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Mercury rising faster than the market

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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 update our demand-supply housing balance measures.

The month in review (page 2)

> Momentum in the domestic economy continues to slow. However, the Reserve Bank's most recent economic overview confirms that inflation remains the predominant concern, and a substantial slowdown is required for inflation pressure to dissipate.

Property gauges (page 3)

> Affordability measures remain over-extended, and high mortgage rates are having an impact on housing market activity. The question is whether the support from liquidity will diminish, given a global reassessment of risk appetites.

Economic backdrop (page 5)

> The economy looks to be slowing to a roll as tighter monetary policy bites, and softening housing activity diffuses through the broader economy. With inflation pressure remaining intense, and numerous hot spots continuing within the economy, the Reserve Bank will remain on fire watch. The global environment is tenuous.

Mortgage borrowing strategy (page 6)

> The Reserve Bank has foreshadowed that the OCR interest rate will stay at current levels for longer than previously forecast. In the absence of a global event, or house prices falling 10 percent, rates look set to remain high for a while yet. Borrowing at 2-year rates looks to remain the sweet spot, balancing up the respective risks.

Feature article – Demand-Supply housing balance (page 7)

> We have updated our demand-supply housing balance measures for data to September. The sales-to-consents ratio slipped across the entire country. In every region, except Auckland, this measure indicates (to a varying degree) an excess in the pending supply of housing.

Key forecasts (page 12)

The month in review

Momentum in the domestic economy continues to slow. However, the Reserve Bank's most recent economic overview confirms that inflation remains the predominant concern, and a substantial slowdown is required for inflation pressure to dissipate.

House sales rise but the property market continues to moderate.

> **REINZ housing data – November.** Seasonally adjusted house sales rose 1.9 percent in November and follows a 12.2 percent increase in October. However, house sales still remain 21.6 percent below November 2006 levels. The median house price was $352,000, taking annual growth to 6.7 percent. Looking at the 3-month annualised rate, house price growth is 1.1 percent, or basically flat. Key in the release was the median number of days to sell a house increasing to 40 days (s.a.) – the highest level since the start of 2002 – and a clear indication the heat has gone out of the market. Historically, a rise in the median days to sell has preceded easing house prices and we expect this cycle to be no different.

Inflation remains the prime concern for Reserve Bankers…

> **Reserve Bank *Monetary Policy Statement*.** The RBNZ left the OCR unchanged at 8.25 percent. The no change decision was widely expected, but a more hawkish rhetoric was a surprise. It was the weight of the text that was directed at inflationary pressures (glossing over the global picture) and signalling interest rates being higher-for-longer that caught everyone's attention. While the RBNZ views that economic activity has largely evolved as outlined in the September *Statement*, the outlook for inflation has deteriorated, giving less scope to be mindful of real domestic and global economic developments.

> **Building Consents – October.** Residential dwelling consent issuance continued to ease in October. Following a 10.2 percent fall in September, seasonally adjusted dwelling consents issued fell a further 4.8 percent in October. Excluding apartments, the fall was more modest at 1.7 percent. Total residential dwelling consents issued is now down 16.1 percent on a year ago. Non-residential building consents reversed the softness recorded in September and rebounded in October.

… even though the domestic economy is losing steam.

> **External migration – October.** Monthly net migration inflows softened in October. A seasonally adjusted net inflow of just 260 people was recorded in October. This was half the average monthly net inflow of the past six months of around 520 people. The 12-month net total is now sitting at 7,517 people – the lowest level since the start of 2006. Slowing net migration will continue to take pressure off the housing market and consumer spending.

> **Mortgage lending - October.** Household credit growth has eased in recent months. Seasonally adjusted growth of 0.8 percent was recorded in October. This matched September's outturn, which was the lowest monthly change since 2002 and consistent with annual growth slowing to single digits as the current financial year progresses.

> **Value of Work Put in Place - September.** Total real construction activity rose by 2.1 percent in the September quarter. This strength was underpinned by a 5.1 percent increase in real residential work put in place. This increase seems at odds with how much consents issuance has been approved lately. Non-residential work put in place fell 2.6 percent.

Assessment

A continued softening tone is expected.

Signs that the domestic economy is slowing will give the Reserve Bank comfort that the monetary policy medicine is working. However, they will remain alert for any signs that the domestic economy may rebound given pending stimulus from tax cuts, infrastructure spending, and a super-sized dairy payout. Key to arresting inflation pressure is a sustained slowdown in domestic spending and activity. This means more of the same softening tone into 2008, and notably across the housing market.

Property gauges

Affordability measures remain over-extended, and high mortgage rates are having an impact on housing market activity. The question is whether the support from liquidity will diminish, given a global reassessment of risk appetites.

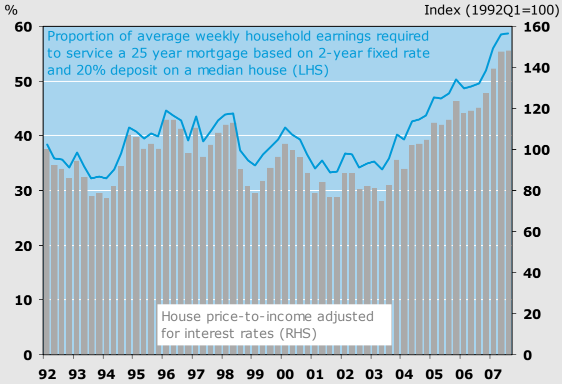
We use eight gauges to assess the state of the property market, and whether warning signs are emerging.

- **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.

The housing market and consumer spending are slowing. The Reserve Bank is now waiting for signs that this slowdown is translating into reduced inflation pressure from the non-tradables sector. They will remain cautious until they see conclusive evidence of this.

