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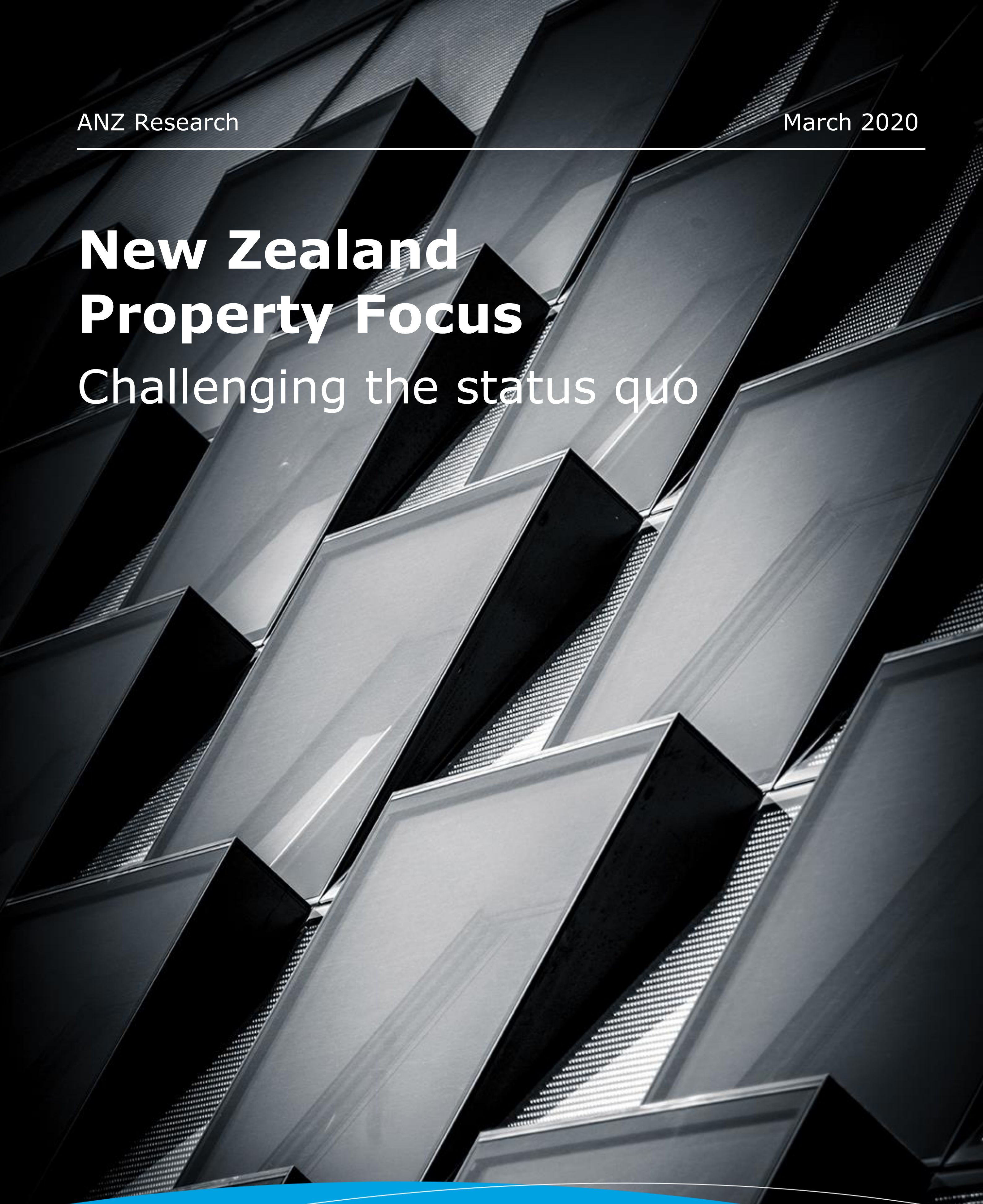

New Zealand Property Focus

Challenging the status quo

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INSIDE

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Summary

Our monthly *Property Focus* publication provides an independent appraisal of recent developments in the residential property market.

Feature Article: Challenging the status quo

A recession is now underway that may be quite deep. The global and domestic slowdown on the back of the COVID-19 outbreak will see new challenges emerge for the construction industry. Demand will moderate on weaker sentiment and incomes, particularly on the residential side. Projects could be delayed and costs increase, intensifying financial pressures that already exist for some as a result of squeezed profitability, credit constraints and low cash buffers. The lower OCR will ease financial pressure for construction-related firms by lowering debt-servicing costs, although the availability of credit will remain a constraint for some. Firms will need to actively manage risks in the difficult and uncertain period ahead that may be prolonged.

Property gauges

The housing market will be weighed down by the recession now underway. **We now expect house prices to fall 3½% this year** as the impact of the global downturn weighs on business conditions, sentiment, incomes and household wealth. This drop is broadly in line with the GDP impact we are expecting. There are risks in both directions. Migration could be stronger if more kiwis decide to come home, and the lower OCR will provide a cushion. But likewise there are very significant downside risks to GDP and incomes. The outlooks for funding markets and credit availability are uncertain and could also pose downside risk.

Economic overview

The economy is experiencing a recession, which may be deep. The RBNZ has slashed the OCR to 0.25% and committed to keeping it there for at least a year. They have also indicated that they will conduct large-scale asset purchases to provide further stimulus if required. We think it will be. Tougher bank capital requirements have been delayed to encourage credit creation, and the RBNZ are ready to step in to ensure the financial system functions smoothly. The Government has also announced a bold stimulus package targeted at affected businesses and cushioning household incomes and spending. A bigger and broader package will be needed in time. Fortunately, the Government has plenty of financial scope to respond. Bond purchases by the RBNZ will keep the Government's borrowing costs contained, with these now looking more urgent.

Mortgage borrowing strategy

Mortgage rates have fallen to all-time lows this week following the RBNZ's 75bp cut in the OCR on Monday. And with the RBNZ committing to keeping the OCR at 0.25% for at least 12 months, hinting that it stands ready to do quantitative easing to drive term interest rates lower, and to ensure that banks and businesses have continued access to funding, mortgage rates are unlikely to rise any time soon. They may well fall from here, but with floating rates still much higher than most banks' short-term fixed rates and 1-year rates the lowest by some margin, we favour the 1 year.

Feature Article: Challenging the status quo

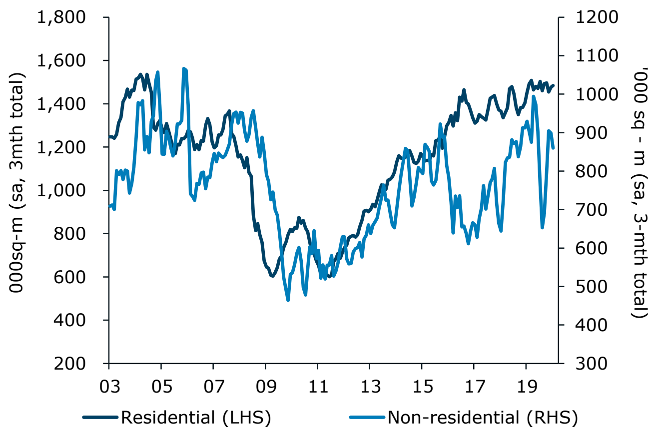
Summary

A recession is now underway that may be quite deep. The global and domestic slowdown on the back of the COVID-19 outbreak will see new challenges emerge for the construction industry. Demand will moderate on weaker sentiment and incomes, particularly on the residential side. And although it is quite domestically focused, construction (like many industries) is reliant on imported building materials and is likely to be affected by disrupted global supply chains, particularly in the areas of commercial and heavy construction. Projects could be delayed and costs increase, intensifying financial pressures that already exist for some as a result of squeezed profitability, credit constraints and low cash buffers. The property development segment could be particularly vulnerable. The lower OCR will ease financial pressure for construction-related firms by lowering debt-servicing costs, although the availability of credit will remain a constraint for some. Lower interest rates will also support activity, particularly once challenges start to dissipate. Over the longer term, the pipeline of work is expected to be supported by both population growth and public sector work, and the outlook is positive. However, firms will need to actively manage risks in the difficult and uncertain period ahead that may be prolonged.

