily achieved over this tightening cycle.

So let's take a closer look at why households will largely be able to successfully navigate their way through the increases to interest rates and inflation.

Factors that will cushion the impacts…

Regulations were introduced in 2009 as a consequence of the GFC around responsible lending. APRA also introduced a range of additional measures to improve lending standards and curb risk between 2014 and 2018.

The current mortgage serviceability buffer requires borrowers to demonstrate they can afford a mortgage 3% higher than the advertised rate – standing them in good stead against the predictions the cash rate will increase by around 2%. These measures also have had the added benefit of seeing a significant reduction in high loan to value ratios.

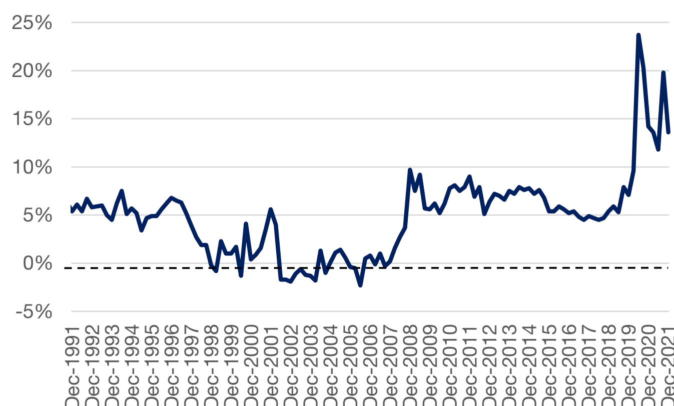
The current housing debt to housing asset ratio of 22% is the lowest it has been in 18 years.

Strong savings growth will also offset rate rises for the vast majority of households. The CBA estimates that householders squirrelled away savings in excess of more than $230 billion during the pandemic.

A recent survey showed that 80% of borrowers reported having buffers as much as $100,000+ in their mortgage offset, redraw or savings accounts.

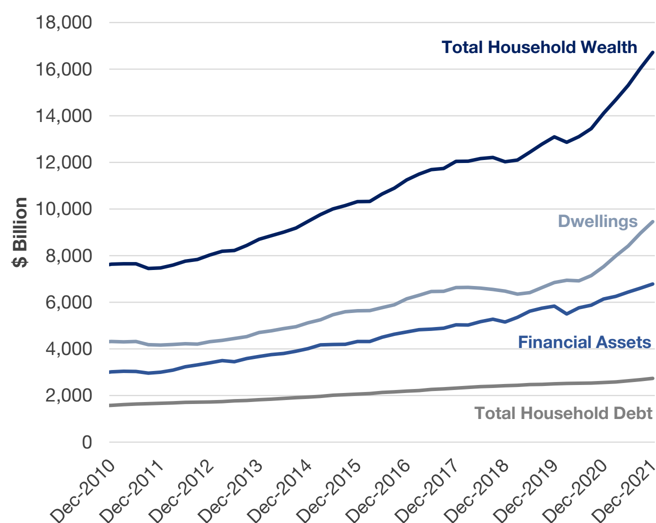
Capital Economics has forecast that households on aggregate will be able to run down their holdings of offset and redraw deposits until the end of 2024 before having to adjust spending. Even the RBA has assessed that the median borrower has mortgage excess payment buffers of just over 21 months. And this saving pattern is expected to continue for some time to come, with consumption continuing to recover unabated even in the face of declining consumer sentiment.

HOUSEHOLD SAVINGS RATIO
(Source: ABS)



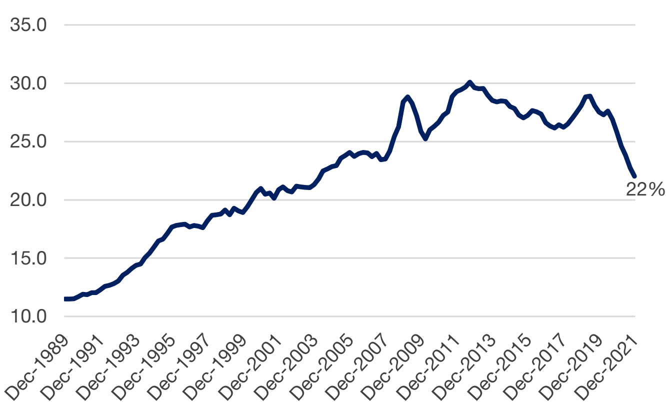
HOUSEHOLD WEALTH & LIABILITIES

(Source: ABS)



