THE IMPACT OF COVID-19 ON AUSTRALIA'S RESIDENTIAL PROPERTY MARKET

KPMG Economics

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Contents

Executive Summary

In this study KPMG has sought to understand whether the COVID-19 pandemic has resulted in property prices being on a higher trajectory than would have been the case if COVID-19 had not occurred.

Key findings

- House prices in most capitals were expected to enter a cyclical upswing at the start of 2020.
- The onset of the COVID-19 pandemic disrupted this cyclical upswing with house prices contracting in all capital cities except Canberra during the June quarter 2020.
- Government policy responses alleviated uncertainty regarding the direct and indirect impacts of COVID-19 on the property market. This, combined with the material decline in mortgage interest rates, has seen property prices rise dramatically in the past 6 to 9 months.
- The rises in residential property prices have been greater than we estimate would have occurred in the counterfactual no-COVID-19 scenario.
- It appears the short-term positive of lower mortgage interest rates has swamped the longer-term negative factors of lower population and price disequilibrium during this recent price spike.
- However, residential property price growth is expected to temper over the next 2 to 3 years as lower population growth, reversion back to equilibrium and higher mortgage lending rates weigh on property prices.
- Notwithstanding this moderating property price growth during 2022 and 2023, KPMG's analysis shows that house prices are expected to be between 4 percent and 12 percent higher and unit values are expected to be between 0 percent and 13 percent higher than would have been the case in the absence of COVID-19.

Introduction

Since the beginning of 2021 a number of Australia's capital cities have seen their residential property markets experience a significant upswing in prices. Various market commentators have suggested this robust price growth is likely to last for some time, while others have suggested residential property price increases will moderate after this initial spike. This paper by KPMG Economics in Australia seeks to contribute to this discussion.

Drivers of house price growth in Australia

KPMG has published several papers over the past few years presenting our research and analysis on housing affordability and the drivers of house price growth, with a particular focus on the two largest housing markets in Australia; Sydney and Melbourne.

Our last research paper *Housing affordability: What's driving house prices in Sydney and Melbourne?* applied econometric modelling techniques to reach a conclusion that home buyers already intuitively knew; housing markets are complex. This complexity stems from the fact that house prices are influenced by a range of factors, like interest rates, building activity and population growth. At times these factors reinforce each other and at other times they are counteracting.

KPMG's analysis found a long-run relationship between house prices and variables relating to the stock of dwellings and population. Over time house prices tend to revert back to an equilibrium level suggested by the long run relationship. However, in the short run transitory dynamics can push or pull property prices towards or away from the long run equilibrium.

The model developed by KPMG is designed to capture these short and long run dynamics of the property market in a consistent framework.

We have previously described this cycle in the following stylised way; price pressures induce new construction activity; dwellings are over supplied relative to current demand; prices drop (or stay flat); access to financing for new development becomes tighter, resulting in a decline in new supply; demand soaks up the excess supply over time; prices rise; access to finance is opened up again; developers start building again; and dwellings are over supplied (again).

Another important point to note is that not only are residential property markets complex, they are also not uniform across the country. For example, market dynamics are different for houses located in Brisbane compared to units located in Hobart.

The impact of the COVID-19 pandemic

Many of the factors that drive the short-term or long-term price of residential property have been impacted by the onset of the global coronavirus pandemic.

Australia's population is now anticipated to be lower by about 1 million people by the end of this decade compared to the pre-pandemic forecasts.

This reduced population growth will feed into the property market through a combination of ways, including reducing the immediate demand pressures for accommodation as Australia's border remain shut to both returning travellers and foreign migrants. The longer the borders remain shut the larger the impact will be on Australia's population due to the cumulative impact of fewer new migrants settling in Australia and loss of subsequent natural population increase from these new migrants.

The Commonwealth Government and the Reserve Bank of Australia (RBA) have implemented a range of policy responses to deal with the economic impacts of the coronavirus pandemic.

These policy responses have included direct support to the residential construction sector through the HomeBuilder program and more broadly to the economy as a whole through the adoption of highly accommodative monetary policy settings.

