When the Reserve Bank Governor says the Sydney property market is crazy, you have to take talk of a housing bubble seriously. And you don't have to live in Sydney to be concerned.

Governor Glenn Stevens' remarks last year helped fuel a national debate about house prices and affordability especially for first homebuyers, a debate that has only expanded since then.

While other property markets in Australia are definitely not in bubble territory, some of the remedies being discussed to tackle housing affordability have the potential to affect property investors wherever they live.

Definition of a bubble

So what is the definition of a housing bubble and are we there yet?
According to Investopedia, a housing bubble is a run-up in housing prices fuelled by demand, speculation and the belief that recent history is an infallible forecast of the future.

The website goes on to say that traditionally housing markets are not as prone to bubbles as other financial markets due to the large transaction and carrying costs associated with owning a house.

"However a combination of very low interest rates and a loosening of credit underwriting standards can bring borrowers into the market, fuelling demand."

Evidence of a bubble

So what is the evidence to support the bubble theory?
Property prices in Sydney grew by over 50 per cent in the five years to the end of 2015[i] while Melbourne prices have risen 26 per cent. Elsewhere in Australia, growth has been closer to 10 per cent over that period.[ii]

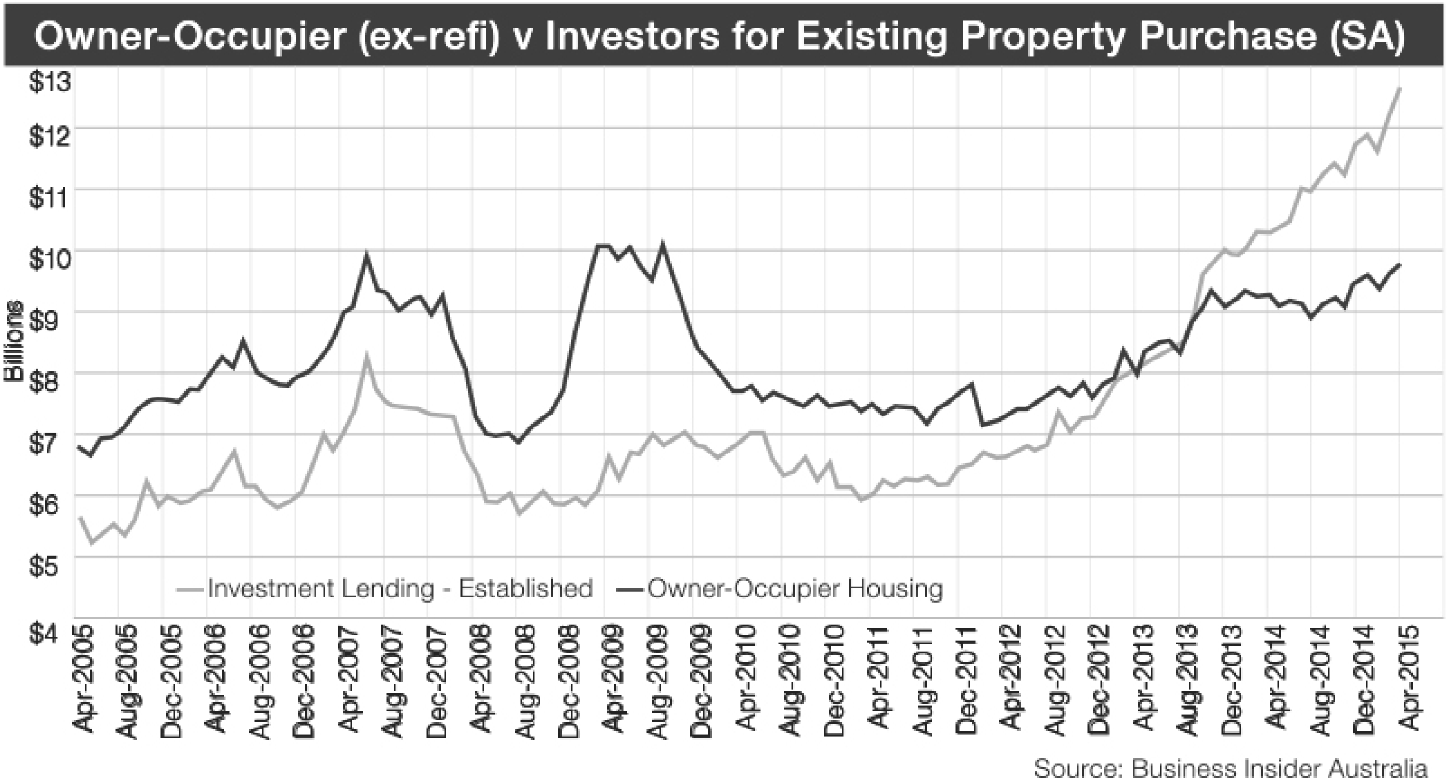
If there is a bubble, it's only in Sydney and Melbourne.
If you look at other cities' price growth rates, even as far back as 10 years, then Sydney and Melbourne are the only cities that deviate significantly from the national average.[iii]

