Property Observer

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What the cash rate means for capital home values

The Reserve Bank's official cash rate is expected to remain at, or near, record lows for most of the year. That's great news for mortgage holders but investors may be wondering what it means for capital values.

Interest rates are a key determinant of Australian property prices as the cash rate affects funding costs, with most people taking out a mortgage to buy, says ANZ chief economist Warren Hogan.

"When interest rates go down it will clearly support property prices and typically result in rising prices. When interest rates go up it will act as a headwind to property prices and will relate to property prices coming down," Hogan says.

But it's not a simple relationship, he says. "It depends on the situation in the market and the economy ... If you are cutting rates because the economy is in a hole you will not see prices rise."

A range of other factors also drives property prices, diluting the effect of interest rate movements, says BIS Shrapnel senior manager – residential property, Angie Zigomanis.

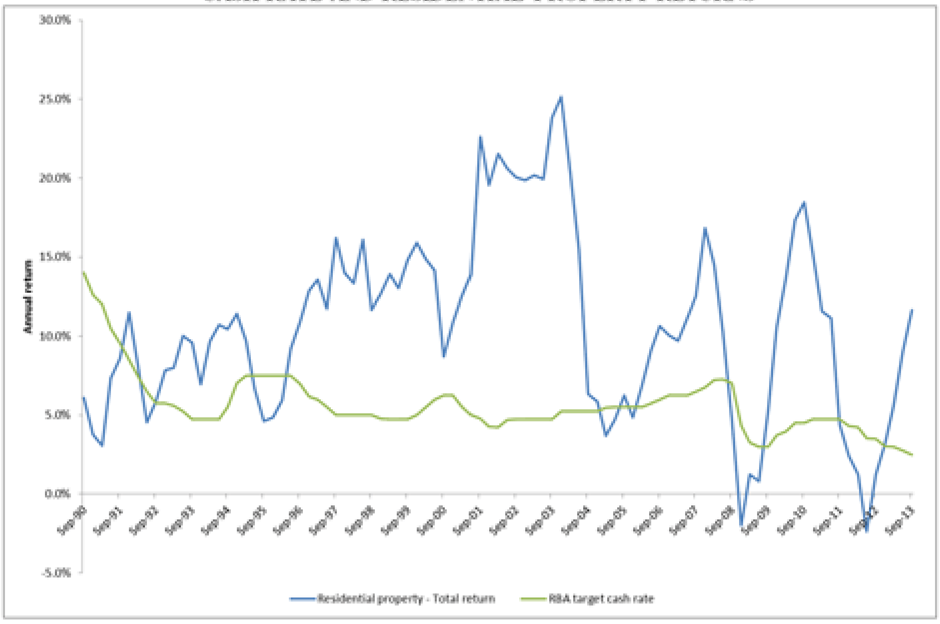
"One of them is the general demand-supply situation in the city; affordability and economic conditions within the market as well," Zigomanis says.

Population expansion and employment growth also influence prices, says Atchison Consulting managing director Ken Atchison.

"In Australia, migration has been a huge driver of demand due to the strong growth in the working population," he says.

Atchison Consulting's analysis shows only a weak relationship between changes in the RBA cash rate and changes in residential property prices in Australia.

