Property Focus
New Zealand
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The turn

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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, the feature article is on the regional supply and demand balance.

The month in review (page 2)

> The housing market has now finally turned, having recorded sharp declines in activity in the past three months. With further softness in market activity expected, the Reserve Bank will be more confident that no further interest rate hikes are needed.

Property gauges (page 3)

> The real estate market is still receiving support from liquidity and restricted supply. But affordability measures remain over-extended, and high mortgage rates are having an impact on housing market activity.

Economic backdrop (page 5)

> The balance of risks facing the New Zealand economy has shifted, and we now expect an earlier start to the monetary policy easing cycle than previously forecast.

Mortgage borrowing strategy (page 6)

> We expect the Reserve Bank to lower the Official Cash Rate in early 2008 – partly reversing the 2007 late cycle hikes. However the cuts won't be overly aggressive due to ongoing inflation pressures. Mortgage borrowers should consider two-year fixed rates, with one-year fixed rates increasingly viable for those who expect an earlier start to the easing cycle.

Feature article – Looking for some balance (page 7)

> Our simple demand-supply housing balance measures across the regions highlight that Auckland remains the hottest. However, the majority of regions are now shifting to a position of excess supply.

Key forecasts (page 12)

The month in review

The housing market has now finally turned, having recorded sharp declines in activity over the past three months. With further softness in market activity expected, the Reserve Bank will be more confident that no further interest rate hikes are needed.

The housing market has turned …

- **REINZ housing data – August.** Housing market activity softened further in August, with house sales well down (-9.0 percent seasonally adjusted) and days to sell up (to 34, seasonally adjusted). House prices posted a small gain, but when looking at the less-volatile three month average, annual house price inflation continues to ease.
- **Building work put in place – June quarter.** Total real building work put in place fell 0.5 percent in the June quarter, driven by a decline in non-residential construction activity (-6.3 percent). Real residential building work increased 3.6 percent over the quarter.
- **QV monthly house prices – August.** Prices over the three months ending August were 13.3 percent higher than the same period a year ago.
- **Retail sales – June quarter.** Both monthly and quarterly retail spending figures were lower than expected (total nominal retail sales fell 0.4 percent s.a. in June, while quarterly volumes were down a seasonally adjusted 0.6 percent). But these came on the heels of strong increases in May and Q1, respectively. Nevertheless, a moderating trend is clearly apparent in spending patterns.

… and further softness is expected.

- **External migration – July.** The easing trend in net migration inflows continues, driven by higher departures and static arrivals. A seasonally adjusted net migration inflow of 440 was recorded in July, pulling the annual total down to 8,966. The slowing in net migration will take further pressure off the housing market, a development that the Reserve Bank will welcome.
- **Building Consents – July.** Residential building consents fell sharply (-15.5 percent s.a.) in July, reversing the strength recorded in June when numbers were boosted by builders trying to beat council fee increases. On an ex-apartment basis, consents fell a more modest 1.4 percent in the month. The number of consents being issued remains close to the average number issued over the first half of this year.
- **Mortgage lending - July.** Growth in lending to households slowed over July (total lending to households rose 0.9 percent seasonally adjusted over the month, its slowest monthly growth rate since July 2006, and down on the average monthly increase of 1.1 percent over the first half of the year).

Assessment

Now we just need to see this translate into reduced pressure on non-tradable inflation.

While the labour market remains strong, and a boost to rural incomes courtesy of a higher forecast dairy payout will provide some support to the housing market, mortgage interest rates at current levels will continue to act as a drag on housing demand. This, along with easing net migration, is likely to see further moderation in activity over the months ahead, and suggests that the housing market is unlikely to shake off its winter blues. The late 2006 pickup in housing was due in part to lower petrol prices and a mortgage war. Neither of these are likely this time around.

With the housing market now finally turned, the Reserve Bank will be more confident that no further official interest rate hikes will be needed. The key for the Reserve Bank going forward is whether consumer spending continues to moderate. Ultimately, the Reserve Bank will be looking for evidence of the slowdown in the housing market translating through into reduced pressure on non-tradable inflation, including housing inflation and construction costs.

Property gauges

The real estate market is still receiving support from liquidity and restricted supply. But affordability measures remain over-extended, and high mortgage rates are having an impact on housing market activity.

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

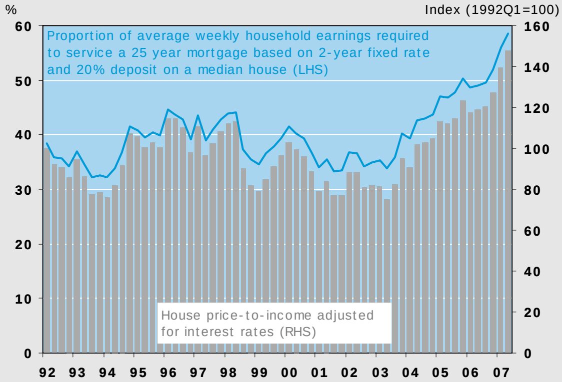
- **Affordability.** For new entrants into the housing market, we measure affordability using the ratio of house prices-to-income (augmented for interest rates), and mortgage payments as a proportion of income.
- **Serviceability / indebtedness.** For existing homeowners, serviceability relates interest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

Housing market data suggests that the market has finally turned in response to higher mortgage interest rates, slowing net migration, and reduced confidence about the economic outlook.

The Reserve Bank will now be looking for signs that the slowdown in housing market activity is translating into reduced inflation pressure from the non-tradables sector. They will remain cautious until they see conclusive evidence of this.

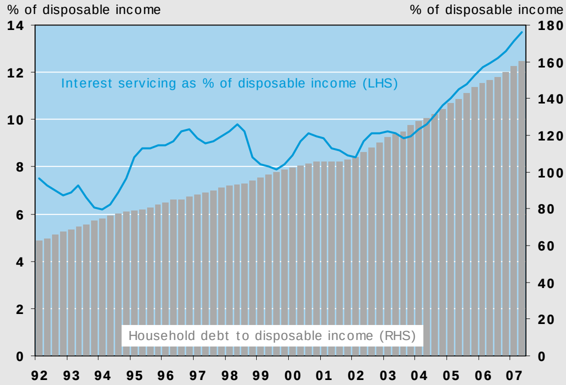
Indicator	Level	Direction for prices	Comment
Affordability	Expensive	↓	Affordability continues to deteriorate sharply, not helped at all by high mortgage rates.
Serviceability / indebtedness	High	↓	Household indebtedness and the debt servicing burden keep hitting new highs and show no signs of consolidating yet.
Interest rates	High	↓	Further increases in shorter-term mortgage interest rates. With most rates above 9 percent, there is nowhere on the curve for borrowers to hide.
Migration	Medium	↔/↓	Migration inflows continue to slow.
Supply-demand balance	Neutral	↔	Close to balance, in line with slowing migration inflows.
Consents and house sales	Consents strong, sales softening	↔	The real estate market still looks to be supply constrained in some areas. The pre-fee-increase in consent issuance has been reversed.
Liquidity	High	↑/↔	Liquidity remains abundant, but global events suggest diminished appetites to lend could be pending.
Globalisation	Cheap in world terms	↑	On a relative basis, NZ property is still cheap.
On balance		↓	**RBNZ is winning.**