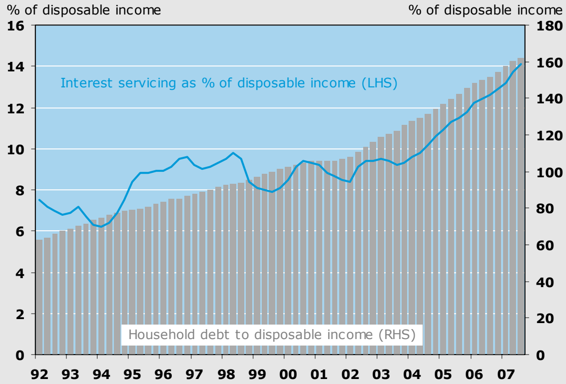
Indicator	Level	Direction for prices	Comment
Affordability	Expensive	↓	Price increases are showing signs of slowing, but mortgage rates have increased. Affordability remains at extremely expensive levels.
Serviceability / indebtedness	High	↓	Household indebtedness and the debt servicing burden keep hitting new highs and show no signs of consolidating yet.
Interest rates	High	↓	Fixed term rates remain high. With the Reserve Bank still concerned about inflation, little relief is in sight.
Migration	Medium	↔/↓	Migration inflows are softer and remaining below historical averages.
Supply-demand balance	Neutral	↔	Close to balance.
Consents and house sales	Consents stable, sales softening	↓	Looking through recent volatility, ex-apartment consent issuance has been stable. Time to sell is lengthening.
Liquidity	High	↑/↔	Liquidity remains abundant. But global financial market volatility and changing attitudes towards risk have increased the likelihood that diminished appetites to lend could be pending from certain pockets.
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		↓	**RBNZ is winning, but needs to see more proof.**

Housing Affordability



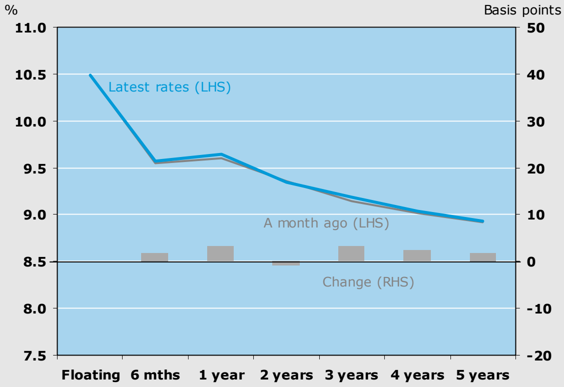
Sources: ANZ National Bank, Statistics NZ, REINZ, Reserve Bank

Serviceability and indebtedness



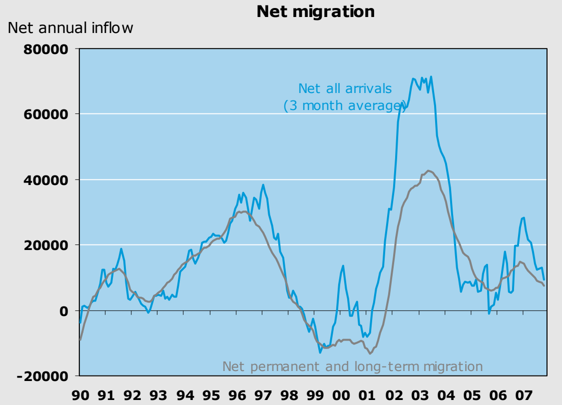
Sources: ANZ National Bank, Reserve Bank

New customer average residential mortgage rate



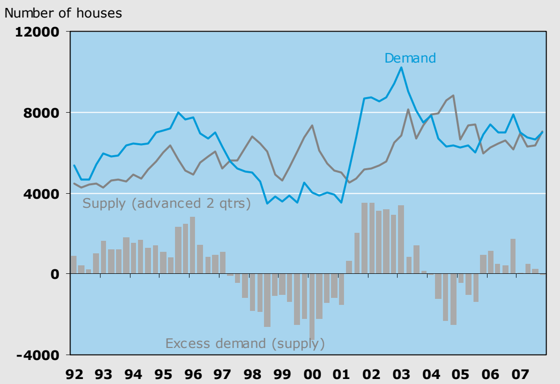
Sources: ANZ National Bank, Reserve Bank, www.interest.co.nz

Net migration



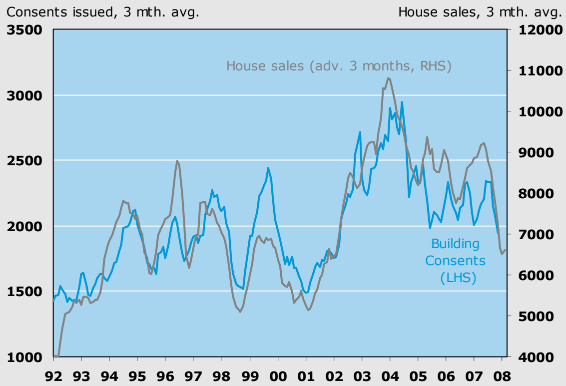
Sources: ANZ National Bank, Statistics NZ

Housing supply-demand balance



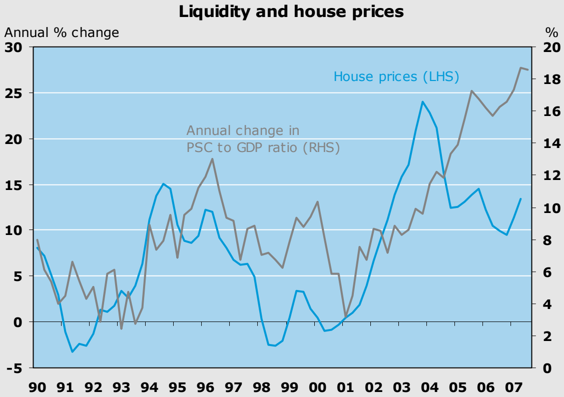
Sources: ANZ National Bank, Statistics NZ

Building consents and house sales



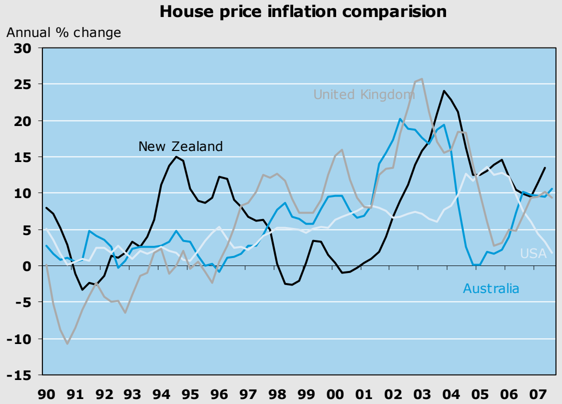
Sources: ANZ National Bank, Statistics NZ, REINZ

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 economy looks to be slowing to a roll as tighter monetary policy bites, and softening housing activity diffuses through the broader economy. With inflation pressure remaining intense, and numerous hot spots continuing within the economy, the Reserve Bank will remain on fire watch. The global environment is tenuous.