It is instructive to estimate the path residential property prices would have taken if the pandemic had not occurred. We are able to do this with our models by using pre-pandemic inputs. That is, we use as model inputs the pre-pandemic forecasts for population by state prepared by the Australian Bureau of Statistics and our own forecasts for other exogenous variables as at December 2019, including the projected level of the cash rate over the short to medium term. With pre-pandemic projections of the inputs we can use KPMG's models to estimate for each capital city 'counterfactual' price paths for houses and units. These counterfactual price paths are our best estimate of what would have happened to house prices in the absence of the COVID-19 pandemic.

Key assumptions

KPMG Economic's dwelling price forecasts utilise an error-correction model (ECM) framework. This framework was chosen as our analysis found that over time house prices tend to revert back to the equilibrium suggested by the long run relationship between population and housing stock, but that in the short run factors like interest rates and investor share can influence prices around the long run equilibrium.

Long run property prices

Real house prices in the long run are heavily conditioned by two key factors; how many households need to be accommodated (demand) and how many properties exist to accommodate them (supply).

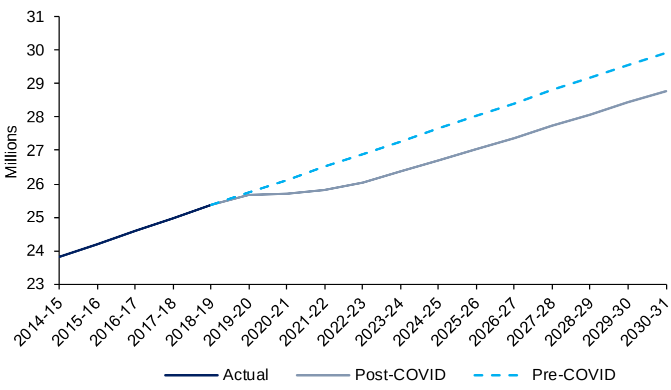
Both of these factors have been materially impacted by the onset of the coronavirus, and to some extent by the economic policy responses by government.

Population

COVID-19 border closures and travel restrictions are having a significant impact on migration and thereby population projections. Estimates of future population are inherently uncertain, and future estimates are more variable given the increased instability associated with COVID-19.

The Centre of Population released a Population Statement for Australia in early December 2020 with COVID-19 population projections out to June 2030.

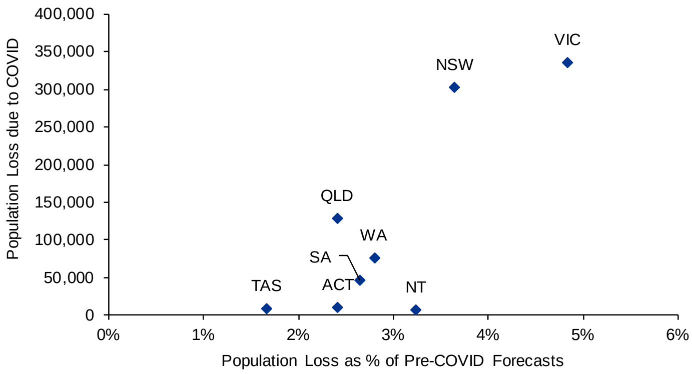
Population Forecasts, Pre- & Post-COVD, Australia



According to the Population Statement released by the Australian Government, Australia's population is projected to increase from 25.36 million at June 2019 to reach 28.43 million by June 2030, or 1.11 million less than it could have otherwise been without COVID-19. KPMG's report Pathways to recovery: International students will boost our living standards projected Australia's population could be in the order of 1.08 million less than it could have been without COVID-19 by June 2030, which is broadly consistent with the projections released in December 2020.

The population projections also reveal the expected impact will not be uniform across different states and territories, with Victoria anticipated to suffer the greatest effect on its population growth, with Tasmania the least impacted.

Change in Population Forecasts by State due to COVID as at 30 June 2024



Dwelling Supply

Australia's stock of dwellings change over time as our population changes and demographic factors, including family composition and age, influence the type of dwellings in demand.