High times

The construction industry has been running hot. The Canterbury earthquakes provided an enormous boost, with activity subsequently supported by low interest rates, a strong housing market, and income growth. Recently, activity has been running strong across the board, both by region and by sector: residential and non-residential (figure 1).

Figure 1: Consented volume of building work

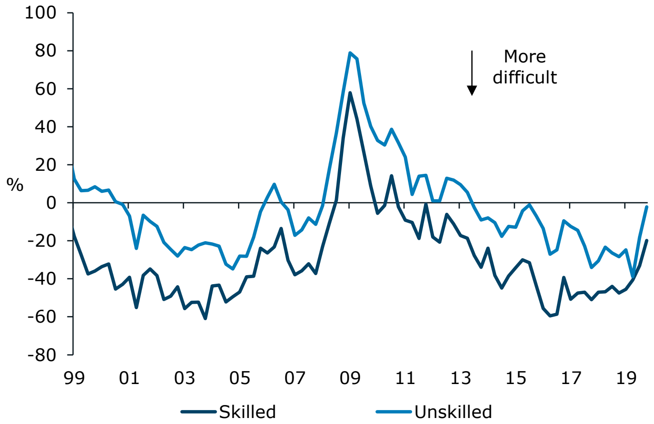


Source: Statistics NZ

But it hasn't necessarily been easy

Reflecting a solid pipeline of work, sentiment amongst construction firms has been very positive relative to other industries. But achieving high levels of activity hasn't necessarily been easy. Sure, there has been a lot of work out there, but making good profits has come with its own challenges. Consistently, labour has been difficult to come by (and keep) – there could be worse problems, but it's been a consistent and important problem nonetheless (figure 2).

Figure 2: Ease of finding skilled labour for builders



Source: NZIER

Wages have risen to attract talent, but the overarching issue has been that the workers simply aren't there, especially with a shortage of apprentices in the pipeline. And of course, the rising price of labour has made a dent in firms' margins. Construction is reasonably labour intensive, with labour costs comprising 40-45% of input costs. And wage rises have been particularly expensive per unit of output when considered alongside lacklustre productivity growth in the industry.

Profitability has been squeezed in recent years but has improved a bit recently. Cost pressures are acute – not just for labour, but also in the regulatory space, and reflecting operational costs associated with delays. Efficiency gains to mitigate the pressure have been difficult to achieve. And there have been some reports of offshore construction companies starting to make inroads in the market, increasing competition.

Adding to financial pressures for some, credit has been difficult to come by. Banks have been more cautious about extending credit in recent times, and often businesses do not have large cash buffers.

Emerging challenges

The synchronised global slowdown that is underway on the back of the COVID-19 outbreak is set to result in a recession that is looking quite deep. All industries will be affected, including construction, meaning the best is behind us.

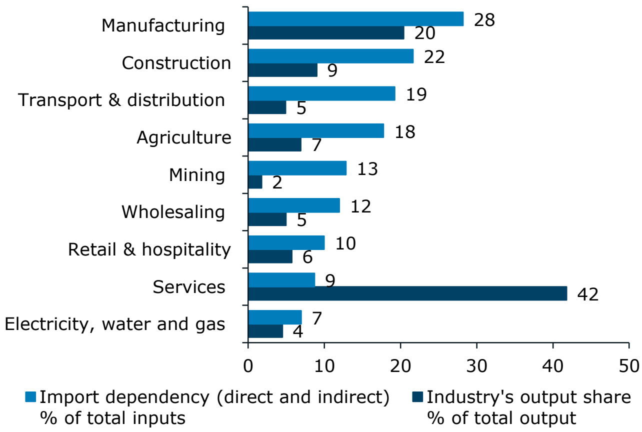
The construction industry isn't on the front line in terms of economic effects from the global outbreak (which we have discussed here and here), since it is domestically focused. And relative to other industries, it also has a starting point of strong demand. But it will not be immune to the slowdown in demand taking place – especially if the virus establishes itself here and causes widespread disruption. On the plus side, the sector may benefit from projects in the "recovery" part of the Government's stimulus package – we'll find out in the May Budget.

Supply disruption

Supply disruption is an immediate concern. Like most industries, domestic construction is reliant on imported materials and global supply chains. In total, 20-25% of construction inputs are imported, either directly or indirectly (figure 3). Activity is starting to resume gradually in China, but now the virus is rampant in many other countries, threatening other parts of global supply chains.

Commercial and civil construction firms are most vulnerable to import disruption. Not only do they import more goods overall than residential firms do, but they import more specialised materials, and from limited sources. By contrast, residential firms use more generic products, and products that are more easily sourced domestically or from alternative foreign markets. Still, even here there may be competition from other countries for products that can still be sourced, and purchases could therefore be at higher prices. Freight costs could also increase due to reductions in both shipping and airfreight capacity.

Figure 3: Import reliance of industries



Source: Statistics NZ, ANZ Research

We are already starting to see delays in sourcing building materials in some areas, notably specialised materials for larger heavy construction projects. Looking forward, supplies could run short more generally if disruption in production and shipping continues, especially if disruption becomes widespread globally and alternative markets become difficult to tap, including for generic goods.

Such disruption could see some projects delayed, particularly commercial and infrastructure projects that are more reliant on specialised parts. If such disruption occurred, we think delays are more likely than total canning of existing projects, since the longer-term fundamentals for these projects remain intact and considerable investment has taken place already in getting them underway.

Softer demand

The pipeline of projects may be affected significantly by the looming recession. On the commercial side, some projects will be cancelled, particularly where the sunk costs are relatively low as they are early on in the planning. Uncertainty could impact commercial clients' appetite to commit, or they may no longer be financially viable, especially in directly affected sectors (eg hotels, accommodation for foreign students). And with sentiment likely to slide further, firms may be reluctant to invest in buildings more broadly.

While residential construction is a bit more insulated from supply disruption, it is more vulnerable to the certain softening in domestic demand underway. Residential construction is quite cyclical. High-end projects are most vulnerable, and are particularly affected by business confidence; clients may plan a project and get consent but then not go ahead if they aren't confident in the outlook for their business. Commercial construction is less vulnerable to this; already-planned projects have a longer life-cycle, as well as higher up-front costs, and their completion rates are therefore less cyclical.

Residential construction activity is expected to soften this year from high levels – with risks it could be a material drop, reflecting the synchronised domestic slowdown that is underway. The slowdown will weigh on incomes, the housing market and building activity broadly, even with the OCR now super low, as job security is diminishing. If the virus becomes well-established here, then risks would rise significantly further.

