It is time to look back at our forecasts made back in October last year for 2020

by Louis Christopher, CEO

City/Region	2020 Scenario 1 (base case)	2020 Scenario 2	2020 Scenario 3	2020 Scenario 4
	▪ Cash rate unchanged at 0.75% ▪ Economy recovering ▪ AUD ranges between US$0.65–US$0.75 ▪ No APRA Intervention until late 2020 at the earliest	▪ RBA cuts to 0.50% by April 2020 ▪ Trade wars tentatively stabilised ▪ Economy stable ▪ No APRA intervention	▪ Scenario One HOWEVER ▪ APRA Intervention occurs Mid-2020	▪ Trade talks collapse ▪ Economy weakening ▪ RBA cuts cash rate to zero by end 2020 ▪ QE starts
Perth	+3% to +6%	+4% to +7%	+3% to +6%	-6% to -2%
Brisbane	+3% to +6%	+4% to +7%	+3% to +6%	-3% to +1%
Darwin	-5% to -2%	-4% to -1%	-5% to -2%	-7% to -3%
Melbourne	+11% to +15%	+12% to +17%	+5% to +9%	0% to +4%
Sydney	+10% to +14%	+11% to +16%	+4% to +8%	0% to +4%
Adelaide	+1% to +4%	+1% to +4%	+1% to +4%	-2% to +2%
Hobart	+5% to +8%	+6% to +9%	+4% to +7%	+3% to +6%
Canberra	+3% to +7%	+4% to +8%	+2% to +5%	+4% to +7%
Capital City Average (weighted)	**+7% to +11%**	**+8% to +13%**	**+4% to +7%**	**-1% to +3%**

Source: SQM Research

Despite the current gains recorded for the March quarter being on track with our base case forecasts, given current events, there is only a single scenario that is still feasible and that is **Scenario 4** – a scenario we outlined in our top 4 scenarios for 2020. One where the RBA would bring the cash rate to zero and start quantitative easing. It was based on a possibility the tentative trade war truce between the U.S and China would collapse and a 'take no prisoners' trade war would break out between the two countries, turning into a global trade war.

The outlook for housing in this scenario was one where the market would eventually stall and start to record price decreases from mid-year onwards. That the rate cuts and money printing would not be able to offset job losses and subsequently, forced sales activity.

Yes, the RBA has now had to introduce quantitative easing. Yes, the cash rate is now just 0.25%. But what we now face economically is a tsunami that dwarfs even a global trade war.

To get a sense of the economic carnage that is underway, check out this **gif** of U.S jobless claims.

The scale of what we are facing right now on the economic front is something never truly encountered since The Great Depression. And if we don't manage it well then a depression (a contract in in GDP of greater than 10%) is what we will have – something which I am far more frightened of than catching Covid-19. And believe me, I do not want to catch this virus.

So, with that in mind, I want to now give a general outlook on what I think are two main scenarios that are really in play this year.

A V-shaped recovery

Let's be clear, despite the positive Corelogic numbers (dwelling prices rose 2.8% for the quarter) and indeed our asking price indexes, I think housing price expectations have already corrected by 5% to 10% from their very highs. That may not show up in the official numbers as the highs were only briefly obtained during the later stages of February. It is anecdotal only, through my discussions with real estate agents and the sharp fall in clearance rates, which were already occurring prior to the auction ban starting from the 25th of March.

The best case scenario from here for property owners and investors is one where we get to zero new Covid-19 cases before April is over with. And on that front the numbers have been looking promising. I believe it is now a 50% chance that our three major states will record a zero new Covid-19 cases day before the month is over. If we get to that point, the next question begs how long will restrictions be kept? Potentially some restrictions could be lifted in May. And my bet is that when restrictions are eventually lifted, they will be lifted in the reverse order that they were placed on to begin with. As the ban on auctions occurred as one of the last stages (25 March), it is quite feasible that lifting that ban could come sooner than expected.

If we are able to get back to close to normal business by end of May (I certainly don't think all restrictions will be lifted by that time), then I think confidence in the housing market is going to return. Assisted with all the stimulus announced and the economic damage relatively limited, it would mean a fall in housing prices recorded for the June quarter but a bounce back in the September and December quarters. The net result for the year may come in at our Scenario 4 range or slightly better.

It should not be underestimated how much expenditure has been announced (including RBA money printing via quantitative easing) and how low lending rates are now. A borrower with a good credit rating can now expect a variable owner occupier lending rate somewhere between **2.5%** to **2.8%.** Average capital city gross rental yields are running at about **2.9%** for houses and **3.9%** for units.