Housing Affordability



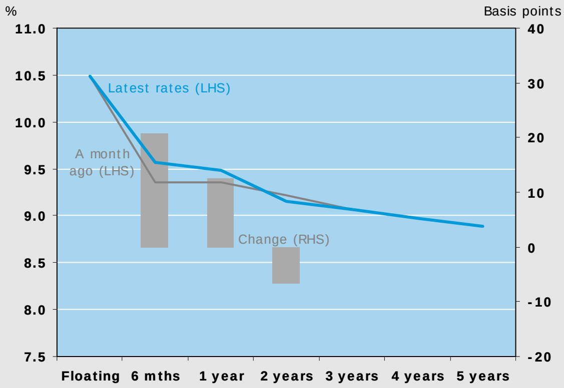
Sources: ANZ National Bank, Statistics NZ, REINZ, Reserve Bank

Serviceability and indebtedness



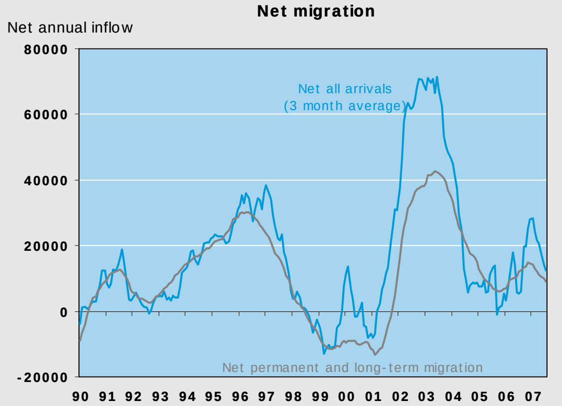
Sources: ANZ National Bank, Reserve Bank

New customer average residential mortgage rate



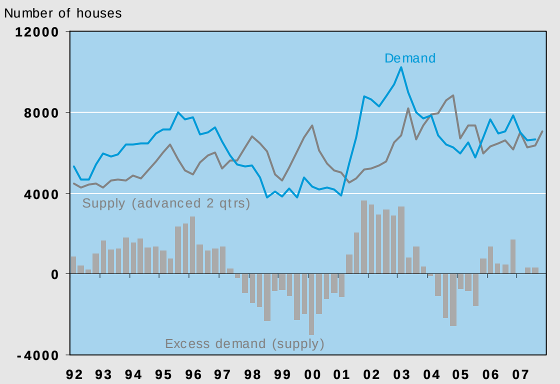
Sources: ANZ National Bank, Reserve Bank, www.interest.co.nz

Net migration



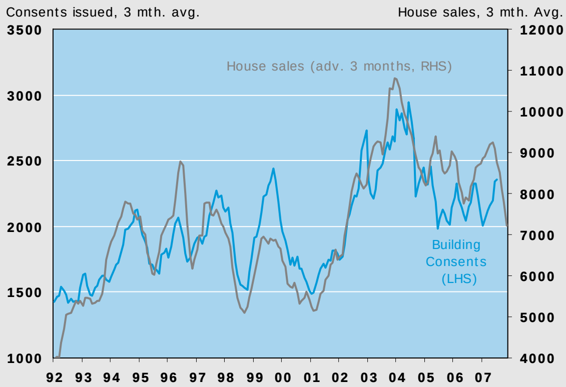
Sources: ANZ National Bank, Statistics NZ

Housing supply-demand balance



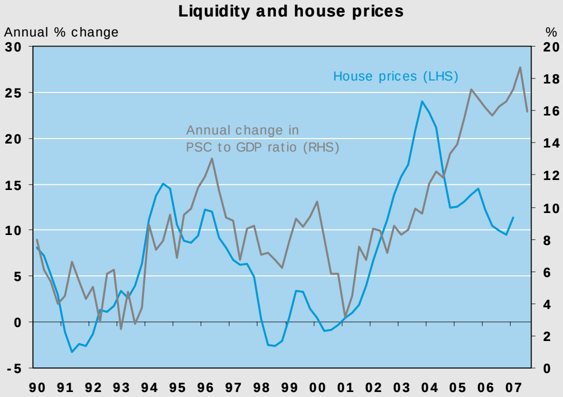
Sources: ANZ National Bank, Statistics NZ

Building consents and house sales



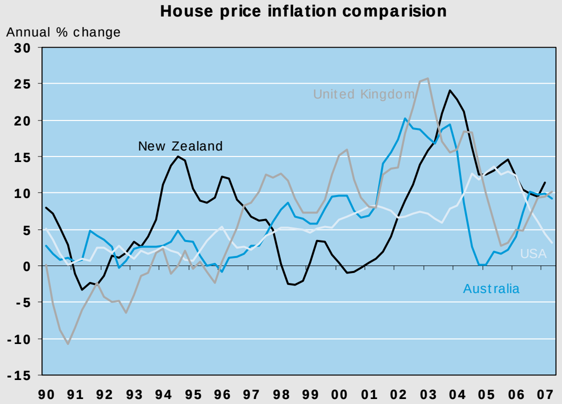
Sources: ANZ National Bank, Statistics NZ, REINZ

Liquidity and house prices



Sources: ANZ National Bank, QV, Reserve Bank

House price inflation comparision



Sources: ANZ National Bank, QV, Nationwide, Bloomberg

Economic backdrop

The balance of risks facing the New Zealand economy has shifted, and we now expect an earlier start to the monetary policy easing cycle than previously forecast.

> The balance of risks has shifted.

The credit cycle has turned…

Last month we wrote about the re-pricing of risk and sharp reduction in liquidity that has been occurring in global financial markets. We believe this is a significant development, and will likely dominate the positive impact on the economy of surging commodity prices and a monster dairy payout.

