Weekly Economic Outlook

Bank of Melbourne

Monday, 14 February 2022

Dwelling Prices to Peak Later This Year

Chatter about rate hikes is dominating the world of economics. We've heard a lot from the Reserve Bank (RBA) over the past two weeks and speculation about when rates will increase has intensified.

There was the RBA meeting at the start of this month, a speech from the Governor and new forecasts in the quarterly Statement on Monetary Policy. Further, last Friday was the RBA's semi-annual parliamentary testimony, where politicians quizzed the central bankers on their thinking. Notably, the Governor acknowledged he would like to see "another couple of CPIs" before determining inflation is sustainably in the target band.

Tomorrow, this run of events will be rounded out by the minutes from the meeting earlier in the month. We'll be looking for any further colour on what exactly will trigger rate hikes.

We continue to expect the Reserve Bank will begin hiking the cash rate in August this year. Before then, we will receive two more updates on inflation: one in April and one in July. While there is ongoing debate about the exact timing of the first hike, one thing economists do agree on is that it is only a matter of time before the RBA is forced to lift the cash rate. And after years of record low rates, what will this mean for the housing market?

Well, it will inevitably take the steam out of the market. However, housing demand is currently still running strong. The key drivers of demand remain low interest rates and low unemployment. In fact, in January prices rose 1.1% to be 22.4% higher over the year, marking the strongest annual growth since the late 1980s. Demand remains particularly strong in the smaller capital cities of Brisbane and Adelaide, as well as regional areas, partly reflecting their relative affordability and population inflows from other cities.

However, the pace of the boom is already moderating, alongside several headwinds. Stretched affordability, a lift in supply and higher fixed interest rates for new borrowers are weighing on the market. Indeed, the monthly pace of growth is well down from its peak of 2.8% in March 2021.

We expect the momentum in the housing market will carry through the first half of the year. And following our projection the RBA will lift the cash rate in August, we expect dwelling prices will peak and begin declining in the second half of this year. But we expect this will still leave dwelling prices up over the calendar year 2022.

We expect dwelling prices will continue to soften further over 2023. Something that will prevent deep price falls is the health of the labour market. In past downturns, the availability of stock for sale dwindled as households waited for a better time to sell, which in turn limited the size of the price declines. This behaviour plays out if households are not under any pressure to sell, which depends on employment and mortgage buffers.

A key uncertainty over the dwelling price forecasts is where the cash rate peaks in this cycle and where the neutral cash rate lies. We estimate neutral sits around 1.75% – this is the level of the cash rate that is neither stimulatory or contractionary. If the RBA needs to push the cash rate above 1.75%, then it is reasonable to expect larger decline in dwelling prices. This is a possibility if the RBA to needs to act more aggressively to tame inflation. The RBA's repeated assurances that it will be patient in raising the cash rate, despite elevated inflation and unemployment headed below full employment suggests there is a risk that the inflation genie escapes from the bottle.

The price correction is anticipated to be more pronounced in cities where affordability is more stretched – notably Sydney and Melbourne. The reflects their greater sensitivity to interest rates because households in these cities have bigger mortgages. However, there are shortages of housing in parts of Sydney. The declines are likely to be more modest in Brisbane and Adelaide, where affordability is less of a constraint.

Another consideration for the housing market is whether APRA will tighten the screws with additional macroprudential measures. APRA stepped in last October, but further action will hinge on when the Reserve Bank (RBA) lifts interest rates and regulators' views around the riskiness of new lending. With higher interest rates, there will be less need for APRA to intervene to cool risks in the housing market.

Separately, labour force data for January will be released on Thursday. We expect employment rose by 30k in January. Recall, the jobs market had significant momentum at the end of last year with a record 366.1k jobs added in November and a solid 64.8k new jobs in December. Indeed, employment hit a record level in December. In turn, we expect the unemployment rate declined to 4.0% in January, from 4.2% in December – its lowest level since 2008. This is consistent with holding the participation rate flat at 66.1%.

Of course, Omicron drove significant disruptions to the economy in January. The 'shadow lockdown' which saw millions in isolation exacerbated staff shortages many businesses were already facing. This will primarily be reflected in hours worked in the labour force data. In other words, we expect the fallout from Omicron generally meant people worked less hours, rather than lost their jobs. This is consistent with previous lockdowns. Another complicating factor is that January coincides with the summer holidays, when more Australians are on leave which also hits hours worked.

As a result of these uncertainties, there is a wide range of forecasts from economists for the monthly jobs change in January, from -60k to +59k. Temporary disruptions aside, job ads and vacancies continue to point to further jobs growth in the months ahead. And as a result, we expect the unemployment rate will have a 3-handle in the second half of this year, and sustain a 3 handle into 2023. Australia has not sustained an unemployment picture like this since the 1970s.

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Forecasts

		2022				2023	
End Period:	**Close (11 Feb)**	**Q1 (f)**	**Q2 (f)**	**Q3 (f)**	**Q4 (f)**	**Q1 (f)**	**Q2 (f)**
Aust. Interest Rates:							
RBA Cash Rate, %	0.10	0.10	0.10	0.25	0.50	0.75	1.00
90 Day BBSW, %	0.08	0.10	0.10	0.35	0.60	0.95	1.20
3 Year Swap, %	1.88	1.75	1.75	1.80	1.90	2.00	2.10
10 Year Bond, %	2.19	2.15	2.40	2.40	2.50	2.50	2.40
US Interest Rates:							
Fed Funds Rate, %	0.125	0.375	0.625	0.875	1.125	1.375	1.625
US 10 Year Bond, %	2.03	2.00	2.30	2.40	2.50	2.50	2.40
USD Exchange Rates:							
AUD-USD	0.7140	0.70	0.70	0.71	0.73	0.75	0.76
USD-JPY	116.10	116	117	117	118	118	119
EUR-USD	1.1395	1.13	1.11	1.12	1.13	1.14	1.15
GBP-USD	1.3540	1.36	1.37	1.38	1.38	1.38	1.37
NZD-USD	0.6651	0.65	0.65	0.66	0.68	0.69	0.70
AUD Exchange Rates:							
AUD-USD	0.7140	0.70	0.70	0.71	0.73	0.75	0.76
AUD-EUR	0.6266	0.62	0.63	0.63	0.65	0.66	0.66
AUD-JPY	82.895	81.2	81.9	83.1	86.1	88.5	90.4
AUD-GBP	0.5273	0.51	0.51	0.51	0.53	0.54	0.55
AUD-NZD	1.0735	1.08	1.08	1.08	1.08	1.09	1.09

	2020	**2021 (f)**	**2022 (f)**	**2023 (f)**
GDP, %	-0.8	3.2	5.5	2.7
CPI (Headline), %	0.9	3.5	3.1	2.8
CPI (Trimmed mean), %	1.2	2.6	2.8	2.8
Unemployment Rate, %	6.8	4.7	3.8	3.9
Wages Growth, %	1.4	2.3	3.2	3.5

AUD cross exchange rates have been rounded.

Financial forecasts are quarter end.

GDP, CPI, employment and wage growth forecasts are year end.

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