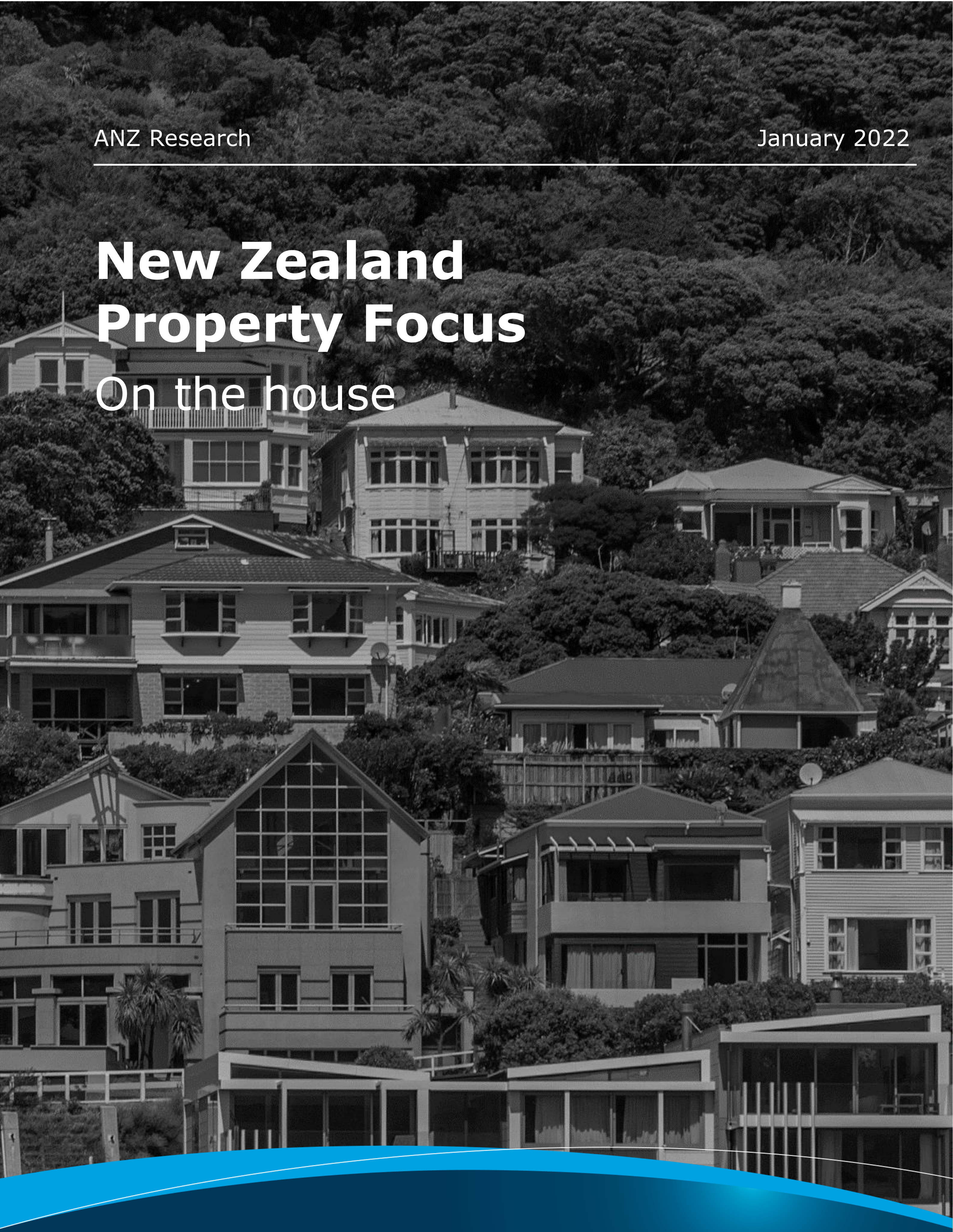
New Zealand Property Focus

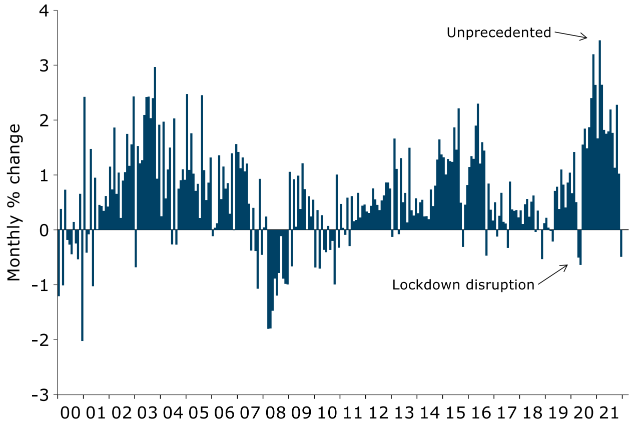
On the house



At a glance

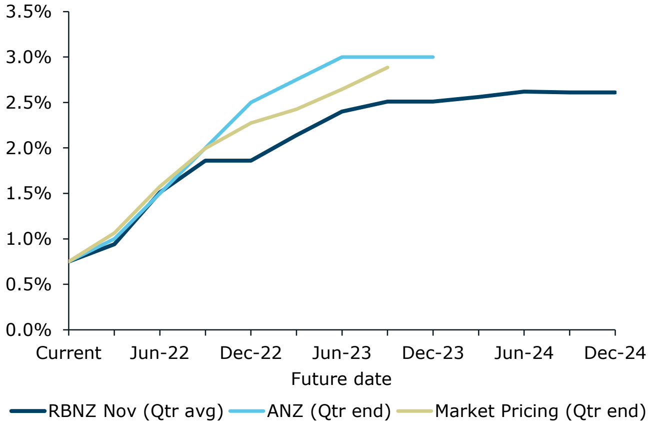
New Zealand house prices fell in December