A significant part of the growth recorded in the New Zealand economy over the past few years has been on the back of leverage. It has been a circle of success where liquidity drives asset prices, the scope to leverage, more liquidity, asset prices and leverage…and the spiral has been in motion.

This cycle of success is now being challenged from two areas.

… and this adds a layer of vulnerability to the NZ economy.

- Risk is being re-priced around the globe, and (foreign) lenders are demanding more to compensate for risk. As a net borrower and reliant on international capital to fund our savings shortfall, New Zealand – and the housing market – will not be immune to the re-pricing and cost of risk (funding) that is appearing.
- Stresses across non-bank financial institutions. While there are some quality players in the industry and they have a role to play in the economy, the combination of altered risk appetites and perception risk following numerous collapses is placing stress on funding across the sector. While it represents a small pocket of total lending for the economy, it has been a significant source of growth in lending, and notably to the speculative end of the market.

We have brought forward our expectation of the timing of start of the easing cycle.

We believe these developments represent a fundamental shift in the balance of risks facing the New Zealand economy. Lacking the credit fix in certain pockets of the economy, it may well turn into a case of cold turkey. This in turn suggests we are likely to see certain (speculative) pockets of the housing market, and pockets of durable spending soften considerably over the coming six months. Standing back, the economy is transitioning, where the growth baton is transferred from the spending side of the economy, to more export and earnings based industries. But with the export sector unlikely to join the fray until late 2008, the economy is likely to lack a real engine of growth over the coming six months. Soft growth from the domestic economy is in turn expected to dampen inflation emanating from the non-tradable sector.

But interest rates will remain restrictive given inflation risks.

In such an environment we see the Reserve Bank being able to remove some of the "late-cycle insurance" that they took out in the first half of this year. Easing back on the brake will enable the Reserve Bank time to monitor developments while at the same time not locking up the economy's wheels. Interest rate settings are still expected to be on the restrictive side for most of next year, as a precaution against inflation remaining sticky, just not as restrictive as they currently are.

> More to come from offshore.

A 12.2 percent slump in US pending home sales in August raises serious questions about the state of the US housing market and suggests that it is yet to find a floor. The US Federal Reserve's "Beige Book" has reported that most banks have tightened lending standards, and that this was having a noticeable effect on US housing market activity. This indicates that the US housing market adjustment has more to run yet, and raises fears that subprime losses will continue to mount. This suggests that the liquidity concerns that have provided the backdrop for the past couple of months will be with us for some time to come.

Mortgage borrowing strategy

We expect the Reserve Bank to lower the Official Cash Rate in early 2008 – partly reversing the 2007 late cycle hikes. However the cuts won't be overly aggressive due to ongoing inflation pressures. Mortgage borrowers should consider two-year fixed rates, with one-year fixed rates increasingly viable for those who expect an earlier start to the easing cycle.

> Our view

We have brought forward our expectations for the timing of the start of the Reserve Bank's easing cycle to March 2008.

The balance of risks has tipped towards an earlier start to the easing cycle.

As discussed on page 5, the balance of risks facing the NZ economy (and hence interest rates) has shifted markedly over the past two months. The economic outlook continues to be underpinned by higher dairy prices, a tight labour market, and promises of an election year *Budget* fiscal injection. But the global and credit environment (which we discussed in last month's *Property Focus*) are increasingly skewing the risk profile for the macroeconomic outlook. And in such an environment, our "RBNZ on hold for the foreseeable future" interest rate view has become increasingly tenuous.

We now see the Reserve Bank removing the inflationary insurance policy that they took out through the first half of 2007, returning the OCR to 7½ percent by June 2008. This would leave monetary policy in a still-restrictive stance (appropriate given the still strong inflation pressures) and allow the Reserve Bank the opportunity to assess the data flow over the remainder of the year. As inflation pressure subsides thereafter, they will have scope to lower the OCR to more neutral levels (6½ percent) in 2009.

> Themes we favour in the current environment

There is nowhere to hide in the current interest rate environment.

In addition to overlaying the increasingly negative risk outlook, global credit concerns are also putting pressure on short-term wholesale interest rates (as evidenced by the 90 day bank bill trading at 8.86 percent despite expectations that the Reserve Bank is not expected to raise interest rates further). This has flowed through into higher short-duration mortgage interest rates on offer. This reduces the attractiveness of these rates from a borrower's perspective.

And with 5-year mortgage interest rates close to 9 percent (well above their historical average), there would appear to be little advantage to borrowing at this part of the curve except perhaps to pick up some minor (and short-term) cash-flow advantages.

- **Take a balanced (diversified) approach.** A balanced approach to spread risk by having exposure to different parts of the mortgage yield curve.
- **We are more inclined to 2-year rates given global developments.** Fixing for a shorter duration will enable you to take advantage of lower rates in the event of a global "accident" or realisation of the downside risks facing the NZ economy. With liquidity issues placing upward pressure on the shorter-end of the NZ wholesale interest rate curve, and this feeding through into 6-12 month mortgage rates, 2-year mortgage rates would appear to be relatively attractive. Those who believe the Reserve Bank will ease more aggressively next year can consider fixing for one year at a slightly higher rate.
- **We continue to struggle to see value in the 5-year rate at present.**

Feature article – Looking for some balance

Our simple demand-supply housing balance measures across the regions highlight that Auckland remains the hottest. However, the majority of regions are now shifting to a position of excess supply.

REINZ housing market data shows housing market activity is moderating. House sales have continued their trend lower, and days to sell have ticked up. Interest rate hikes look to be slowing demand. However, market movements are a combination of both supply and demand, with tight supplies having previously kept prices elevated even when house sales have softened.

We monitor two simple gauges to highlight supply-demand balance within the property market, and across the regions.

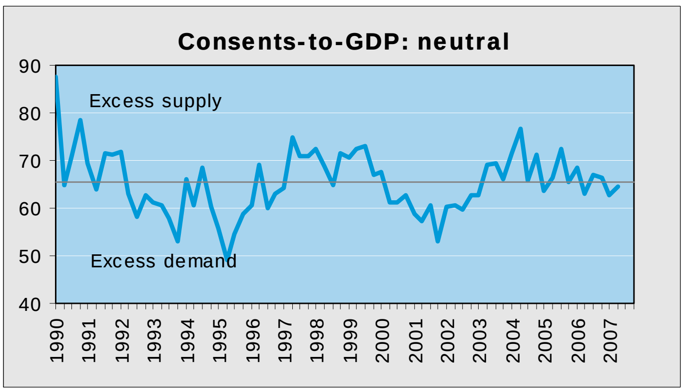
- The ratio of consents (supply) to economic growth within a region. If consents are growing faster than demand growth within the region, it is indicative of excess supply, and of course the converse applies.
- The ratio of house sales to consents. Another supply-demand balance measure, with an up-tick in the ratio indicating excess demand, and a fall below trend suggesting a supply glut pending.

