



## quarterly update

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### March 2005

### Summary

**Very strong price rises across all of the capital cities in recent years have resulted in affordability constraints now emerging in most residential property markets around Australia. This will limit the ability of further strong price rises, particularly in a rising interest rate environment. In the short term, strong economic growth will continue to support house prices, despite the recent rise in interest rates.**

**We see some scope for modest increases in prices in Perth, Brisbane, and Darwin over the next twelve months, with little change in prices in Sydney, Melbourne, Adelaide, Canberra, and Hobart.**

**However, sharper rises in interest rates forecast for calendar year 2006 will result in modest price declines across most capital city markets during 2006/07.**

### Economic outlook, inflation and interest rates

The Australian economy continues to move through a long upswing cycle. Although headline GDP growth has slowed abruptly since mid 2004, demand is still rising at a robust pace, both domestically and abroad. Indeed, the problem is that demand is rising too strongly for Australia's productive sector, which is struggling to keep up.

In effect, a long period of under-investment in Australia's infrastructure and productive capacity is finally hitting home. The general pattern of strong demand and tight capacity will continue to shape economic activity over the next two years. Efforts to bring new investment through quickly will see strong rises in capital spending driving another leg to the current upswing cycle in domestic demand. However, pressures will inevitably lead to higher imports, higher inflation, and higher interest rates as well. The main question is the timing of these coming through.

GDP growth was limited to 2.9% in calendar year 2004, constrained by almost non-existent growth in the final six months of the year. It appears, however, that this figure is concealing strong

domestic demand. The increase in total spending in the economy, GNE (Gross National Expenditure), ran at a substantial 4.6% in the same period, with the remainder of domestic demand being picked up by rising imports, which increased by 14%.

Despite the conflicting data, we believe that economic growth will continue to remain strong. Although the housing market has now clearly peaked, increasing business investment is beginning to take over as the key driver of economic growth. We have already seen rising investment in the resources sector, as businesses gear up to meet rising demand driven by near insatiable growth from the Chinese market. Further growth in investment is expected to come from a major round of public infrastructure projects just getting underway, and a coming major cycle in non-residential building.

However, this will impact on inflation as the constraints on the capacity will hamper the ability of the economy to meet demand and labour productivity growth weakens. Indeed, some sectors (resources and construction) have already

**Table 1:** Number of home loans approved for owner occupation  
- % change on previous year

State	New Dwellings			Established Dwellings		
	Jul 03–Dec 03	Jan 04–Jun 04	Jul 04–Dec 04	Jul 03–Dec 03	Jan 04–Jun 04	Jul 04–Dec 04
New South Wales	7	-2	-15	4	-18	-19
Victoria	5	-5	-9	2	-15	-6
Queensland	17	-7	-23	17	-14	-17
South Australia	7	2	-12	14	-8	-1
Western Australia	24	17	1	14	-1	5
Tasmania	6	16	0	4	-19	-23
Northern Territory	45	22	43	27	9	47
A.C.T.	0	-25	-28	-8	-32	-31
Australia	11	0	-12	8	-15	-12

Source: Australian Bureau of Statistics

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showed substantial wages growth, with other sectors forecast to follow. The resultant inflationary pressures appear to be a looming concern for the Reserve Bank, and are likely to be the main reasons behind the 0.25% rise in interest rates in March 2005.

With these pressures forecast to remain in the economy until the effects of stronger investment in production alleviate some of the bottlenecks, the pieces are in place for the CPI to rise beyond the Reserve Bank's targeted 2-3% range. In response, we expect to see further rises in the cash rate.

We anticipate a further rise of 0.25% by June 2005 (reflecting a standard variable rate of 7.6%), with successive rounds of rises over the next 18 months culminating in housing interest rates peaking at just over 9% by September 2006.

## Home Loan Activity

Trends in finance for owner occupation in both new and established dwellings highlight that the market peaked in the second half of 2003, before weakening over calendar year 2004. At the national level, finance for new dwellings was flat in the six months to June 2004, and 12% down in the December 2004 half compared to the corresponding period the previous year. In comparison, finance for established dwellings showed a more immediate decline of 15% in the June half and 12% in the December half, compared to the same periods in 2003.

Finance activity for owner occupation has shown the largest percentage declines in New South Wales, Queensland, and the Australian Capital Territory in 2004, with more moderate declines in the other states. Only Northern Territory and Western Australia have shown a strengthening in home loan activity during 2004.

However, there has been a modest recovery in finance to first home buyers, particularly in Western Australia and, to a lesser extent, Victoria. While all states now offer additional financial incentives to first home buyers on top of the Federal Government's First Home Owner's Grant, these two states have benefited the most.

Investor activity continues to weaken, with the value of loans to investor purchasers in the last six months of 2004 down by 23% of the corresponding period in the previous year. Similarly, the level of investor finance has fallen to 39% of total residential purchaser activity in the year to December 2004, after peaking at 46% one year earlier. This is expected to decline below 30% over the next twelve months.

