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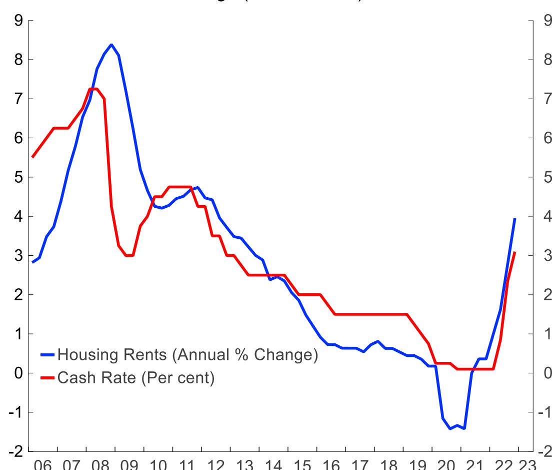
Data Snapshot

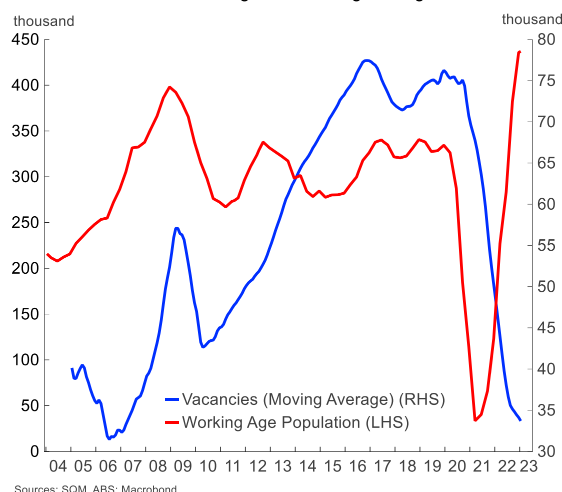
Tuesday, 28 February 2023

Housing Insights

Renters – The Dark Horse Of The Rate Cycle

- **Advertised rents are likely to increase by a further 11.5% in 2023, on top of the 10% recorded to 2022 – this would be the sharpest annual increase in advertised rents on record.**
- **Higher advertised rents will feed through to existing rents with a lag. It takes time for existing rental agreements to expire. We expect rents to increase on average by up to 7.5% in 2023, on top of the 4% recorded in 2022. The 2023 increase would be the sharpest increase since 2008.**
- **The one-third of Australian households who rent will see their total rental bill increase by up to $10 billion by the end of 2023. Renters tend to be low- and middle-income households with smaller savings buffers and if they are forced to rein in their non-housing spending, consumption could be up to 1% lower by the end of 2023.**
- **Renters entered this hiking cycle in a precarious position - housing costs for this group as a share of income was close to a record high. This share was around 5 percentage points higher than for households with mortgages – they, therefore, have less capacity to deal with higher prices.**
- **Higher interest rates have important impacts on the rental market. Higher interest rates and a downturn in house prices reduce residential construction activity. Higher interest rates also increase the minimum return investors require to invest. These impacts reduce the supply of new rental properties. Eventually, higher rents will entice investors to return to the market. We expect this to happen towards the end of 2023 in some pockets, only after further rent hikes.**
- **The return of migrants and international students is providing an important injection of labour supply, but it's also putting a further strain on the rental market. Last time we had as strong a pickup in migration was in 2008-09; back then, interest rates were falling in the aftermath of the GFC. This led to a strong supply side response and increase in rental properties. In this cycle, we expect the supply response to lag, exacerbating the pressure in rents.**





The Reserve Bank of Australia (RBA) has delivered 325 basis points of interest rate hikes since May 2022. The amount and speed of rate hikes means the responses of households and businesses are highly uncertain. The RBA has signalled further rate hikes “over the next few months”.

A larger proportion of disposable income must be used to service existing and new debt when interest rates rise. The largest liability on household balance sheets are mortgages. It, therefore, makes sense for commentators to focus on the impact of higher interest rates on the one-third of Australian households with a mortgage.

