"Tell a European you think there's a housing bubble and you'll have a reasonable discussion. Tell an Australian and you'll have World War III. Been there, done that!"

Jeremy Grantham

"Home prices are a function of income and the leverage applied."

Michael Burry

There is a common perception, particularly among Australians, that property - "bricks and mortar" - makes the best investment. It's "secure" and tangible. You can touch it; it's not going anywhere. And when Australians think about property they typically think about residential property. But just how safe is this asset class?

There are currently almost $600 billion[1] of interest-only loans on Australian residential property, accounting for 40% of residential housing lending. Whilst 64% of investor loans are interest-only (encouraged, no doubt, by the magic pudding of negative gearing), what is more disturbing is that 23% of owner-occupier loans are also interest-only. There is no rational reason to defer the repayment of non-deductible debt (such as that on a principal residence) which suggests that financial stress is the reason for this choice.

Prompted by APRA (and perhaps their own assessment that the residential housing is in the late stages of a bull market) banks are currently stamping down on interest-only loans. They are imposing higher interest rates on new ones than they are on principal and interest loans and refusing to roll over existing ones when their terms expire. If a bank insists on a borrower rolling an existing interest-only loan over to a 25-year principal and interest loan, the minimum monthly repayment rises by forty percent![2] Throw in a one percent rise in the mortgage rate and the monthly repayment is 55% higher. If an owner-occupier is struggling to meet mortgage payments to the extent that they opt for an interest-only loan, what are the chances they are able to absorb a 55% rise in their monthly loan repayments?[3]

Asset bubbles are only able to persist because of the availability of credit. Without it there would be insufficient demand to push prices higher. And so it is with Australian residential property. Over the past decade wages growth has been stagnant, but the price of residential housing has risen

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[1] This is more than the combined market capitalisation of the "big four" banks plus BHP Billiton, Telstra and Woolworths.

[2] Based on a mortgage rate of 5%.

[3] RBA data suggests that around a third of housing borrowers have less than one month's buffer to their mortgage payments.

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relentlessly, and in lock-step with the level of household debt. Take that punch-bowl away, as regulators and banks appear to be starting to do, and we might begin to wonder just how safe "bricks and mortar" is as an investment.

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