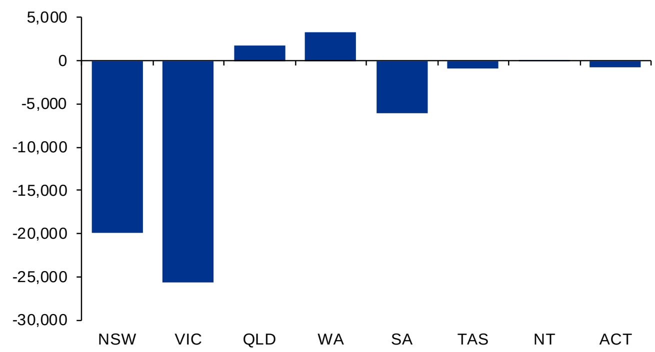
The number and type of dwellings used to accommodate our population are counted during each 5-yearly Census conducted by the Australia Bureau of Statistics. At points in time between these 5 year intervals it is difficult to accurately estimate the stock of dwellings.

Simply adding housing completions to the Census housing population values does not take into consideration the fact that developments can occur on greenfield and brownfield sites, meaning existing dwellings are occasionally demolished to make way for new properties. For example, KPMG has previously found that for every ten dwellings constructed the stock of dwellings increase by nine.

For this study we have completed a more detailed analysis for each capital city of the relationship between population and dwelling approvals, as well as dwelling approvals and dwelling completions (both in terms of completion rates and the time lag between receipt of a building approval and delivery of an occupancy-ready dwelling).

The key findings of this analysis are summarized in the following chart, which shows that during the four years from the start of 2020 to the end of 2023 the stocks of houses and units in Victoria and New South Wales are expected be around 25,000 and 20,000 lower respectively than would have been the case in the absence of the COVID-19 pandemic. Interestingly, Queensland and Western Australia are likely to see slightly higher dwelling stocks due to a range of factors, including positive net interstate migration.

Expected difference in Dwelling Stock by State due to COVID, March 2020 to December 2023



Short run property prices

Real property prices in the short run are influenced by a range of factors that can have positive and negative impacts of varying magnitudes.

KPMG's analysis identified a range of short run factors that influence real dwelling prices, including:

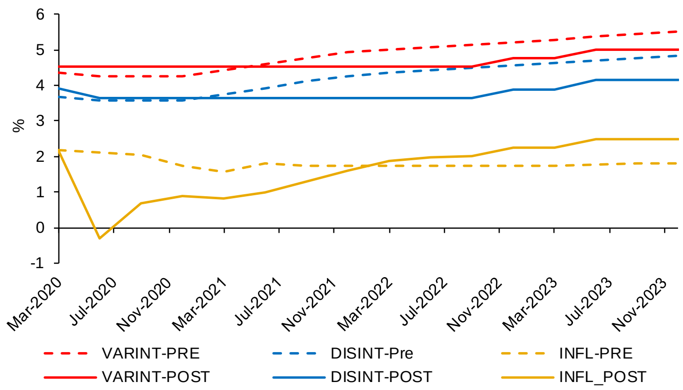
- momentum, by growth in real dwelling prices in the previous period
- dwelling prices in other markets
- the magnitude of the gap between the actual price and the estimated long run equilibrium price
- real mortgage interest rates
- the share of dwellings purchased by investors
- the existence of macroprudential controls.

In the context of this modelling analysis only real mortgage interest rates and the level of investor participation are not determined within the model (endogenously). Projections for these variables must be determined externally (exogenously).

Projections for variable mortgage interest rates (VARINT), discounted variable mortgage interest rates (DISINT), and inflation (INFL) were obtained from KPMG's macroeconomic forecasts completed in December 2019 (Pre-COVID-19) and in March 2021 (Post-COVID-19).