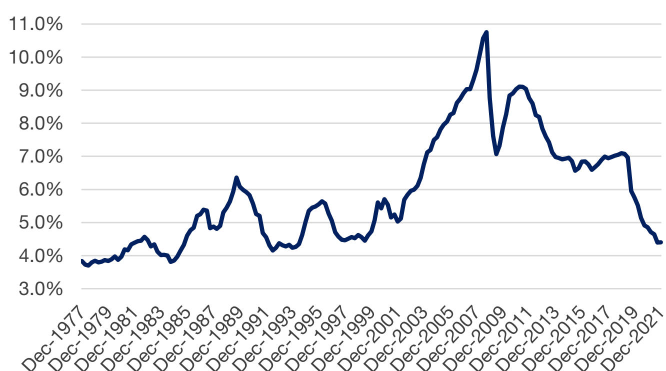
HOUSEHOLD DEBT TO ASSETS

(Source: ABS)



HOUSING INTEREST PAYMENTS AS A PERCENTAGE OF DISPOSABLE INCOME

(Source: ABS)



Further, households have benefitted from the way variable mortgages are structured. They are designed to pay more interest than principal at the front end of the loan. More of the principal is paid at the back end of a loan. This has added to the buffer for those with mortgages and will enable borrowers to handle increases in the cash rate without the same corresponding percentage increase in their monthly dollar mortgage payment giving the flexibility to reduce the principal payment component at the front end of their loans as interest rates increase.

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And the employment and wages growth story adds further to the certainty. ANZ forecasts that unemployment will continue falling to 3.3% (a 50 year low) while wages will accelerate through this tightening cycle similar to what occurred during the 2002-08 cycle.

According to the RBA, current mortgage interest payments as a percentage of disposable income in Australia is at a 23 year low of 4.4%. With strong employment and wage growth, the share of household income spent on interest payments is expected to stay well below the long-term average.

We'd also add to this equation the fact that households with mortgages have been preparing for interest rate increases for quite some time. A cash rate of 0.1% was widely understood to be an emergency response to the pandemic from the RBA to keep the economy ticking over during an unprecedented period in history. And we understand that the first increase in more than a decade during an election campaign is tantalisingly easy fodder for a beat-up.

Why rising interest rates won't stress the majority of mortgage holders…

There is a large amount of poorly researched 'analysis' of how the interest-rate-hiking cycle will lead to severe financial stress for mortgage holders.

Any speculation of widespread mortgage stress needs to be put in context of how those householders who borrowed heavily in recent years to buy a house are actually faring.

Let's have a look at an example:

- Someone who borrowed $500,000 in late 2018 to buy a house in Brisbane for $750,000 is now sitting on a property worth around $1.125 million. That's $375,000 capital gain in just over three years.
- Until last week, that borrower had seen their mortgage interest rate drop by around 150 basis points.

- If this household maintained their original repayments, they will now be many months ahead of their repayment schedule.
- They will continue to get ahead and will not have to look at increasing repayments until rates rise by at least 150 basis points.

For those lucky enough to own residential property with a mortgage, there is little to suggest that financial stress will be a concern, given how healthy most household balance sheets are.

(Stephen Koukoulas – Managing Director Market Economics, former Senior Economic Adviser to Prime Minister Julia Gillard, and former Chief Economist of Citibank Australia)

Rental market will further underpin prices…

The vacancy rate is the best indicator of population movement into a region as migrants (interstate and overseas) are usually renters before they become buyers. And students, who are also flooding back in from overseas, are nearly all renters.

Hence, migration matters a lot when it comes to rents. The vacancy rate in SEQ at present is around 0.7% and falling.

Rents have climbed on average 16.9% in Brisbane and 28.2% on the Gold Coast in the last 12 months (SQM Research) and in the majority of the high-value suburbs of Brisbane, the Sunshine Coast and the Gold Coast where Mosaic has a large portfolio of Mosaic rental properties that it manages, we have seen average rents climb substantially higher than this in many instances over this recent period.

