



## Impacts from falling home prices – the wealth effect

September 2022

### Key points

- > Declining home prices will have a negative impact on household wealth as 65% of wealth is related to housing.
- > Lower household wealth is negative for consumer spending – something known as the “wealth effect”.
- > Consumer spending is holding up for now thanks to high household accumulated savings, housing prepayments, a shift in spending from goods to services and lags from interest rate rises to changes in housing debt payments.
- > However, this won't last forever. A negative wealth effect, rising interest rates constraining household purchasing power, high inflation and poor consumer confidence will be negative for consumer spending in 2023. We see consumer spending growth declining to under 1% per annum by late 2023 – well below its long-run average level of around 3% per annum.

### Introduction

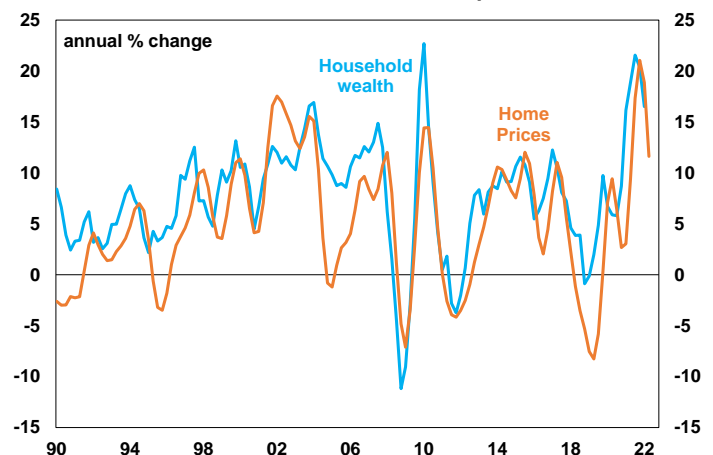
The impacts of interest rate hikes on consumers are well known: higher interest means that mortgage debt servicing costs will go up which is negative for consumer spending. But, rate hikes are also bad news for home prices which will create another negative for households via the destruction of wealth and the associated “wealth effect”. We look at the impacts from falling home prices on the consumer in this *Econosights*.

### Housing as a source of wealth

Household wealth is a measure of the value of physical assets owned like homes and the land they sit on and business premises as well as financial assets like shares. Housing is both a source of wealth but also a form of consumption. Households can be a home owner while non-home owners “consume” housing through paying rent. As a result, changes in home prices do not have an equal impact across households, which can make measuring a direct wealth effect difficult. For example, higher home prices are positive for investors and home owners with no plans to upgrade but are negative for households looking to get into the market or upgrade. Renters may also be worse off as higher home prices could lead to higher rents. However, the composition of home ownership in Australia means that the majority of the population benefits from higher home prices, with 2/3 of households (or around 7 million households) either owning a home outright or paying a mortgage.

Housing is the largest single source of wealth for households, at 65% of total household wealth. The chart below shows the close relationship between home prices and wealth, with periods of rising (or falling) home prices also coinciding with increasing (or declining) household wealth.

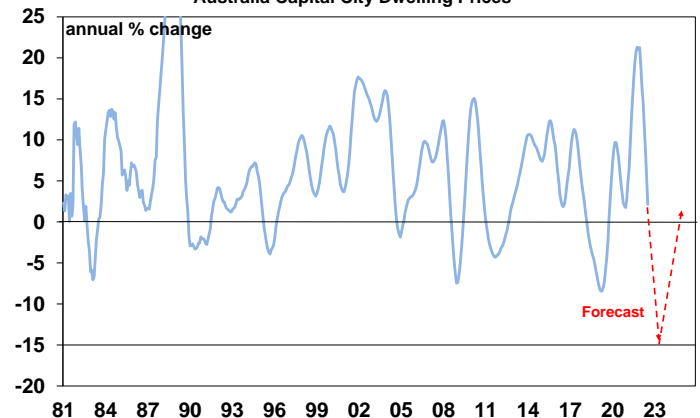
Household wealth and home prices



Source: ABS, AMP

National home prices peaked in April 2022 and have fallen by nearly 5% to mid-September, and we expect a peak-to-trough decline in prices of 15-20% with prices declining into 2023 before stabilising late next year. Home prices are declining from a combination of: higher mortgage rates from RBA rate hikes and expectations of further rate rises (which has lifted fixed mortgage rates nearly 3 times from early 2021 levels and variable rates are rising further), poor affordability (especially in Sydney and Melbourne) as prices ran up hard over 2020/21 and a lift in supply in Sydney and Melbourne as we come into the spring selling season. Our expectations for a further fall in home prices means we also expect household wealth to decline.

Australia Capital City Dwelling Prices

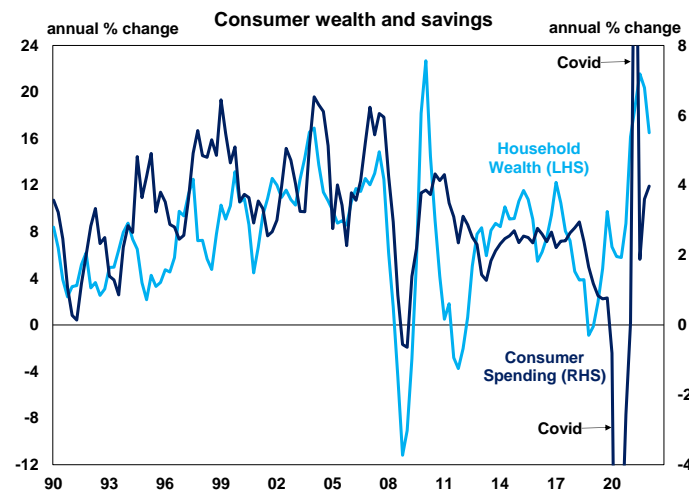


Source: CoreLogic, AMP

### The wealth effect

The “wealth effect” is an economic concept referring to a change in consumer spending following an adjustment to household wealth. The historical relationship between wealth and consumer

spending shows that rising wealth coincides with rising consumer spending and vice versa (see the chart below) and intuitively this makes sense – when you feel like your assets are worth more, you feel more confident to spend.