However, around one third of Australian households rent. Little, if no, attention has been given to this significant subset of Australian households. We argue that this is an important channel for the transmission of monetary policy and will amplify the expected slowdown in household spending, albeit with a lag. We also note that the consumption impacts for renters will likely be larger than in previous cycles, given the starting position for many renters. Key drivers underpinning this conclusion are:

1. ***Housing costs as a share of gross disposable income for renters were close to a record high as we entered this rate hiking cycle***. Further, housing costs as a share gross disposable income for renters are around 5 percentage points higher compared with households with a mortgage. Renters, therefore, have less capacity to deal with higher prices.
2. ***On the demand side, the rental market is extremely tight and will only get tighter.*** Rental vacancy rates are at a record low with advertised rents increasing at double-digit rates in 2022. As existing rental agreements expire, higher advertised rates will flow through to renewed agreements. This will only be amplified by the expected record increase in net overseas arrivals, putting further upward pressure on rents.
3. ***On the supply side, rents will increase as landlords pass on higher interest costs. Plus, the supply of new stock will respond with a longer than usual lag.*** *In a world characterised by higher interest rates, there will be upward pressure on rents to entice new supply from investors.* The unwinding of government subsidies and higher input and labour costs are supressing economic returns. At the same time, higher global interest rates and risk-free returns are increasing the hurdle rate of return for investors. Combined, these factors will delay new supply. Critically, last time we had a migration boom of this size was in 2008-09; back then, interest rates were declining in the aftermath of the GFC, generating a significant supply side response. This time around, interest rates are on the up, delaying the supply side response, which will only work to exacerbate the tightness in the market.

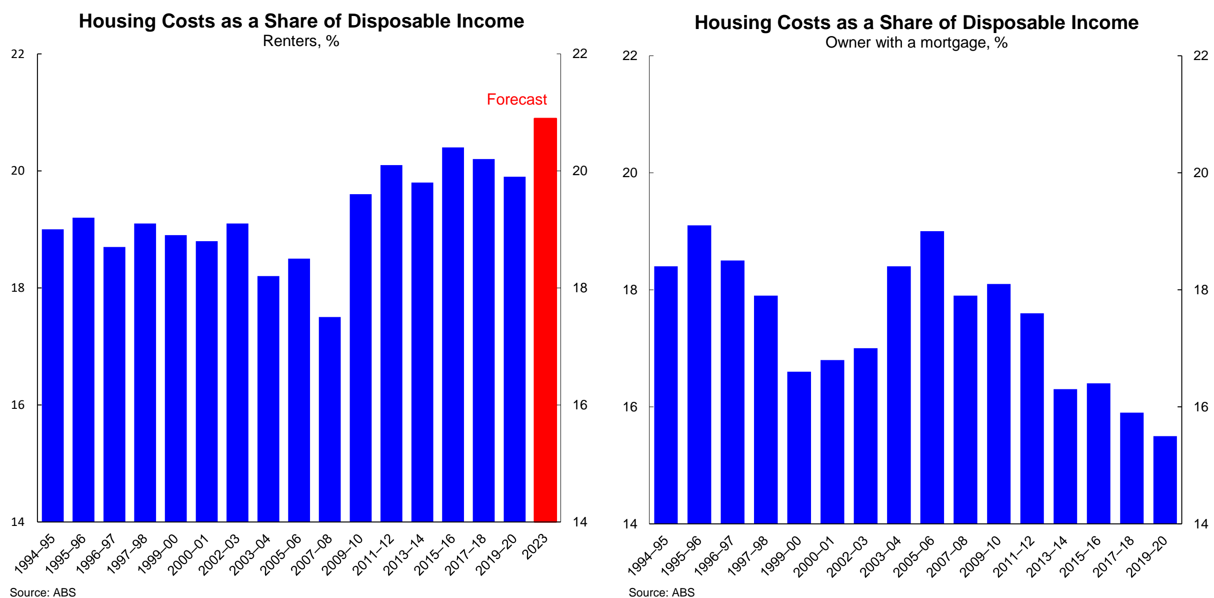
Given these dynamics, we estimate that advertised rents will increase by a further 11.5% in 2023, with the stock of rents, as measured by the consumer price index (CPI), increasing by up to 7.5% in 2023, on the back of a 4% increase in 2022. Generally, renters are not well equipped to absorb this increase in housing costs – they tend to be a younger cohort, low- and middle-income households with lower savings. To fund the increase in housing costs, renters will likely need to directly substitute away from other spending categories.

