Property Focus
New Zealand
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Open partnerships
Open possibilities

Re-entry after a prolonged orbit

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Summary

> The monthly Property Focus publication is aimed at providing investors and prospective homeowners with an independent appraisal of recent developments in the property market, as well as our favoured mortgage borrowing strategy. In this issue, we re-visit an analysis showing which regions had the most sections and apartments for sale, relative to regional totals.

The month in review **(page 2)**

> The Reserve Bank would have taken comfort from the latest Real Estate Institute's housing report (and the same for buyers), but falling house prices will be discomforting news for vendors. The housing market is slowing rapidly, and at a time the labour market is strong.

Property gauges **(page 3)**

> Housing affordability measures remain over-extended, and higher mortgage rates are starting to bite. Don't expect any respite for a while yet.

Economic backdrop **(page 5)**

> Inflation pressures remain disconcerting. The interest rate heat will remain on the property market until inflation pressure subsides. House prices look set to fall at least 5 percent, and we would not rule out a 10 percent fall. Uncertainty stemming from global credit dislocation remains a key risk.

Mortgage borrowing strategy **(page 6)**

> We continue to maintain a view that interest rates will fall in 2008, largely reflecting our wariness over the NZ property market and the global scene, and notably the tightening in credit conditions. We are more inclined towards shortening up the duration of borrowing from last month's recommended 2 to 3 year rates.

Feature article – More vulnerable? **(page 7)**

> Sections and apartments are often talked about as the most vulnerable parts of the property market. In October last year we presented a table showing which regions had the most sections and apartments for sale, relative to regional totals. We have updated our analysis, and while the regional rankings are similar, incredibly 80 percent of regions have shown an increase in available listings of sections and apartments. It reinforces our view that prices in both areas are likely to come under pressure, particularly sections.

Key forecasts **(page 11)**

The month in review

Space, the final frontier.

The Reserve Bank would have taken comfort from the latest Real Estate Institute's housing report (and the same for buyers), but falling house prices will be discomforting news for vendors. The housing market is slowing rapidly, and at a time the labour market is strong.

These are the voyages of the starship REINZterprise.

> **REINZ housing data – January.** Seasonally adjusted house sales fell 0.3 percent in January, following a 7.7 percent fall in December. House sales are now down 31.5 percent on a year ago. The median house price fell $5,000 and comes after a $7,000 fall in December. This now takes the median house price to $340,000. In annual terms, house price growth has slowed to 4.0 percent after being at close to 15 percent over the first half of 2007. However, looking at the more timely six month picture, prices have fallen 2 percent. Median days to sell was effectively unchanged at 40 days (in seasonally adjusted terms). There are widespread anecdotes of a greater number of listings, which suggests prices will have to adjust further.

Its mission: to explore strange new worlds,

> **External Migration – December.** Net migration for the month of December was virtually flat. The country gained a net 20 people, the lowest since 2001. For the 12 months to December 2007, net migration was 5,491, well down from the 14,609 recorded in the previous year. Permanent and long-term (PLT) arrivals continue to hold up at current levels, an indication that NZ continues to attract people who want to come and live in this country. However, the number of PLT departures have risen and is the main driver of the decline in net migration numbers.

… to seek out new lending and new civilisations,

> **Mortgage lending - December.** Lending to households was up only 0.7 percent in the final month of 2007 – the lowest monthly rate of increase in five years. Annual growth in lending to households eased to 12.8 percent in December, the lowest rate of increase since mid-2003. Moreover, these figures won't reflect the increase in fixed mortgage rates this year.

… to boldly go where no man has built before.

> **Building Consents – December.** The total number of residential dwelling consents issued fell 5.2 percent in December, following a flat result in November. On an ex-apartment basis, consent issuance was much weaker, falling 11.3 percent and easily reversing the 1.2 percent increase recorded in November. On a trend basis, both total and ex-apartment consents have posted six consecutive monthly falls.

> **Offshore.** Credit markets remain on edge as the ripple effects of US subprime lending continue to percolate. While the US Federal Reserve has cut interest rates aggressively to restore confidence, lending standards have tightened, and credit / swap spreads continue to push out. The latter are signs that markets remain on edge, and in a globalised world, the danger is that New Zealand gets caught in the rip.