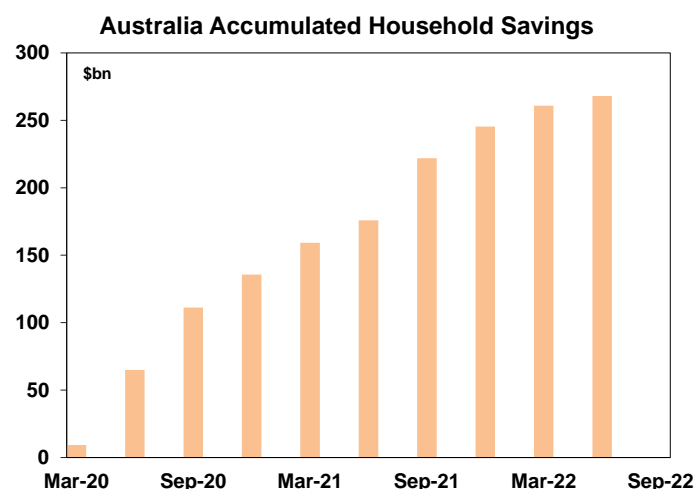


Source: ABS, AMP

Our expectations for declining home prices in 2022/23 and, as a result, household wealth, means that consumer spending growth will also slow. We expect a weakening in consumer spending to just under 1% (year on year) by December 2023 which will weigh on GDP taking it well below normal levels of around 3% growth in consumer spending.

The wealth effect may also show up in timely motor vehicle sales figures. So far, motor vehicle sales are still holding up and are up 17.3% on a year ago as at August.

In the short-term, household consumption may hold up despite rising interest rates and lower wealth because of high household savings. Coming into the rate hiking cycle, households were in good shape with high accumulated savings (worth \$270bn – see the chart below) from fiscal support payments handed out by the government during the pandemic, interest rate cuts in 2020/21 and lower-than-usual services spending over the past two years. Cashed up households have also meant that housing prepayment buffers are high (RBA research suggests ¼ of variable mortgages are more than 3 months ahead on repayments) which the risk of missed payments/bad loans as interest rates go up.

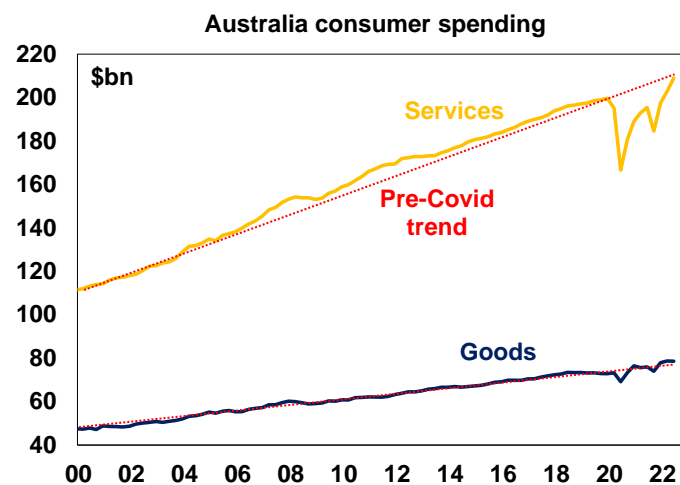


Source: ABS, AMP

Household spending is also benefitting from higher spending on services, as households get back to doing pre-Covid activities.

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Despite the cost of living pressures on households (rising interest rates and high inflation) and negative impacts of declines in household wealth, services spending may rise further in the short-term from the reopening of the Australian and global economies. The chart below shows that services spending is only now getting back to its pre-Covid trend.



Source: ABS, AMP

### Other impacts of falling home prices

There are also other impacts of falling home prices including:

- **Higher risk of negative equity loans** (which means that the market value of the home is less than the debt taken against the home) which increases the risk that the household will default if they can't repay the debt by selling the property.
- **Lower bank profitability and increased risk of bank stress.** Declines in home prices mean lower lending which is negative for banks as housing makes up 60% of bank lending. Falling home prices also increases the risk of defaults, as explained above, which means that banks could take a hit to their capital. The loans which are most at risk are those with high loan-to-value ratios but the share of new lending to these areas is low (at around 5% of new lending).

### Conclusion

So far, consumer spending has held up well in Australia despite high inflation (especially on essential items), rising interest rates (a total of 2.25% since May), a collapse in consumer confidence and the negative wealth effect. Spending is holding up thanks to high household savings, housing prepayments, a shift in spending from goods to services and lags of changes in RBA interest rates to minimum housing repayments. In our view, consumer spending is set to slow down significantly in 2023 as consumers start to feel the impacts of rate rises, household wealth deteriorates and accumulated savings decline.

On our forecasts, annual growth in consumer spending will be under 1% by late 2023, well below its usual levels of around 3% per annum. This will weigh on GDP growth (household consumption is over 50% of GDP) and we see GDP growth slowing to under 2% per annum by late 2023.

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