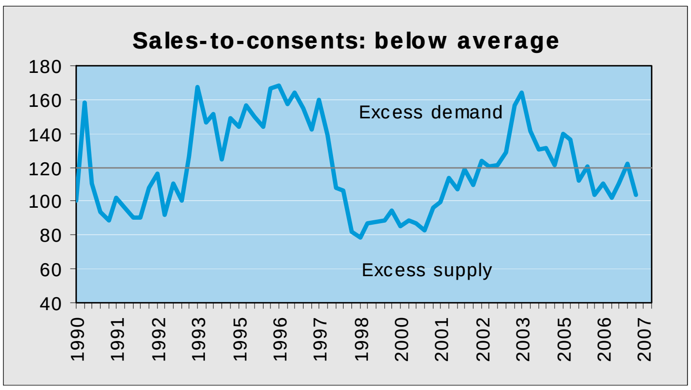
Across the regions, we note the following:

- Auckland remains the national hot-spot although conditions have eased since last quarter. The ratio of consents to GDP remains below trend (too little supply), while the ratio of sales to consents did fall, but remains indicative of still strong demand.
- Our demand-supply indicators suggest roughly balanced conditions in Northland, Waikato and Canterbury.
- The majority of regions are now showing early signs of a market that is set to move in the favour of buyers. The ratio of consents to GDP has been trending up in Gisborne, Taranaki, Hawke's Bay, Manawatu/Wanganui, Nelson/Marlborough and West Coast. Wellington also experienced a sharp shift to excess supply conditions in the quarter. In these same regions, the ratio of house sales to consents has fallen below the historical average.

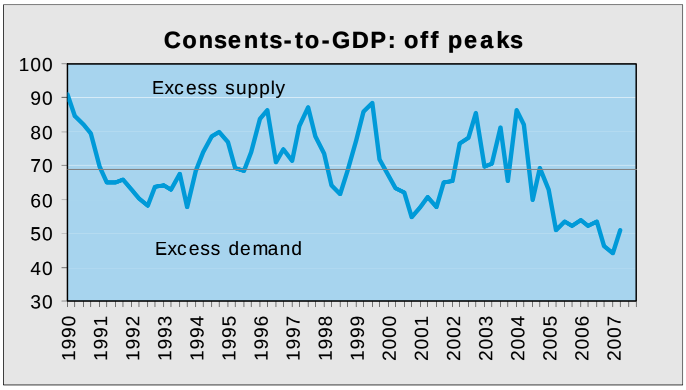
Only Auckland is still facing excess demand conditions. The majority of the other regions look to be showing pending excess supply relative to demand. The tight demand-supply balance that has been supportive of the housing market for some time finally looks to be turning. This suggests that house price growth, which has already softened over the past three months (although not yet apparent in annual terms), will continue to moderate over the year.