Financial pressure

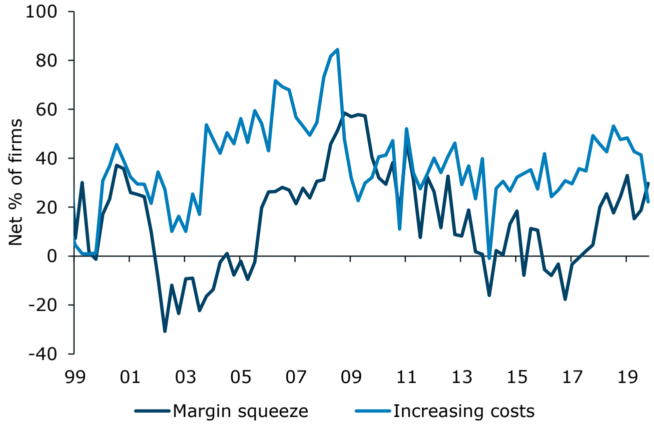
Emerging challenges could intensify the financial pressures that already exist for some construction firms. Cost pressures have been a constant, with margin squeeze a particular issue since mid-2017 (figure 4).

Financial concerns are particularly relevant in the commercial construction space where overheads are large, and the operational costs of delays very expensive.

Costs are likely to increase further in the short term, impacting the bottom line, especially if materials become scarcer. And delays to projects will increase operational costs. Likewise, there will likely be difficulty sourcing migrant labour with global mobility restricted. In particular, many construction workers come from the Philippines, both labourers and specialists. Difficulty finding labour in order to complete jobs could contribute to delays and lead to higher wage costs in the short term.

A weaker demand outlook may make it difficult for these cost increases to be passed through to prices, with margins potentially squeezed even further.

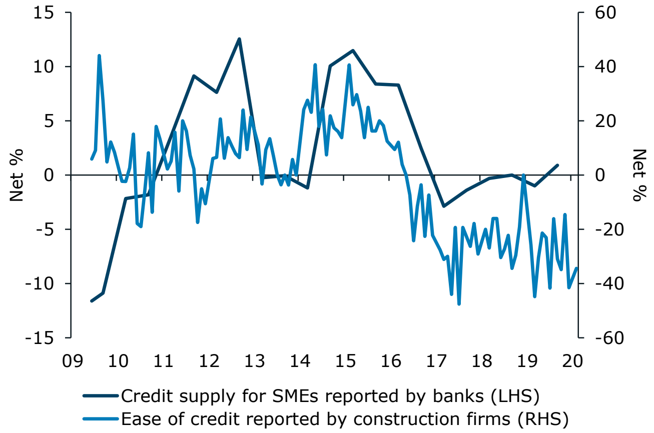
Figure 4: Experienced profitability and reported costs (construction industry)



Source: NZIER

Navigating these financial pressures will be challenging for some. In some cases, margins are unsustainably thin, cash buffers are limited, and/or credit is constrained (figure 5). The outlook for credit conditions is uncertain, but banks naturally have a role to play. This will be an important factor influencing how firms navigate the period ahead.

Figure 5: Credit conditions reported by banks and perceived by construction firms



Source: RBNZ, ANZ Research

Possible financial concerns are also particularly relevant for property developers, for whom credit conditions are already very stringent. There are strict covenants and equity and pre-sale requirements for these firms, given the natural pro-cyclicality and inherent riskiness of this sector.

Adding to this, property developers are particularly vulnerable to cost increases associated with disruption and delays, since they have to line up many sub-contractors and materials in order for a project to be completed. It takes only one disruption in the chain to see delays, leading to higher costs and exacerbating financial pressures. Moreover, with households likely to be quite cautious for a time, pre-sales may be more difficult to secure. And if the housing market and land prices soften as we expect, it could impact developers' equity too.

Policy to provide some support

The RBNZ has slashed the OCR to 0.25% and delayed the imposition of tougher capital requirements for banks by a year. These measures will provide some support. And the RBNZ stands ready to conduct quantitative easing, if needed, to ensure that financial conditions remain easy. Scope to directly lean against the impacts of the current slowdown is somewhat limited, given the nature of the shock. But lower interest rates will directly ease costs for construction firms, at a time when cost pressures from other areas are likely to be increasing. This plus freeing up bank lending by deferring the tougher capital limits are key areas where we see the RBNZ as being able to soften the blow of the slowdown.

A lower OCR is not necessarily going to spur demand. Lower interest rates are unlikely to be enough to get more commercial or property development projects across the line in the short term. This reflects capacity constraints presented by potential disruption, and the fact that credit availability is currently a more important consideration for firms than the price. And while a lower OCR will help to support land/house values and demand for residential building relative to otherwise, some softening is likely, even with this support.

Over time, however, we expect that lower interest rates will help to facilitate the eventual economic recovery by supporting the housing market and encouraging demand for building generally, especially once conditions in the domestic economy normalise and sentiment improves. An eventual recovery in business investment will support commercial construction. And for those in the infrastructure space in particular, government spending will support the pipeline of projects.

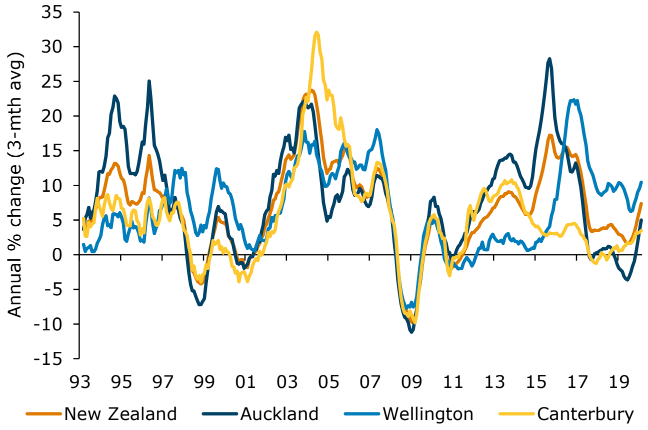
The Government's business continuity plan will help the construction sector hold onto their staff should the slowdown accelerate quickly. Banks will naturally also play a role in helping firms and households get through.

The construction accord with the Government (aimed at facilitating fairer procurement processes) will help spur dialogue between Government and firms on industry impacts. But it would also be helpful for the Government to be ready with planned projects to support the pipeline through the eventual recovery.

The May Budget may reveal more on this front, as it is being reworked in light of the near-term slowdown we are facing.

Much is uncertain. How the Government, the RBNZ, banks and clients respond will be important for how impacts pan out. Firms should be working to manage emerging risks – eventual recovery is expected, but the downturn may be painful, and impacts could persist for a while.

Figure 1. Regional house price inflation



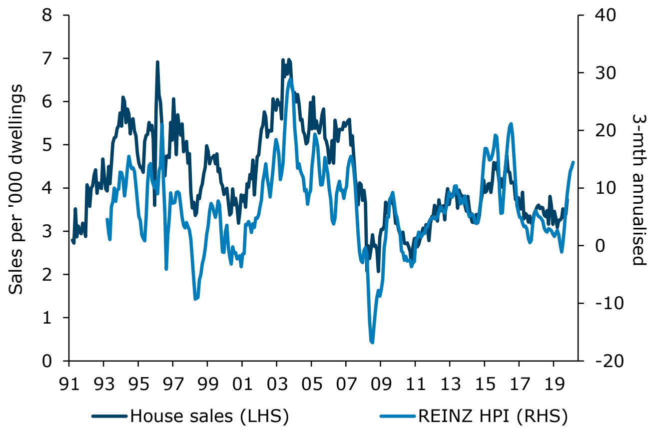
Source: ANZ Research, REINZ

House prices rose 2.0% m/m in February, accelerating to 7.4% y/y – just above the long-run average rate of 6.8% y/y, and above where nominal GDP growth is tracking.

Auckland continued to stage a comeback. After bottoming out at -3.7% y/y in August last year, growth has picked up sharply to 5.0%. Outside of Auckland, house prices were up 9.4% y/y. Smaller regions continue to show greater upwards momentum although some centres, such as Bay of Plenty, have stabilised (around 6.0% annual growth).