Here's a brief snapshot of what is happening on the ground when it comes to rents.

- There are now around 49,000 fewer rental properties in total across Greater Brisbane than there were 5 years ago.
- There were 12,800 vacant rental properties available across Greater Brisbane leading into 2017.

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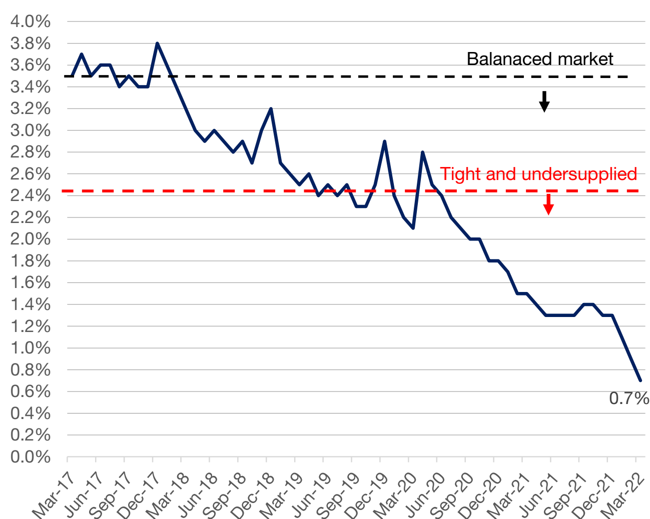
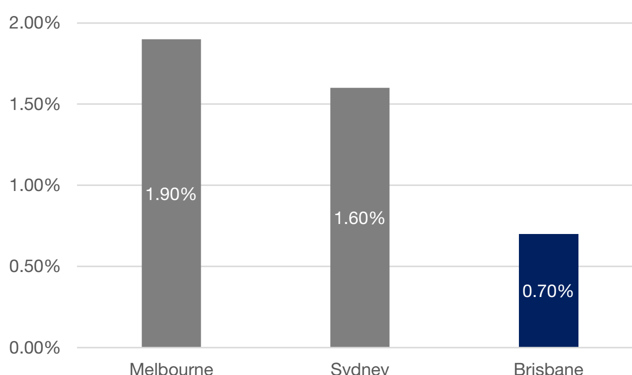
- SQM Research's most recent vacancy data from March 2022 now reports that there are only 2,460 rentals available.
- In the first 3 months of this year alone, the number of vacant properties declined by just shy of the number that now remains. If the same rate of rental absorption occurs again, come July only 80 rental properties will be available across all of Brisbane. And given accelerating interstate and overseas migration, the rental market is likely to reach its tightest level on record by late 2022. The same thing is looking likely on the Sunshine Coast and Gold Coast.

BRISBANE RESIDENTIAL VACANCY RATE
(Source: RTA)



BRISBANE VACANCY COMPARISON
(Source: SQM Research)



APARTMENT YIELDS COMPARISON - MAY 2022
(Source: SQM Research)

We expect the rental market to continue to tighten further, lifting rents even higher, as international students and migrants from interstate and overseas continue to support demand. We also think housing investment commitments will increase further in the next 12 months as investors seek yield in a world awash with capital and much uncertainty around where people should invest this capital.

The historical stability of bricks and mortar is once again becoming a safe haven of choice for many people, with reliable yield even more important as capital growth rates decline in the face of rising interest rates.

This will be even more pronounced with the recent substantial falls in equity markets globally as well as the bloodbath in alternative asset classes like cryptocurrencies and once fashionable tech stocks. Safe yielding residential property in high-value locations will start to look even more attractive for many retail investors.

And lastly, with respect to rents, it is important to note that in every prior period that we have studied, rising and sustainable rents with declining vacancy rates and continuing strong population growth, has historically always flowed through to a rise in the underlying value of residential properties.

Rents have climbed on average 16.9% in Brisbane and 28.2% on the Gold Coast in the last 12 months and in the majority of the high-value suburbs of Brisbane, the Sunshine Coast and the Gold Coast where Mosaic has a large portfolio of rental properties under management, we have seen average rents climb substantially higher than this.

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With rampant construction cost escalation preventing many developers from being able to respond to this demand by bringing new projects to market, we expect the worsening rental crisis (which ultimately results in much higher rents for those that own existing residential property), will further underpin residential property prices in high-value locations, even as interest rates rise.