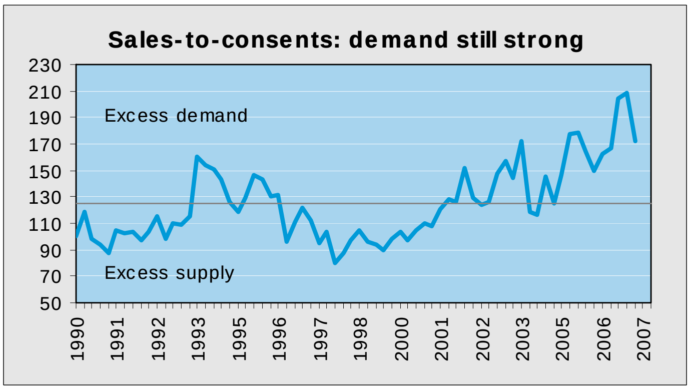
NORTHLAND- BALANCED BUT SHOWING SIGNS OF EASING



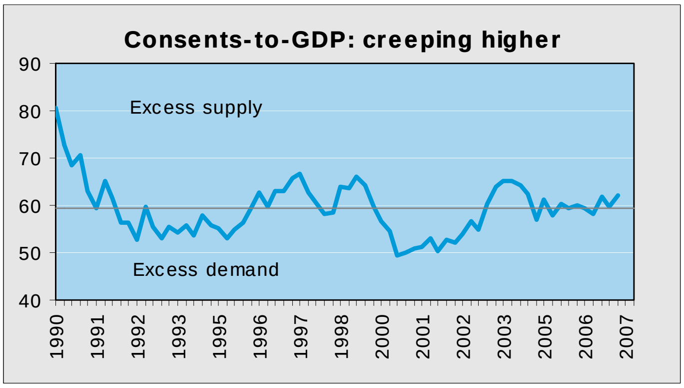


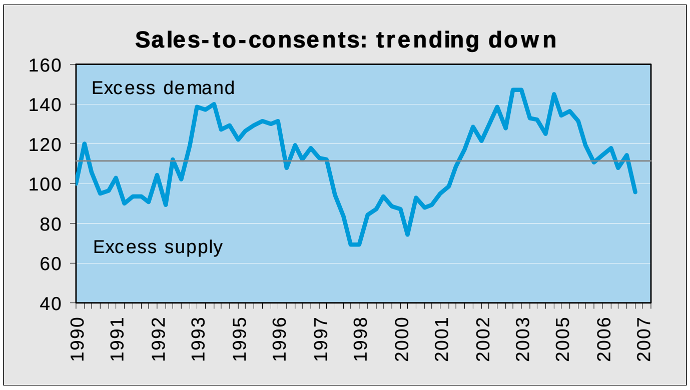
AUCKLAND – STILL A TIGHT MARKET



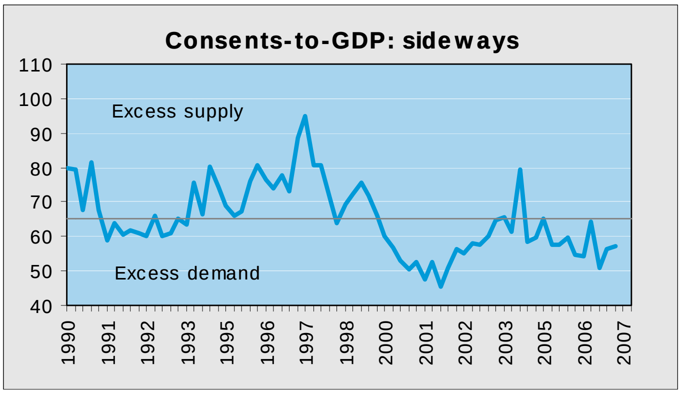


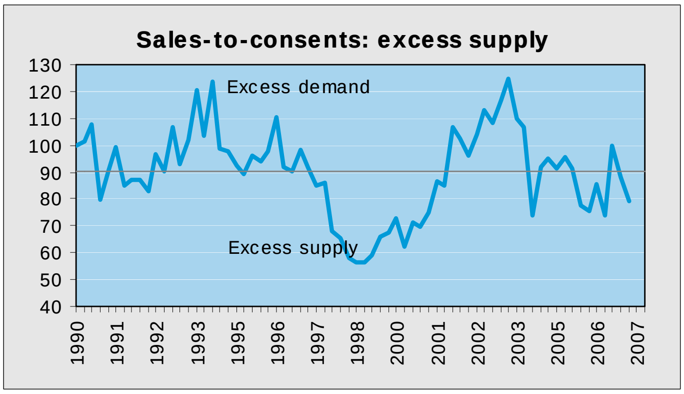
WAIKATO - BALANCED



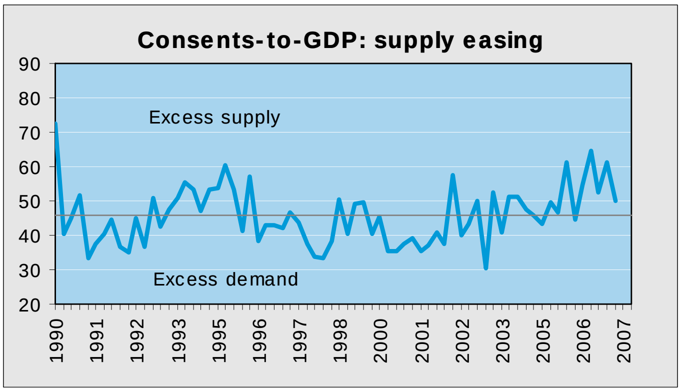


