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FTMA Trussted Insight

WHY 2023 WILL BE CHALLENGING TO NAVIGATE FOR THE HOUSING SECTOR

WITH TIM WOODS OF INDUSTRYEDGE

IndustryEdge

Why 2023 will be challenging to navigate for the housing sector

The long tail of inflation will impact timber markets throughout 2023.

From Tim Woods at [IndustryEdge]

There was little shock when in early February the RBA announced a further 0.25% increase in the cash rate. Capital markets had factored the increase in and were broadly convinced further increases were unlikely. What surprised was the commentary from the RBA Governor Philip Lowe. In the typical language and tones of the economic undertakers, Dr Lowe's February statement made clear, further increases are likely:

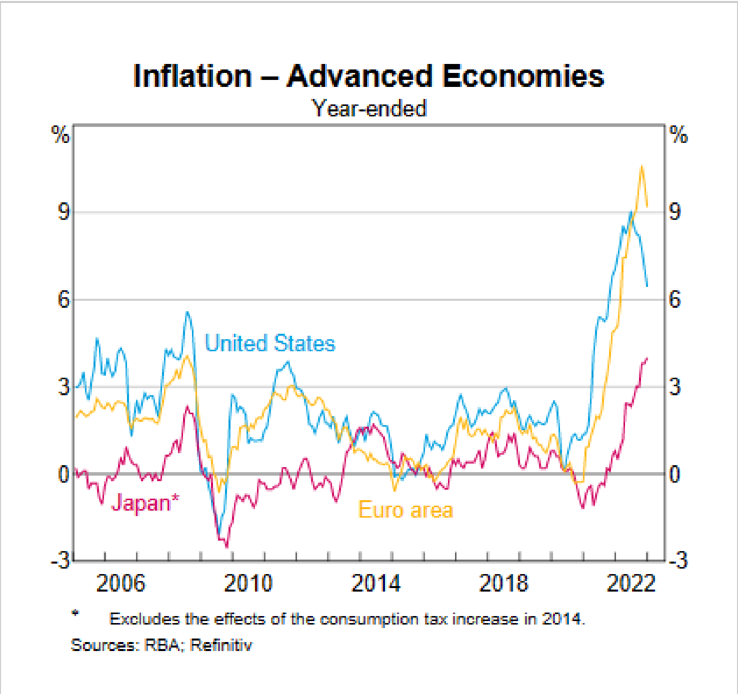
> "The Board expects that further increases in interest rates will be needed over the months ahead to ensure that inflation returns to target and that this period of high inflation is only temporary. In assessing how much further interest rates need to increase, the Board will be paying close attention to developments in the global economy, trends in household spending and the outlook for inflation and the labour market."

Not exactly a shock, perhaps, but a surprise nonetheless. After all, other major economies appeared to be turning the inflation corner, especially in the US.

So, it is important to understand the differences in timing between the large economies of the Northern Hemisphere and the largest developed economy in the deep South (that's Australia, by the way). Australia has a globally integrated economy. It can create its own economic messes, but it cannot shield itself entirely from the conditions in the global economy with which it engages.