> Our core economic view.

Dampening down the hotspots.

Momentum within the economy continues to soften, although this will hardly be startling news to our (property) readers, with the housing market leading the slow-down. And for the property market, the news has hardly been inspiring. Media reports continue to emphasise difficulties across non-bank financial institutions – a key source of finance to the speculative end. The IRD is now more aggressively flexing its muscle towards the property sector, and the size of the property for sale segments across the newspapers has growth exponentially. Section developments are now the next tier we expect to display weakness. While overall the economy has cooled, hot spots remain. Commodity prices hit a new high but appear to be reaching a plateau, as dairy price growth loses some steam. Fonterra has upped their payout this season from $6.40 to $6.90/kg ms. This extra $0.50 translates to roughly an extra $600m in dairy incomes.

The RBNZ is on fire watch.

The Reserve Bank is mindful of the threat from some of these economic hot spots flaring up, and will keep a vigilant watch over the heat of the upcoming summer. Unfortunately, the Reserve Bank has no tool to combat surging commodity prices, although a stronger currency is mitigating the impact somewhat. Each upside commodity price surprise, or prospect for additional tax cuts, raises the probability of a corresponding rise in the Official Cash Rate – a blunt tool directed at the housing market. A further rate hike cannot be ruled out in the current inflationary environment, although we are certainly not taking this stance at present. This largely reflects our belief that house prices are already on the cusp of falling, and will drop over 2008 as opposed to flat-line as assumed by the Reserve Bank. Moreover, the domestic economy is weak with softness in the housing market seeping into the domestic economy, momentum in the global economy is slowing, and we expect this to manifest in easing commodity prices over the coming months.

> Offshore developments.

Put another log on the fire …

As we've noted previously, it is the global economy that represents the biggest risk to NZ at present. The last two times the NZ property market has been belted (1991 and 1997) coincided with weak international conditions, which eventually fed into the NZ economy. Global economic conditions remain fragile. The US economy is on the cusp of a recession, with house prices down 5 percent and expected to fall another 10. Momentum in Japan and Europe is slowing. Non-Japan Asia remains the shining star – for now. Credit dislocation has central banks on alert, either cutting rates or taking circumspect tones. Five central banks have jointly announced a series of coordinated measures in an attempt to ease short-term funding pressures.

… cook me up some bacon and some beans.

Why is the RBNZ out of sync with global developments? Essentially it is because they have more inflation pressure to combat. While current inflation pressure is known, the outlook for the global economy is not. They simply don't have the headroom to wait for a potential "event" to assist on the inflation front. For now it's a question of watch, worry and wait. But if the global economy can navigate through the current credit-related fiasco, it will be due to excess liquidity, Sovereign Wealth Funds buying distressed assets, and aggressive action by the Fed and other central banks. Given stratospheric commodity prices and low global unemployment rates, re-injecting liquidity at this juncture may well be the coup-de-grâce on a global inflation problem. And the end-game here is higher interest rates….if we can get past the current mess.

Mortgage borrowing strategy

The Reserve Bank has foreshadowed that the OCR interest rate will stay at current levels for longer than previously forecast. In the absence of a global event, or house prices falling 10 percent, rates look set to remain high for a while yet. Borrowing at 2-year rates looks to remain the sweet spot, balancing up the respective risks.

> Our view

The RBNZ has announced no change to the OCR in the foreseeable future.

At the latest monetary policy review, the RBNZ left the OCR unchanged at 8.25 percent. The no change decision was widely expected, but the more hawkish rhetoric was a surprise, considering the reduced tone coming from offshore central banks recently. Although the RBNZ still feel the current level of the OCR is consistent with maintaining inflation between 1 and 3 percent over the medium-term, at present the inflation forecast track looks to be stretching the interpretation of the Policy Targets Agreement. Higher inflation pressures mean that the Bank has pushed out any easings in monetary policy until the second half of 2009.

We have taken three messages from our reading of the December *Monetary Policy Statement,* released by the Reserve Bank.

- Inflation pressure is more pronounced, explicitly tying the Reserve Bank's hands.
- The RBNZ want to get maximum policy traction out of the yield curve, ensuring that the pipeline tightening continues to filter through to the housing sector.
- In the absence of a global event, rates will likely remain high for a very long time.

We broadly agree with the thrust of the Reserve Bank's assessment. Inflation pressure is problematic. Rates will remain high to ensure domestic momentum slows, thereby eventually removing inflationary hot-spots such as housing, and capping firm's ability to pass on price increases.

However, there are two broad differences between us and the RBNZ.

- We believe the housing market is weaker than the Reserve Bank is portraying. (The Reserve Bank expect house prices to flatten, whereas we believe they are already set to fall 5 percent).
- The global economy is softer, and this softness will mitigate some of the upside inflationary pressure coming from commodity prices.

Deal or no deal.

We continue to expect rates to move lower in late 2008. Stepping back, 12 months is still a long-way away, hence the spirit of the view is one of rates remaining high for sometime. However, we also remain alert to the potential for conditions to change rapidly given the global environoment.

> Themes we favour in the current environment

We continue to prefer rates in the middle part of the fixed rate mortgage curve, as they appear to offer the best combination of flexibility against lower relative cost.

- **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 to 3-year rates given recent developments.** With the OCR likely to be kept high for longer, these rates appear to offer a reasonable balance between cost and flexibility.
- **We continue to struggle to see value in the 5-year rate at present.** However, if we see the global inflation picture start to deteriorate, we will be inclined towards the longer duration.

Feature article – Pssst… your slip is showing

We have updated our demand-supply housing balance measures for data to September. The sales-to-consents ratio slipped across the entire country. In every region, except Auckland, this measure indicates (to a varying degree) an excess in the pending supply of housing.

The housing market has turned.

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.