Down 0.5% m/m nationally



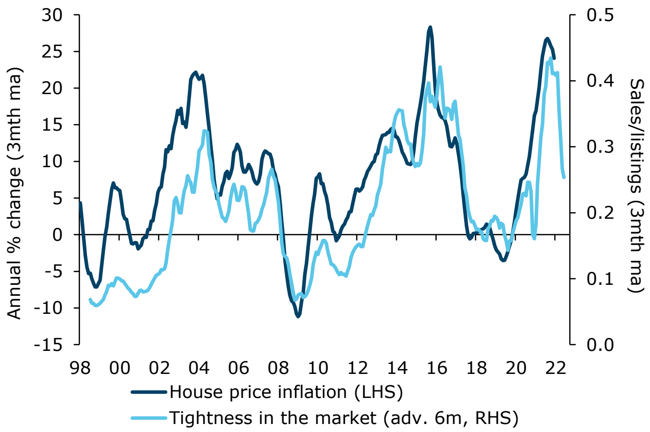
We think more OCR hikes will be needed

And that will weigh on house prices



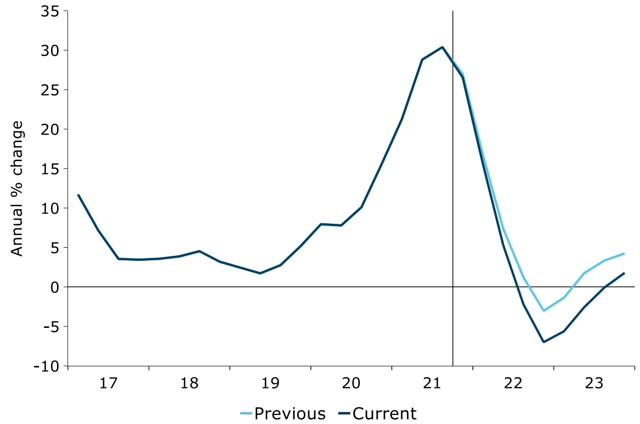
Market tightness in Auckland

Is consistent with our view that further moderation is on the way



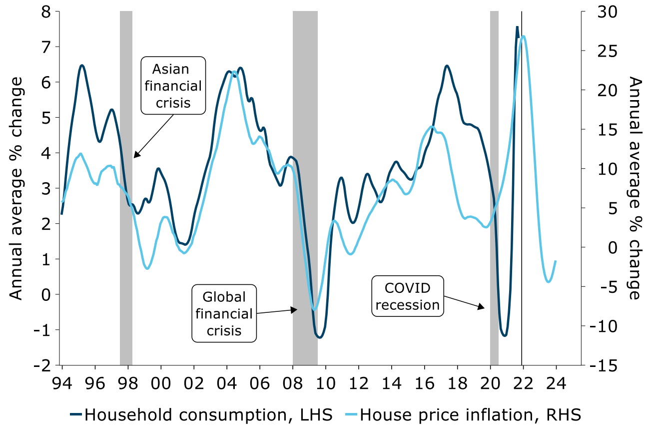
Our outlook for house prices

Has been downgraded



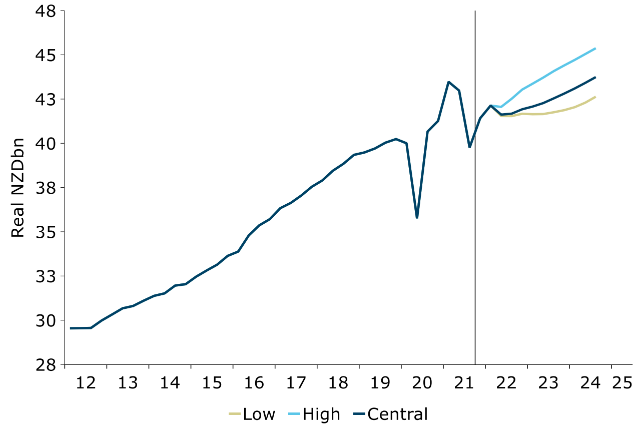
House prices and the economy

Are they joined at the hip?



Moderate house price falls

May slow the economy a little



Source: REINZ, Stats NZ, Macrobond, Barfoot and Thompson, RBNZ, Bloomberg, ANZ Research

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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.

Housing market overview

House prices fell in December and we think there's more to come. CPI inflation pressures continue to intensify, and that has led us to upgrade our OCR outlook. Implied higher mortgage rates mean a weaker outlook for house prices. However, at this stage we'd still classify our (downgraded) outlook for a 7% fall in house prices as a soft landing. A very severe contraction in house prices would likely require a significant household income shock, forcing the sale of properties. That's always a possibility, but it's not our central forecast. Nonetheless, numerous house price headwinds are expected to make for a very different housing market vibe over 2022, and any market that was this nutty on the way up has to be at risk of a few unpleasant bumps on the way down. See our Market Overview.

Feature Article: Correlation or causation?