Remember that real assets with a consistent and reliable income yield that is hedged to inflation are the best assets to own as inflation and interest rates rise.

As wages go up the higher inflationary environment becomes self-sustaining as other income sources such as rent, continue to climb, offsetting inflation and the rise in real interest rates.

Will housing prices fall…

As a consequence of what I have outlined above, this is not the type of environment where we would expect to see forced sales due to people not being able to make their mortgage payments. In turn, this means that property prices are unlikely to be adversely impacted in a material way.

We will more than likely see reports of the median property price decreasing until we move past the end of this current tightening cycle – likely the end of 2023. And even in the event of a 10% decline in reported median house prices, this is still only giving back a portion of the extraordinary gains of the last 18 to 24 months.

Remember the median price is based on the prices people are paying – it's not a reflection of the values of properties that are not on the market.

This means the median – the middle price in a list of prices achieved over a defined period, not the average price – is impacted positively or negatively by the type of product (sample) being sold during the period in question.

Over the past year or so the number of high-end sales has in some respects disproportionally increased the reported median value. With increased interest rates, the amount people will be able to borrow will be less than has been the case because they will not be able to service as much debt as they would have under lower rates.

This means the ceiling on what they are able to afford to pay will be lower. The number of people competing for property at the higher end also possibly diminishes slightly. So while this means the reported median prices will likely fall in many areas from the second half of 2022 into 2023, and the extent of any such falls will vary significantly between different markets, it will not impact the **real values** of most property in high-value locations where supply is perpetually constrained, employment is at historically strong levels, demand is always high (given so many people want to live there) and migration is high and increasing.

This is particularly the case across the more affluent and sought-after areas of SEQ. We believe that property pricing won't rise considerably from here over the next 12 months (albeit there will still be gains in SEQ tapering out in the months ahead towards the back end of 2022), but real values won't be heading southward either in the sought-after areas mentioned above.

You'll also see the volume of overall lending decrease too. Analysts will tell us that this is a sign of the market cooling. The number of loans being written is largely being impacted currently by trade and supply shortages causing delays to construction starts – particularly relating to house and land.

This pushes out the start date of these loans significantly compared to "normal" times. And so whilst credit volumes will fall from the record levels of 2021, they will be returning to more pre-pandemic levels.

SEQ is well placed to continue performing…

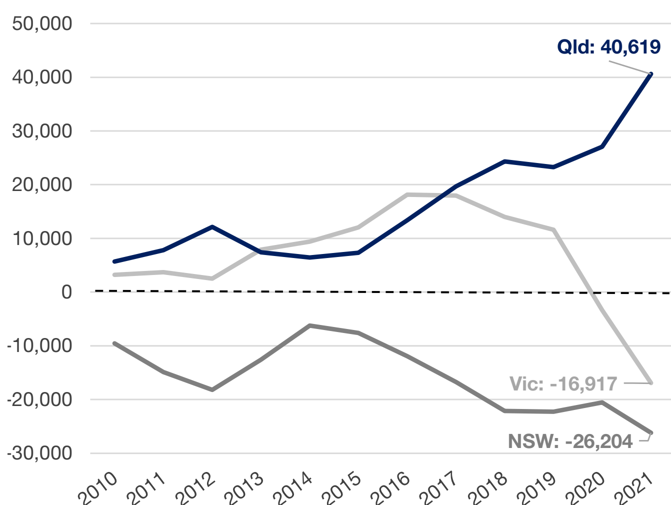
The SEQ story is a very strong one. The region should remain resilient to higher interest rates because of its relative affordability, high population growth, constrained supply, accelerating interstate and overseas migration, rising rents and low vacancy rates, and the Olympic program.

Affordability is one of our strongest cards in the deck. The differential in pricing with our southern counterparts sees Melbourne and Sydney apartment prices currently 30% and 70% respectively more expensive than Brisbane. This differential also means that our average home loan in Brisbane is much lower than those in Sydney and Melbourne, meaning the impacts of rate increases on SEQ property will be less.

And our population is swelling. Victorians are leaving their state in droves with a decrease in population of 32,000 in the previous year. And while Sydney saw an increase of 24,000, Queensland's population rose by a massive 58,000.