Looking forward, house prices will be affected by difficult economic conditions as a result of the COVID-19 outbreak, notably with the NZ labour market set to weaken considerably. Monetary and fiscal policy will cushion some of the blow, but it won't be enough to keep house prices from falling.

Figure 2. REINZ house prices and sales



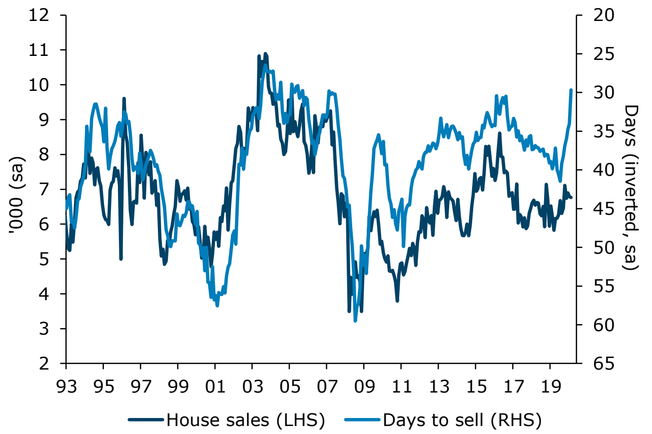
Source: ANZ Research, REINZ

Sales volumes and prices tend to be closely correlated, although at times tight dwelling supply can complicate the relationship.

Across the country, sales fell 0.3% m/m in February but are up 9.5% y/y (3mma). Auckland sales up 29% y/y, making up a third of sales over the last three months, a notable contrast to the almost 15% decline seen over the year to May 2019. Ex-Auckland sales were up 4.1% y/y with some of the smaller centres falling considerably. Annual growth in Taranaki, West Coast and Southland are down around 8-10% y/y.

Overall, the level of house sales looks contained relative to history. Sales are expected to move lower alongside prices, as difficult labour market conditions impact on households and investors alike.

Figure 3. Sales and median days to sell

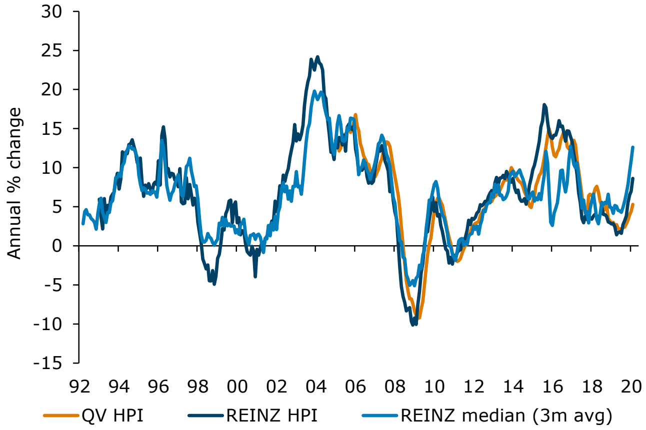


Source: ANZ Research, REINZ

How long it takes to sell a house is also an indicator of the strength of the market, encompassing both demand and supply-side considerations. Larger cities tend to see houses sell more quickly, but deviations in a region from its average provide an indicator of the heat in a market at any given time.

The number of days it takes to sell a house has fallen from mid-2019 and dipped sharply to 30 days in February. This is well below the historical average of 39 days, with the market still very tight overall. We expect this metric to soften quickly, with demand pulling back, incomes softer, and uncertainty rife.

Figure 4. REINZ and QV house prices

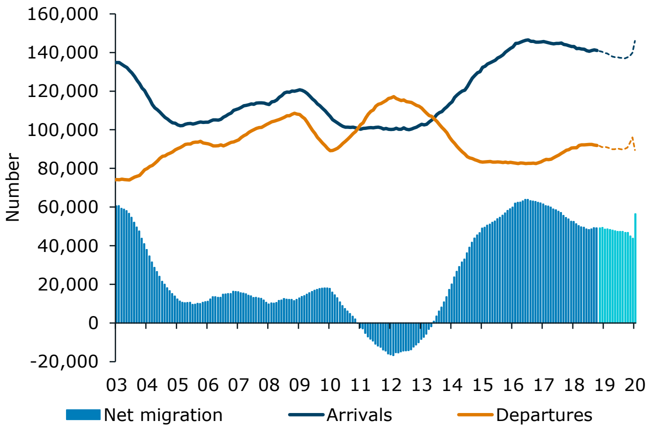


Source: ANZ Research, REINZ, QVNZ

There are three monthly measures of house prices in New Zealand: the median and house price index measures produced by REINZ, and the monthly QVNZ house price index. The latter tends to lag the other measures as it records sales later in the transaction process. Moreover, movements do not line up exactly, given differing methodologies (the REINZ house price index and QVNZ measures attempt to adjust for the quality of houses sold).

The REINZ HPI – our preferred measure – increased to 7.4% y/y in December. This is above the QVNZ measure, which came in at 5.3% y/y. The REINZ median also crept up to 13% y/y (3mma), up from 9.5% in December.

Figure 5. Annual migration*



Source: Statistics NZ

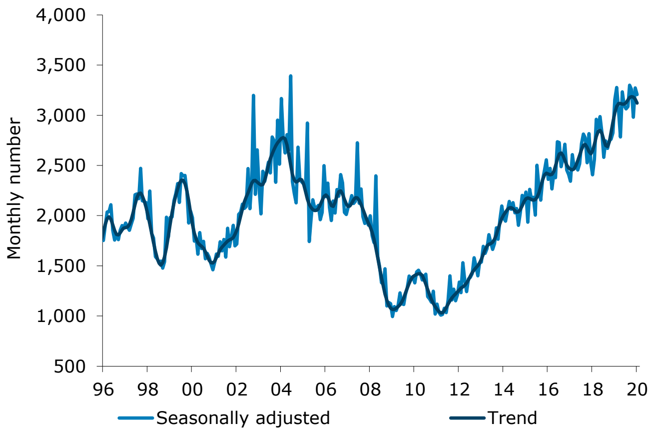
*Dotted lines show the last nine months of data, which are subject to substantial revisions.

Migration flows to and from New Zealand are one of the major drivers of housing market cycles. The early-1970s, mid-1990s, mid-2000s and most recent house price booms have coincided with large net migration inflows.

We estimate that the downward trend in migration has continued. To avoid unnecessary noise in our economic outlook we're now forecasting net migration with a lag (between 9-12 months), ie not using the most recent reported data which is volatile and revisions are extremely large.

The older, more reliable data suggest the cycle was still easing into mid-2018, before picking up heading into 2019. We think a gradual easing trend will set in beyond 2019, but there is upside risk if kiwis come home in droves.

Figure 6. Residential building consents

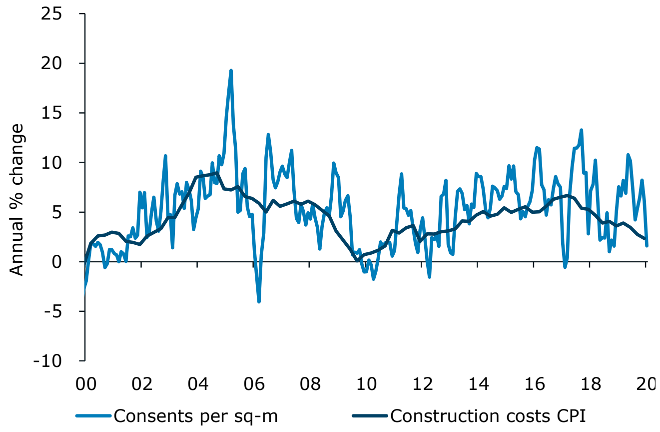


Source: ANZ Research, Statistics NZ

Residential building consents dipped 2.0% m/m in February, coming off a 9.8% lift in the month prior. These data tend to be volatile month-to-month, largely driven by fluctuations in multi-unit consents. Annual consent issuance has risen since 2012, but appears (tentatively) to be topping out at 37k-38k. Auckland consents have been strong but have come under pressure in recent months. The rise in Canterbury's annual consents is persisting.