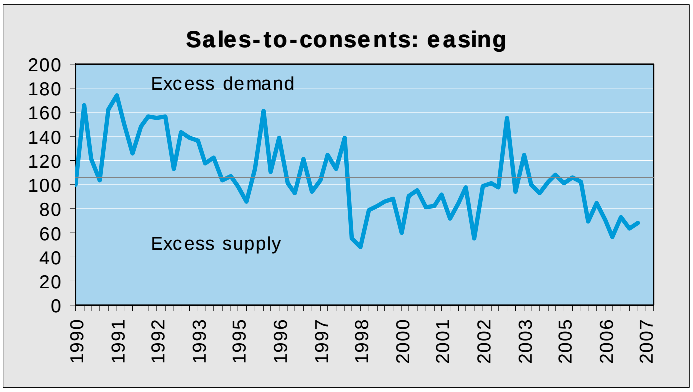
BAY OF PLENTY – HOUSE SUPPLY REMAINS SHORT, ALTHOUGH DEMAND EASING



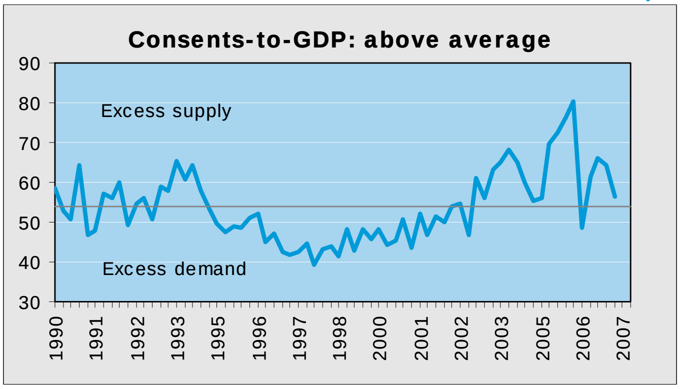


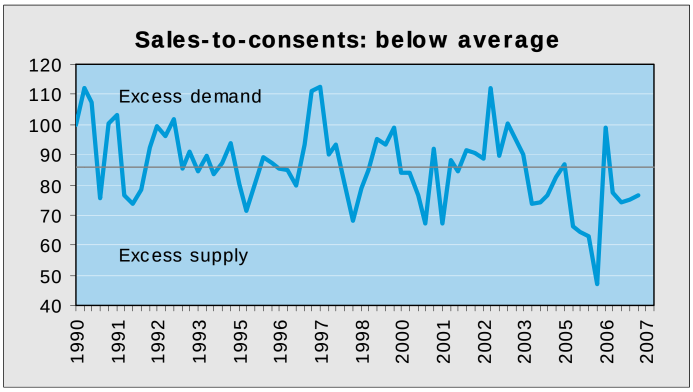
GISBORNE – TOO MANY HOUSES



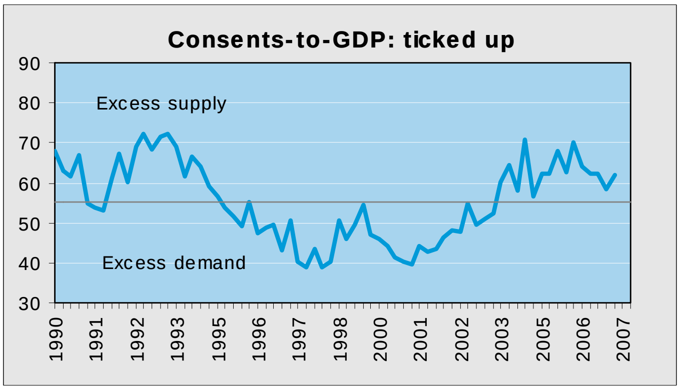


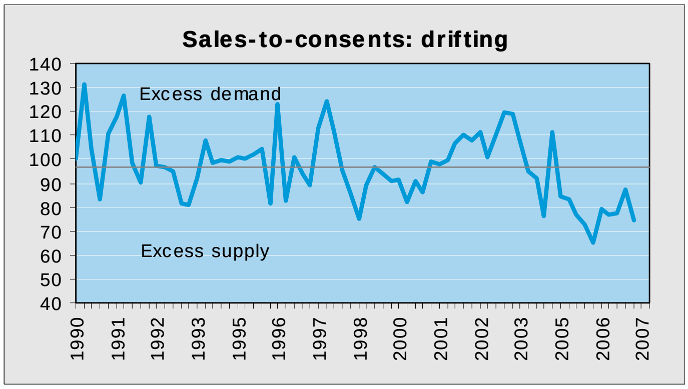
HAWKE'S BAY – DITTO, BUT NOT AS BAD AS MARCH