In this feature article we explore whether the moderate house price declines we're expecting in 2022 will cause wider economic momentum to stumble. Our modelling suggests that household consumption won't be too badly impacted by moderately declining house prices – especially given that the tight labour market should support household incomes. But there are risks. Falling house prices may cause a more significant decline in the construction industry, or a souring in consumer and business sentiment, and either of these factors could feed through into more serious impacts on the wider economy. See this month's Feature Article.

Mortgage borrowing strategy

Average mortgage rates are unchanged compared with last month. Although this is the first month of no changes seen since rates started rising in the middle of last year, with the OCR on track for 3% (from a current level of 0.75%) and wholesale rates up sharply since the beginning of the year, mortgage rates are likely to remain on an upward trajectory for the time being. It is not just local interest rates that are on the rise, so too are global interest rates, and that brings with it the risk of higher longer term wholesale and mortgage rates. When we look at where breakevens sit, now that we expect the OCR to go much higher (we had thought it would top out at 2% but we now think 3%), the idea of fixing for longer now looks more compelling. The 1yr rate remains the lowest rate, but if the OCR reaches 3%, 1yr mortgages are on track for around 5%, and that could make for some expensive rollovers. It may thus be worth considering fixing for 2 to 3 years. See our Mortgage Borrowing Strategy.