We now expect to see potentially severe household income disruptions, health concerns weighing on sentiment, and supply chain and work disruptions impacting activity. It's hard to see building consents heading higher in that environment.

Figure 7. Construction cost inflation



Source: ANZ Research, Statistics NZ

Construction cost inflation has softened since 2017 and we don't expect it to reach the dizzying heights (6.7% y/y) achieved over 2016-2017 in this cycle. Growth in the cost of consented work per square metre – a proxy – fell to 1.6% y/y (3mma) in January, which is a decent nudge down from the 7.0% y/y average in the year to December 2019. This data is extremely volatile (largely due to the different types dwellings being consented).

Typically, in times of economic strain and uncertainty, big-ticket items such as house builds take a backseat as households hunker down and ride out difficult times. With demand expected to be weaker, construction costs are likely to come under pressure.

Figure 8. New mortgage lending and housing turnover

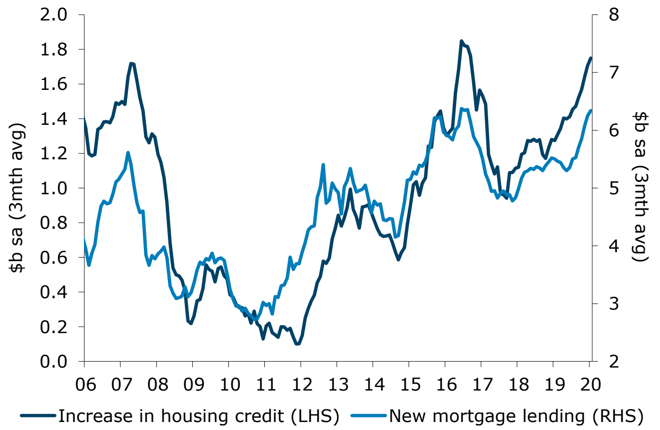
Source: ANZ Research, RBNZ

New residential mortgage lending figures are published by the RBNZ. These are gross (rather than net) flows and can provide leading information on household credit growth and housing market activity.

New mortgage lending moves closely with the value of new house sales. New mortgage lending increased 1.3% m/m (sa) in January, down from a 4.3% m/m jump in December. Greater lending is being propped up by recent strong overall housing turnover.

January data now seems like an age ago, and are well out of step with where we are at the current juncture. Labour market strain will impact households' willingness and ability to purchase houses and take on more debt. These data will come under pressure post February.

Figure 9. New mortgage lending and housing credit

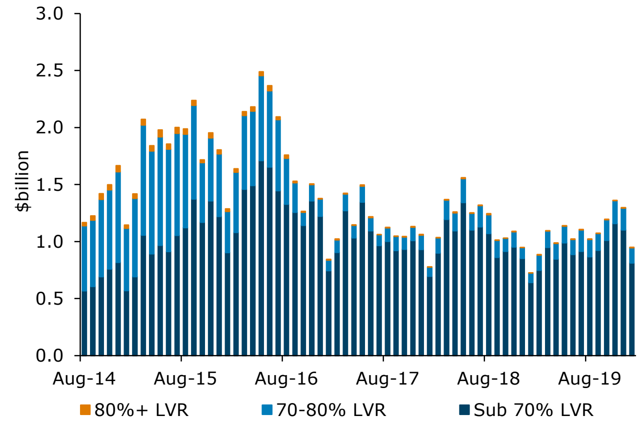


Source: ANZ Research, REINZ, RBNZ

Household credit has been growing at a relatively steady pace for the past year or so. This continued in January and appeared to be heading towards another peak in housing credit.

The outlook for credit will be affected by a number of forces, but holding the trump card at the moment is household incomes. Many sectors are reporting extreme difficulty and signalling lay-offs. Our own business outlook survey points to a sizable labour market impact. This will limit growth in housing credit, with the OCR at new lows will cushion the blow. On the other hand, the outlook for credit conditions is highly uncertain. A delay to the increase in bank capital requirements will help, but how funding conditions evolve will be important.

Figure 10. Investor lending by LVR

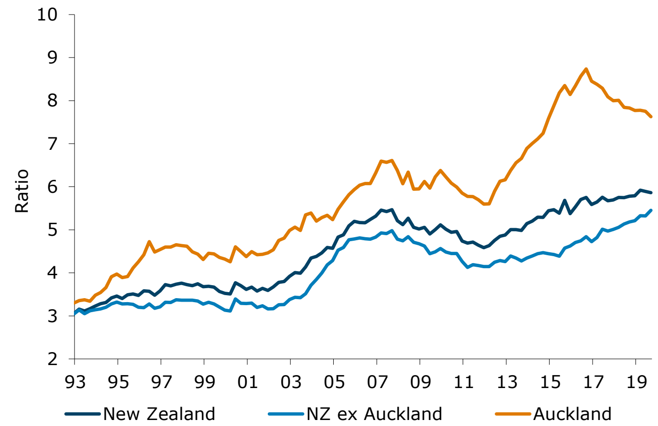


Source: ANZ Research, RBNZ

Lending to investors was up 2.7% m/m in January (seasonally adjusted, ANZ estimate) having achieved solid monthly outturns since mid-2019. New lending to investors as a percentage of the total eked out a small gain to 20.2% (from 19.9% in December). This is well below the near-35% peaks seen in 2016.

The share of riskier lending remains stable, with LVR restrictions remaining in place to limit their impact for the time being. The share of investor lending at loan-to-value ratios of less than 70% has barely shifted in recent times, sitting comfortably at 85%. In late-2014 it was around 50%. Demand from investors is likely to be just as affected as demand from other buyers, so we see this broadly stable from here.

Figure 11. Regional house prices to income

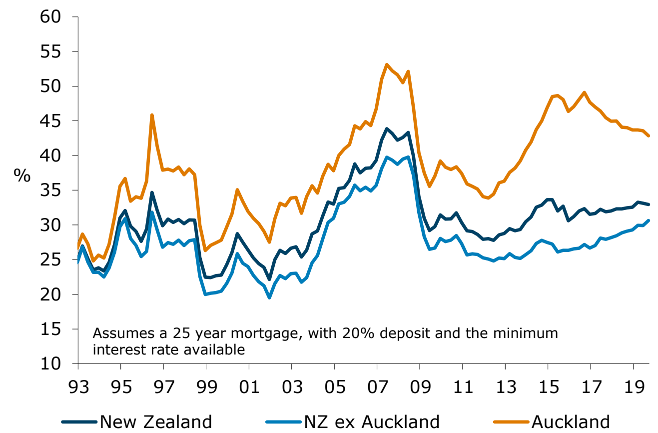


Source: ANZ Research, REINZ, Statistics NZ

One commonly cited measure of housing affordability is the ratio of average house prices to incomes. It is a standard measure used internationally to compare housing affordability across countries. It isn't perfect; it does not take into account things like average housing size and quality, interest rates, and financial liberalisation. Therefore, it is really only a partial gauge as some of these factors mean that it is logical for this ratio to have risen over time.