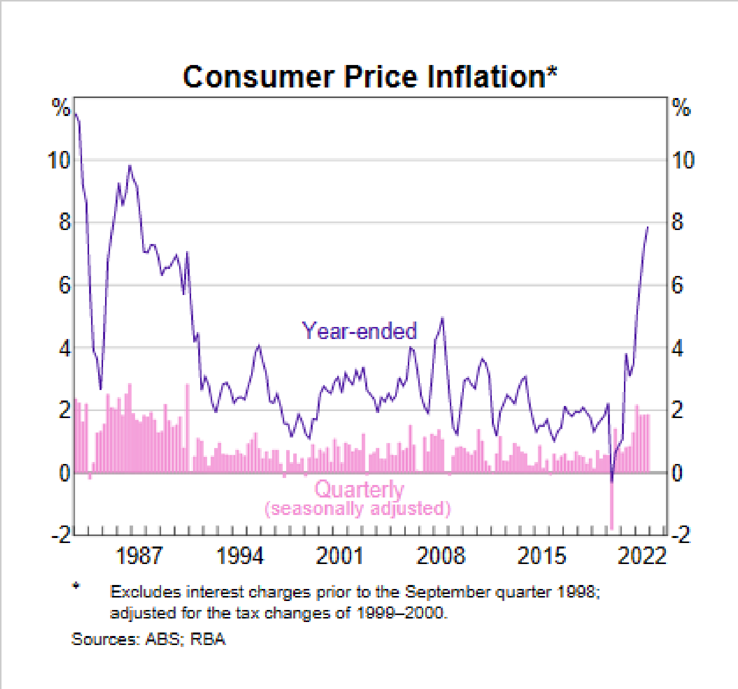
Inflation trends are global, not local

In this first chart we can see the main global inflation trends – for the US, the EU and Japan. We can see that the US and the EU appear to have turned the inflation corner in the last two to three months.



Source: ABS

The recent experience has been one where inflation in Australia has lagged the global economic leaders, but is closely correlated to them, over time, as the second chart shows. That might mean that while the rest of the world sees a dip in inflation now, Australia may well wait another three to six months for the same experience.



Interest rates still moving in response to local inflation

We have discussed this previously, but at its simplest, interest rates are a mechanism to bring inflation under control. Higher payments on things like mortgages removes money from the economy, which can turn prices down and in particular, slow prices growth.

In early February, the RBA lifted the official cash rate to 3.35%, the ninth successive increase over just ten months.

There could be a lot to say about interest rates, their use and where the pain of 'monetary policy' is often felt, but for our purposes here, it is enough to call out two points:

- There is no certainty of the timing or extent to which interest rate increases will slow prices growth, and
- Interest rate increases always have a big impact on the housing sector, both for established dwellings and new builds.

Daily, the news tells us about house prices declining and mortgage stress increasing. This is real in the economy and very real in our society. Concerns about property prices invade every conversation. Unless that conversation is about the unavailability of rental properties. That also is a topic for another day.

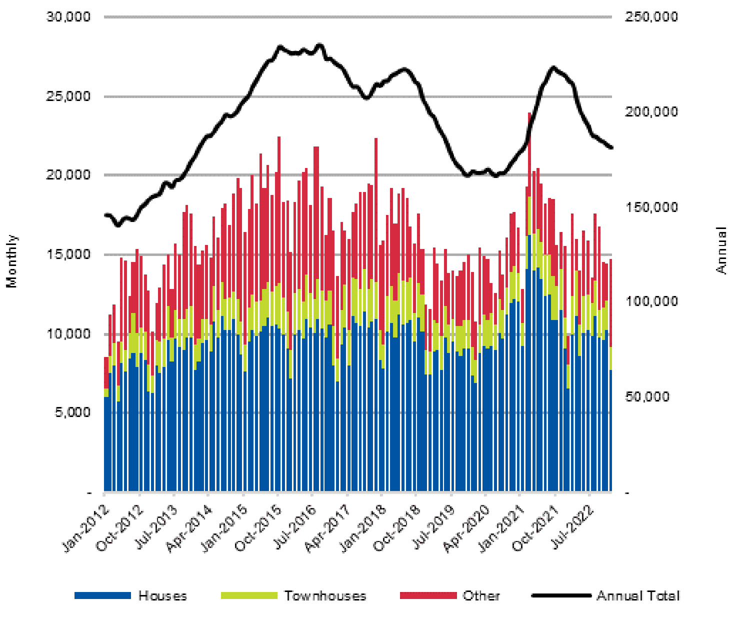
Monthly, the news includes stories about the declining rate of approvals for new builds. That is where our focus lies, because it is here that the real work of the future lies, especially in free-standing houses and the ever-growing stock of townhouses. One reason for slowing approvals is the higher prices and uncertainty created by price inflation. Those seeking to build a house become concerned – understandably – that the cost of the build will increase further and perhaps beyond the value of the house. Most of all, they worry they will not be able to afford the mortgage repayments, as interest rates rise.

Little wonder then that approvals for new dwellings began to cool right around the period when interest rates began to rise.

Market reacts to even the hint of higher interest rates

Here we can see approvals on a monthly basis since 2012. If we are searching for a take-out from this standard data, it might be that unlike inflation in Australia, which lags the world, the very sniff of an interest rate rise cools the local market for new dwellings.