Housing market overview

Summary

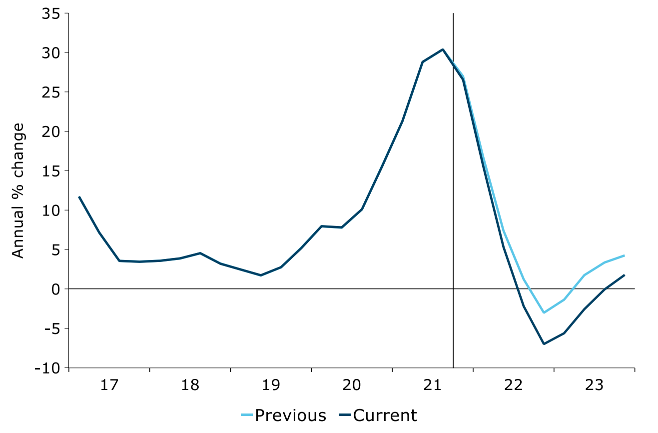
House prices fell in December and we think there's more to come. CPI inflation pressures continue to intensify, and that has led us to upgrade our OCR outlook. Implied higher mortgage rates mean a weaker outlook for house prices. However, at this stage we'd still classify our (downgraded) outlook for a 7% fall in house prices as a soft landing. A very severe contraction in house prices would likely require a significant household income shock, forcing the sale of properties. That's always a possibility, but it's not our central forecast. Nonetheless, numerous house price headwinds are expected to make for a very different housing market vibe over 2022, and any market that was this nutty on the way up has to be at risk of a few unpleasant bumps on the way down.

Past the peak

Annual house price inflation slowed another 2.3% points in December to a still-bananas pace of 26.5%, and broader market conditions suggest there is plenty more moderation to come. Our outlook certainly incorporates more, with annual inflation dipping negative in late 2022 (figure 1) as higher mortgage rates, affordability constraints, tighter credit conditions, and housing policy changes continue to bite.

In fact, with even higher interest rates now expected, we have downgraded our house price outlook. We now expect house prices to fall around 7% over the next year or so (previous forecast was closer to a 3% fall). However, we'd still call this a soft landing, given the starting point. It would likely take a significant household income shock (forcing the sale of properties) for house prices to experience a very severe contraction. That said, anecdote regarding the impacts of the CCCFA have certainly made our ears prick up, and the 0.5% m/m contraction in December suggests this may be biting hard. It's entirely possible this is the straw that breaks the housing market's back, contributing to a sharper fall in prices than we assume.

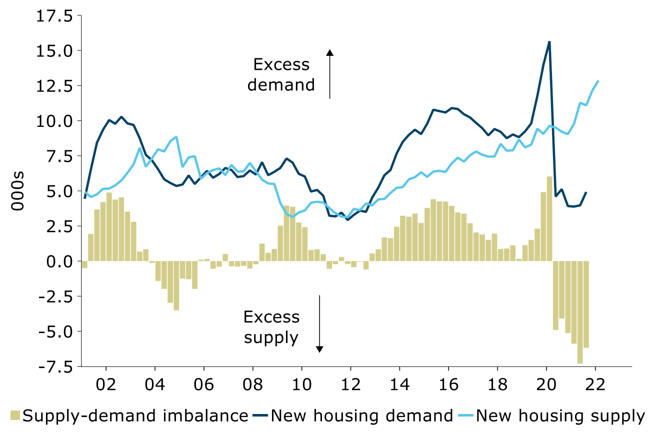
Figure 1. House price forecast



Source: REINZ, Macrobond, ANZ Research

Supply is a building headwind too. By our estimates, the closed border alongside gangbusters construction activity means New Zealand's housing deficit is closing to the tune of around 6,000 houses per quarter (figure 2). Supply continuing to outstrip new demand limits the likelihood that house prices will get wind in their sails again any time soon. But while there is still plenty of work to do before supply and demand are in balance once more (we estimate a housing shortfall of around 60,000 houses), a severe contraction in house prices and sentiment could certainly put the brakes on construction activity in time (not that we're seeing much evidence of that at the moment!). In other words, unless the Government really ups its house-building game during the next construction cycle downturn, we're doubtful NZ will end up with a sustained housing surplus.