Nationally, the ratio has been stable at around 6 times income since early 2017. Auckland has seen its ratio ease from 9 times in 2016 to an estimated 7.6 times in Q3 2019, reflecting house prices easing from recent highs. Excluding Auckland, the ratio has continued to rise; at 5.5 times incomes this is at record highs, and about where the national average peaked last cycle.

Figure 12. Regional mortgage payments to income



Source: ANZ Research, REINZ, RBNZ, Statistics NZ

Another, arguably more comprehensive, measure of housing affordability is to look at it through the lens of debt serviceability, as this also takes into account interest rates, which are an important driver of housing market cycles.

We estimate that for a purchaser of a median-priced home (20% deposit), the average mortgage payment to income nationally is 31%, having eased a little on the back of lower mortgage rates. In Auckland it is 41%, with gradual easing from recent highs continuing. In the rest of New Zealand it is 29%, having gradually increased on the back of house price rises. Although servicing is currently manageable, households could be vulnerable in the event of a lift in interest rates or reduction in income.

Property gauges

The housing market will be weighed down by the recession now underway. We now expect house prices to fall 3½% this year as the impact of the global downturn weighs on business conditions, sentiment, incomes and household wealth. This drop is broadly in line with the GDP impact we are expecting. There are risks in either direction. Migration could be stronger if more kiwis decide to come home, and the lower OCR will provide a cushion. But likewise there are very significant downside risks to GDP and incomes. The outlooks for funding markets and credit availability are uncertain and could also pose downside risk.

We use ten gauges to assess the state of the property market and look for signs that changes are in the wind.

Affordability. For new entrants into the housing market, we measure affordability using the ratio of house prices to income (adjusted 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 debt.

Migration. A key source of demand for housing.

Supply-demand balance. We use dwelling consents issuance to proxy growth in 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 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, the UK, and Australia, in recognition of the important role that global factors play in New Zealand's property cycle.

Housing supply. We look at the supply of housing listed on the market, recorded as the number of months needed to clear the housing stock. A high figure indicates that buyers have the upper hand.

House prices to rents. We look at median prices to rents as an indicator of relative affordability.

Policy changes. Government and macro-prudential policy can affect the property market landscape.

Indicator	Level	Direction for prices	Comment
Affordability	Unaffordable	↓↓	Affordability constraints are relevant. Hard to see people buying super-expensive houses when the outlook is bleak.
Serviceability/ indebtedness	Jobs in jeopardy	↓↓	Serviceability is fine, but job security isn't. Debt levels are high, incomes are expected to be lower, and uncertainty is rife.
Interest rates / RBNZ	Flat	↔/↑	The OCR is set to remain at 0.25% for at least 12 months. Funding costs will matter for mortgage rates too though.
Migration	Peaking	↔/↑	Migration has been moderating, but it could increase if kiwis decide to come home.
Supply-demand balance	Eroding	↔/↓	Pent-up demand is starting to be eroded, after a significant amount of new building in recent years.
Consents and house sales	Turn	↓↓	Consent levels are high. But the market is set for a turn, which may see transactions and new projects dry up, with prices moving lower.
Liquidity	Relief	↔	The outlook is uncertain. Delayed capital changes will provide relief, but funding pressure and credit constraints are still possible.
Global forces	Weak	↓↓	The global slowdown will weigh on housing markets around the world, with sentiment and incomes under pressure.
Housing supply	Too few	↔/↑	The Government is going to take a more active role, but there are still questions about crowding out other work and labour shortages.
House prices to rents	Too high	↔/↓	Buying remains relatively expensive. Lower interest rates are suppressing yields, but incomes will be under pressure.
Policy changes	Dampening	↔/↑	Policy changes have been a headwind. But the Government's COVID-19 response will help cushion the economic blow.
On balance	**Down**	↓	**House prices are expected to move lower this year, but will eventually recover when the economy does.**

Property gauges

Figure 1: Housing affordability

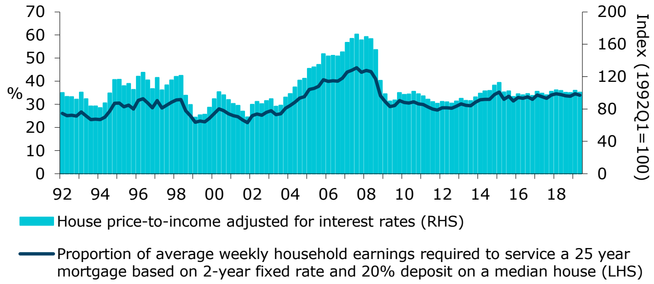


Figure 2: Household debt to disposable income

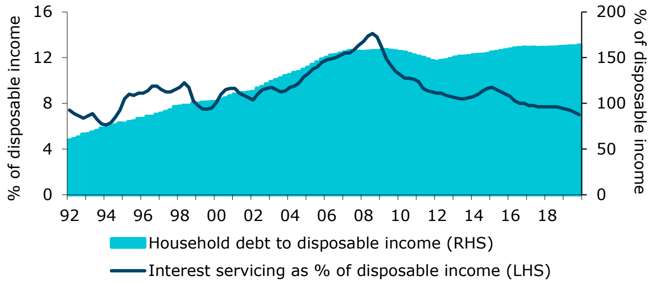


Figure 3: New customer average residential mortgage rate (<80% LVR)