On our numbers the rental bill could increase by up to $10 billion by the end of 2023. This is significant. The Australia Bureau of Statistics (ABS) estimates that households paid around $51 billion in rent in 2021-22. Renters tend to be low- and middle-income households with smaller savings buffers and if they are forced to rein in their non-housing spending, consumption could be up to 1% lower by the end of 2023 (household consumption is around $1.1 trillion).

Starting position: Renters are not well equipped to absorb an increase in housing costs.

The latest available data from the Australian Bureau of Statistics (ABS) shows that on average households that rent use around 20% of their gross disposable income to finance housing costs. This has increased since the turn of the millennium and is considerably higher than the 15.5% of gross disposable income which households with mortgages use on housing costs. Given the expected increase in rents, housing costs as a share of gross disposable income is expected to increase to a record high in 2023. Given this, renters have less capacity to use income to meet higher housing costs.

Additionally, much has been said on the use of large, accumulated savings from the pandemic to offset the increase in housing costs, especially for households with a mortgage. However, renters tend to be in the lower end of the income distribution and recent data shows that the large savings buffers accumulated during the pandemic are heavily distributed towards higher income households. Specifically, around 64% of the savings built up since 2020 are held by the highest income quintile. The median household in the lowest income quintile did not build any savings buffers.

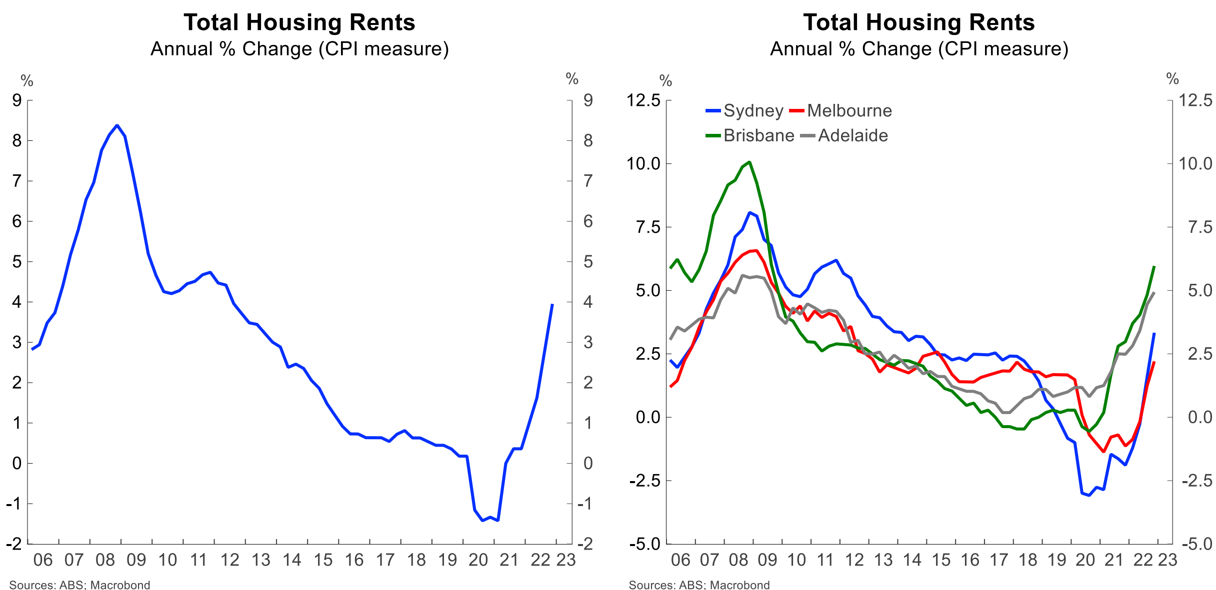


Rental demand is running hot…and accelerating fast!