Australian Dwelling Approvals by Main Type: 2012 – 2022 (Number)



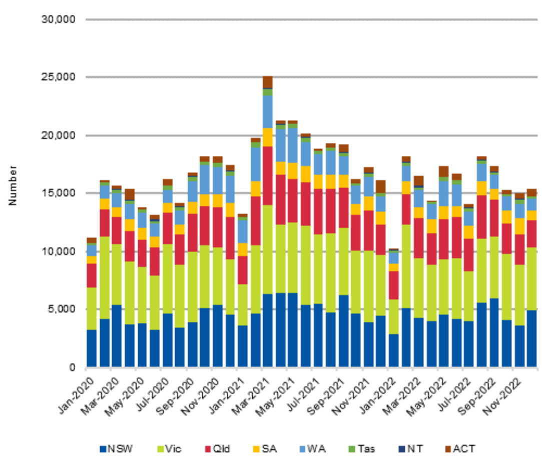
Source: ABS and IndustryEdge

	Houses	Townhouses	Other	Annual Total
2021	148,446	27,668	43,272	219,386
2022	114,821	24,969	41,883	181,673
% Change	-22.7%	-9.8%	-3.2%	-17.2%

We are often asked about the differences in approvals around the states and territories, which can be seen in the next chart. There are significant differences, some of which are explained by land releases and banking strategies in different states, minerals resources projects in states like Western Australia, government housing expenditure in the Northern Territory and so on. Net interstate migration is also important, as is the end-destination of international migrants.

This chart is presented over a much shorter timeframe, to show recent movements more clearly.

Australian Dwelling Approvals by State: 2020 – 2022 (Number)



Source: ABS and IndustryEdge

	NSW	Vic	Qld	SA	WA	Tas	NT	ACT
2021	62,779	71,332	43,513	14,799	25,562	3,986	638	5,647
2022	53,312	61,861	35,357	12,874	16,264	3,170	671	5,387
% Change	-15.1%	-13.3%	-18.7%	-13.0%	-36.4%	-20.5%	5.2%	-4.6%

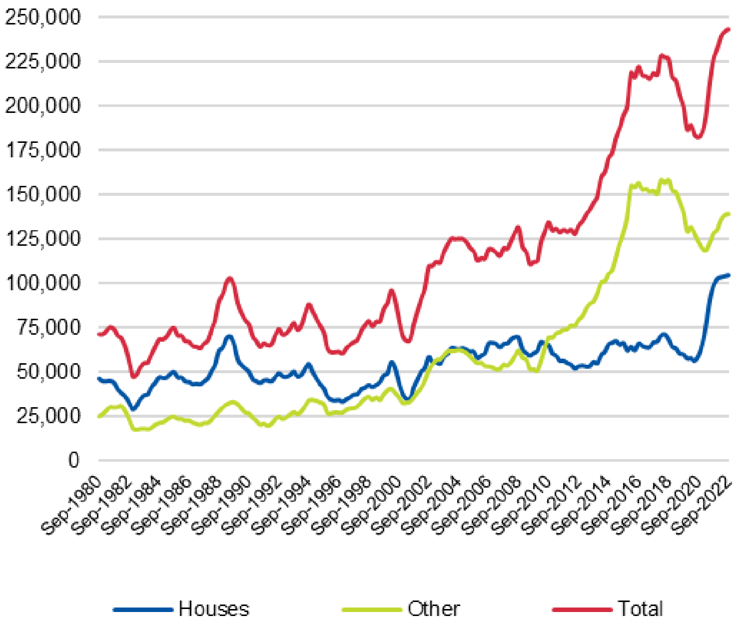
The bottom line is there are differences between the states, but on a medium-term basis (say two years or more), they are fairly hard to predict.

Overall, higher interest rates are driving lower approvals. That has been going on for some time, so we could be forgiven for expecting the pipeline of building work was diminishing. But not yet, as the next charts demonstrate.

How could the pipeline of work still be growing?

At the end of September 2022 (the latest pipeline data), Australia had a total 243,542 dwellings under construction. Both houses (104,331) and all other dwelling types (139,211) were at record levels. That is, despite moderating approvals, housing under construction grew in the September quarter.

Australian Residential Housing Pipeline by Main Type: SQ'80 – SQ'22 (Number)



Source: ABS and IndustryEdge

The simple fact is the housing supply chain is struggling to keep up with demand and the pressures of too much work. There is a terrible danger in this form of economic 'friction', because it runs counter to the basis on which the supply chain has made its assumptions and decisions, including on pricing.

