Abstract

One of the puzzles of the late 2000s is the sharply contrasting performance of the US and Australian housing markets. The US market suffered a sharp fall in values, while prices actually rose in Australia. In terms of price-to-income (PY) ratios, the Australian market appeared more over-valued. However, there is no theoretical basis for PY ratios, or equivalent models based on PY ratios, being used as a metric for assessing the long term equilibrium or fundamental price for housing. And the empirical evidence is weak, notwithstanding the experience of the US in the 2000s. The equity market is assessed in terms of price-to-earnings (PE) ratios or earnings yields, relative to some premium over the risk free rate as per the real bond yield in so-called US Treasury Model. Alternately Campbell and Shiller (2001) define a long term average of the earnings yield as equilibrium and describe a tendency for deviations from this long term average to be mean-reverting. While housing tends to be treated as different, there is a growing literature that also applies this standard asset pricing theory to housing. This paper looks at long term estimates of the gross (and net) rental yield for housing in the US and Australia, focusing on the period 1960-2010. It then looks at the various periods when the rental yields have deviated from the long term means and whether explanations can be found in terms of fundamentals, e.g. high real interest rates in the 1980s in Australia, or whether ‘irrational exuberance’ is the explanation as in the US in the 2000s. This also gives a framework to discuss the factors (China/resources boom, differences in monetary policy) that contribute to the sharply contrasting experiences of the US and Australia in the second half of the 2000s.


December 2010
Figure 1: US Gross dwelling rental yield 1959-2009

Figure 2: Australian gross rental yield 1960-2010