After the initial lockdown disruptions in 2020, rents began to grow rapidly following a period of weak growth. Given borders remained closed and population growth was negligible, most of this growth is explained by a fall in the household formation rate or the average number of people living in a dwelling.

Due to lockdowns, people reassessed their housing needs and the average number of people per household declined. This occurred as preferences changed and people left share houses, upgraded to a bigger dwelling with a backyard or space for a home office. As a result, more of the rental stock was being used up by the same amount of people. This put upward pressure on rents as demand strengthened and by the end of 2021 (before borders reopened) annual growth accelerated.

Existing rents on the other hand, which are captured by the consumer price index (CPI) are slower to change. It takes time for the stock of rental agreements to expire and then be renewed. It can, therefore, take time before rising advertised rents are picked up by the CPI. However, we have already started to see a sharp pickup in CPI rents given the ongoing tightness in the rental market. This trend is expected to continue.

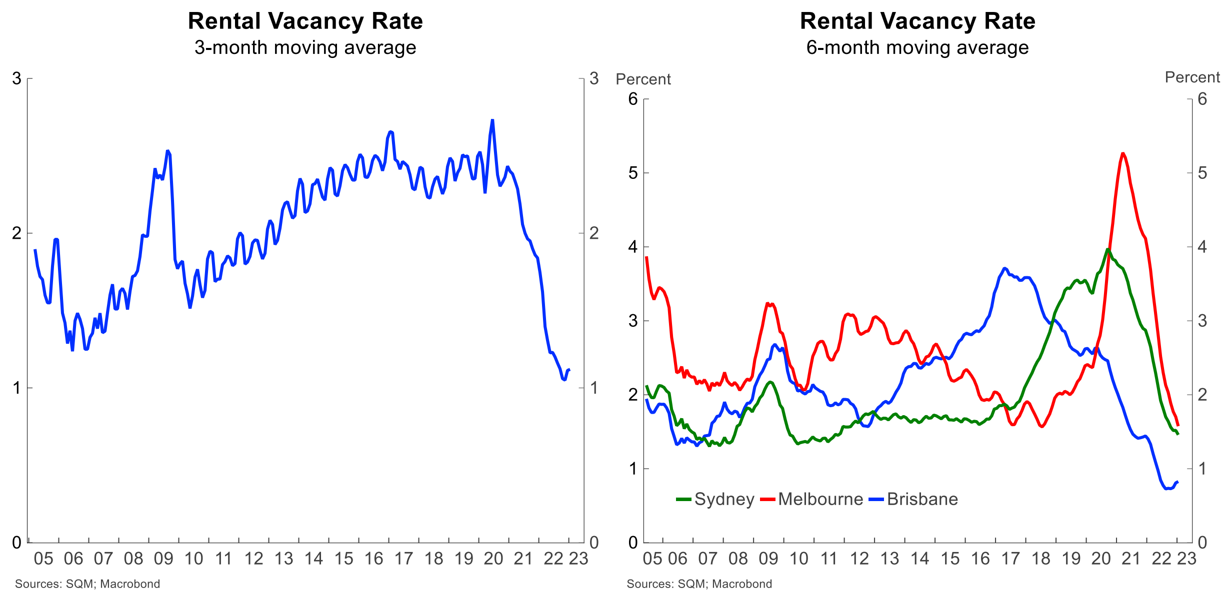


Since then, the rapid increase in migration numbers, coupled with extremely low rental vacancy rates has seen advertised rents increase at annual rates not seen in over a decade – since the mining investment boom.

An increase in population growth adds to demand for housing, after all, migrants need houses. On average, migrants take around 4-7 years to buy a home. We also know that around 70% of all overseas migrants enter the rental market, this number is likely even higher for temporary arrivals. Ii means that a spike in migration will add to rental demand.