That means property owners on a purely interest expenses verses rental payments scenario could do better owning. And of course it also means that investors may find more cashflow positive properties in our major cities.

That said though, we think there is trouble ahead for the rental market. We will come to that point later.

The worse-case scenario

The worse-case scenario is we have a second wave in new virus case counts and it occurs shortly after some restrictions are lifted. Or that new case numbers flatten at current levels but never quite manage to get to zero cases or stay at zero cases. This appears to be the plight of South Korea at the moment.

If this second wave were to occur, we think the housing market will have a much deeper correction.

A second wave of new Covid-19 cases is a great risk. Note, a second wave of Spanish Flue hit Australia in mid-1919 and this occurred just after restrictions were lifted after the first wave, noting hospital numbers (which is the available data we have for time) never actually got to zero on the lull.

Such a scenario would mean current restrictions would stay with us for longer. Probably more than six months. Or worse, more restrictions added. A second wave of infections may be more deadly as it would potentially occur over the course of the Southern Hemisphere winter. A sharp rise in deaths may result in more panic at the shops and most certainly a new low in confidence.

Damage to the economy would be deeper and longer lasting. Many businesses, including those that are currently on life-support, would not last the distance and will be liquidated.

You see, even with the generous measures announced for small business, it won't be enough to keep much of the sector alive for half a year. When there is little to zero revenues coming in, month after month, PAYG relief is not enough. Being subsidised to cover employee wages at $1,500 a fortnight is not enough. Neither is a $10,000 cash grant for most. And forget about asking small business to go into debt. Most of them, particularly in retail, hospitality and tourism, will refuse to do so. And so job creation would occur at a far slower rate when a recovery would eventually return.

With the surging and sustained unemployment rate, the banks could start to get nervous on mortgages. Potentially, after the six-month hiatus, banks may be backed into a corner where they are forced to repossession on defaulted housing loans. Now I believe the RBA and/or the Federal Government would come to the rescue to enable banks to avoid a mass repossession event. Let's keep in mind that in 2008, the banks could have pulled the trigger on the commercial property sector. Many owners at the time were in breach of lending covenants. The banks, by and large, chose not to pull that trigger. Mainly for their own self-preservation, as doing so would have created a cascading affect that would have smashed their balance sheets.

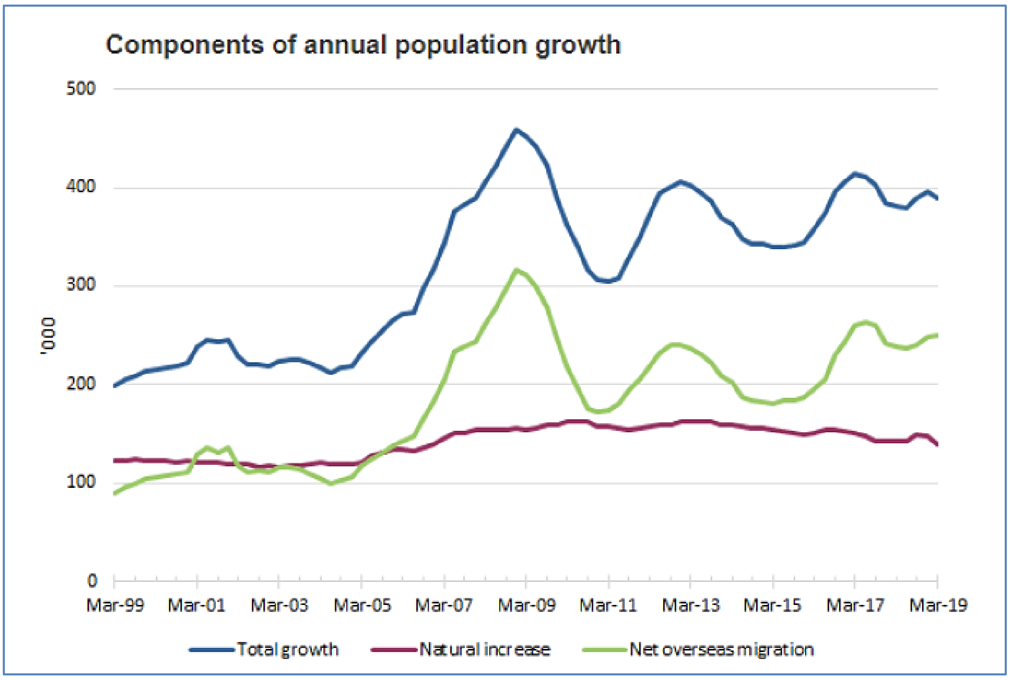
So I am not convinced we will see a lot of forced sales activity, even in this bleaker scenario. All the same, there will be many property owners who will want to sell out if this crisis goes on for six months or more. They will see the falls in dwelling prices over the course of the June quarter. And they will be very protective of what is left of their net wealth.