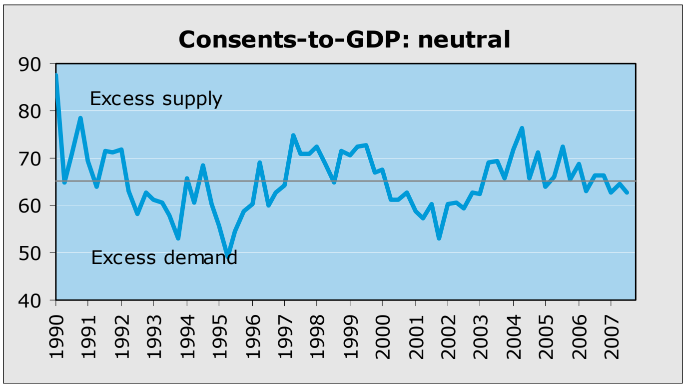
Across the regions, there are three distinct groupings:

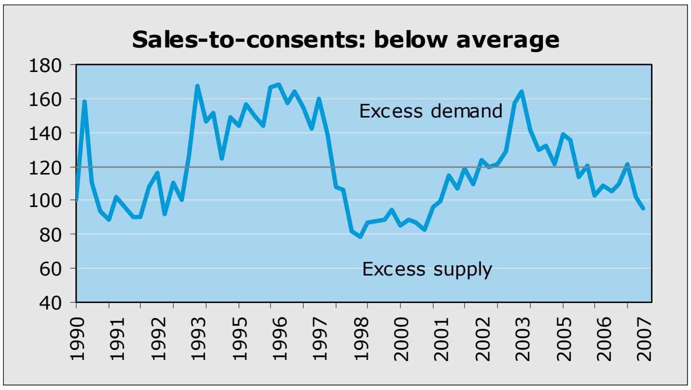
- Auckland is out on its own with both measures indicating an excess demand. The ratio of consents to GDP remains below trend (too little supply). The ratio of sales to consents fell, but it still remains indicative of excess demand.
- The demand-to-supply conditions are close to balance in Northland, Waikato, Bay of Plenty and Canterbury.
- The remaining regions are now showing signs of a market that is moving in the favour of buyers. Supply is in excess of demand over both indicators in Taranaki, Manawatu-Wanganui, the West Coast, Otago and Southland. The remainder of New Zealand (Gisborne, Hawke's Bay, Wellington, Nelson-Marlborough) has only one of the two indicators registering an excess of supply.

Further softening is expected.

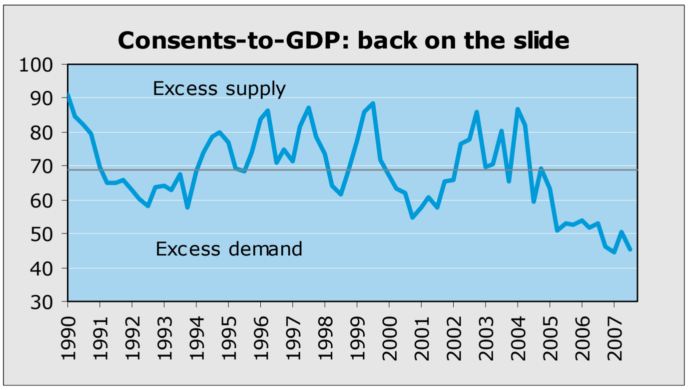
Only Auckland is facing excess demand conditions but this is narrowing rapidly. Our gauges are calculated on a quarterly frequency and thus only available to September. House sales rebounded in October and November, but the average period of time to sell lengthened. We expect house sale numbers to ease modestly in response to a lift in mortgage rates. This suggests that house price growth, which has already softened over recent months, will continue to moderate over next year.

