

Spreadsheets and Tables to Assist in the Rent Vs Buy Decision

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With the amount of spruiking and propoganda around at the moment, it's definitely time to update the discussion of this issue and provide a few more tools to assist potential buyers (including some other work that I published in the blog section of my website).

Firstly, interest rates set by the RBA have indeed dropped a lot – as have mortgage rates. I admit to being surprised that mortgage rates dropped as much as they have – but that probably needs to be seen in the context of political jawboning (compare this with the forgotten small business owners who have seen very little interest rate easing) and the sensitivity of banks' profitability to residential housing (and any collapse).

After the last interest rate reduction, banks signalled that they would be unable to pass on cuts in full to mortgage rates – that is because they are highly dependent on international providers of credit who currently require a significant premium. So, mortgage rates much below 5% are unlikely. Moreover, these tight international credit conditions are unlikely to change in the short term – in fact, there is every chance that this could get worse as the impact of the financial crisis on Australia becomes clearer.

This could ultimately force our mortgage rates up. But for the purpose of this report, I'll stick with the mortgage rate scales that I used in the original report.

The first component is simply a repeat of the spreadsheets showing the amount of deposit required to maintain the same standard of living when purchasing a home for \$x when paying rent of \$y/fortnight.

The second component is an update of data published in the blog section of my website which shows the premium paid (in fortnightly costs) to buy the median priced home in each Aussie capital over renting it.

And the third component is a simple comparison of several scenarios that may help a first home buyer to weigh up whether it is better to continue to save a deposit over the next two years.

Updated Excel spreadsheet can be downloaded from my website at www.geocities.com/homes4aussies/renvbuy2.xls

At the end I have also included some interesting new research on the challenges confronting first home buyers.

Results

Table 1 contains the cost of living gap for variously priced homes at various rents at a mortgage rate of 5% which approximates current standard variable rates in the mortgage market (tables for other mortgage rates are in the spreadsheets).

Table 1 – Cost of living gap at an interest rate of 5%.

	Rent paid/fortnight								
	\$ 500	\$ 550	\$ 600	\$ 650	\$ 700	\$ 750	\$ 800	\$ 850	\$ 900
Loan Equivalent	\$148,809	\$167,410	\$ 186,011	\$204,612	\$223,213	\$241,814	\$260,415	\$279,017	\$297,618
House Price									
\$ 150,000	\$ 8,691								
\$ 200,000	\$ 61,191	\$ 42,590	\$ 23,989	\$ 5,388					
\$ 250,000	\$113,691	\$ 95,090	\$ 76,489	\$ 57,888	\$ 39,287	\$ 20,686	\$ 2,085		
\$ 300,000	\$166,191	\$147,590	\$ 128,989	\$110,388	\$ 91,787	\$ 73,186	\$ 54,585	\$ 35,983	\$ 17,382
\$ 350,000	\$218,691	\$200,090	\$ 181,489	\$162,888	\$144,287	\$125,686	\$107,085	\$ 88,483	\$ 69,882
\$ 400,000	\$271,191	\$252,590	\$ 233,989	\$215,388	\$196,787	\$178,186	\$159,585	\$140,983	\$122,382
\$ 450,000	\$323,691	\$305,090	\$ 286,489	\$267,888	\$249,287	\$230,686	\$212,085	\$193,483	\$174,882
\$ 500,000	\$376,191	\$357,590	\$ 338,989	\$320,388	\$301,787	\$283,186	\$264,585	\$245,983	\$227,382
\$ 550,000	\$428,691	\$410,090	\$ 391,489	\$372,888	\$354,287	\$335,686	\$317,085	\$298,483	\$279,882
\$ 600,000	\$481,191	\$462,590	\$ 443,989	\$425,388	\$406,787	\$388,186	\$369,585	\$350,983	\$332,382

Currently the median priced house in most Australian capitals is \$400,000 or more, and the median rent is around \$350 per week. If you look at the cell corresponding to a \$400,000 house which rents for \$700 per fortnight you will see that you would need to have a massive deposit of almost \$200,000 to buy that house and enjoy the same standard of living as you do renting it! This is a clear demonstration of just how inflated are the prices of our houses!!