Assessment

There is no doubting the property market is weakening – rapidly. House prices are easing, supply is rising, and at a time everyone has a job (the unemployment rate fell to a historical low in the December quarter). It makes us wonder where the end-game is for the property market, once the labour market turns with such an outcome a precondition to seeing inflation pressure subside.

For now, a softening housing market represents welcome news for the Reserve Bank, although weakness in the residential sector needs to broaden to other pockets of the economy for them to be comforted that inflation pressures within the economy will subside. In the meantime, the property market looks set to continue weakening, particularly on the prices front, given rising listings and more cautious buyers.

Property gauges

Housing affordability measures remain over-extended, and higher mortgage rates are starting to bite. Don't expect any respite for a while yet.

We use eight gauges to assess the state of the property market, and whether warning signs are emerging.

> **Affordability.** For new entrants into the housing market, we measure affordability using the ratio of house prices-to-income (augmented for interest rates), and mortgage payments as a proportion of income.

> **Serviceability / indebtedness.** For existing homeowners, serviceability relates interest payments to income while indebtedness is measured as the level of debt relative to income.

> **Interest rates.** Interest rates affect both the affordability of new houses and the serviceability of existing mortgage payments.

> **Migration.** A key source of demand for new housing.

> **Supply-demand balance.** We use dwelling consents issuance to proxy supply. Demand is derived via the natural growth rate in the population, net migration, and the average household size.

> **Consents and house sales.** These are both key gauges of activity in the property market.

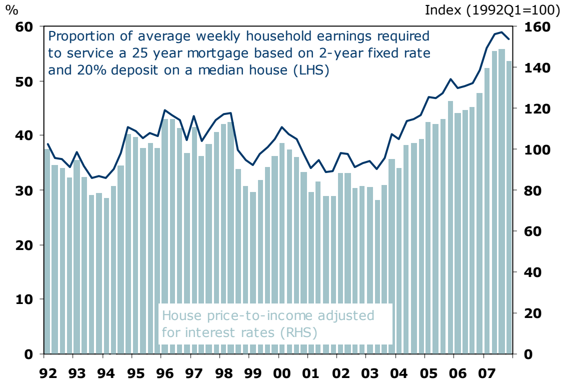
> **Liquidity.** We look at growth in Private Sector Credit relative to GDP to assess the availability of credit in supporting the property market.

> **Globalisation.** We look at relative property price movements between New Zealand, the US, UK and Australia in recognition of the important role that globalisation is playing in NZ's property cycle.

Elevated fixed rate mortgages and increased listings suggest housing demand will remain under pressure over the coming months.

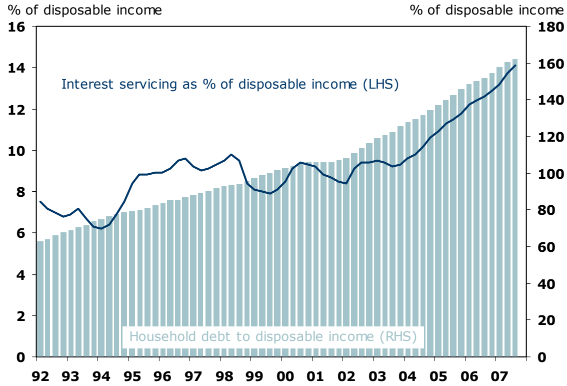
Indicator	Level	Direction for prices	Comment
Affordability	Expensive	↓	Affordability remains at extremely expensive levels.
Serviceability / indebtedness	High	↓	Household indebtedness and the debt servicing burden keep hitting new highs and show no signs of consolidating yet.
Interest rates	High	↔/↓	Fixed-term mortgage rates eased back, but remain high.
Migration	Medium	↔/↓	Migration inflows still trending down.
Supply-demand balance	Neutral	↔	Close to balance.
Consents and house sales	Consents easing, sales softening	↓	Ex-apartment consent issuance has been easing. Sales volumes are falling.
Liquidity	High	↔	Liquidity remains abundant but we are detecting changes in risk appetites as the flow-on from a turn in the credit cycle and global unease unfolds.
Globalisation	Not that cheap	↔	Median house prices in New Zealand are more expensive compared to the US (based on current exchange rates), but cheaper than in Australia.
On balance		↓	**The Right Stuff**