Low interest rates

Another factor contributing to high demand for property is that interest rates are at historically low levels (the base rate is currently 2 per cent) with the possibility they could go even lower.

That in itself is a driver of the strong interest in property. After all, if interest rates on cash and fixed-interest investments are low, investors need to find better returns in other asset classes.

And that's why they are turning to property as well as high dividend-paying shares. As the chart below shows, investors are pushing owner occupiers out of the market, particularly first homebuyers.



Investors are flooding the market, not only because they are turning their backs on cash but also to benefit from the tax advantages of negative gearing.

Of course, historically low interest rates imply that ultimately they must reverse the trend and rise. When they do, many borrowers may find themselves struggling to meet the repayments on property bought at highly inflated prices.

Housing affordability

While it may still be possible to buy reasonably priced property outside Sydney and Melbourne, housing affordability is a key issue in Australia when compared with the rest of the world.

Using a common measure of affordability (comparing the median house price to household income), Australia stands at 6.4 times household income compared with 3.7 times in the US and 4.6 times in the UK . And Sydney is one of the most expensive cities in the world with affordability at a high 11.6.[iii]

To try and stem this strong demand in Sydney and Melbourne, the Australian Prudential Regulation Authority (APRA) has sought cooperation from lenders to tighten their criteria for lending to investors to dampen activity.

While the major players have complied, The Property Professionals of Australia's chair Ben Kingsley does not believe that this is a sound solution to cooling the market in the long term. And he questions applying this restriction across Australia when it is only Sydney and Melbourne where the issue applies.

Other suggestions to improve the affordability of property include scrapping stamp duty to make it easier for owner occupiers and removing negative gearing to reduce the number of investors.

Returns on property

The return on investment property comes from a combination of capital growth and rental income. Yet many Sydney properties have a net yield less than the cash rate of 2 per cent. This means the price-to-earnings (PE) ratio is 50 or above, compared with a PE of 15 for the Australian sharemarket. On this measure, Sydney property appears to offer less value for money than shares.

Over the long term, such low yields will not deliver the results that many investors, particularly those building wealth for their retirement, want.

In addition, property is a bulky asset. If you need to lay your hands on $50,000, you can hardly sell off the lounge room.

Whether or not you agree there is a housing bubble in Sydney and Melbourne is probably not the issue. Rather, concern should be focused on whether property, at current prices, stacks up as a long-term investment.

If you would like to discuss any of the issues raised in this article in relation to your investment portfolio, then call us.

i www.afr.com/real-estate/no-housing-bubble-but-sydney-gains-worrisome-says-hsbcs-paul-bloxham-20150610-ghkeu4

ii www.businessinsider.com.au/heres-how-sydneys-property-market-is-making-it-hard-for-the-rba-to-properly-help-the-rest-of-australia-2015-6 iii theconversation.com/blowing-bubbles-the-tricky-task-of-tackling-sydneys-property-market-42988

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