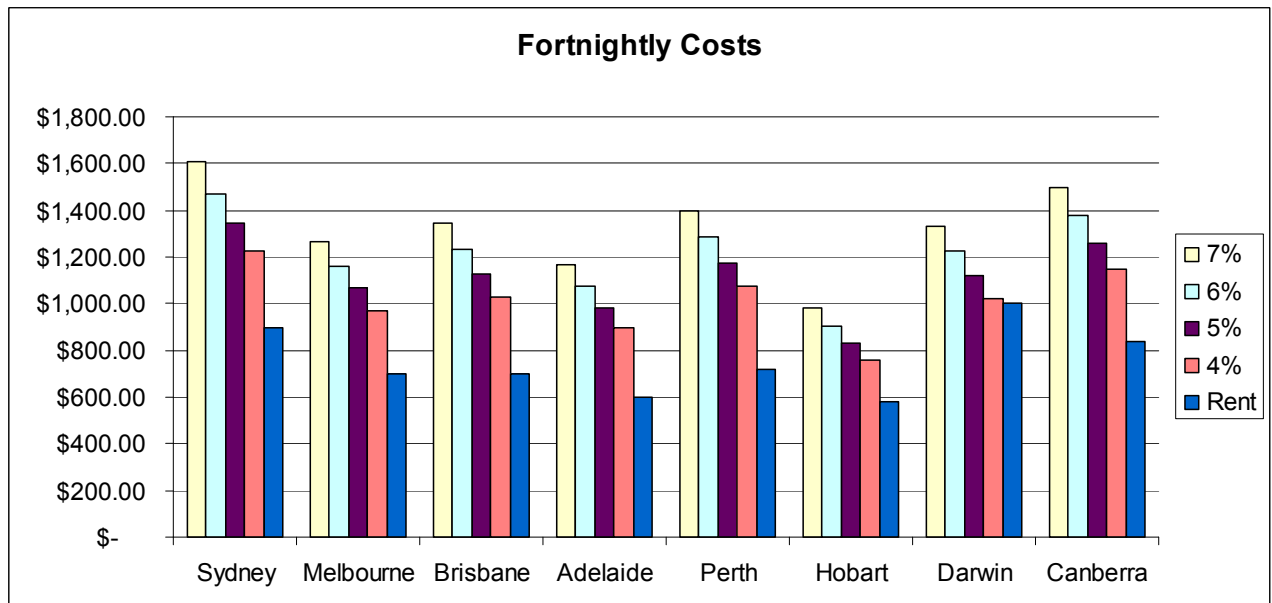
And let’s not forget, this is calculated at **a mortgage rate of 5%** - this was unheard of just 12 months ago! More to the point, just how long will they stay at this level if we get the surging inflation many predict?

Clearly, and as the RBA has frequently pointed out, the cause of the housing affordability crisis in Australia is not interest rates – it is the house price bubble. Houses are massively overpriced! Of course this has not prevented the RBA from recently changing tact and joining the ranks of the spruikers suggesting that the affordability crisis has been solved by lower interest rates – note to Glen: if rising rates didn’t cause the crisis, lowering rates will not solve it!

As all readers of my website know, affordability will not return to Australia’s housing markets until the cost of living gap is reduced by falling house prices. It’s just the simple reality of the market.

Now when you look at the affordability issue in terms of fortnightly expenses, you find that the massive propaganda blitz of recent weeks that “renting is more expensive than buying” is just a complete load of baloney (should we be surprised? Of course not – but it was interesting to see Rory’s mob join in the blitz – perhaps they’re worried he might not be up to the Kosciusko hike ;-)

Graph 1 shows that it is much cheaper to rent the median home than buy it in all Australian capital cities, even at these record low interest rates, with the exception of Darwin. And it needs to be highlighted that this analysis assumes **a deposit of 10% ontop of the first home owners grant and boost**. Clearly, the gap would be larger again if the buyer had a lesser deposit!



Graph 1 – The fortnightly expense of buying the median priced home versus paying median house rent in all Australian capital cities at various mortgage rates.

If mortgage rates were to get as low as **4%**, under these conditions (most critically, a 10% deposit) the fortnightly expense of **buying is still 136% to 150% of the expense of renting** in all Aussie capital cities with the exception of Darwin – so it costs one-third to one-half more. And that is at a mortgage rate that I do not think is achievable (given the cost of foreign credit), let alone sustainable!