The main metric through which we observe this dynamic is the rental vacancy rate. The vacancy rate measures the share of the total rental stock which is currently vacant. When the vacancy rate is high, there are lots of vacant properties and vice versa. Therefore, when we experience a spike

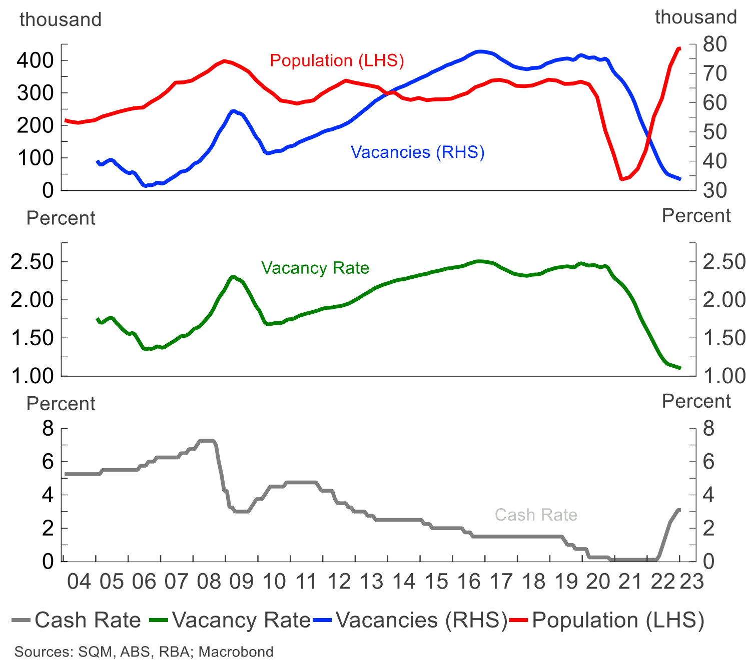
in net arrivals from migration, we tend to see a fall in the vacancy rate as more of the rental stock is used.



When we last experienced a surge in overseas arrivals in the mid-to-late 2000's, the national vacancy rate reached a low of 1.3% on a 6-month moving average basis. This was driven by a surge in net overseas arrivals in the visas categories that add to labour supply (i.e. temporary skilled visas, temporary worker visas and temporary student visas), of nearly 760k over the three years to June 2009. So far, since July last year alone we have seen net arrivals hit almost 410k. In other words, in just seven months we have had over half the number of net arrivals recorded over 3 years during the last migration boom. Not surprisingly, as of January 2023, the national vacancy rate is sitting at 1.1% on a 6-month moving average basis and could push lower. This is well below the long-run average of around 2.2%.

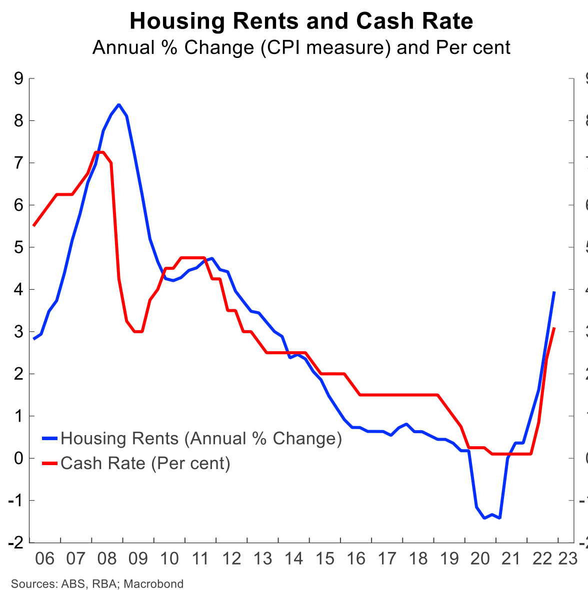
A low vacancy rate means a tighter rental market as prospective renters must compete for a smaller supply of available stock. This puts upward pressure on rents, as renters bid up prices to secure a home. However, a tight rental market also makes it easier for landlords to increase rents (either to cover higher costs or to increase profit) as renters effectively become 'price takers' if they wish to secure somewhere to live.