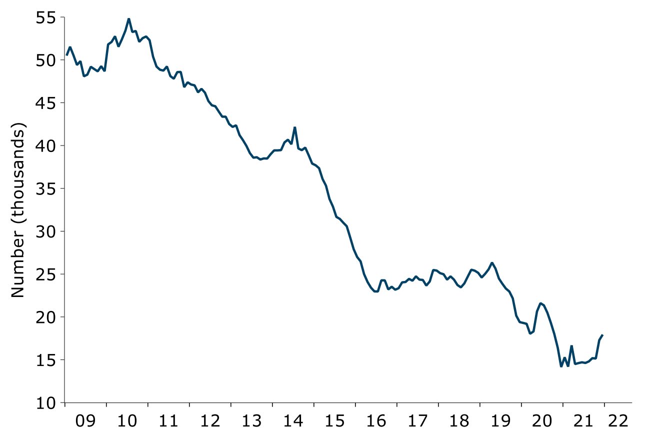
Figure 2. Housing supply and demand imbalance



Source: Stats NZ, Macrobond, ANZ Research

But it's not just new supply. Listings data also suggest that 2022 may be a better year for home buyers than 2021 was. Seasonally adjusted properties available for sale climbed a little further out of their record-low hole in December (Figure 3). That's a trend that buyers will be hoping to see continue through 2022.

Figure 3. Inventories

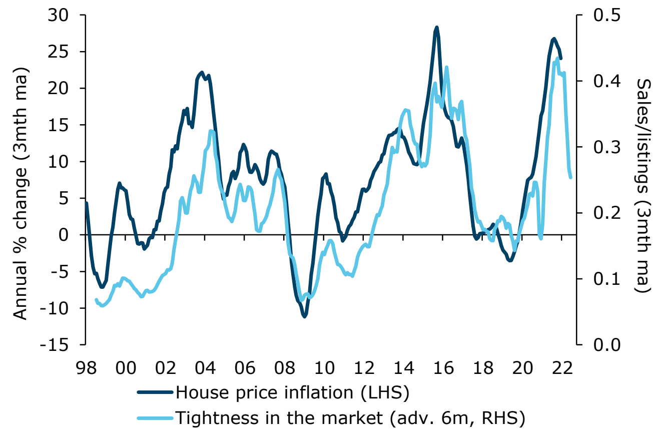


Source: Realestate.co.nz, Macrobond, ANZ Research

Housing market overview

Barfoot and Thompson provide some handy data for the Auckland region, and it shows market tightness (as measured by the ratio of sales to listings) has dropped away quite rapidly (figure 4). While there may be some lingering lockdown-induced noise in here, this six-month lead for house price inflation will be worth keeping a close eye on over coming months as we try to gauge the likely trough of the house price cycle.

Figure 4. Market tightness and house price inflation (Auckland)

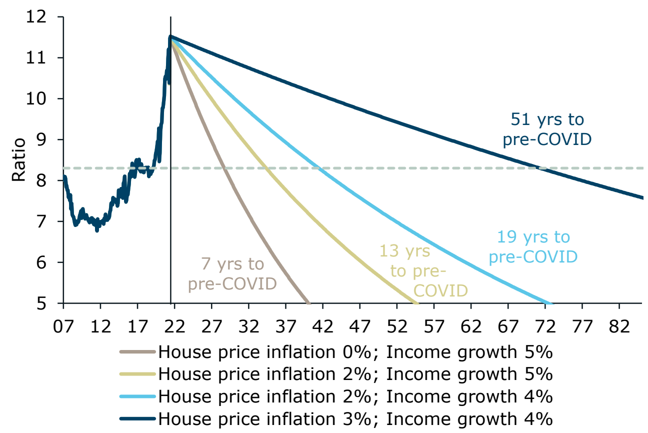


Source: Barfoot and Thompson, ANZ Research

All up, annual house price inflation is past the peak and is expected to continue slowing. However, given the pace of price gains over the past year or so, the level of house prices remains extremely high relative to incomes, meaning housing unaffordability is still going nowhere fast. Political appetite for correcting the problem appears to favour stable house prices alongside growing incomes, but there are two potential issues with this strategy:

1. It's difficult to engineer the economic conditions where house prices are not growing, but real income growth is strong.
2. A strategy that relies on income growth outpacing house price growth would likely take years (possibly decades) to see housing affordability back at their already-unaffordable pre-crisis level (figure 5).