Somebody wisely looking at fixing their repayment costs over 10 to 15 years would be looking at a rate of 7% - which is a reasonable estimate of average mortgage rates over the long term – will note that the fortnightly expense of **buying is 170% to 195% of the expense of renting** in those same capital cities!

Now, spruikers will say that this is calculated on houses, not apartments. But the reality remains that over two-thirds of all first home buyers still buy houses (it used to be that 85% bought houses, until the affordability crisis caused young Aussies to compromise on, perhaps in their own mind just delay, their housing aspirations – I’ll explain a little more later.)

The final comparison is the scenario analysis and the results are summarised in Table 2.

Scenarios	Repaid in full
Buy now and make minimum repayments	March 2034
Scenario 1 – buy now, make extra repayments as if mortgage rate was 8%	January 2029
Scenario 2 – buy in 2 years, prices flat, rent increases \$20 in year 2, no FHB boost, repayments same \$ amount as in Scenario 1.	April 2029
Scenario 3 - buy in 2 years, prices decrease 10% pa, no rental increase, no FHB boost, repayments same \$ amount as in Scenario 1.	April 2022

Table 2 – results of the scenario analysis.

Really, what we are looking at is when the buyer will own their home outright – that’s what it boils down to. This translates to a whole heap of other things – like building up equity to be used

(hopefully) wisely, eg. to build further wealth for a comfortable retirement, and to fulfil important personal and family ambitions such as providing children with a great start in life.

I think one of the most important things this analysis shows is just what a significant commitment it is to buy a home. Somebody buying a home now with a 25 year loan term and making minimum repayments right through will not own their home until March 2034.

The other interesting outcomes are these:

- A) There is virtually no advantage to buying a home now, including with the extra \$7,000 “boost” from the government, over buying in two years time if house prices remain flat and rents increase modestly, if the savings from renting over buying are diligently saved; and
- B) There is a very significant advantage to be gained by buying in two years time, over buying now including with extra \$7,000 “boost”, if house prices fall and rents remain flat. In this example, the buyer owned their home outright about 7 years earlier by waiting two years rather than buying immediately and making extra repayments.

Now critics will say this does not include a scenario for prices increasing – well, the thing is, I have not heard anybody suggesting that Aussie house prices will go up in the next couple of years. Actually, some of the most bullish commentators on the Australian housing market that I know are forecasting a fall of 10% this year. And it is clear that the fall out from the global financial crisis has a long way to run – it’s important to remember that unemployment does not peak until well after the recession ends – eg. in the recession of the early 1990s unemployment peaked around 2 years after the recession ended (ie. the economy returned to growth).

In my own honest view, 10% pa falls over the next 2 years is conservative – I actually think that falls will be closer to 14% pa, perhaps more – and I would not be surprised in the least if rents began to fall (reasons for these forecasts are amply explained on my website.)