Housing Affordability



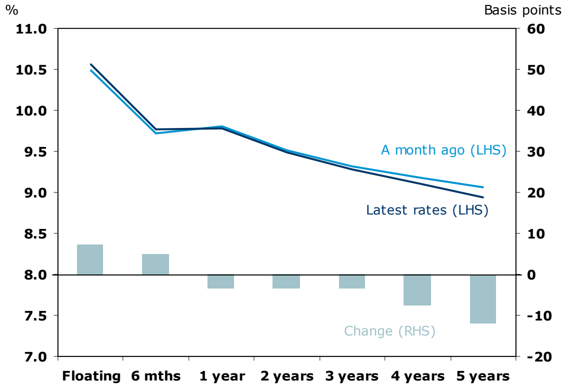
Sources: ANZ National Bank, Statistics NZ, REINZ, Reserve Bank

Serviceability and indebtedness



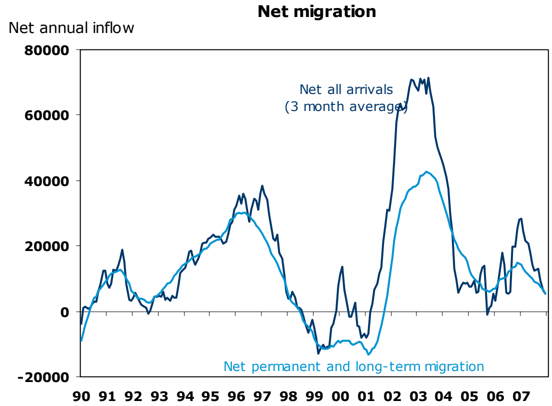
Sources: ANZ National Bank, Reserve Bank

New customer average residential mortgage rate



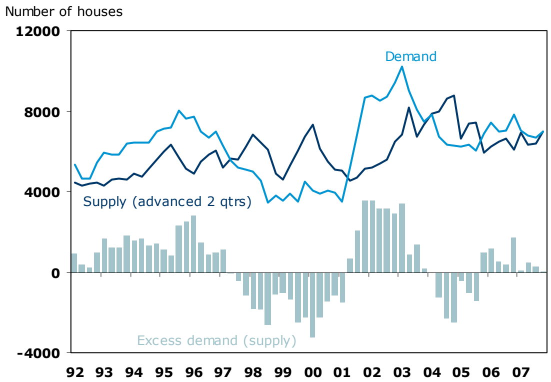
Sources: ANZ National Bank, Reserve Bank, www.interest.co.nz

Net migration



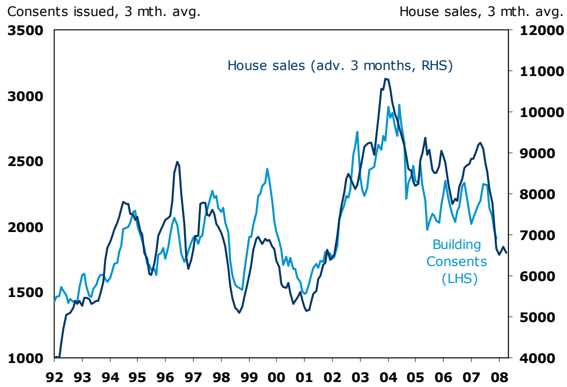
Sources: ANZ National Bank, Statistics NZ

Housing supply-demand balance



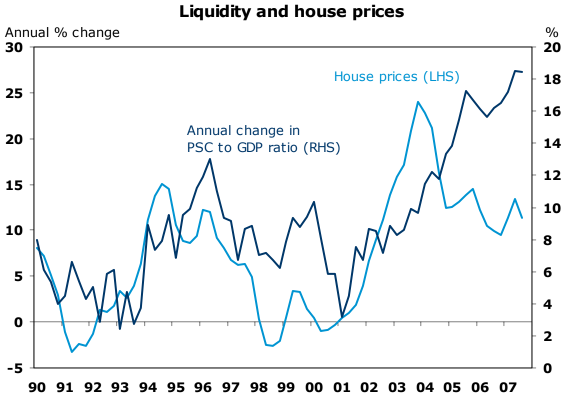
Sources: ANZ National Bank, Statistics NZ