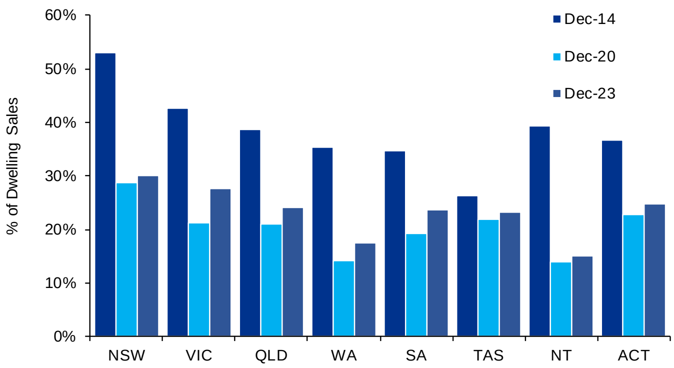
As shown in the chart below KPMG's March 2021 projections have mortgage lending rates trending upwards from the middle of 2022 in line with higher wholesale borrowing costs faced by the banking sector in Australia. Also, we are anticipating inflation to rise and be at the lower end of the RBA Target Band from the middle of 2022 as well.

Forecasts of Interest Rates and Inflation, Pre- and Post-COVID



In terms of investor participation in the dwelling market we have maintained the same assumptions between the Pre-COVID-19 and Post-COVID-19 scenarios on the basis of the assumption that the risk profile of investing in property relative to other asset classes has not changed as a consequence of the pandemic.

Proportion of Dwelling Purchases by Investors



Our findings

The uncertainty associated with the coronavirus saw dwelling prices in most markets fall during 2020, despite the fact that market conditions at the beginning of the year were highly conducive to strong price growth.

The key findings of KPMG's analysis are summarised by the charts presented in the appendix. The charts show for each capital city two sets of projections for house prices and unit prices. The projections labelled "Post-COVID-19" reflect our best estimate of what will happen to dwelling prices in the current environment while the projections labelled "Pre-COVID-19" reflect our best estimate of what would have happened to dwelling prices in the absence of COVID-19.

In the Pre-COVID-19 scenario all of Australia's capital cities, with the exception of Darwin, were expected to achieve strong nominal property price growth over the four years of the new decade. Sydney was on the cusp of a significant price hike. Over time some of this increase would have flowed through to prices in the related markets of Melbourne and Brisbane.

Instead of seeing strong property price growth during the first half of 2020 the onset of the coronavirus pandemic instead saw all Australian housing markets, except Canberra, experience nominal price declines of between -0.3 percent (Hobart) and -2.8 percent (Melbourne) during the June quarter 2020.

In response to the COVID-19-induced economic downturn the Reserve Bank of Australia and the Commonwealth and State governments implemented a range of policy responses to support the domestic economy. These policies have impacted Australia's property market directly and indirectly.

For example:

- The *HomeBuilder* program provided eligible owner-occupiers (including first home buyers) with a grant to build a new home or substantially renovate an existing home for contracts signed between 4 June 2020 and 31 March 2021. This policy will lead to increased housing stock in the short-term, and all else being equal, will put downward pressure on long run house prices.
- Monetary policy settings, including a lowering of the cash rate to 0.1 percent, the introduction of the Term Funding Facility, and the targeting of 3-year Commonwealth Government bond rates to 0.1 percent have resulted in a decline in mortgage interest rates paid by borrowers. The combination of these policies have led to lower mortgage interest rates and, all else equal, put upward pressure on house prices.

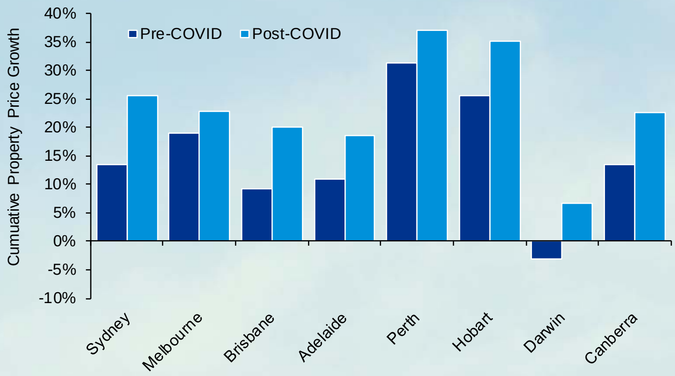
The chart below summarises our findings on the key question of whether property prices are likely to be higher or lower as a consequence of the COVID-19 pandemic. The chart indicates that the factors driving house prices upwards, such as lower mortgage rates, are expected to outweigh the factors that put downward pressure on house prices, such as lower population growth.