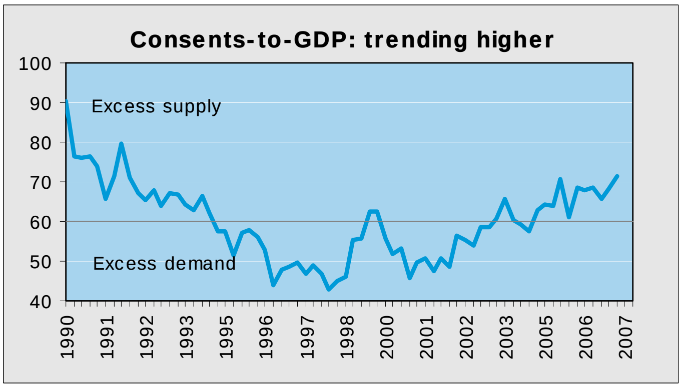


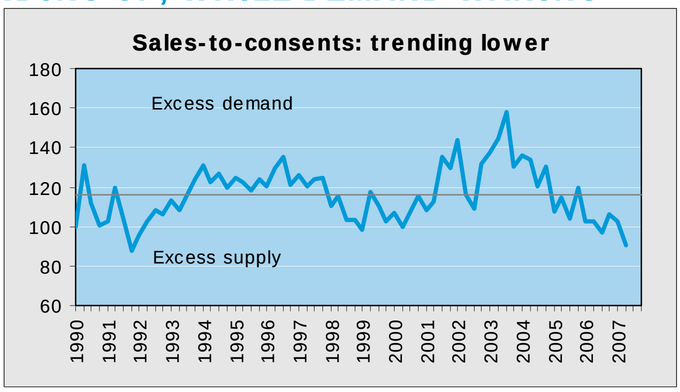
TARANAKI – TOO MANY HOUSES



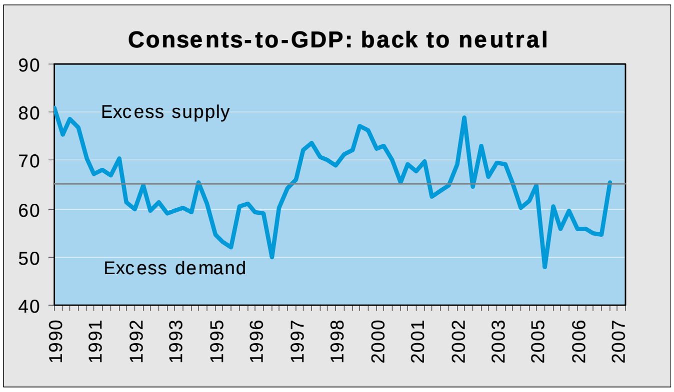


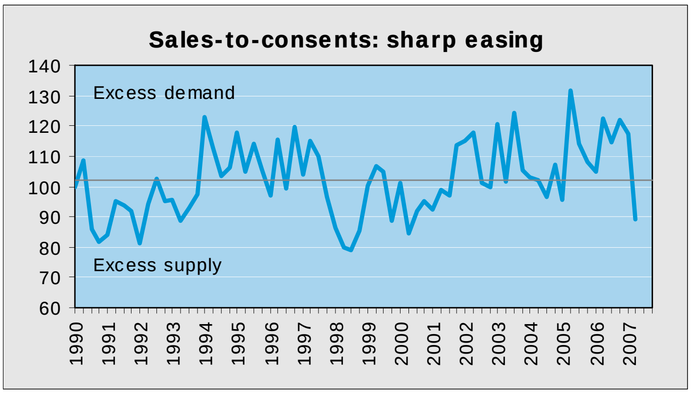
MANAWATU/WANGANUI – SUPPLY TRENDING UP, WHILE DEMAND WANING



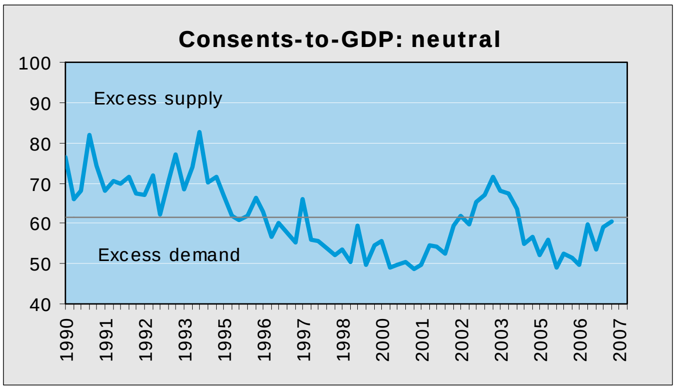


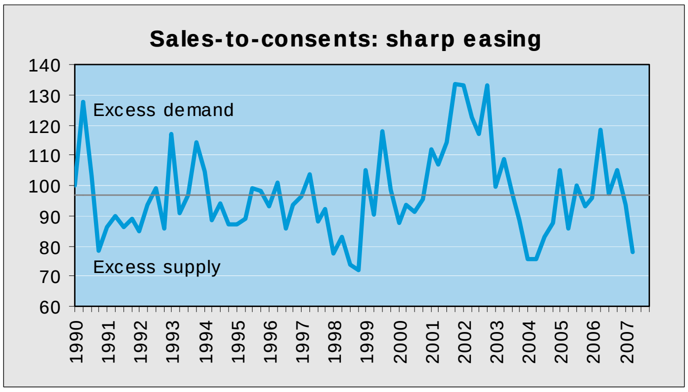
WELLINGTON – SHARP CORRECTION



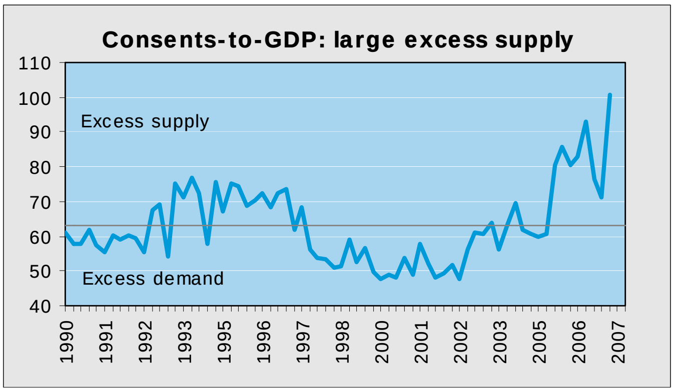


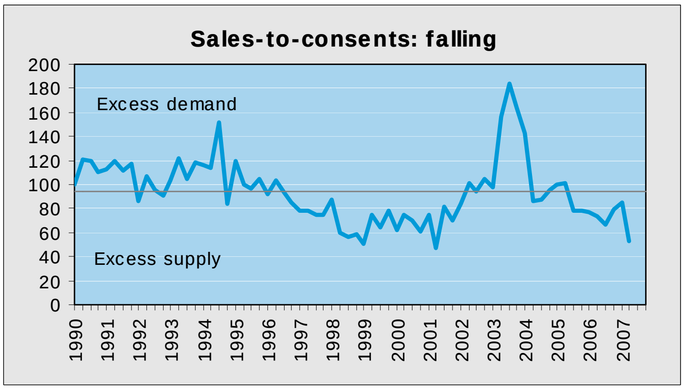
NELSON / MARLBOROUGH – SHARP SLOWING IN DEMAND



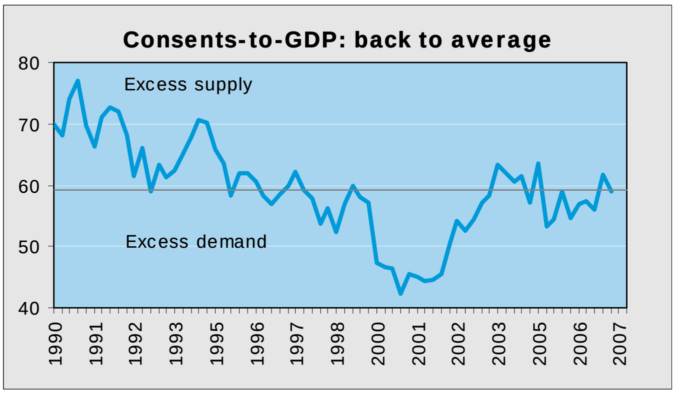


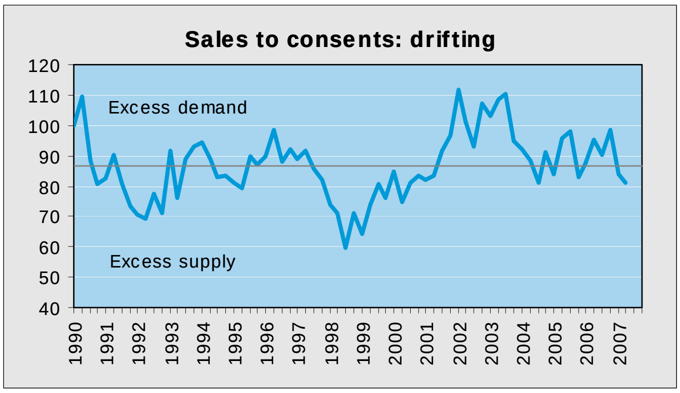
WEST COAST – A LOT OF HOUSES SET TO POP UP ON THE COAST. ARE THE BUYERS AROUND?