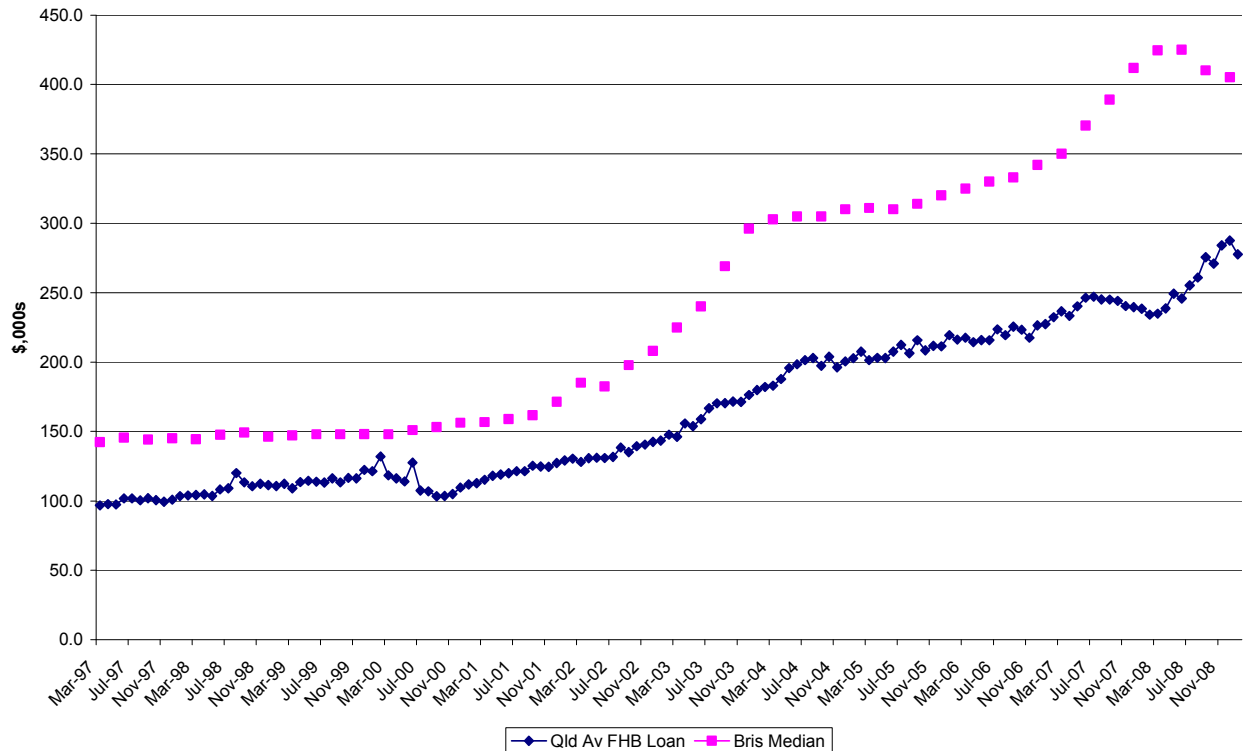
Whilst we can only make our best judgment on what will happen in the future, taking account of all of the information at our disposal, one thing is absolutely certain right now – renting is by far and a way the most economically sensible decision for Australians who have not yet purchased a home!

What’s more, as the experience of overseas housing markets – together with the scenario analysis - clearly shows, there is potentially much to be gained by patiently accumulating a greater deposit and observing the market.

Concluding comments about the situation confronting first home buyers

I just want to share some preliminary work that I’m analysing at the moment – it relates specifically to Brisbane, and I will eventually include it in a revision of my paper “what really is happening in the Brisbane market” – but it is a fairly nice example of what has confronted first home buyers over the last decade.

Below is a graph of the median Brisbane house price and the average first home buyer loan (data from the ABS) going back to March 1997.



Graph 2 – Average Queensland first home buyer loan and Brisbane median price (data from ABS)

Notice that up until 2001, when the housing bubble first arrived in Brisbane, the gap between the average first home buyer loan and the median price was consistently close. Through this period the median home was around 20-40% more than the average first home buyer loan – in one month the gap was only 18%.

Looked at in another way, a first home buyer taking on the average loan in this period was able to afford the median home if they had a deposit in the range of 25-35%. That might sound like a fair bit now, but you need to remember that houses were one-third the price, and wages were way more than one-third current levels! At the time it was a deposit of around \$40,000.

Not all would have had such a deposit, but we can assume that from 1997-2001 a great majority of first home buyers were buying median-equivalent homes or very close to it.

Notice how the gap between those lines opens up after 2001 and follow that through to March 2008, the peak of the affordability crisis in Brisbane. At that point, the median home was over 80% more than the average first home buyer loan! And a first home buyer taking out the average first home buyer loan and purchasing the median priced home needed a deposit of \$210,825 !!

(By the way, notice that these numbers are starting to sound similar to numbers mentioned earlier – that should be of no surprise – because the relationship between rent and purchase price should be relatively consistent over time – though I was pleased by how close reality came to my modelling.)

This is yet another indication of just what a massive bubble we've experienced. Clearly, very, very few first home buyers have been buying anywhere near median home equivalents. And Fujitsu Consulting surveys of first home buyers certainly proves this to be correct with their data showing that in January 2009 the average first home buyer purchase price in Brisbane was \$291,000 (Martin North, Fujitsu Consulting, personal communication).