While our analysis shows that the decline in mortgage interest rates has contributed to the strong property price increased observed over the past year, there is an expectation that house price growth will moderate in the next few years as mortgage interest rates start to rise and the impact of lower than anticipated population growth starts to bite.

As previously discussed, over the longer term real house prices in Australia have a tendency to revert back to equilibrium levels consistent with underlying demand and supply factors. This tendency means that that as property prices get further away from the underlying equilibrium level there is a build up of pressure for the market to cool down if prices are above the long run equilibrium level and vice versa if prices are below the equilibrium level.

Our analysis suggests that the recent spike has moved house prices further away from the estimated equilibrium price levels. Our expectation is that this disequilibrium will start to contract. Over the next two to three years this will place downward pressure on prices and eventually outweigh the positive impacts on prices of the shorter term factors, which are expected to weaken over time.

Cumulative Nominal Property Price Growth Dec 2019-Dec 2023, Pre- and Post-COVID



Conclusion

The coronavirus pandemic has disrupted all economies and markets around the world. Expectations of population growth have been revised as a consequence of disruption to international migration and declining birth rates. The economic consequences associated with managing the health impacts of COVID-19 has seen some countries apply fiscal and monetary policy stimulus packages to support individuals and markets most negatively effected.

This overlay of declining population growth, increased uncertainty and growing economic disruption paint a picture that is not conducive to nominal price growth in asset markets. Given these fundamentals Australia saw its stock market experience a freefall in asset values at the start of the pandemic, while residential property prices also experienced nominal declines of around 3% in the June quarter 2020.

Since then we have witnessed a turnaround in the share market, with the All Ordinaries Index pushing record highs on a daily basis, while property markets have seen prices recover and shoot upwards.

In this study KPMG has sought to understand whether property prices are likely to be higher or lower in the post-COVID-19 world relative to the counterfactual scenario where COVID-19 did not occur.

The key findings of our analysis are summarised below.

- House prices in most capital cities were expected to enter a cyclical upswing at the start of 2020.
- The onset of the COVID-19 pandemic resulted in this cyclical upswing being disrupted with house prices contracting in every housing market except Canberra during the June quarter 2020.
- Government policy responses alleviated uncertainty regarding the direct and indirect impacts of COVID-19 on the property market. This, combined with the material decline in mortgage interest rates, has seen property prices rise dramatically in the past 6 to 9 months.
- The rises in residential property prices have been greater than we estimate would have occurred in the counterfactual no-COVID-19 scenario.
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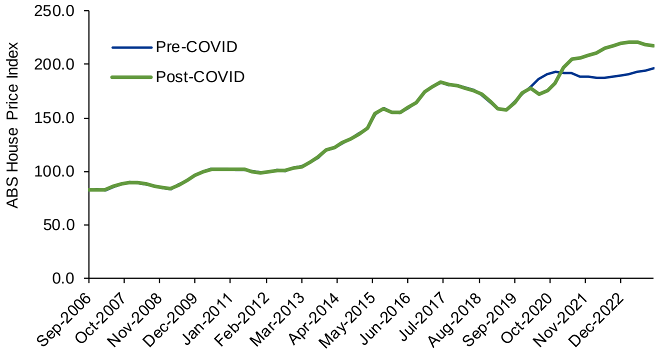
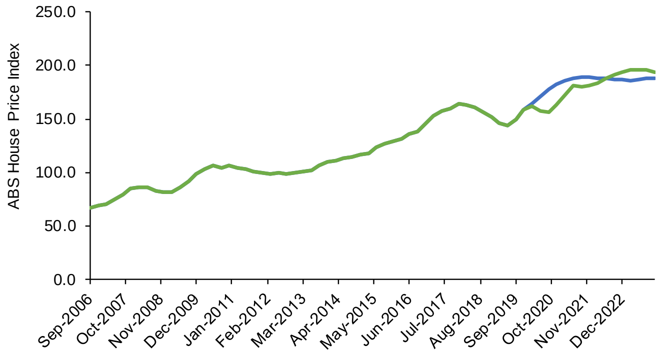
Appendices