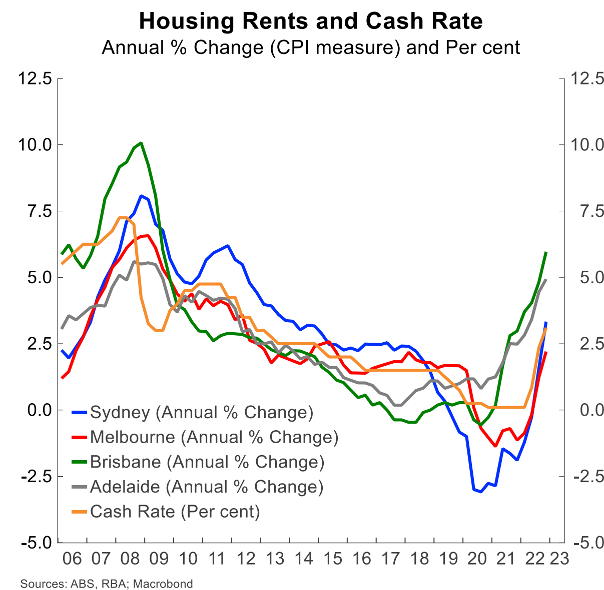
In late 2007, annual growth in advertised rents hit almost 10% as population growth pushed vacancy rates down. Already, we have seen advertised rents growing at over 10% annually and we are only at the beginning of the rental shock. Plus this time, we are not expecting to see the same supply response as in the late 2000's. This time, interest rates are increasing.



Investors are passing on higher interest costs to their tenants.

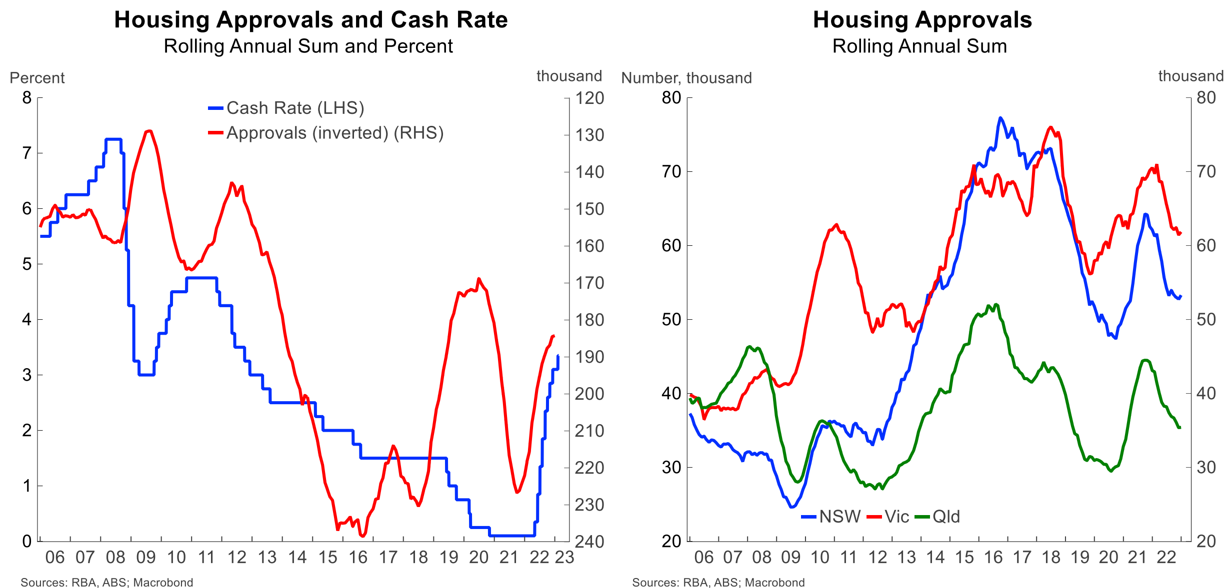
Like any other asset class, investors require an appropriate risk-adjusted return. Higher interest rates represent a higher cost for investors. They will, therefore, try to pass on these higher costs to maintain returns. The tax treatment of housing investment, including negative gearing and the capital gains discount, may mean that investors do not have to pass on the entire amount. However, in a sellers' market with record low vacancy rates, investors may try to pass on increased interest costs and then some. In history we have seen a very close relationship between growth in rents and interest rates with a lag of a few quarters – reflecting the time it takes for existing agreements to expired, be updated, and come into play.