Building consents and house sales



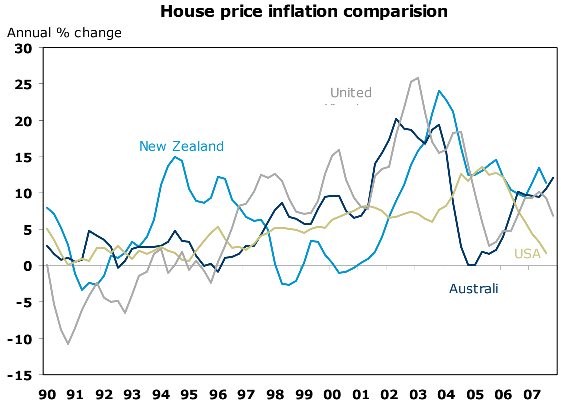
Sources: ANZ National Bank, Statistics NZ, REINZ

Liquidity and house prices



Sources: ANZ National Bank, QV, Reserve Bank

House price inflation comparision



Sources: ANZ National Bank, QV, Nationwide, Bloomberg

Economic Backdrop

Houston, we have a problem.

Inflation pressures remain disconcerting. The interest rate heat will remain on the property market until inflation pressure subsides. House prices look set to fall at least 5 percent, and we would not rule out a 10 percent fall. Uncertainty stemming from global credit dislocation remains a key risk.

Our core economic view

Inflation pressures remain worrying. Financial conditions remain very tight, as the RBNZ waits for the weak housing market to percolate through to other parts of the economy and in turn dampen inflation.

One small step (down) for man, one giant leap for fiscal-mankind.

The economy ended 2007 with reasonable momentum, although the four OCR increases last year were gaining a foothold with domestic demand soft and retailing flat-lining since March 2007. However the picture in early 2008 is looking different. Momentum has softened even more rapidly. House prices are now actively falling. Global uncertainty has intensified (refer below). The equity market is falling and the rural cheque book is now closing as drought conditions percolate. Times have changed, although it won't be for another six weeks before we see it conclusively in the data. New Zealand feels like an aeroplane that is progressively losing its engines. Prospects for 2008 now look contingent on pending fiscal largesse in the form of tax cuts, and late cycle support from the labour market.

Use the (labour) Force, Luke.

We've pencilled in a 5 percent fall in house prices but would not be surprised to see something closer to 10 percent. House prices are already easing at a time the labour market remains strong. A precondition to seeing inflation pressure subside is a turn in the labour market. It makes us wonder what the end-game looks like for house prices in this environment.

History boffins are telling us that house prices never fall. They have three times since 1990, we counter. Well never by much is the retort. This property cycle has been the biggest in history on the upside so we doubt "the average cycle" in turn provides a logical benchmark for the dip.

The Eagle had landed

Certainly it's a sombre picture. Yet we need to be realistic. After five years of double-digit gains, and a 90 percent surge, investors shouldn't be surprised to give a little back.

Offshore developments

A key source of uncertainty at present is over how the global outlook will play out, and notably the repricing of risk that is unfolding. The context is simple. New Zealand has a savings shortfall and runs a huge current account deficit, which makes the country very susceptible to swings in global credit sentiment.

Calling occupants of interplanetary craft

Global credit sentiment remains precarious. While the US Federal Reserve is trying to stabilise conditions, swap spreads and credit spreads continue to widen, and surveys point to tightening credit conditions. Investors are being far more discerning in their investment decisions, and demanding a higher yield (risk premium) to compensate for heightened uncertainty.

To be sure, we have already seen some fallout from the global re-pricing of risk, with close to $2 billion of investor funds at risk from finance company failures. These failures have seen the lending tap withdrawn as balance sheets are consolidated, and are acting to accentuate weakness in the market that the RBNZ and easing migration trends were already fostering. At the same time, funding costs to financial intermediaries are rising, a cost borrowers will progressively have to face. However, the real danger at present is that not only is the price of credit changing, but in some instances it starts being rationed.

Mortgage borrowing strategy

We continue to maintain a view that interest rates will fall in 2008, largely reflecting our wariness over the NZ property market and the global scene, and notably the tightening in credit conditions. We are more inclined towards shortening up the duration of borrowing from last month's recommended 2 to 3 year rates.

Our view

Hello, HAL do you read me, HAL?

As noted by the RBNZ in their *OCR Review* last month, the interest rate outlook contains a wider degree of uncertainty than normal. Based purely on domestic considerations, the upside inflation risks facing the Reserve Bank suggests that interest rates are set to stay high for a long time. If global conditions stabilise and commodity prices continue to rise, a further 50bps of hikes – while not our core view – could be necessary.