## Underlying Demand

### NET OVERSEAS MIGRATION

After peaking at a ten year high of 135,700 in 2000/01, Australia's net overseas migration fell back to 110,600 in 2001/02, before rising over the following two years to 117,600 in 2003/04. Over the last five years, Australia's net overseas migration inflow (averaging 117,500 per annum) has run well ahead of the 1990s average. This rise has corresponded with strong economic growth in Australia relative to the rest of the world, and a rise in long term overseas visitors (i.e. people staying for more than twelve months, but not permanently).

The latest data for March and June 2004 suggests that net overseas migration has eased back slightly on the corresponding periods the previous year, particularly in

New South Wales and Queensland, while the inflow into Victoria strengthened considerably.

Nevertheless, we expect net overseas migration to have increased to an estimated 125,000 in 2004/05, supported by the Federal Government's target intake of 133,000. It has been suggested that the Federal Government may raise its official intake by 20,000 in 2005/06 to accommodate growing skills shortages in particular sectors of the economy, adding further upside to net overseas migration in the coming years

In recent years, the proportion of Australia's overseas migrants into New South Wales has declined from in excess of 40% prior to 2001/02, to as low as 33% in 2003/04. This has been offset by a higher inflow into Queensland (rising from a long term 14%-16%, to in excess of 20% in 2001/02 and 2003/04), and to a lesser extent, Victoria (from a long term 25%, to 29% in 2003/04). However, we expect this to ultimately revert closer to long term levels, as relative house prices and economic conditions across the states also move back closer to long term levels.

The proportion of overseas migrants settling in Western Australia is expected to increase slightly (from a long term 13.5% to 14.5%), as economic conditions there strengthen, while the proportion of those ending up in South Australia (4.2%), Tasmania (0.5%), Australian Capital Territory (0.5%), and Northern Territory (0.3%) will remain at long term levels.0.3

## NET INTERSTATE MIGRATION

In recent years, net interstate migration into both Queensland and Western Australia have benefited from the employment prospects generated by strong economic growth, greater housing affordability and, to a lesser extent, the lifestyle attractions of a warmer climate. This has helped to drive up prices in both these states.

The main outflow has come from New South Wales, as residents have sought to escape the decline in affordability due to rapid house price rises in Sydney. More recently, Victoria's net inflow has also

**Table 2: Net overseas migration ('000s)**

Year June	NSW	VIC	QLD	SA	WA	TAS	ACT	NT	Aust.
1998	31.8	19.3	12.5	3.2	12.0	0.0	0.6	-0.2	79.2
1999	41.1	24.7	13.7	2.7	13.4	0.2	1.0	-0.2	96.5
2000	43.7	27.0	17.5	3.8	14.0	0.4	0.9	-0.1	107.3
2001	58.6	35.3	21.0	2.8	16.3	0.1	0.9	0.7	135.7
2002	44.4	20.3	26.5	2.8	15.0	0.3	0.7	0.7	110.6
2003	40.9	26.8	27.1	3.9	15.6	1.0	0.3	0.9	116.5
2004	39.3	34.6	19.7	5.5	17.1	0.6	0.6	0.2	117.6
Forecast									
2005	43.8	32.5	23.8	5.3	18.1	0.6	0.4	0.6	125.0
2006	47.3	35.1	25.7	5.7	19.6	0.7	0.4	0.7	135.0
2007	49.0	36.4	26.6	5.9	20.3	0.7	0.4	0.7	140.0

Source: ABS, BIS Shrapnel

**Table 3: Net interstate migration ('000s)**

Year June	NSW	VIC	QLD	SA	WA	TAS	ACT	NT
1998	-12.2	-0.3	17.4	-2.0	3.2	-3.6	-0.5	-2.0
1999	-13.1	2.5	16.7	-1.6	0.3	-3.3	-1.0	-0.5
2000	-14.3	5.2	18.5	-3.5	-2.2	-2.6	-0.9	-0.1
2001	-16.3	5.2	20.0	-2.4	-3.1	-2.1	-1.6	0.4
2002	-24.4	4.4	31.2	-1.6	-4.4	-1.5	-2.6	-1.0
2003	-31.8	0.0	39.2	-1.5	-2.8	1.9	-3.4	-1.6
2004	-30.4	-2.3	36.7	-3.2	1.3	2.5	-2.1	-2.4
Forecast								
2005	-28.0	-5.0	33.0	-3.0	4.0	0.5	0.0	-1.5
2006	-25.0	-9.0	31.0	-3.0	6.0	0.0	1.0	-1.0
2007	-25.0	-11.0	33.5	-3.0	5.0	-0.5	1.0	0.0

Source: ABS, BIS Shrapnel

resorted to a net outflow, which is expected to increase, as the economy underperforms relative to Queensland's.

With Sydney house prices now slowing, the movement of residents eased in 2003/04, although the rising net outflow from Victoria will result in the inflow into Queensland remaining at around 2003/04 levels. The net inflow into Western Australia is expected to further rise as economic conditions and employment prospects continue to surge.

The Northern Territory's net interstate migration outflow also improved in 2003/04, benefiting from the booming resources sector, and we expect this to revert to zero in 2004/05.