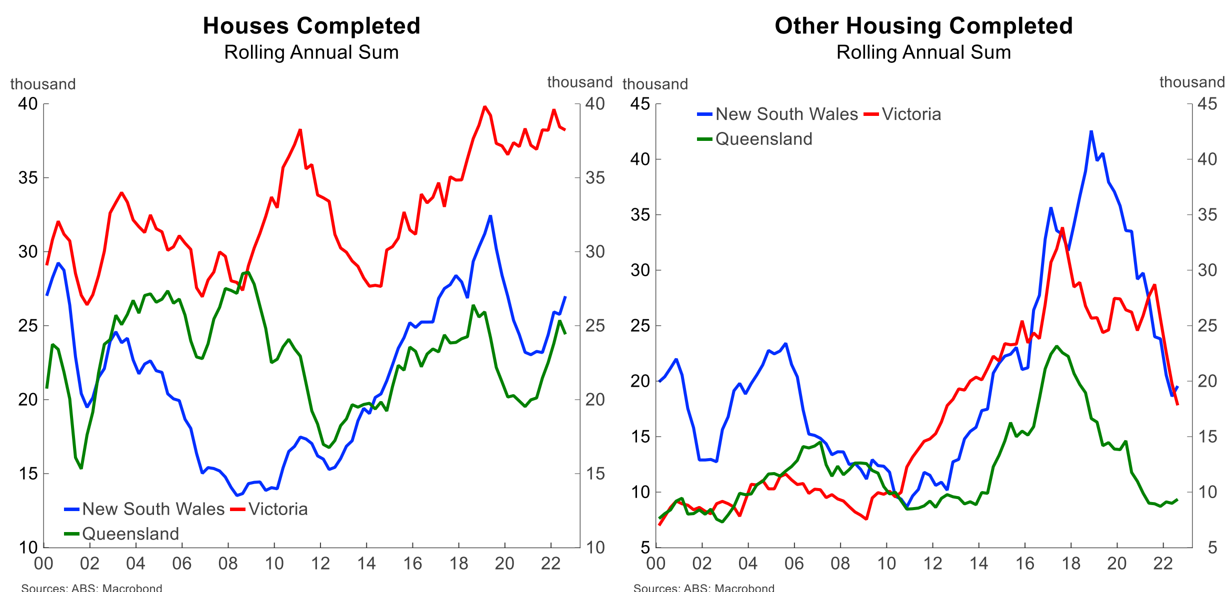


The residential construction pipeline has taken a hit from inflation and tighter monetary policy.

Higher interest rates lead to a reduction in house prices and investment in dwellings. We have already seen this play out particularly in the markets along the east coast. Housing approvals have fallen sharply since interest rates have increased, adding to a fall in new investment prompted by surging construction costs. Borrowing for the construction of new dwellings, and to purchase new dwellings, have also declined sharply. All these indicators point to significant weakness in residential construction going forward.



During the pandemic when mortgage rates were at record lows, we saw housing approvals and building commencements pick up strongly. The pipeline of approved projects has largely flowed through to completions, and we are now seeing completions go sideways without leading to a significant improvement in the rental vacancy rate. Indeed, in their New Home Sales Report released on 21 February 2023, the Housing Industry Associated is forecasting that the number of dwellings commencing construction is set to decline this year and next to its lowest level since 2012 – pointing to further weakness in residential construction.