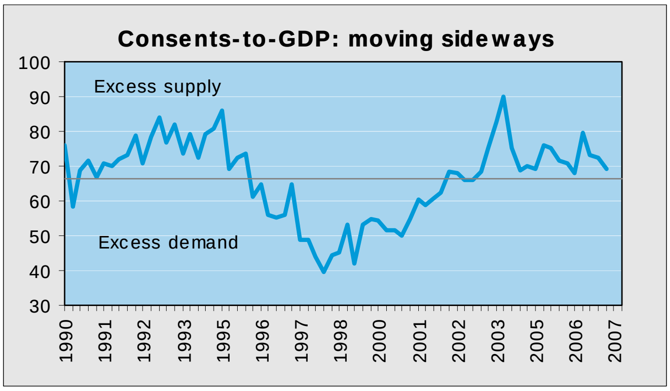


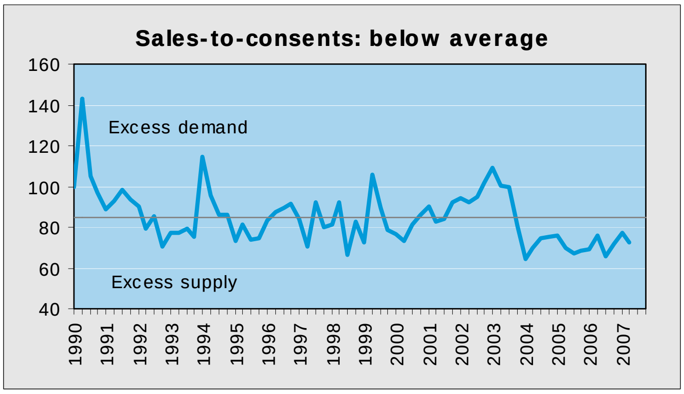
CANTERBURY – BROADLY BALANCED



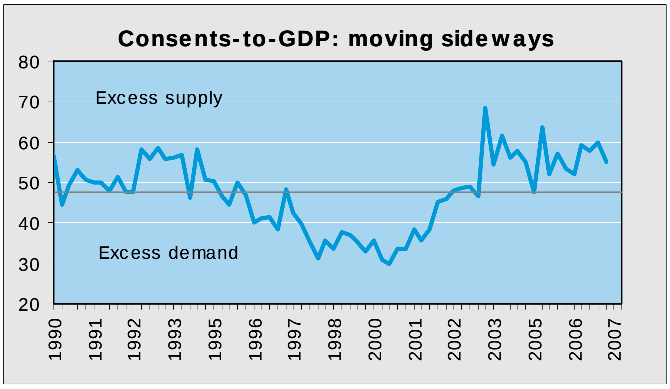


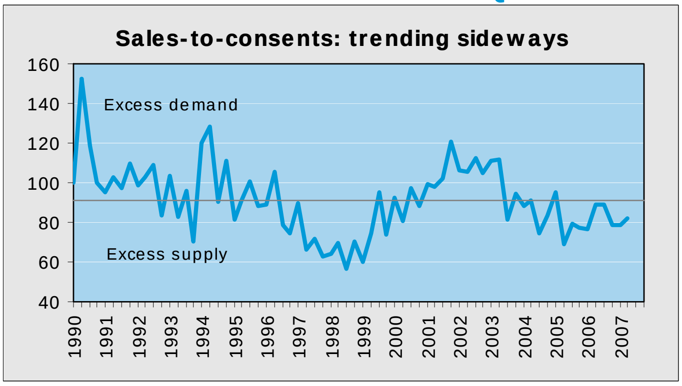
OTAGO – STILL EXCESS



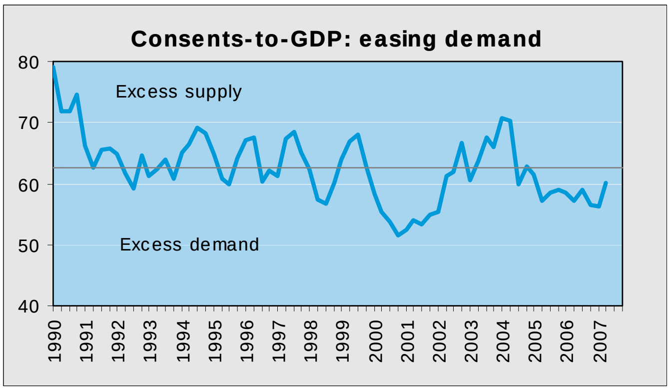


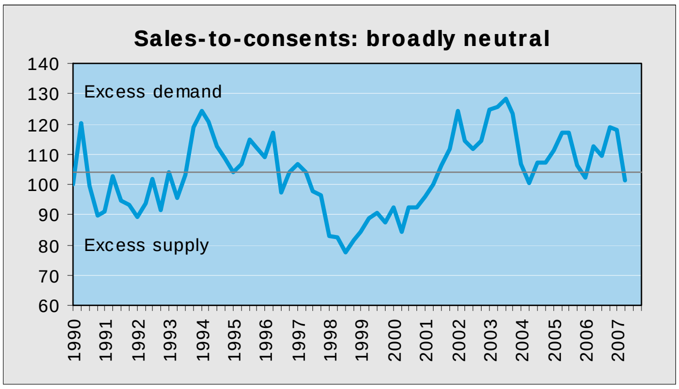
SOUTHLAND – EXCESS SUPPLY BUT NOT AS PRONOUNCED AS IN Q1





NEW ZEALAND – CONDITIONS EASING





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	1,007	1,027	1,048	1,068	1,089	1,109
550	937	958	979	1,000	1,021	1,043	1,064	1,086	1,108	1,130	1,153	1,175	1,198	1,220
600	1,022	1,045	1,068	1,091	1,114	1,137	1,161	1,185	1,209	1,233	1,257	1,282	1,306	1,331
650	1,108	1,132	1,157	1,182	1,207	1,232	1,258	1,284	1,310	1,336	1,362	1,389	1,415	1,442
700	1,193	1,219	1,246	1,273	1,300	1,327	1,355	1,382	1,410	1,438	1,467	1,495	1,524	1,553
750	1,278	1,306	1,335	1,364	1,393	1,422	1,451	1,481	1,511	1,541	1,572	1,602	1,633	1,664
800	1,363	1,393	1,424	1,454	1,485	1,517	1,548	1,580	1,612	1,644	1,676	1,709	1,742	1,775
850	1,448	1,480	1,513	1,545	1,578	1,611	1,645	1,679	1,713	1,747	1,781	1,816	1,851	1,886
900	1,534	1,567	1,602	1,636	1,671	1,706	1,742	1,777	1,813	1,849	1,886	1,923	1,960	1,997
950	1,619	1,655	1,691	1,727	1,764	1,801	1,838	1,876	1,914	1,952	1,991	2,029	2,069	2,108
1,000	1,704	1,742	1,780	1,818	1,857	1,896	1,935	1,975	2,015	2,055	2,095	2,136	2,177	2,219

Housing market indicators for August 2007 (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	19.8	-0.7	187	(-24%)	45	Longest days to sell in North Island
Auckland	13.9	-0.4	2,201	(-13%)	31	Lowest days to sell in North Island
Waikato/BOP/Gisborne	14.0	2.4	912	(-15%)	42	Prices recovered, back to June's record high
Hawke's Bay	7.8	0.6	266	(-7%)	42	Number of sales lowest since January 06
Taranaki	7.3	-4.8	148	(-10%)	42	Largest three month price fall in the nation
Manawatu-Wanganui	7.1	1.6	296	(-20%)	41	Lowest annual percent price gains in the North Island
Wellington	13.4	-1.9	838	(+9%)	31	Sales volumes recovered from July low
Nelson-Marlborough	14.0	0.4	209	(-14%)	31	Small recovery in days to sell since July
Canterbury/Westland	13.4	1.1	936	(-5%)	32	Days to sell above 30 for first time in a year
Otago	8.2	-0.2	254	(-13%)	31	Prices back to within a whisker of record highs
Central Otago Lakes	2.0	1.2	95	(-5%)	46	Fewest sales since October 04
Southland	17.7	8.1	254	(+6%)	17	Leading the way on recent price movements
NEW ZEALAND	12.9	0.0	6,610	(-9%)	34	Three successive (large) falls in sales

Key forecasts

	Actual			Forecast						
Economic indicators	Sep 06	Dec 06	Mar 07	Jun 07	Sep 07	Dec 07	Mar 08	Jun 08	Sep 08	Dec 08
GDP (ann avg % chg)	1.4	1.5	1.7	2.1	2.3	2.2	1.8	1.4	1.2	1.2
CPI inflation (%)	3.5	2.6	2.5	2.0[a]	2.0	2.9	2.9	2.6	2.6	2.7
Unemployment rate (%)	3.8	3.7	3.7	3.6[a]	3.7	3.8	3.9	4.0	4.2	4.3

	Actual			Forecast (end month)						
Interest rates	Jul 07	Aug 07	Current	Dec 07	Mar 08	Jun 08	Sep 08	Dec 08	Mar 09	Jun 09
Call rate	8.25	8.25	8.25	8.25	8.00	7.50	7.50	7.50	7.25	6.75
90-day bank bill rate	8.4	8.7	8.8	8.7	8.3	7.9	7.7	7.7	7.3	6.8
Floating mortgage rate	10.3	10.5	10.5	10.5	10.2	9.7	9.7	9.7	9.5	9.0
1-yr fixed mortgage rate	9.3	9.4	9.5	9.4	9.1	8.8	8.6	8.6	8.3	7.8
2-yr fixed mortgage rate	9.2	9.2	9.2	9.2	8.9	8.7	8.6	8.6	8.3	8.0
5-yr fixed mortgage rate	8.9	8.9	8.9	8.8	8.7	8.6	8.6	8.6	8.6	8.3

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