NORTHLAND- MOVING TOWARDS OVER SUPPLY

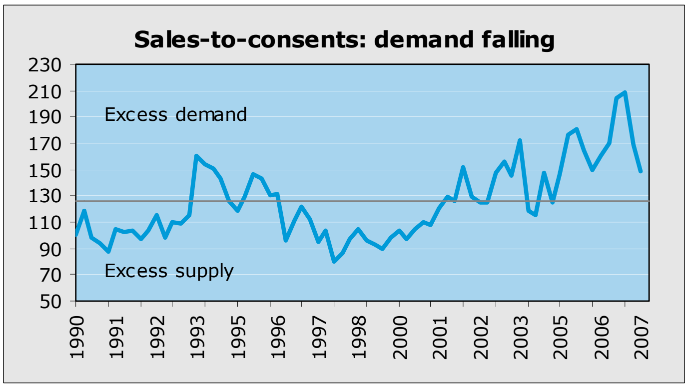




AUCKLAND – ON A SLIPPERY SLOPE

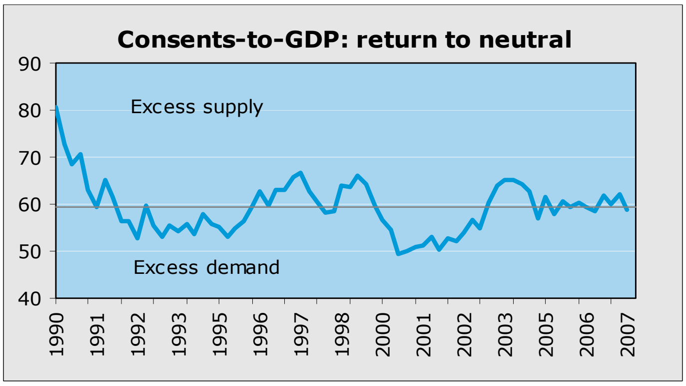


Consents-to-GDP: back on the slide

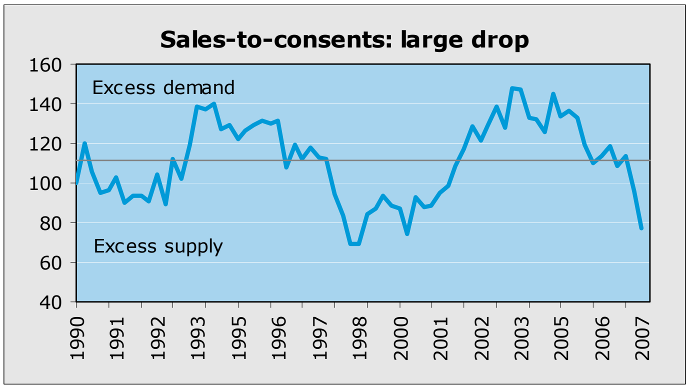


Sales-to-consents: demand falling

WAIKATO – ON THE DECLINE

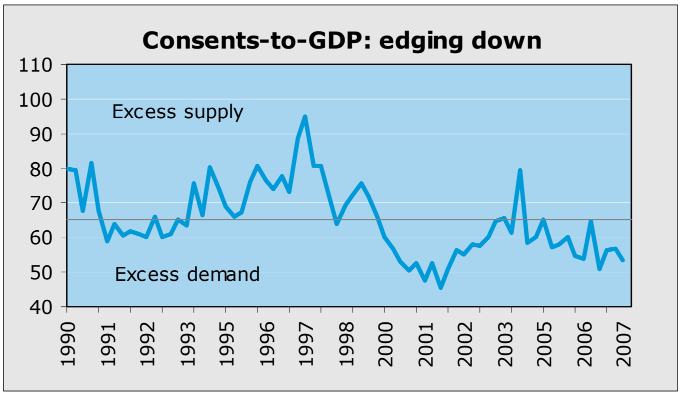


Consents-to-GDP: return to neutral

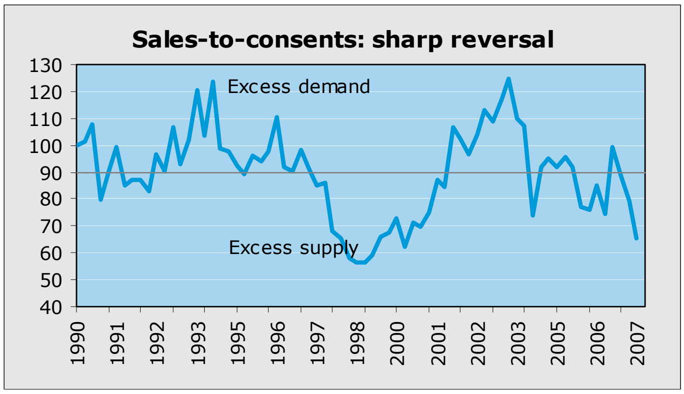


Sales-to-consents: large drop

BAY OF PLENTY – DEMAND DRIES UP

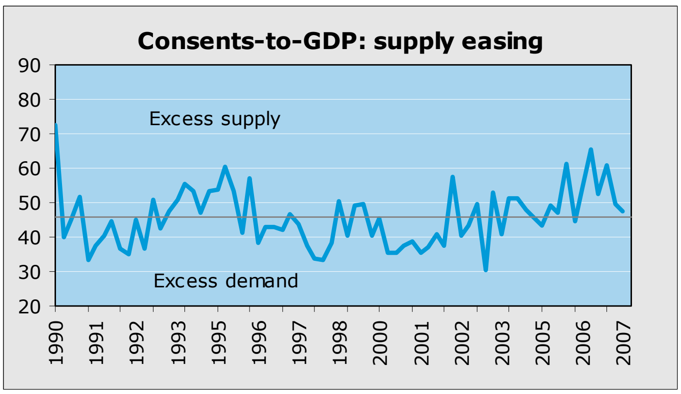