At the same time considerable downside risks are also prevalent. The housing market is very weak, credit concerns internationally are escalating, the danger is this impacts on the supply as well as the price of credit, and the economic aeroplane feels like it is progressively losing its engines.

Affirmative, Dave, I read you.

The risk profile looks non-symmetric to us in terms of the implications for interest rates. At present there looks to be 50 basis points of upside risk versus 200 basis points on the reverse. While policymakers (borrowers) always face a degree of uncertainty in setting policy (deciding where to borrow), the current global growth gyrations suggests a wide confidence interval should surround the range of possible outcomes. The standard approach in an uncertain environment is to adopt a "middle of the road approach", which is what the Reserve Bank appears to be doing by holding, watching and waiting. The same could easily apply to borrowers. However, some potential shocks do have greater consequences than others – even if they are no more (or even less) likely to occur, and in such instances the distribution of outcomes can become heavily skewed to one side. The bottom line is that there looks to be 50bps of upside interest rate risk, versus a potential downside of 200bps.

Open the pod bay doors, HAL.

Themes we favour in the current environment

I'm sorry Dave, I'm afraid I can't do that.

If (a big IF) conditions stabilise, mortgage borrowers should not expect much relief in floating or shorter-term borrowing rates any time soon. While these remain at current levels (9½ percent plus), their attractiveness will be limited to those borrowers who require the increased flexibility that they offer.

Fixed mortgage lending rates eased slightly over the past month, while the floating mortgage rates rose. Relative to last month's recommendation targeting the 2 to 3 year part of the curve, we are now more inclined towards the former given the deterioration we are seeing across credit markets, and altered risk profile. It's leaving us more alert to the possibility of this economic cycle unfolding sharply. Five-year mortgage interest rates remain well above their historical average and their advantages in the current environment are a small cash-flow advantage and hedge against a full-blown inflation problem.

> **Take a balanced (diversified) approach** along the curve (25% 1 year, 50% three years, and 25% five years).

> **We are more inclined to a term of 2 years on outright positions given recent developments.** While interest rates could rise and also remain higher for longer, there is also a growing risk of this cycle unfolding sharply. We are becoming increasingly drawn to the latter.

> **While slipping below 9 percent, the five year part of the curve looks expensive buying** – this is one of the highest levels it has been for eight years. However, those maintaining bullish property views, or are very wary of inflation, should have a chunk locked in here.

Feature article – More vulnerable?

Sections and apartments are often talked about as the most vulnerable parts of the property market. In October last year we presented a table showing which regions had the most sections and apartments for sale, relative to regional totals. We have updated our analysis, and while the regional rankings are similar, incredibly 80 percent of regions have shown an increase in available listings of sections and apartments. It reinforces our view that prices in both areas are likely to come under pressure, particularly sections.

On the lookout for Klingons

The section and apartment sectors of the property market – traditionally more speculative areas – are often touted as being the pockets that are the most vulnerable at this stage in the property cycle. Higher interest rates or changes in the credit cycle often mean that these pockets can experience large price swings, relative to other types of property, as demand wanes.

~~Beam~~ Trade me up, Scotty

The table on the following page, which we first presented in October last year, shows the number of sections and apartments for sale relative to the total number of properties on the market. It is based on data from the Trade Me website (which provided easy access to this type of data) and although it is somewhat of a crude indicator, we feel it is still reasonably effective nonetheless. The table ranks the various regions from highest to lowest and also show their movement compared with October 2007.

So what does it show?

- Compared with October 2007, an incredible 80 percent of regions have shown an increase in section and apartment listings relative to totals. The average increase in this ratio across the regions was a stunning 23 percent.
- The relative rankings of the regions are reasonably similar to October 2007. Those regions that had a relatively high proportion of sections and apartments for sale in October, typically still have high proportions now, and vice versa. The biggest movers of note were Southland, which has gone from having the top ranking in October (ratio of 50.4 percent) to being the 24th ranked region now (ratio of 24.1 percent). Given the continued strength in the Southland property market, the only reason we can think of for this is that these properties (mainly sections) have been sold. The biggest mover in the opposite direction was Papakura, which has increased from its 37th ranking, to 11th now.
- There remains a holiday or retirement destination theme. Popular locations for the family bach and retirement, namely Thames/Coromandel, Taupo, Tasman, Northland, and Queenstown all have a high exposure. These regions have experienced significant expansion and price growth over this latest cycle, but could now be in a position of increased vulnerability. We remain surprised that regions with similar characteristics, namely Bay of Plenty areas, Hawke's Bay and Kapiti Coast do not have higher exposures.
- In terms of the big bellwether Auckland region, the city ranks highly (large number of apartments), but the majority of areas within greater Auckland are in the lower quartile. Other large cities, Wellington, Christchurch and Dunedin are also in the middle to lower half of the regions.