The buy side of the property equation would be hit very hard as it is being hit hard now. But far worse than what we had in 2018 or indeed 2008.

You see it's not just the loss of employees representing many first home buyers, but, as mentioned above it is also the potential wipe out of many thousands of small business owners, who themselves employ nearly 50% of the total workforce. Small business owners actually represent a very large component of the home buyer market. As at the 2016 Census there were over two million small businesses.

So this is very much a buy side issue in my view. Anyone that is worried they will lose their job or their business, won't be seriously thinking of taking out a home loan to buy into the property market.

Let's also remind ourselves that our international border is closed to most except for permanent residents, citizens and some temporary visa holders. And I believe it will remain closed for many months to come. So underlying demand for housing, which has been predominantly driven by net overseas migration has now stalled for this year. This will be a different experience to the Spanish Flu of 1919, whereby population growth still expanded at a very strong rate (1.9% for 2019) due to our soldiers returning home as well as the settling of European refuges.



Up to a 30% peak to trough price decline cannot be ruled out.

In this more bleaker scenario, a 30% decline in dwelling prices would be on the cards. Note, I have not modelled this out, other than taking elements such as previous work on the relationship between unemployment and the housing market. Modelling in this environment is almost impossible. It is simply based on my experience and study. The most overvalued cities would be hit the hardest, that being Sydney and Melbourne. Other cities should do better than a 30% correction given their relative fair value. Now some of you will note that during The Great Depression, the Australian housing market did not correct by this magnitude. Nor, during the Spanish plague of 1919 did the Australian housing market record such a correction. However, those two markets were not laden with the debt burden our current housing market has. Not even close. The only market that comes close in Australia was the massive boom/bust of the 1890s.

Of course, it should be noted that period was also laden by a very dodgy and nearly entirely unregulated banking sector.

Either way, the rental market is in trouble.

Overall, a stalling in underlying demand for accommodation driven by near zero migration, combined with a reduction in existing tenancy demand (as a result of job losses) plus a very likely increase in supply from empty AirBNB accommodation will likely mean we can now expect a rise in rental vacancies over this year. Previously the forecast was for a gentle reduction in vacancies in 2020 as dwelling completions were (and still are) due to fall.

On our estimates and other estimates, there are some 120,000+ properties nationwide at any point in time being used for short term accommodation via websites such as airbnb**.** And on our latest numbers for February**,** there were some 68,000 vacant rental properties available for normal leasing.

I can't tell you how many property owners are going to switch back to longer term leasing but there will be a number, especially if this plays out for longer. This is not a scenario here. This is our view. Our view is that rental vacancy rates are going to rise sharply over the short term. I think we can expect the rate to rise from the current **2.0%** to north of **2.5%** and perhaps north of 3.0%. That may not sound like much to you but if we do hit 3.0% that would be a record high on our index which goes back to 2005. Rents would fall as a result. Perhaps our weekly asking rents index is already revealing some weakness with national asking rents for houses down by **0.9%** for the month and **0.3%** down for units

The weakness in the rental market will probably put off many would-be property investors over 2020 creating more issues on the buy side of the market.

So what is it going to be? - Scenario 1, Scenario 2 or another scenario?

The next 30 days will likely tell the story. It is very hard to judge it. Like everyone else I am watching the new case numbers closely.

Let me tell you. I don't want Scenario 2 to play out. A depression would create massive economic misery. Suicides will rise, so will crime.

There is also the possibility we muddle through somewhere between the two scenarios. A world where daily new virus cases don't quite get to zero but there isn't a second wave. Restrictions lifted very gradually over many months. Eventually, a vaccine is produced and distributed in 2021. We would need to see what is lifted and at what point in time to work out the impact on the housing market. Regardless, rents will still be hit for simply the fact that the international border will still remain closed.

For further information please contact Louis Christopher: T 02 9220 4603 or info@sqmresearch.com.au

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