After a long term departure of residents to other states, Tasmania experienced a net inflow in 2002/03 and 2003/04-primarily as older residents trade down from their more expensive dwellings on the mainland. This has been the key driver of the massive house price growth in this

period and should continue in the short term, although a lack of employment drivers will prevent the net inflow being permanent.

South Australia and the Australian Capital Territory both experience a consistent net interstate migration outflow, which will continue to impact on demand.

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**Table 4: Median house prices by capital city**

Quarter ended	Sydney		Melbourne		Brisbane		Adelaide		Perth		Hobart		Canberra		Darwin	
	\$'000	% Var	\$'000	% Var	\$'000	% Var	\$'000	% Var	\$'000	% Var	\$'000	% Var	\$'000	% Var	\$'000	% Var
1996	210.0	4.0	153.0	5.5	130.0	0.0	111.5	-1.1	127.0	-0.8	112.0	6.7	158.0	3.9	168.0	-6.7
1997	230.0	9.5	170.0	11.1	134.0	3.1	114.9	3.0	135.0	6.3	105.0	-6.3	155.0	-1.9	178.0	6.0
1998	260.0	13.0	198.0	16.5	139.0	3.7	120.3	4.7	143.3	6.1	107.0	1.9	160.0	3.2	180.0	1.1
1999	280.0	7.7	226.0	14.1	145.0	4.3	125.0	3.9	148.5	3.6	115.0	7.5	158.0	-13	176.0	-2.2
2000	315.0	12.5	264.0	13.8	155.0	6.9	135.0	8.0	157.8	6.3	130.0	13.0	184.0	16.5	190.4	8.2
2001	316.0	0.3	302.0	14.4	160.0	3.2	148.2	9.8	165.7	5.0	120.3	-7.5	203.0	10.3	187.0	-1.8
2002	388.0	22.8	347.0	14.9	185.0	15.6	170.0	14.6	185.7	12.1	130.0	8.1	227.6	12.1	200.0	7.0
2003	465.0	19.8	365.0	5.2	235.0	27.0	220.0	29.4	210.2	13.2	180.0	38.5	320.0	40.6	206.0	3.0
2004	520.0	11.8	371.0	1.6	307.3	30.7	250.0	13.6	255.0	21.3	252.0	40.0	372.4	16.4	255.0	23.8
Quarterly																
Sep 04	500.0	6.4	363.0	-3.2	305.0	13.0	263.0	16.9	253.0	7.7	256.0	30.2	348.7	-1.8	259.6	21.9
Dec 04	505.0	1.0	382.5	-1.1	305.0	2.3	270.0	12.5	267.0	8.1	265.0	17.1	350.0	-5.4	260.0	13.0

Note: % var in Sep and Dec 2004 represent an annual increase. Source: R.E.I.A, BIS Shrapnel

## PRICES

Underlying demand in New South Wales has weakened due to reduced net overseas migration inflow and an increase in the net interstate migration outflow, evidenced by the Sydney median house price peaking at \$520,000 in March quarter 2004, before falling back to \$500,000 in the September quarter, and \$505,000 in the December quarter. We expect prices to hover around this level over the next twelve months.

Price growth in the Melbourne residential market has been relatively static since mid 2003. Although the median house price showed a 5% increase from the September to December quarter 2004, this does not appear to be part of a rising trend in the market, but rather a one-off figure influenced by lower sales volumes. We expect to see prices continue to remain static in the short term, as a rising net interstate migration outflow impacts on demand and the market faces a minor oversupply of stock, particularly in the inner Melbourne apartment market.

The sharp rise in Brisbane's median house price (92% increase in the three years to June 2004) tapered off during

calendar 2004 to remain at around the \$305,000 level. With strong demand still in the market as a result of high net overseas and interstate migration inflows, we believe that there is still some scope for further modest growth of 5-6% in the next year, but affordability issues will prevent more solid rises.

Growth in Adelaide's median house price moderated over calendar 2004, as high levels of dwelling construction activity are resulting in an emerging excess of dwelling stock as underlying demand eases. Price growth is expected to be limited in the short term, without strong population growth driving demand.

Underlying demand in Perth is strengthening dramatically due to the increasing net interstate migration inflow into Western Australia. As Perth house prices have not increased at the same rate as the other capitals in recent years, we expect to see some further scope for price rises of 8-10% in the next year or so.

Hobart's median house price nearly doubled between June 2002 and June 2004, benefiting from the complete

reversal of the persistent net interstate migration outflow to a net inflow in 2002/03. With the median house price now at similar levels to Adelaide and Perth, we anticipate the scope for further growth to be limited without the employment drivers necessary to encourage continued migration.

Canberra's median house price has dropped back dramatically in the last six months of calendar 2004, as high construction and weakening demand has impacted on dwelling prices. This will continue to influence price growth, which is expected to remain flat.

Although Darwin house prices have been relatively weak in recent years, a booming resource sector will encourage demand and subsequently, price growth. We expect this to underpin price growth of 7-10% in the next twelve months.



This overview is produced by PMI in conjunction with BIS Shrapnel.