The Hitchhiker's Guide to the vulnerability

The upshot

Rising supply of sections and apartments on the market relative to the total stock of houses is one sign of unease. With both exposed to high interest rates (low yield or high carry cost), likely diminished appetites to lend, credit disclocation in certain pockets, and land-banking – which has the potential to unwind quickly, we expect prices for both apartments and sections to come under continued downward pressure. This is particularly so for sections and land.

Warning! Warning! Danger, Will Robinson!

Number of sections and apartments for sale, relative to total properties for sale					
Rank	Region	Number of apartment and sections as % of total listings	Oct-07 %	% change from Oct-07	Oct-07 rank
1	Queenstown Lakes	52.1	43.5	19.7	2
2	Auckland City	43.8	37.0	18.5	5
3	Northland - Far North	42.7	40.5	5.5	4
4	Thames/Coromandel	39.4	34.8	13.1	6
5	West Coast	36.6	33.8	8.3	7
6	Tasman	36.5	43.4	-15.9	3
7	Central Otago ex-Qtwn	36.1	33.1	9.2	8
8	Taupo	35.2	32.3	9.1	10
9	Waitaki	33.8	31.0	9.0	12
10	Marlborough	33.5	29.3	14.4	16
11	Papakura	33.2	9.7	241.8	37
12	Northland - Whangarei	33.1	32.9	0.7	9
13	Hurunui, Hanmer	32.5	30.3	7.1	14
14	Rodney	32.4	28.7	12.8	17
15	Kaikoura	32.0	21.4	49.5	22
16	Hauraki	28.9	25.6	12.9	19
17	Western BoP	28.4	24.9	14.1	20
18	Wellington City	28.0	30.7	-8.9	13
19	Gisbourne	27.2	31.0	-12.4	11
20	Whakatane	26.8	27.4	-2.1	18
21	Selwyn	26.3	16.7	57.5	25
22	Nelson City	26.2	29.6	-11.5	15
23	Tauranga City	25.4	22.0	15.3	21
24	Southland	24.1	50.4	-52.2	1
25	Taranaki	23.8	15.1	57.7	28
26	North Shore City	23.7	19.4	22.3	24
27	Waitakere	22.5	14.3	57.3	30
28	Hamilton City	21.5	15.1	42.7	27
29	Kapati Coast	20.7	14.3	44.6	31
30	Waimakariri	20.3	14.5	39.7	29
31	Franklin	16.7	12.5	33.3	34
32	Upper Hutt	15.9	15.2	4.5	26
33	Manawatu/Wanganui	15.2	12.5	21.4	33
34	Dunedin City	15.0	19.6	-23.4	23
35	Hawke's Bay	14.9	13.0	14.8	32
36	Manakau City	14.0	10.0	40.0	36
37	Christchurch City	10.8	8.8	22.5	38
38	Rotorua	9.4	7.1	32.7	39
39	Timaru	9.4	10.6	-11.5	35
40	Lower Hutt	7.8	4.2	85.3	40

Statistical Annex

Weekly mortgage repayments table (based on 25 year term)