House Prices

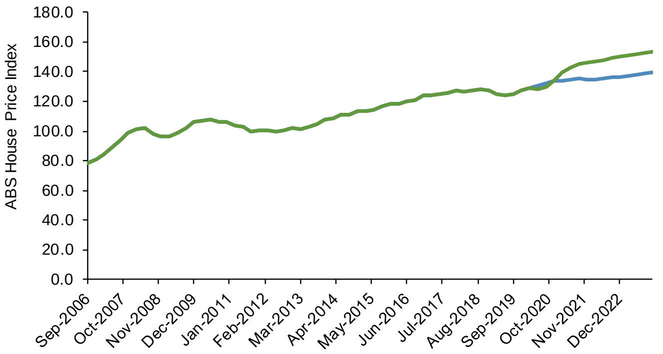
House Prices, Sydney



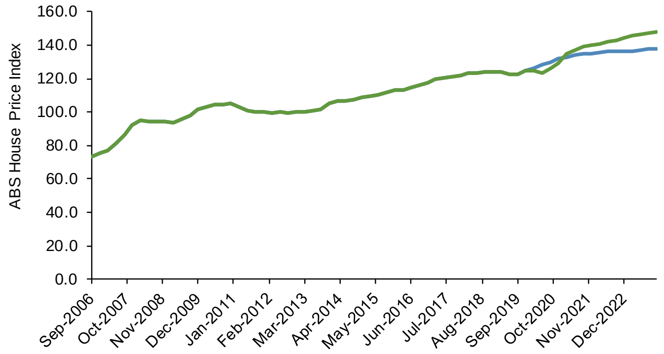
House Prices, Melbourne



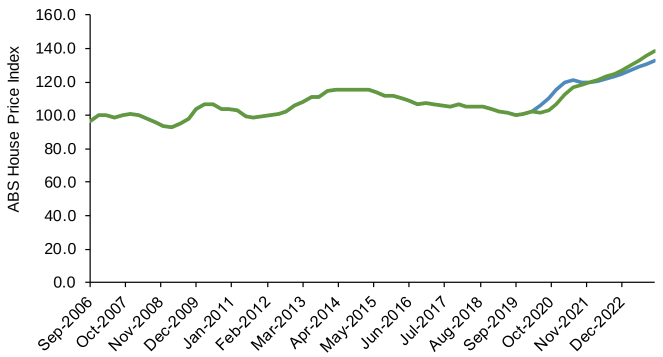
House Prices, Brisbane



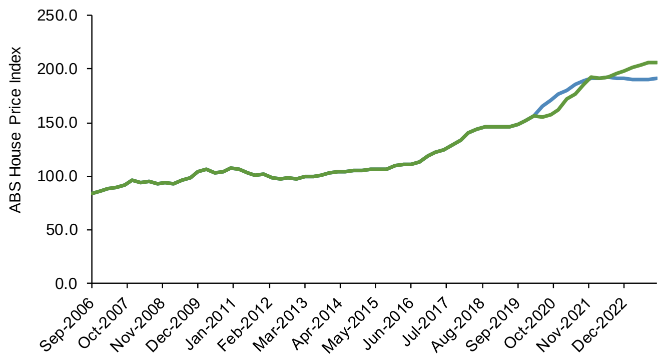
House Prices, Adelaide



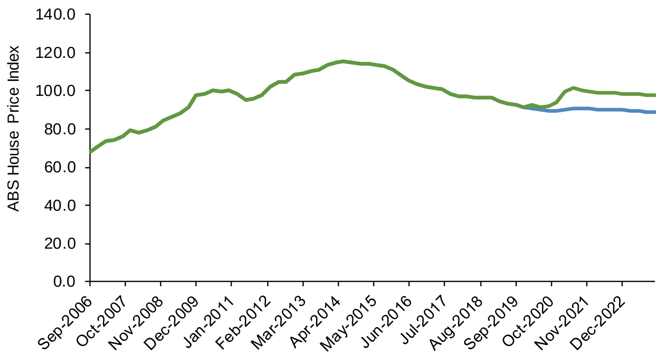
House Prices, Perth