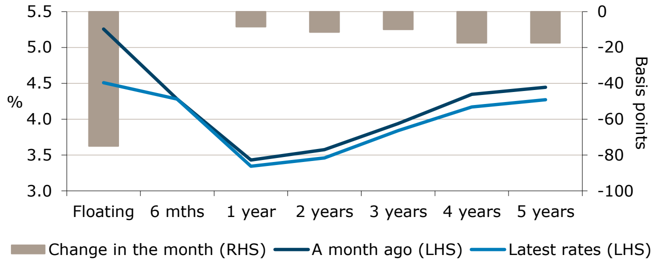


Figure 4: Annual migration*

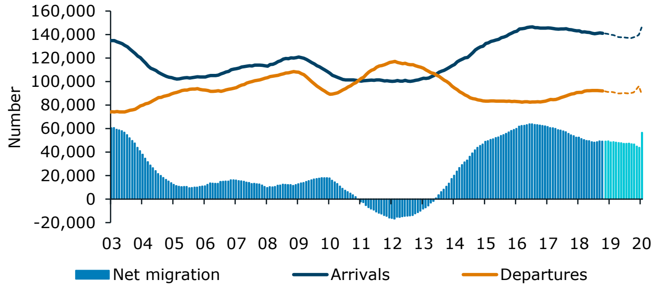


Figure 5: Housing supply-demand balance

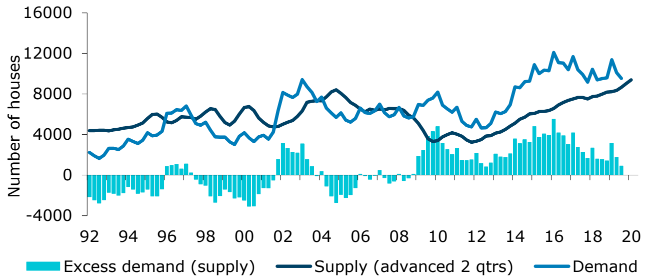


Figure 6: Building consents and house sales

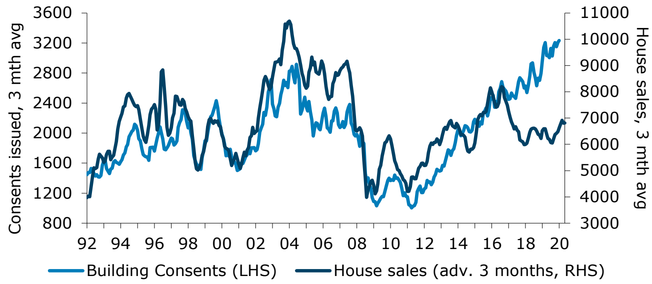


Figure 7: Liquidity and house prices

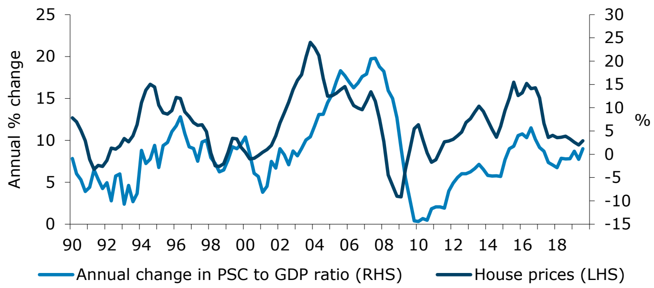


Figure 8: House price inflation comparison

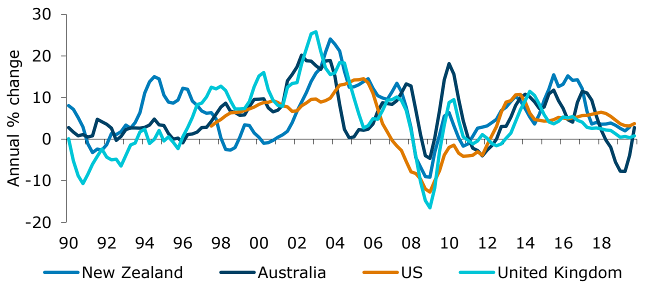


Figure 9: Housing supply

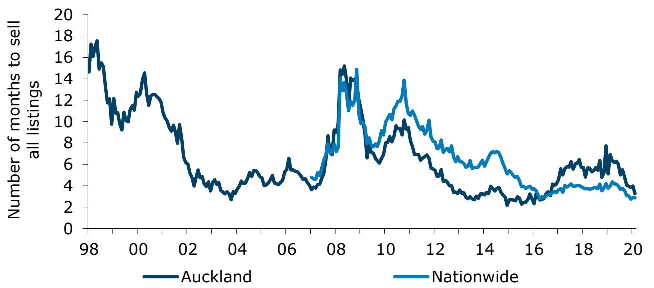
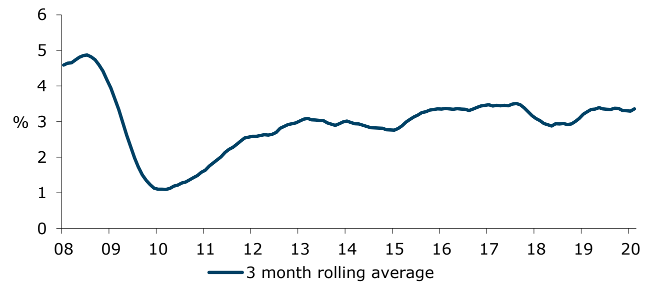


Figure 10: Median rental, annual growth



Source: ANZ Research, Statistics NZ, REINZ, RBNZ, QVNZ, Nationwide, Bloomberg, Barfoot & Thompson

* Dotted lines show the last nine months of data, which we look through because they are subject to substantial revisions. The data prior to June 2014 is back-casted using Stats NZ's discontinued experimental data.

Economic overview

Summary

The economy is experiencing a recession, which may be deep. The COVID-19 outbreak has accelerated at horrifying speed globally, and New Zealand has taken bold measures to contain the spread. These measures will amplify the domestic slowdown already underway, but are the right thing to do to prevent an even larger economic dislocation. The RBNZ has slashed the OCR to 0.25% and committed to keeping it there for at least a year. They have also indicated that they will conduct large-scale asset purchases to provide further stimulus if required. We think it will be. Tougher bank capital requirements have been delayed to encourage credit creation, and the RBNZ are ready to step in to ensure the financial system functions smoothly. The Government has announced a bold stimulus package targeted at helping affected businesses and cushioning household incomes and spending. A bigger and broader package will be needed in time. Fortunately, the Government has plenty of financial scope to respond. Bond yields have widened dramatically with government spending expected to balloon. But bond purchases by the RBNZ will keep the Government's borrowing costs contained, with these now looking more urgent.

Our view

The economy is experiencing a recession, which may be deep. We expect GDP to contract 3½% y/y on average over the coming year, but there are still downside risks.

Exports are taking a massive hit, with global demand slumping, and international travel grinding to a halt. New Zealand has taken bold measures to contain the spread of the virus. These are the right thing to do, but will amplify the economic impacts. Domestic demand is expected to be very significantly affected by pressures on businesses, job losses, weaker sentiment, and eroded wealth positions. Fortunately, a sustained community outbreak has not been seen here. That would increase the economic blow significantly, if it occurred.

Globally, the COVID-19 outbreak has accelerated at horrifying speed. This has seen financial markets capitulate, with stresses clearly emerging. And it has galvanised policymakers around the world. Central banks and Governments are stepping up to do what they can to cushion the blow. It all helps, but until a vaccine can be developed, a slump in global trade and economic activity is looking unavoidable.

Here in New Zealand, the RBNZ slashed the OCR 75bps in an emergency move on Monday. And the RBNZ have committed to keeping it a 0.25% for at least a year. They have also indicated that they will conduct large-scale asset purchases (quantitative easing) to provide further stimulus if required. This could involve purchases of government bonds, mortgage-based securities, or could be widened to other securities if need be. Other central banks have had to take huge steps to prop up credit markets by buying corporate debt, for example.

Tougher bank capital requirements were due to take place this year, but have been delayed to encourage credit creation. The RBNZ also stand ready to step in to ensure the financial system functions smoothly. They can help provide liquidity if the market gets stressed, and could ease the counter-cyclical capital buffer to free up bank capital if need be.

The Government has announced a bold $12bn stimulus package targeted at affected businesses and cushioning household incomes and spending. The response is big by international standards at 4% of GDP. The Government has indicated that this is only the first tranche of the response.

The package includes:

- Wage subsidies for businesses affected by COVID-19 in all regions and sectors for 12 weeks ($5.1bn);
- Increased benefit support of $25 per week and an increase in the Winter Energy Payment ($2.8bn) – both are permanent;
- Business tax changes to free up cash flow ($2.8bn), including re introducing building depreciation, a provisional tax threshold lift, and writing off interest on late tax payments;
- A boost to health spending ($0.5bn); and
- Other initiatives including a self-isolation support, a worker redeployment package, and an aviation support package.

A bigger and broader fiscal package will be needed. Fortunately, the Government has plenty of financial scope to respond, with the fiscal position looking favourable. Nonetheless, Government spending and debt is expected to balloon from here, and bond yields have widened dramatically in response.

We expect that the RBNZ will need to step up with large-scale asset purchases pretty soon. Government bond purchases by the RBNZ will soak up the supply of bonds and keep the Government's borrowing costs contained. Recent market pressures suggest that this is now more urgent.

Overall, it is expected to be a difficult year ahead. Business conditions will be challenging, the labour market is set to deteriorate, and incomes will be affected. The impact could be severe and uncertainty is rife. Our thoughts are with all those affected.