What happens when the delays cause materials or utility (e.g. electricity) costs to increase, create coordination problems increasing finished stock not yet delivered or paid for, increase the number of visits that must be made to site or the wait time at sites? A larger pipeline of work than the system of supply can handle is one ingredient in the current 'profitless boom'.

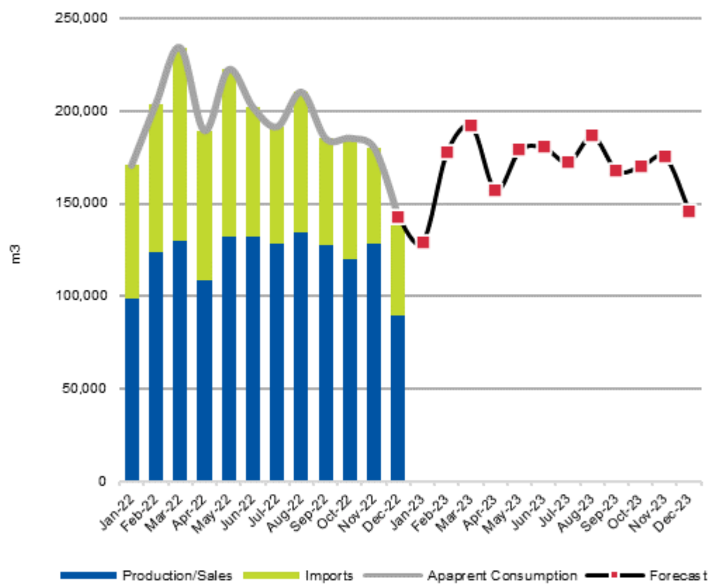
Latest timber demand forecasts point to stability

Ultimately, an elevated level of building activity means higher than average levels of demand for building materials, including wood products, will continue until at least the end of 2023 and probably a time beyond that.

That can be seen in IndustryEdge's latest twelve month forecast for sawn structural softwood consumption. As the chart below demonstrates, consumption has certainly softened from the first half of 2022, when on a monthly basis, it appeared to peak around the 240,000 m^3 per month mark.

It is 2023 that provides us most interest. There are softer months (January for instance), but overall, the forecast shows monthly consumption will be fairly stable, out until the end of 2023.

IndustryEdge Forecast Sawn Softwood Demand: Jan '23 – Dec '23 ('000 m^3)



Source: IndustryEdge based on FWPA and ABS

If the IndustryEdge consumption forecasts hold true, there will be adjustments to supply over time, but there will not be a massive excess of structural timber looking for a home.

That will, of course, impact sawn timber pricing.

Latest timber prices remain elevated

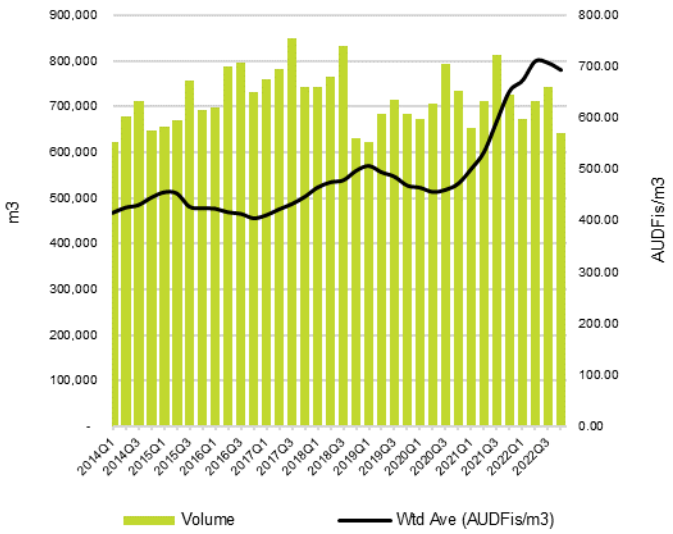
There are two sets of timber prices that theoretically move independently of each other – local supply and import supply. The reality of the market is of course that the supply dynamics mean prices tend to move, overall and over time, in fairly similar directions.

Here, we address both the important local supply prices, using the most up to date available data for each.