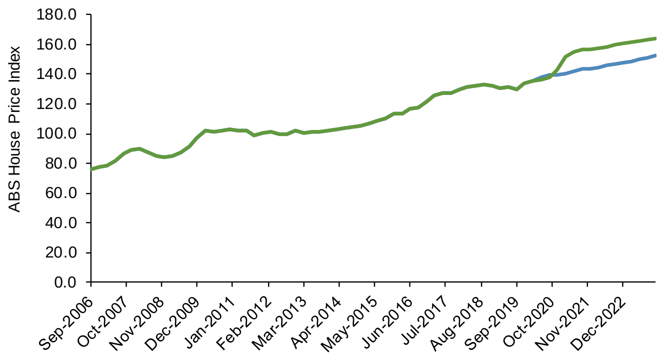
House Prices, Hobart



House Prices, Darwin

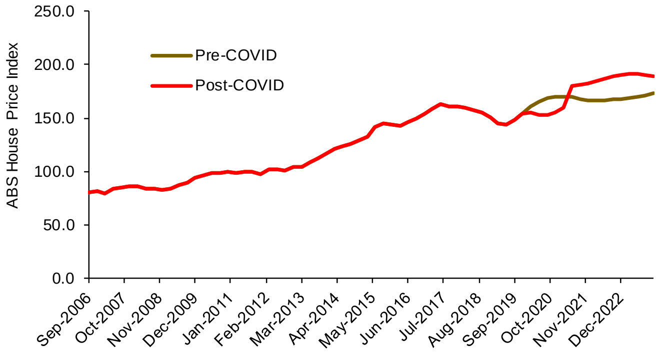


House Prices, Canberra

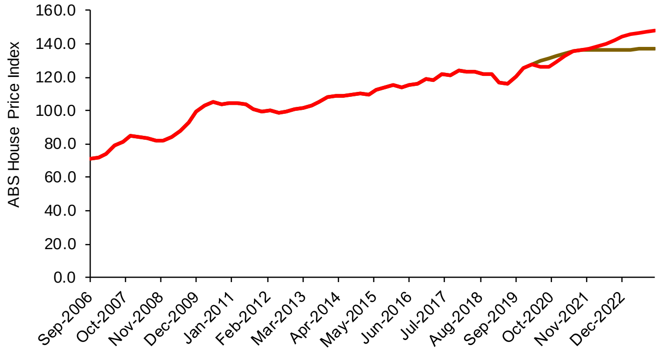


Unit Prices

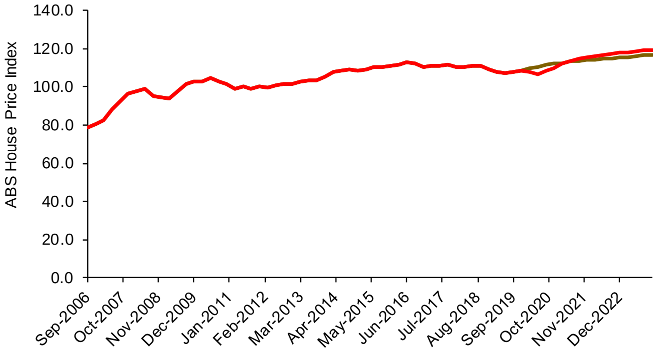
Unit Prices, Sydney



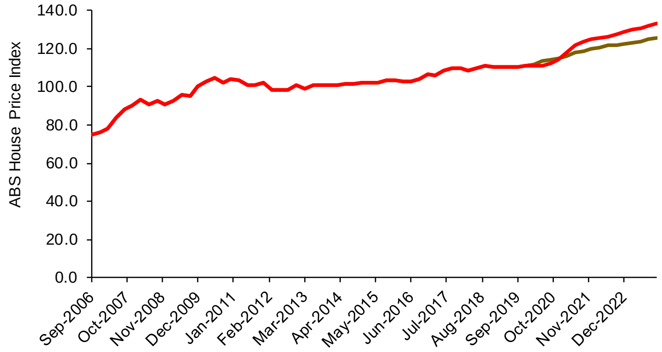
Unit Prices, Melbourne