And this is the final point I want to leave the reader with – isn't that a great thing for the real estate industry? – they've sold young Aussies on the "property ladder", and they aim to reap those rewards for many years to come as the many that purchased well below their desired level of housing look to upgrade. Here's the rub – the young Aussies that fell under the spell of the bubble spent so much on their initial purchase they are really going to need to commit a very large part of their future earnings to paying off that home, and may well be so cheesed off – particularly with house prices remaining subdued for a prolonged period – that they never do take the decision to upgrade.

As I've said elsewhere, I believe firmly that the best strategy is to save a large deposit and purchase one home with the intention of it satisfying the buyer's (foreseeable) needs throughout their life – and minimise the amount of money that is gifted to the property "hangers on" – I'm sure the buyer and their family will have a much more deserved use of that money in mind!!

Method and Assumptions

1. Deposit needed to maintain same standard of living when renting

It is a pretty simple process and there are few assumptions. For interest, some may want to calculate their exact current position. So here is how you do it.

Firstly, take your fortnightly rent and subtract from that the cost of home ownership that you would be subjected to if you purchased. For simplicity, I chose a constant \$100/fortnight irrespective of the price of the house. Now this is extremely conservative - \$2,600 a year for council rates, water, extra insurances, and upkeep. (You might want to increase this.)

Then go to a website that will allow you to calculate the mortgage that you can afford while making those fortnightly repayments – I used the ANZ calculator at <http://www.anz.com.au/common/calculators/loanrepayment/exampleau.asp#profile>. You will need to select the interest rate and you can alter this (as I have below) to look at the affect it has on borrowing capacity. I took the term of the loan as 25 years. Again, you can alter this but it doesn't make a great deal of difference.

Then consider how much you think you will spend on a house, multiply that by 1.05 (to allow for 5% purchase costs) and subtract the mortgage amount that you calculated above. This will tell you the amount of deposit that you require to enjoy the same standard of living after buying your home as you do renting it – I call this the "cost of living" gap.

2. Current premium to live in your own home (while you rent the money from the bank) over renting

Another way to look at the rent versus buy issue is to calculate what would be your ongoing costs (in this case I am using fortnightly costs) to buy the median home in comparison to renting it.

For this comparison I have carried these calculations out for each capital city using published information on median prices (ABS June 2008 quarter) and median rents (APM December 2008 quarter).

House purchase assumptions are these: mortgage term 25 years paid fortnightly, **10% deposit**, government grants totally cover purchase costs, and a very conservative \$100/fn cost of ownership (this would hardly cover rates in many instances).

The loan size required to purchase is calculated for each city, with these parameters, and then the fortnightly repayments – at mortgage rates from 4% to 7% – was determined using an online mortgage calculator, and the costs of ownership were added to determine the fortnightly expense of purchasing the median home in each capital city. This was then compared in dollars and percentage terms to the flat rate expense of renting.

3. This simple scenario is based on a young Aussie considering buying their first home in Brisbane. They have some savings right now - \$40,000 - and reckon with the first home owner's boost, low variable mortgage rates and prices having dropped over the last 12 months, it might be a good time to buy. They currently rent a median type home in Brissie (for \$350/week as per APM median rents for December 2008), and they want to buy a median type home (for \$405,000 – based on the preliminary ABS figure for December 2008). They are eligible for \$7K first home owners grant (and extra \$7K boost at the moment). This smart couple know mortgage rates are low so if they buy they will make repayments as if rates were 8% to get ahead on the loan – and if don't buy, they will be save the "repayment gap" (what repayments would be plus the extra costs of ownership minus their rental expense) to put towards their deposit.

Each scenario has the following additional assumptions: a) if they purchase, they take out a variable loan and interest rates stay at 5% for 2 years, b) cost of ownership \$2,600/yr (no major maintenance required), c) earn 2% pa (net after tax) on savings in bank, d) purchase costs 5%, e) the first home owners grant is still available in 2 years, but the boost has ended, and f) after 2 years interest rates remain at 7.5%, and the original repayment as if mortgage rates were 8% is paid, until the loan is repaid.

The three scenarios are these:

Scenario 1 - Buy immediately;

Scenario 2 - Buy after 2 years, house prices remained flat for 2 years and rent increased by \$20 a week in the second year; and

Scenario 3 - Buy after 2 years, house prices declined 10% pa and rent remained flat