Mortgage Size ($'000)	Mortgage Rate (%)													
	7.50	7.75	8.00	8.25	8.50	8.75	9.00	9.25	9.50	9.75	10.00	10.25	10.50	10.75
100	170	174	178	182	186	190	194	197	201	205	210	214	218	222
150	256	261	267	273	279	284	290	296	302	308	314	320	327	333
200	341	348	356	364	371	379	387	395	403	411	419	427	435	444
250	426	435	445	455	464	474	484	494	504	514	524	534	544	555
300	511	522	534	545	557	569	581	592	604	616	629	641	653	666
350	596	610	623	636	650	664	677	691	705	719	733	748	762	777
400	682	697	712	727	743	758	774	790	806	822	838	855	871	887
450	767	784	801	818	836	853	871	889	907	925	943	961	980	998
500	852	871	890	909	928	948	968	987	1007	1027	1048	1068	1089	1109
550	937	958	979	1000	1021	1043	1064	1086	1108	1130	1153	1175	1198	1220
600	1022	1045	1068	1091	1114	1137	1161	1185	1209	1233	1257	1282	1306	1331
650	1108	1132	1157	1182	1207	1232	1258	1284	1310	1336	1362	1389	1415	1442
700	1193	1219	1246	1273	1300	1327	1355	1382	1410	1438	1467	1495	1524	1553
750	1278	1306	1335	1364	1393	1422	1451	1481	1511	1541	1572	1602	1633	1664
800	1363	1393	1424	1454	1485	1517	1548	1580	1612	1644	1676	1709	1742	1775
850	1448	1480	1513	1545	1578	1611	1645	1679	1713	1747	1781	1816	1851	1886
900	1534	1567	1602	1636	1671	1706	1742	1777	1813	1849	1886	1923	1960	1997
950	1619	1655	1691	1727	1764	1801	1838	1876	1914	1952	1991	2029	2069	2108
1000	1704	1742	1780	1818	1857	1896	1935	1975	2015	2055	2095	2136	2177	2219

Housing market indicators for January 2008 (based on REINZ data)

	House prices (Ann % change)	3mth % chng	No of sales (s.a.)	Mthly % chng	Avg days to sell (s.a)	Comment
Northland	7.5	2.4	162	(+2%)	55	Tops the annual price growth table in the North Island.
Auckland	4.3	0.5	1,962	(-2%)	38	House sales in Auckland fall to a new record low.
Waikato/BOP/Gisborne	3.9	-0.4	913	(-4%)	48	Annual growth in house prices ease to a new low.
Hawke's Bay	0.0	0.8	247	(-9%)	46	Largest fall in sale numbers in the month.
Taranaki	-3.5	1.7	187	(+7%)	42	The only negative annual percentage change in prices.
Manawatu-Wanganui	7.0	2.0	321	(-1%)	47	The number of sales is on downward trend.
Wellington	4.2	0.5	734	(+11%)	36	Boing! A strong rebound in the number of house sales.
Nelson-Marlborough	10.7	0.0	268	(+2%)	34	Now the second quickest locality to sell a house.
Canterbury/Westland	6.9	0.4	921	(+3%)	37	Annual house price growth has hit an 18-month low.
Otago	6.0	1.6	305	(+4%)	39	Weakest annual house price growth in the South Island.
Central Otago Lakes	10.2	-11.5	111	(-8%)	68	Sharp fall in sale values over the past three months.
Southland	44.2	12.2	215	(-4%)	32	On a different planet when compared to the rest of NZ.
NEW ZEALAND	4.0	-1.4	6,379	(0%)	40	Coriolis effect. (An apparent deflection of the path of an object that moves within a rotating frame of reference).

Key forecasts

	Actual			Forecast						
Economic indicators	Mar 07	Jun 07	Sep 07	Dec 07	Mar 08	Jun 08	Sep 08	Dec 08	Mar 09	Jun 09
GDP (ann avg % chg)	1.6	2.1	2.7	3.0	2.8	2.4	1.9	1.5	1.4	1.6
CPI inflation (%)	2.5	2.0	1.8	3.2	3.3	3.0	3.4	3.0	2.9	2.9
Unemployment rate (%)	3.7	3.6	3.5	3.4	3.7	3.8	3.8	4.0	4.1	4.2
	Actual			Forecast (end month)						
Interest rates	Dec 07	Jan 08	Current	Mar 08	Jun 08	Sep 08	Dec 08	Mar 09	Jun 09	Sep 09
Call rate	8.40	8.38	8.25	8.25	8.25	8.00	7.50	7.0	6.75	6.75
90-day bank bill rate	8.9	8.7	8.7	8.7	8.6	8.0	7.5	7.0	7.0	7.0
Floating mortgage rate	10.5	10.5	10.5	10.5	10.5	10.2	9.7	9.2	8.9	8.9
1-yr fixed mortgage rate	9.6	9.8	9.8	9.8	9.6	9.1	8.6	8.2	8.1	8.1
2-yr fixed mortgage rate	9.3	9.5	9.5	9.5	9.4	8.9	8.4	8.0	7.9	7.9
5-yr fixed mortgage rate	8.9	8.9	8.9	8.9	8.9	8.5	8.0	7.6	7.4	7.4

Disclaimer:

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