The first chart (next page) shows the quarterly weighted average prices for locally supplied sawn structural softwood timber. Note this includes all grades of structural timber and is based on East Coast data.

Although the weighted average price came off the peak (down 1.9%) in the December quarter of 2022, the price is still 6.2% higher than a year earlier and more than 46% higher than two years earlier.

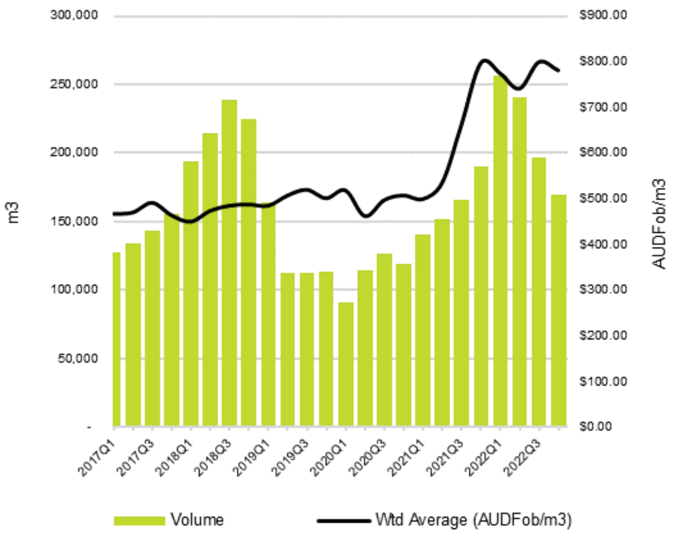
Australian Sawn Structural Softwood Timber Prices: MQ'14 – DQ'22 (m3 & AUDFis/m3)



Source: FWPA and IndustryEdge

The second chart shows the weighted average price of imports of sawn structural timber since 2017. The specific prices are not exactly comparable because they are measured at different points in the supply chain. However, the similarities in the price trajectory are clear.

Imported Sawn Structural Softwood Timber Prices: MQ'17 – DQ'22 (m3 & AUDFob/m3)

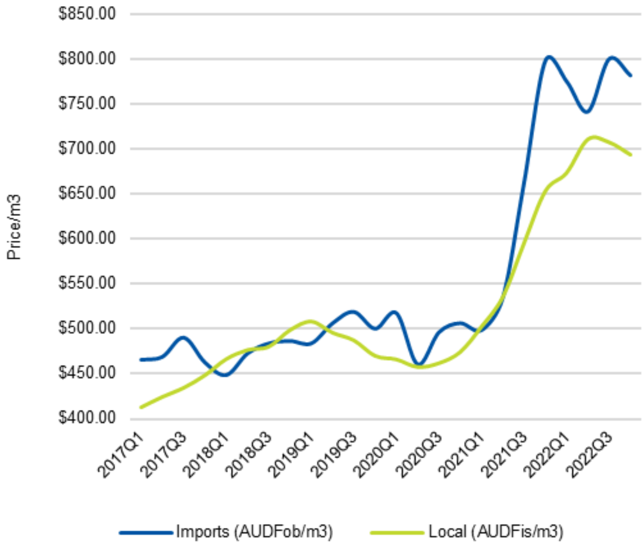


Source: ABS, FWPA and IndustryEdge

Compared to the peak, weighted average import prices in the December quarter of 2022 were down 2.3% and were down 2.1% compared to the December quarter in 2021. Compared to two years earlier, prices are still up over 54%.

As this final chart (next page) shows, those price trends are similar, but not the same.

Comparison of Weighted Average Structural Timber Prices: Import v Local: MQ'17 – DQ'22 (AUDFob/m3and AUDFis/m3)



Source: ABS, FWPA and IndustryEdge

Impact of inflation lingers longer than the headlines

There is some prospect of inflation softening in 2023. Most commentators expect it, and as we observed at the outset, the world appears pointed that way.

However, Australia tends to lag the international conditions and right now, there are few pointers that could provide comfort about general prices coming down in Australia, in the near term.

That appears to be the case for timber prices, as much as other materials, especially because there is a large amount of work yet to be done and plenty of uncertainty about exactly when that building might occur.

Unfortunately, a complex housing market is no clearer in 2023 than it was for most of 2022. The mists may clear later in the year and wouldn't that be welcome?

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