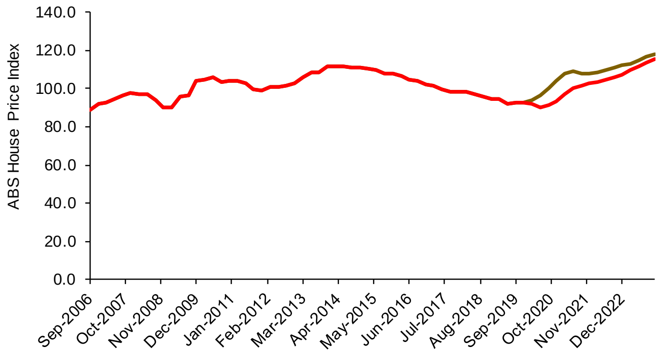
Unit Prices, Brisbane



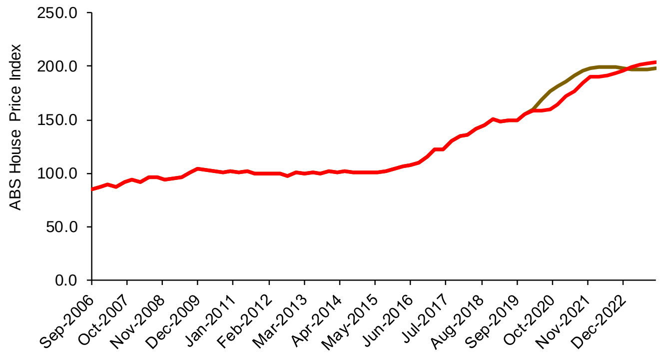
Unit Prices, Adelaide



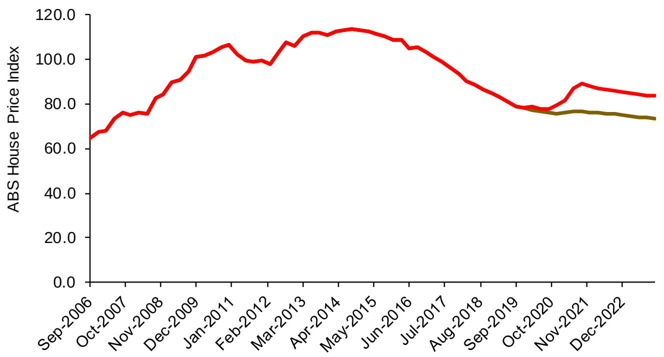
Unit Prices, Perth



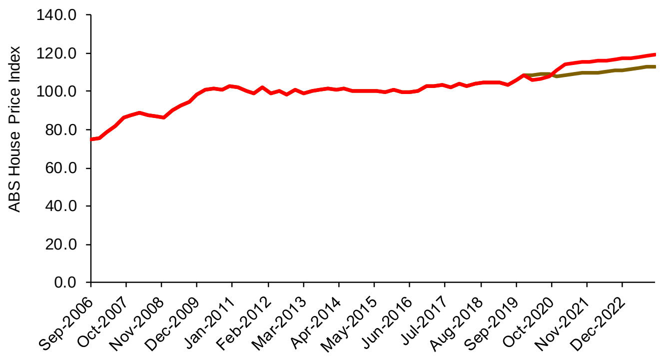
Unit Prices, Hobart



Unit Prices, Darwin



Unit Prices, Canberra



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