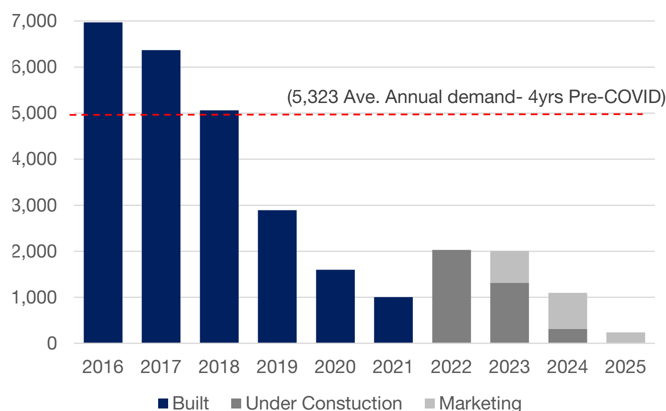
Forty thousand of these new Queenslanders were a result of net interstate migration (which has been on the rise now for a decade). And this will only continue as our borders have opened and we welcome international migration again. In the year prior to the pandemic, we welcomed 35,000 international migrants to our state. So Queensland migration numbers are likely to be much stronger than pre-pandemic numbers over the next 2 to 3 years.

NET INTERSTATE MIGRATION PERFORMANCE
(Source: ABS)



This growth in population naturally adds fuel to the SEQ property market. With the volume of housing stock on the market in Brisbane 20% less than a year ago and 40% below the previous five-year average and with supply already constrained by planning policies, combined with the recent impact of increased building material costs and labour shortages reducing the number of projects that will get off the ground, a shortfall of around 16,000 apartments across inner-Brisbane is expected over the next four years alone.

POTENTIAL APARTMENT SUPPLY - INNER BRISBANE
(Source: SQM Research)



Now let's add in the record-breaking $75 billion infrastructure program for SEQ and the 2032 Olympics major works program to further add to this, and the seeds are firmly sown for a property market that will perform to the positive and particularly when viewed in terms of likely SEQ property prices between now and 2032.

Why buy apartments…

In short, attention is shifting to apartments. The lifestyle they present and the price differential to housing make them the emerging property market poster child. The current median Melbourne and Sydney apartment price is 30% and 70%, respectively, more expensive than Brisbane.

The disparity between house and apartment prices in Brisbane is now the widest in the past two decades. The average price gap between houses and units for the 13 years prior to 2016 was 16%.

As of December last year, this gap has increased to a stunning 70%. And the level of buyer inquiry supports the shift in thinking, with realestate.com reporting inquiry on house and land has slipped 4.4% and 5.1%, respectively, relative to March 2021, while enquiry for apartments has soared 16.6% year-on-year.

We will more than likely see reports of the median property price decreasing until we move past the end of this current tightening cycle – likely the end of 2023.

And even in the event of a 10% decline in reported median house prices, this is still only giving back a portion of the extraordinary gains of the last 18 to 24 months.