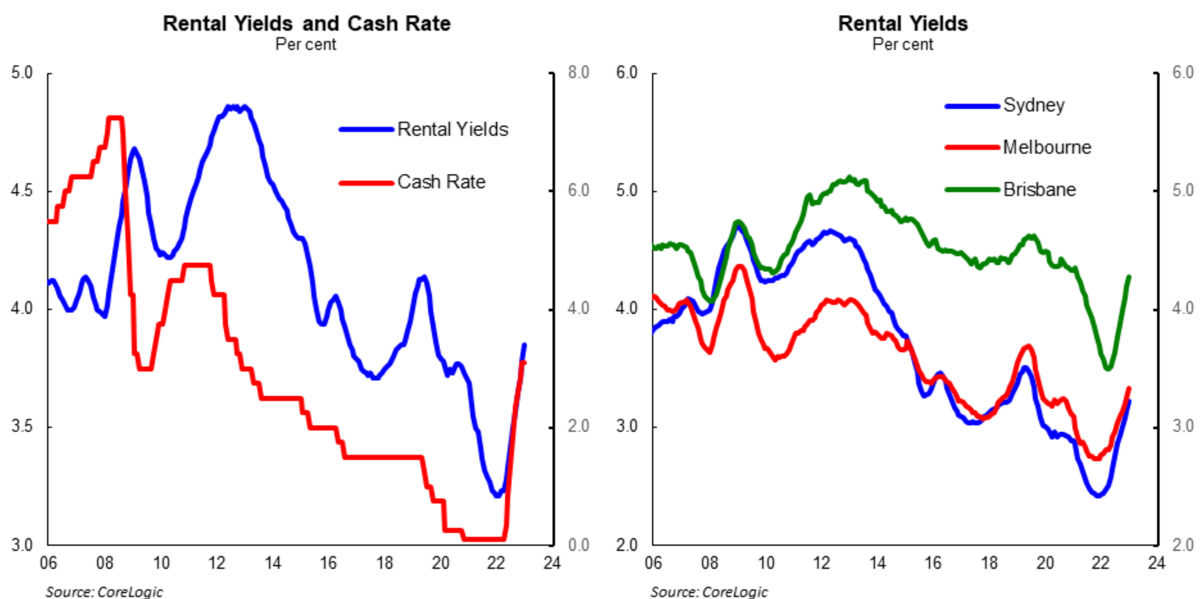


The rental shortage will get worse before it gets better.

Higher rents generally mean higher investment returns, enticing investors and developers into the market. We saw this in the lead up to the GFC, low vacancy rates and higher rents led to a strong supply response. A significant increase in supply puts downward pressure on rents.

However, investors do not only look at the absolute return of investing in housing. These returns are compared with alternative asset classes, such as equities or deposits. With rates going up, the hurdle rate for housing investors has also increased. As a basis for comparison, last time the cash rate was around 3.85% (our current expected terminal cash rate) in late 2012, national rental yields were at around 4.85%. Today national rental yields are around 3.80%.

A critical difference between this cycle and previous cycles where we saw migration rents increase at a record pace is the direction of interest rates. In 2008-09, interest rates declined significantly in the aftermath of the GFC. This supported the supply side response. This time around, we have strong migration and population growth, but interest rates are on the up, and there's a risk they could remain elevated for some time (depending on how inflation evolves). This will delay and dampen any supply-side response, prolonging to shortage in rental properties.



What's the outcome of increasing demand and a fall in the residential construction pipeline?

We estimate that advertised rents are likely to increase by up to 11.5% in 2023 – this comes on the back of a 10% increase in 2022. As more existing rental agreements are renegotiated at higher rents, we estimate that average rents, as measured by the CPI, will increase by up to 7.5% this year, on top of the 4% recorded in 2022.

This could see up to $10 billion redirected from non-housing spending towards rents by the end of 2023. Households that rent went into this hiking cycle spending a greater share of their disposable income on housing. Given the expected increase in rents, housing costs as a share of gross disposable income are expected to increase to an all-time high in 2023. Renters also tend to be lower- and middle-income households who have less capacity to smooth consumption. Instead, they are likely to pull back on non-housing spending. This represents a meaningful risk to household consumption growth in 2023, over and above the uncertainties from increasing mortgage rates for indebted households.

Note these outcomes assume there are no significant changes in the behaviour of households, businesses, and governments. For example, a shift in preferences toward households with a higher average number of people per dwelling could have an impact on expected outcomes.

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