CASH RATE AND RESIDENTIAL PROPERTY RETURNS

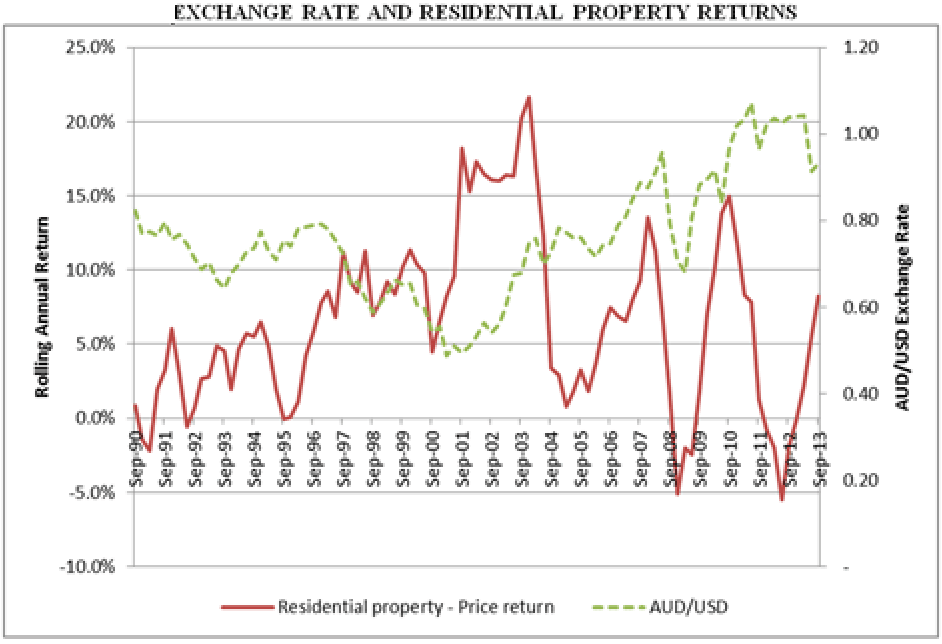


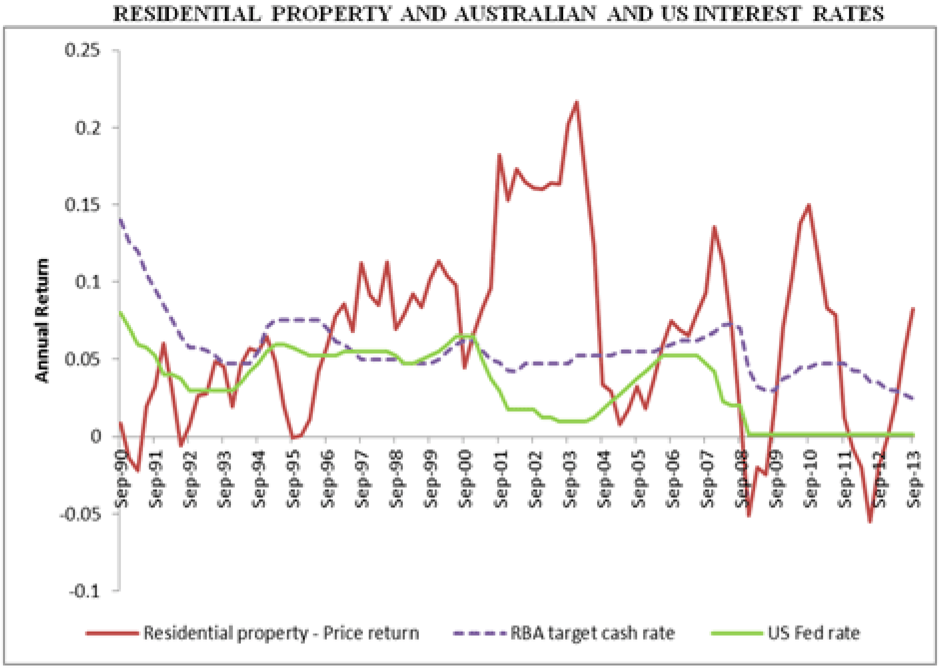
Source: Atchison Consultants

From mid-1995 to mid-1996, cash rates were falling as property prices rose. The same occurred between 2000 and 2001. But at other times, such as around 1991, 2008 and 2011-2012, property prices fell as cash rates were cut.

Atchison's analysis shows that US interest rates set by the Federal Reserve and the US dollar-Australian dollar exchange rate have as much of an impact on Australian residential property prices as local exchange rates.

EXCHANGE RATE AND RESIDENTIAL PROPERTY RETURNS





Source: Atchison Consultants

Atchison says that's because foreign investors are attracted to Australian property when interest rates elsewhere are low and the exchange rate is in their favour.

Additionally, Atchison says when interest rates overseas are lower, Australian banks find it easier to raise capital offshore for lending to Australian borrowers. With the banks more willing to lend, Australians find it easier to buy.

Local interest rate changes come into play in driving property prices indirectly through their impact on the broader economy, Atchison says.

The RBA lifts rates to reduce spending in the economy and control inflation. Higher interest rates force people and businesses to spend more on loan repayments, reducing their disposable incomes.

Conversely, cutting rates reduces mortgage holders' interest costs, giving them more money to spend on goods and services.

Lower interest rates also make it more viable for businesses to invest and property developers to commence housing construction, which creates jobs and drives the economy.

Zigomanis says low cash rates improve the affordability of housing loans, which provides a trigger for price growth to occur. "Interest rates keep falling until the housing market stabilises and in a rising market, interest rates rise to stop the growth," he says.

Despite the recent surge in property prices, most commentators expect the official cash rate to stay low for most of 2014. RBA governor Glenn Stevens noted in February, when rates were left on hold at 2.5%, that: “On present indications, the most prudent course is likely to be a period of stability in interest rates.”

Zigomanis says that with interest rates as low as they are, incremental changes will have less of an effect on the residential property market than they would have at times when rates were higher.

“People factor in a certain level of interest rates when they purchase. People look at what their interest repayments are now and where they could be,” Zigomanis says.

Less than six years ago the official cash rate was 7%. Less than two-and-a-half years ago it was 4.75%. “That’s probably in the back of minds for a lot of purchasers now potentially it could go back up to that level,” he says.