Consents-to-GDP: edging down

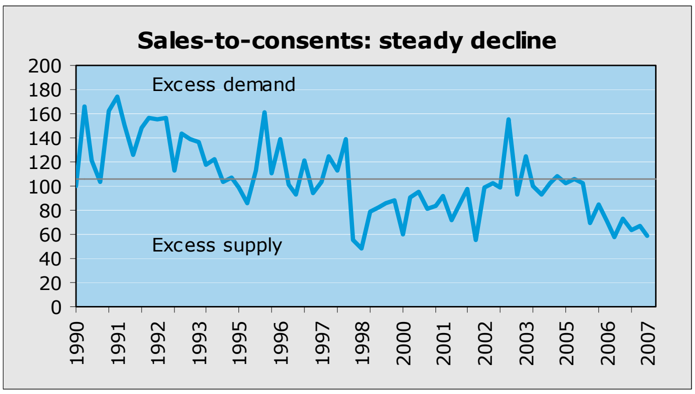


Sales-to-consents: sharp reversal

GISBORNE – MORE HOUSES BEING SOLD

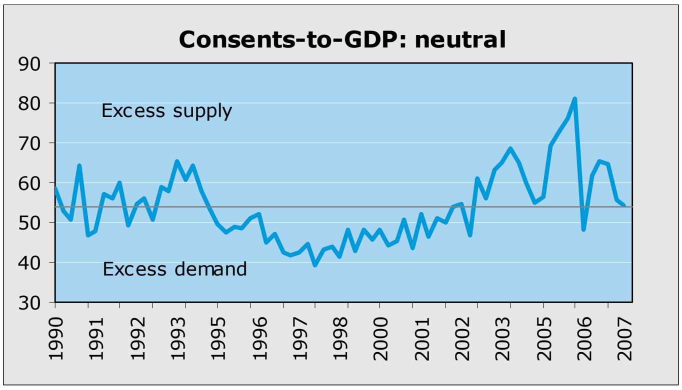


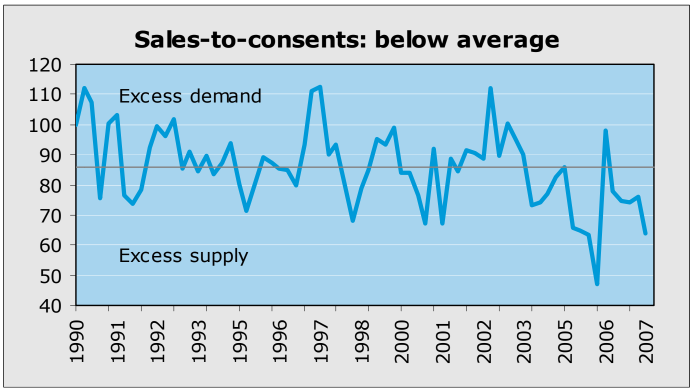
Consents-to-GDP: supply easing



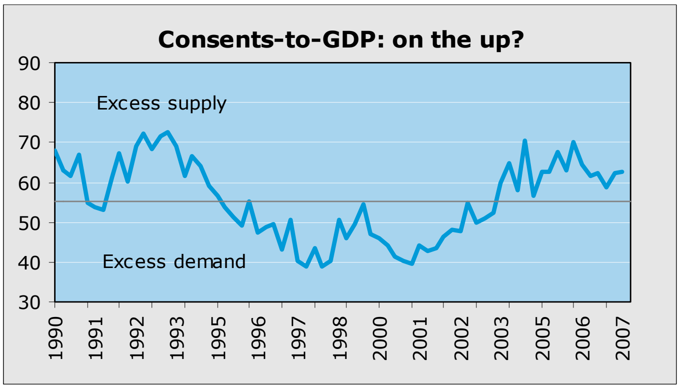
Sales-to-consents: steady decline

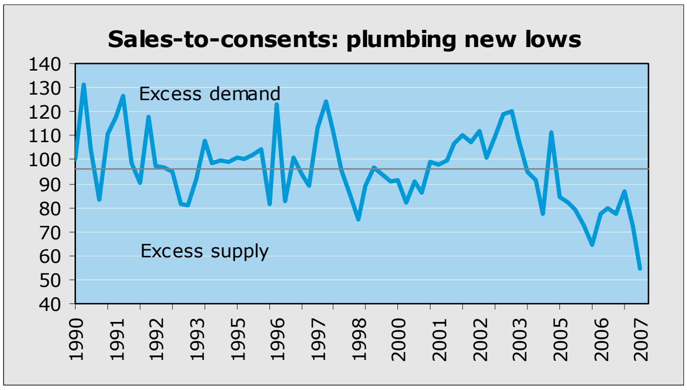
HAWKE'S BAY – DOWN SHE GOES



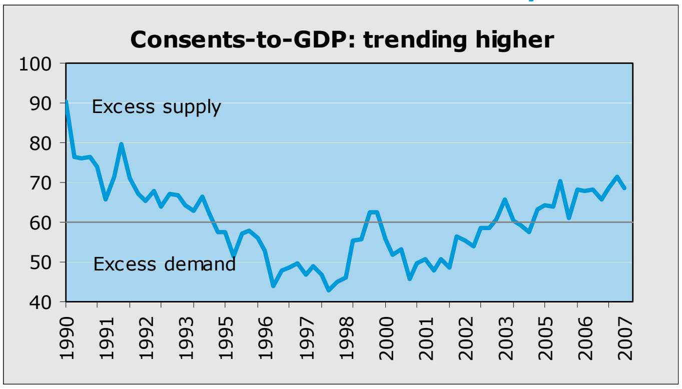


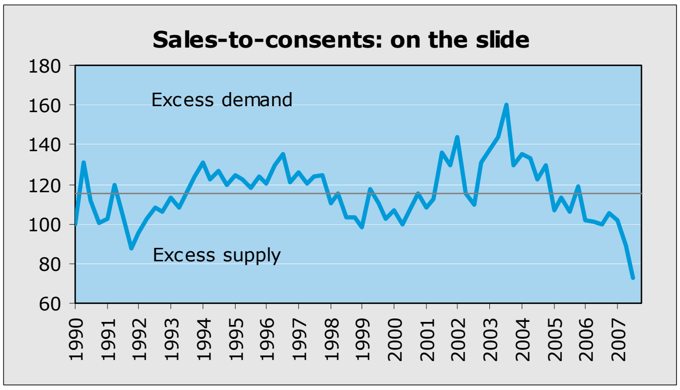
TARANAKI – POURING OIL ON TROUBLED WATERS



