

Interest Rates on the Move, in the Rest of the World

The cost of borrowing is rising and it is constraining investment in housing.

This week will see the US Federal Reserve, the European Central Bank and the Bank of Japan meet to set monetary policy for their respective economies.

The US Federal Reserve is the only one of these which the market is expecting to increase rates. Regardless of their decision at this meeting the expectation is that all of these economies are returning to more neutral rates (higher) as growth returns.

For Australia, there will need to be a substantial change in Australia's economic conditions before interest rates are changed.

The setting of the Official Cash Rate is just one factor that affects the cost of borrowing for the purchase of a home. It is also affected by the cost to Australian banks of borrowing from overseas, regulatory interventions and the risk profile of banks. All of these factors are moving simultaneously to result in higher borrowing costs for customers in Australia.

House prices are falling, in part, due to a correction from the rapid house price rises in recent years and due to the record volume of new homes entering the market. History tells us that as long as population growth remains solid, house price corrections (such as is currently underway) are minor in comparison to the preceding price rises.

A concern is that the fall in house prices have led banks to increase the collateral requirements for the home loans. Banks appear to be responding to the downturn in house prices and the prudential threat posed by the Royal Commission by increasing their oversight of third parties, such as mortgage brokers, and lending practices. These additional constraints, even if they serve only to delay the loan process, could adversely impact on the housing market.

The Rest of the world is now pulling us forward, not holding us back

Despite these negative factors, the rest of the world is pulling the Australian economy forward. The effect of rising cost of borrowing is dwarfed by the effect of rising demand for exports. We are past the downturn in mining investment and it will start to increase over the next few years. Jobs growth is strong and this is starting to result in an increase

in real wage growth. All of these factors will flow through to improve household confidence.

The strengthening economy has ensured that the market for new homes has exceeded expectations. The market for new homes has eased back from the peak in 2016 and remains well above historical levels. We expect that this will continue as the economy continues to grow, population growth remains strong and the official cash rate remains on hold.

The Australian economy is continuing to outperform expectations

GDP rose by 3.1% over the year to March 2018. This is above most forecasts and faster than even the most recent Federal Budget anticipated.

This is the fastest growth since 2016, when growth briefly ticked above 3% and only the second time since 2012 that y/y growth has been above 3%.

The strength was concentrated in net exports and public spending, while growth in household consumption was softer after the strong gain in Q4. Business conditions remain buoyant, but the household sector has underperformed due to soft wage growth, a low saving rate and weakening house prices.

This strong GDP result, along with solid employment growth will result in wage growth strengthening toward the end of the year and take the pressure off the decline in house prices and the low savings rate.

The construction sector is now contributing to growth after years of being a mill stone on the economy.

Investment in residential and mining construction are continuing to contract but engineering investment is more than making up for the other parts of the sector.

This is the start of what we will be calling the Investment Boom 3.0. It will be far less dramatic in its growth than the previous two phases and build more stable employment bases around the economy.

Mining sector investment appears to have reached the bottom of its cycle, but there is no upturn evident at this time. Growth in mining and engineering investment appears likely over the next couple of years and this will offset the downturn in residential construction.

The fortnight ahead – key dates and releases (AEST)

Tuesday 12 June

ABS Housing Finance, April 2018, 11:30am

ABS Lending Finance, April 2018, 11.30am

Thursday 14 June

ABS Labour Force, May 2018, 11.30am

Tasmanian Budget 2018/19 released

Tuesday 19 June

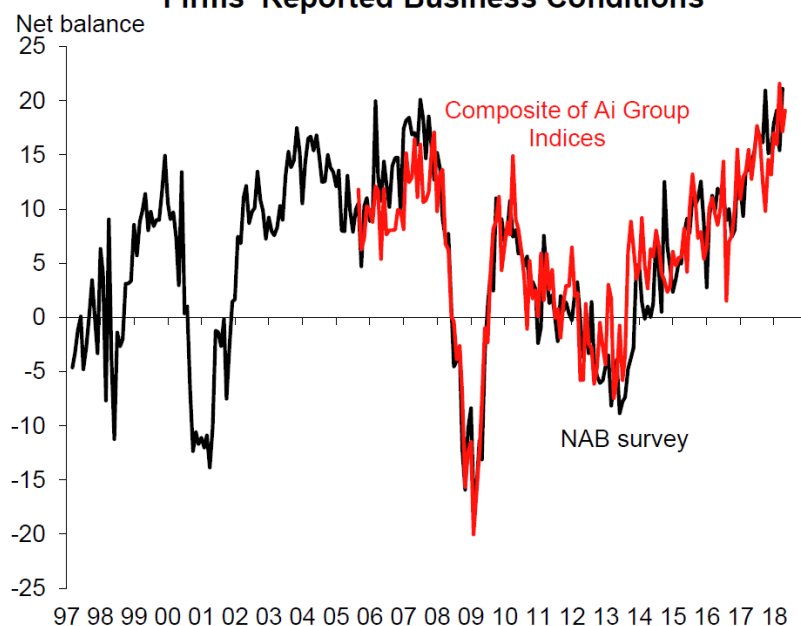
ABS Residential Property Price Index, March Qtr 2018, 11.30am

Thursday 21 June:

ABS Population, December Qtr 2017, 11.30am

Key Treasury Forecasts underlying Budget 2018-19:

Firms' Reported Business Conditions



Source: Ai Group, NAB, Macquarie Macro Strategy

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