Mortgage borrowing strategy

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Summary

Mortgage rates have fallen to all-time lows this week following the RBNZ's 75bp cut in the OCR on Monday. And with the RBNZ committing to keeping the OCR at 0.25% for at least 12 months, hinting that it stands ready to do quantitative easing to drive term interest rates lower, and to ensure that banks and businesses have continued access to funding, mortgage rates are unlikely to rise anytime soon. They may well fall from here, but with floating rates still much higher than most banks' short term fixed rates and 1-year rates the lowest by some margin, we favour the 1 year.

Our view

Mortgage rates are on the move lower again in the wake of the Reserve Bank's 75 basis point emergency rate cut, which took the Official Cash Rate (OCR) to an all-time low of 0.25%. At the same time, the Reserve Bank (RBNZ) committed to keeping the OCR at that level for at least 12 months, and has hinted at quantitative easing (QE), which is aimed at driving long-term wholesale interest rates lower. Should we see QE, it is reasonable to expect lower long-term wholesale rates to be reflected in lower fixed mortgage rates. Ordinarily that's what one would expect and that's what we have seen in recent years as post-GFC funding concerns have eased.

But these are not ordinary times. Cheerful as the prospect of lower mortgage rates might be for homeowners, the reason why they are here (and the reasons behind the RBNZ's decision to cut the OCR) are far from cheerful, and it's all about COVID-19, which threatens to be the biggest peacetime global economic shock experienced in modern times.

One consequence of the shock has been the collapse in growth expectations, which has in turn hit earnings expectations, which has in turn seen equity markets hit hard. Asset markets globally are under severe stress, and that has had a knock on impact on credit margins, which have widened almost as rapidly as the OCR has fallen. This complicates the picture, but central banks including the RBNZ are well placed to contain this threat by helping to fund banks, which ought to keep a lid on fixed mortgage rates.

With the RBNZ committing to keeping the OCR at 0.25% for at least a year and wholesale credit margins widening, we are unlikely to see much or any downward movement in floating rates. With all rates (averaged across all banks) below the floating rate, fixed rates are therefore more attractive. Break-evens point to longer term rates rising over time (for example, the 1-year special rate would have to rise from 3.35% to 3.58% in 1 years' time, and then on to 4.60% in 2 years' time for it to be cheaper in the long run to fix for 2 or 3 years respectively. Yet that's at odds with the likelihood that term wholesale rates fall, irrespective of margins. As such, 1 year specials seem to be the "sweet spot".

That said, as individual borrowers need to consider their own circumstances. Spreading loans over a number of fixed terms is always a strategy that makes sense from a risk-management perspective, given the risk of all loans repricing at the same time.

Figure 1. Carded special mortgage rates^

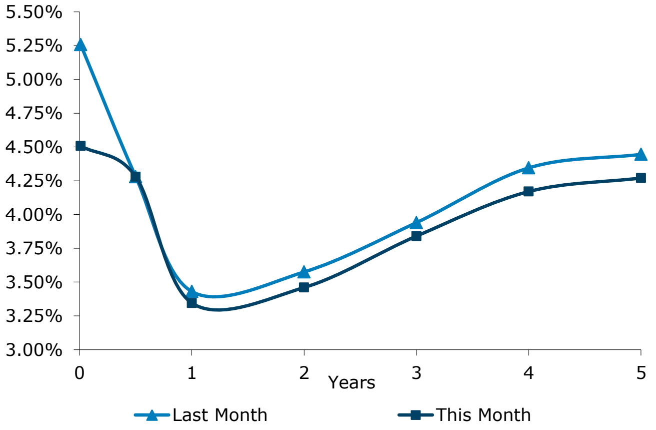

Table 1. Special Mortgage Rates

Term	Current	Breakevens for 20%+ equity borrowers in 6mths	in 1yr	in 18mths	in 2 yrs
Floating	4.51%				
6 months	4.28%	2.41%	3.52%	3.63%	4.41%
1 year	3.35%	2.96%	3.58%	4.02%	4.60%
2 years	3.46%	3.49%	4.09%	4.46%	4.88%
3 years	3.84%	3.96%	4.45%	4.63%	4.81%
4 years	4.17%	4.21%	4.50%		
5 years	4.27%	#Average of "big four" banks			

Table2. Standard Mortgage Rates

Term	Current	Breakevens for standard mortgage rates* in 6mths	in 1yr	in 18mths	in 2 yrs
Floating	4.51%				
6 months	4.53%	3.40%	4.17%	4.03%	4.90%
1 year	3.96%	3.78%	4.10%	4.47%	5.08%
2 years	4.03%	4.13%	4.59%	4.83%	5.16%
3 years	4.38%	4.48%	4.81%	4.95%	5.14%
4 years	4.60%	4.66%	4.88%		
5 years	4.70%	#Average of "big four" banks			

^ Average of carded rates from ANZ, ASB, BNZ and Westpac.

Source: interest.co.nz

Key forecasts

Weekly mortgage repayments table (based on 25-year term)

Mortgage Size ($'000)	Mortgage Rate (%)													
	3.00	3.25	3.50	3.75	4.00	4.25	4.50	4.75	5.00	5.25	5.50	5.75	6.00	6.25
200	219	225	231	237	243	250	256	263	270	276	283	290	297	304
250	273	281	289	296	304	312	320	329	337	345	354	363	371	380
300	328	337	346	356	365	375	385	394	404	415	425	435	446	456
350	383	393	404	415	426	437	449	460	472	484	496	508	520	532
400	437	450	462	474	487	500	513	526	539	553	566	580	594	608
450	492	506	520	534	548	562	577	592	607	622	637	653	669	684
500	547	562	577	593	609	625	641	657	674	691	708	725	743	761
550	601	618	635	652	669	687	705	723	741	760	779	798	817	837
600	656	674	693	711	730	750	769	789	809	829	850	870	891	913
650	711	730	750	771	791	812	833	854	876	898	920	943	966	989
700	766	787	808	830	852	874	897	920	944	967	991	1,015	1,040	1,065
750	820	843	866	889	913	937	961	986	1,011	1,036	1,062	1,088	1,114	1,141
800	875	899	924	948	974	999	1,025	1,052	1,078	1,105	1,133	1,160	1,188	1,217
850	930	955	981	1,008	1,035	1,062	1,089	1,117	1,146	1,174	1,204	1,233	1,263	1,293
900	984	1,011	1,039	1,067	1,095	1,124	1,154	1,183	1,213	1,244	1,274	1,306	1,337	1,369
950	1,039	1,068	1,097	1,126	1,156	1,187	1,218	1,249	1,281	1,313	1,345	1,378	1,411	1,445
1000	1,094	1,124	1,154	1,186	1,217	1,249	1,282	1,315	1,348	1,382	1,416	1,451	1,486	1,521

Housing market indicators for February 2020 (based on REINZ data)

	Median house prices		No of sales (sa)	Mthly % chg	Avg days to sell (sa)
	Ann % chg	3mth % chg			
Northland	12.2	8.0	181	-14%	49
Auckland	4.1	4.0	2,316	+5%	34
Waikato	10.0	3.6	667	-5%	35
Bay of Plenty	14.1	6.2	505	-4%	35
Gisborne	14.4	5.2	67	+46%	28
Hawke's Bay	9.4	-0.4	261	+4%	30
Manawatu-Whanganui	22.7	7.4	358	-17%	21
Taranaki	8.5	3.6	142	-13%	22
Wellington	10.8	2.5	684	-2%	29
Tasman, Nelson and Marlborough	11.5	5.4	237	+19%	32
Canterbury	3.9	2.3	916	-5%	32
Otago	20.1	6.2	344	+3%	27
West Coast	21.5	15.5	38	-13%	49
Southland	12.6	6.4	149	+6%	23
New Zealand	**14.0**	**5.0**	**6,764**	**0%**	**30**

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