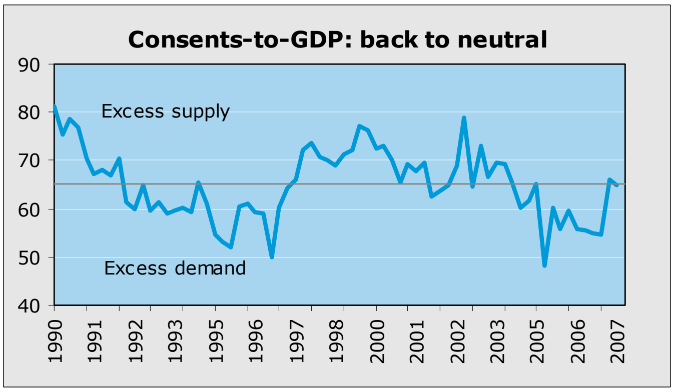


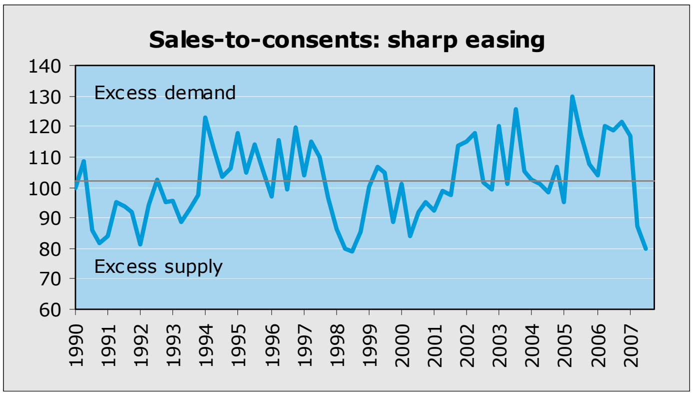
MANAWATU/WANGANUI – LOTS OF HOUSES





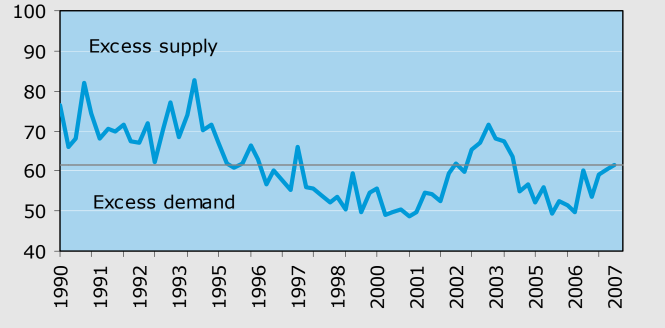
WELLINGTON – OVER CORRECTION



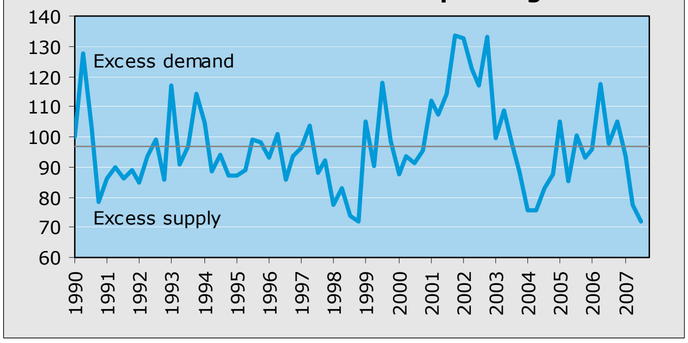


NELSON/MARLBOROUGH – ON THE DIP

Consents-to-GDP: neutral

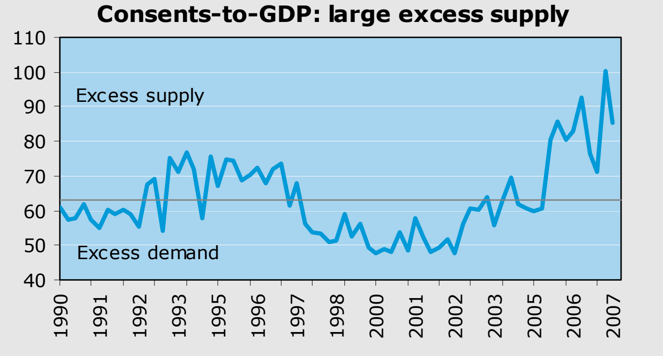


Sales-to-consents: sharp easing

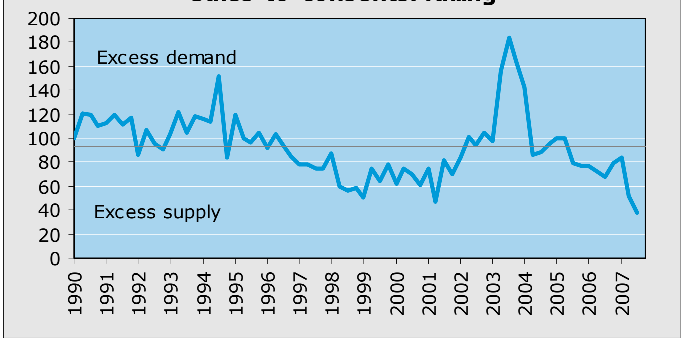


WEST COAST – BUYERS MARKET

Consents-to-GDP: large excess supply

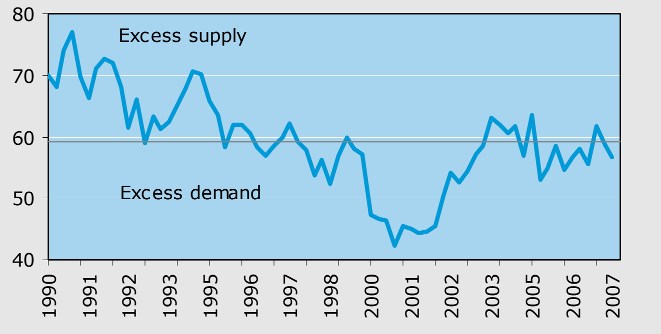


Sales-to-consents: falling

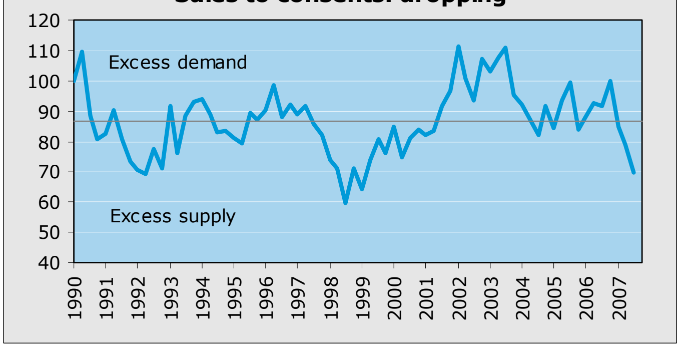


CANTERBURY – MOVING AWAY FROM NEUTRAL

Consents-to-GDP: demand returns

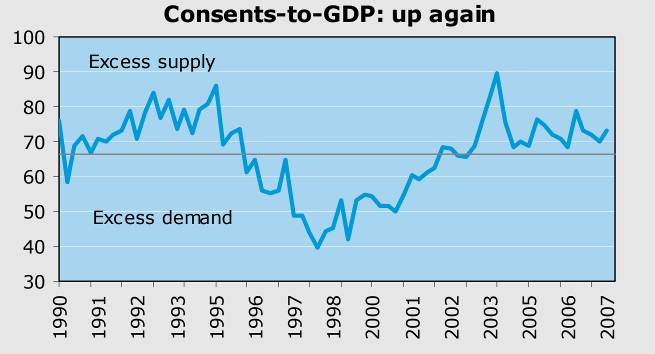


Sales to consents: dropping

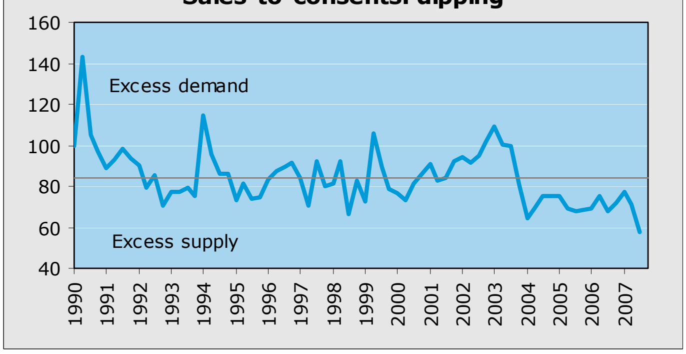


OTAGO – ANOTHER STEP DOWN

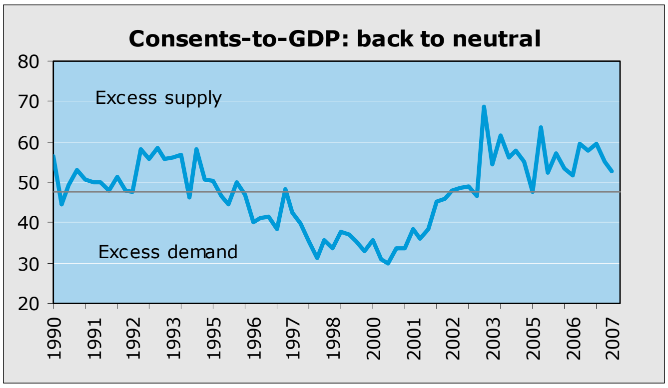
Consents-to-GDP: up again

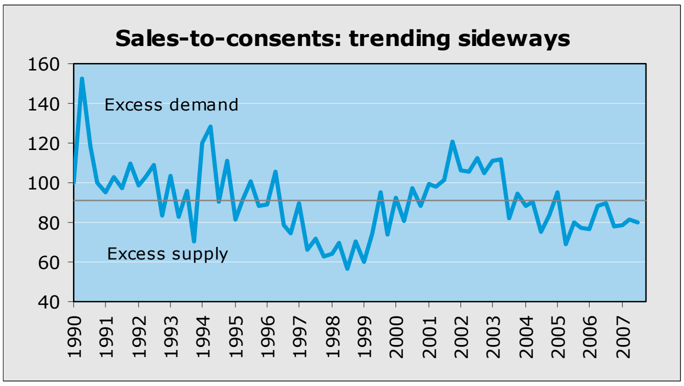


Sales-to-consents: dipping

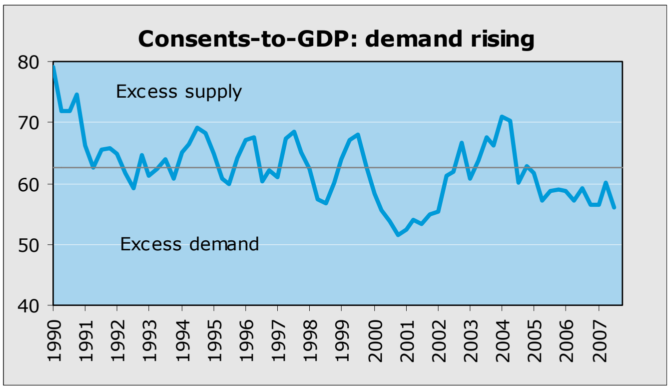


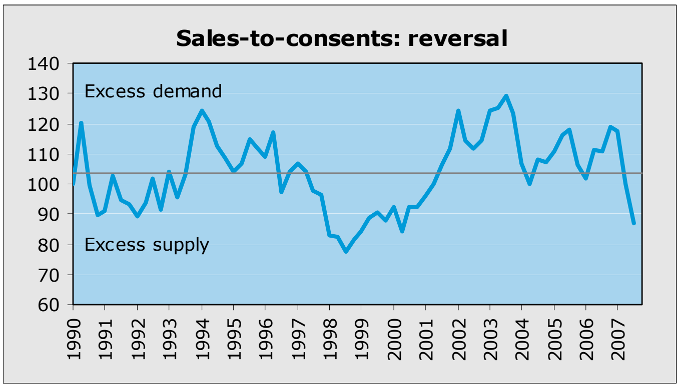
SOUTHLAND – A GEM MAY STILL BE WAITING TO BE FOUND





NEW ZEALAND – DOUBLE DIPPING





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
1,000	1704	1742	1780	1818	1857	1896	1935	1975	2015	2055	2095	2136	2177	2219

Housing market indicators for November 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	7.9	-1.2	153	(+0%)	51	Largest dip in prices over the past 3 months
Auckland	5.9	-0.3	2,194	(-2%)	38	Share of NZ sales has sunk to an 18-month low
Waikato/BOP/Gisborne	5.8	0.5	988	(-2%)	51	Registered the joint longest time to sell a house