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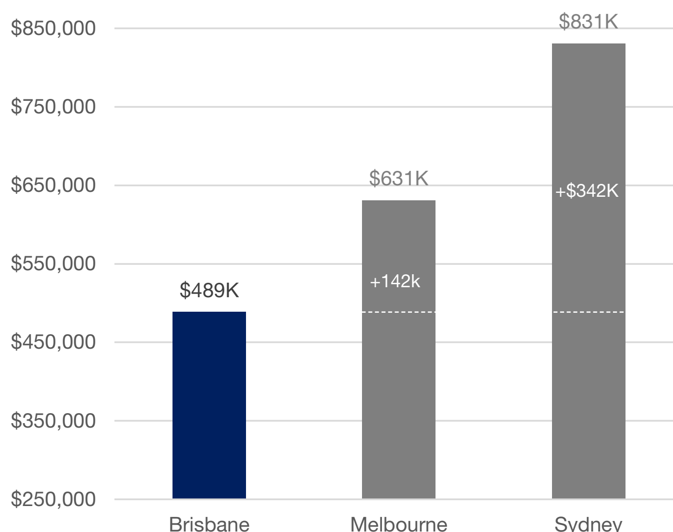
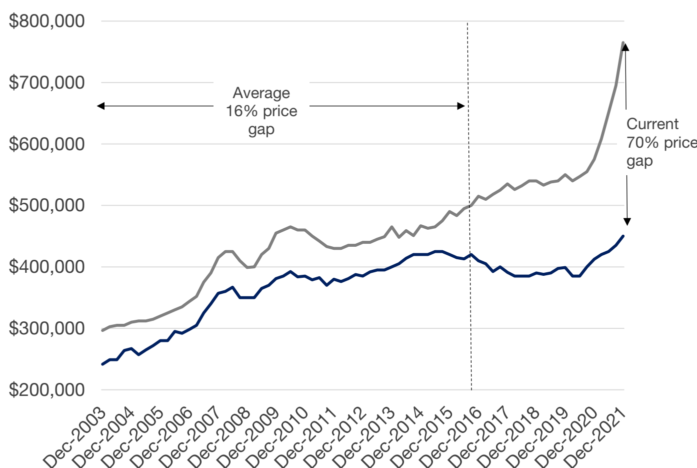
Brisbane apartment prices have risen 20% since October 2020 – just 18 months. Higher interest rates are more likely to exacerbate this shift to apartments to take advantage of the price gap, as buyers will get more for their money buying luxury apartments in the suburbs where they want to live. And while the monthly rate of Brisbane house price growth has eased off, the rate of apartment price growth is being sustained.

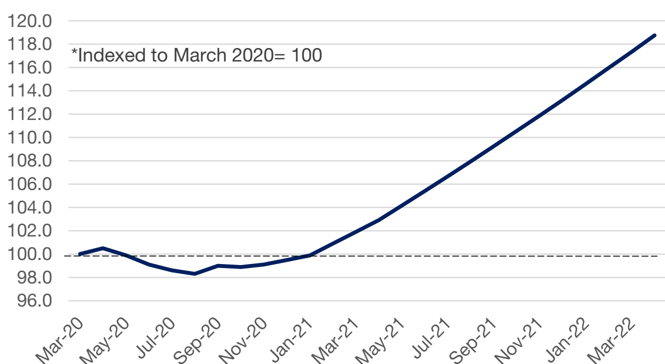
APARTMENT PRICE COMPARISON - APRIL 2022
(Source: CoreLogic)



BRISBANE MEDIAN HOUSE PRICE VS APARTMENT PRICE
(Source: ABS)



BRISBANE APARTMENT PRICE GROWTH
(Source: CoreLogic)



Putting things in perspective…

When you put context around the current and long-term data, it certainly paints a different picture to some of the mainstream commentaries at present.

In essence, when you remove the pressure cooker combination of uncertain times and political opportunism from all sides of politics running into a Federal election, the path forward seems not just manageable for most, but broadly positive.

And importantly, this is off the back of a massive run-up in the value of most residential property over the last 18 to 24 months.

The fundamentals of the market as I have outlined above are really solid – strong savings, accelerating population growth, wage increases, extremely low unemployment, substantial infrastructure investment, constrained supply of housing, comparative affordability, rising rents, and interest rates still well below the long term historical average (and likely to stay negative on a 'real' basis).

Those of you who know us well, understand that we make our decisions through a very conservative framework at Mosaic. We have traded through all aspects of the property market over a long period of time – highs and lows. And our intention is to continue to do this for a much longer time frame in the future, which is why we invest so much energy in understanding what is happening and why.

While the heat will certainly come off the market a little in the coming months (which was always going to be the case after very substantial gains from the previous 18 to 24 months) – we don't see prices dropping substantially in SEQ at all, as some would have you believe (remember the pundits who predicted prices would plummet by 30% at the start of COVID? We were one of the only voices at the time arguing this wouldn't eventuate and shared our research-driven analysis to support this view at the time).

Whilst we recognise there is a myriad of risks looming in the global economy at present which could see conditions deteriorate in the year ahead, this is rarely not the case. Perpetual uncertainty, flamed continually by the media, seems to be with us indefinitely. Looking past this for the foreseeable future, **our outlook remains positive, particularly over a 10-year time horizon where we strongly believe that the most sought after areas of SEQ will be the best performing property markets in Australia this decade.**

I hope this has been useful in helping you form your own balanced views and we look forward to sharing more information with you to keep you up to date in the weeks and months ahead.

Kind Regards