Hawke's Bay	0.0	-1.0	220	(-11%)	46	Sale numbers take a body blow in November
Taranaki	3.8	3.2	202	(+16%)	49	Largest rise in sale numbers in the month
Manawatu-Wanganui	9.6	1.2	345	(+0%)	49	Second strongest annual gain in house prices in NZ
Wellington	6.8	2.1	831	(+8%)	33	House prices jump 30k to hit a new high
Nelson-Marlborough	4.4	2.1	293	(+3%)	38	Prices have been yo-yoing up and down since March
Canterbury/Westland	8.5	1.5	1,082	(+15%)	40	On par or better than the national average
Otago	0.0	1.5	303	(-2%)	37	House prices are at the same level as a year ago
Central Otago Lakes	9.6	7.8	123	(-3%)	46	House prices are up but sale numbers are down
Southland	34.9	9.5	210	(+2%)	30	Prices have risen by over a third from last year
NEW ZEALAND	6.7	1.1	6,953	(+2%)	40	Average days to sell hits a 7½-year high of 40 days

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)	1.7	2.2	2.7	2.8	2.6	2.1	1.7	1.5	1.6	2.0
CPI inflation (%)	2.5	2.0	1.8	3.0	3.0	2.7	3.1	2.9	2.8	2.7
Unemployment rate (%)	3.7	3.6	3.5	3.6	3.7	3.8	3.9	4.0	4.2	4.2
	Actual			**Forecast (end month)**						
Interest rates	Oct 07	Nov 07	Current	Mar 08	Jun 08	Sep 08	Dec 08	Mar 09	Jun 09	Sep 09
Call rate	8.30	8.33	8.25	8.25	8.25	8.00	7.50	7.0	6.75	6.75
90-day bank bill rate	8.7	8.7	8.8	8.7	8.6	8.0	7.5	7.0	7.0	7.0
Floating mortgage rate	10.5	10.5	10.4	10.4	10.4	10.2	9.7	9.2	8.9	8.9
1-yr fixed mortgage rate	9.5	9.6	9.6	9.5	9.4	8.9	8.3	7.9	7.9	7.9
2-yr fixed mortgage rate	9.1	9.4	9.4	9.2	9.1	8.7	8.2	7.9	7.9	7.9
5-yr fixed mortgage rate	8.7	8.9	8.9	8.8	8.8	8.7	8.4	8.3	8.2	8.4

Disclaimer:

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