Figure 5. Median household disposable income (less housing costs) to median house prices



Source: Stats NZ, REINZ, ANZ Research

Indeed, it would seem that in the absence of house price declines, New Zealand's woeful housing unaffordability score is destined to stay elevated for a long while yet. So through that lens, falling house prices may be seen as a good thing.

But with house price declines now expected by most forecasters, it's worth asking the question, "Can house prices fall and not take broader economic momentum (and incomes) along for the ride? See our Feature Article for more.

Housing market indicators for December 2021 (based on REINZ data seasonally adjusted by ANZ Research)

	Median house price			House price index		# of monthly sales	Monthly % change	Average days to sell
	Level	Annual % change	3-mth % change	Annual % change	3-mth % change			
Northland	$735,025	12.9	5.7	27.0	6.7	176	+8%	39
Auckland	$1,277,201	25.9	6.6	21.1	5.1	2,581	+1%	32
Waikato	$840,176	25.9	6.9	28.9	5.7	664	+4%	30
Bay of Plenty	$900,668	28.0	3.3	25.1	5.0	414	-6%	36
Gisborne	$667,651	16.8	12.1	24.2	3.0	48	-15%	37
Hawke's Bay	$811,006	22.3	8.2	24.2	3.0	225	0%	30
Manawatu-Whanganui	$639,171	22.8	2.3	22.0	4.0	362	+9%	33
Taranaki	$584,558	18.3	10.3	27.2	6.0	175	+5%	30
Wellington	$976,313	24.2	10.5	18.4	0.9	723	+8%	34
Tasman, Nelson & Marlborough	$792,342	20.4	3.8			213	+3%	30
Canterbury	$671,931	25.9	5.7	34.1	7.8	1,049	+1%	29
Otago	$718,691	12.9	4.3	19.0	4.0	388	+11%	32
West Coast	$334,041	25.3	19.7	21.3	4.8	36	-7%	36
Southland	$452,170	21.8	4.0	20.1	4.2	178	+30%	33
New Zealand	**$900,569**	**21.6**	**7.0**	**23.1**	**4.2**	**7,316**	**+5%**	**32**

Feature Article: Correlation or causation?

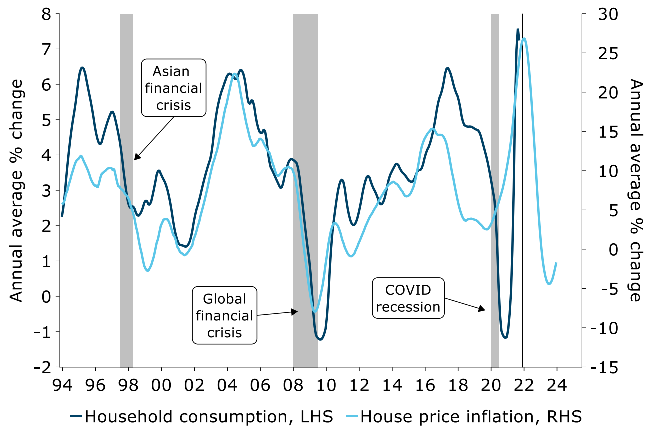
Summary

In this feature article we explore whether the moderate house price declines we're expecting in 2022 will cause wider economic momentum to stumble. Our modelling suggests that household consumption won't be too badly impacted by moderately declining house prices – especially given that the tight labour market should support household incomes. But there are risks. Falling house prices may cause a more significant decline in the construction industry, or a souring in consumer and business sentiment, and either of these factors could feed through into more serious impacts on the wider economy.

Joined at the hip?

We're expecting that house prices will fall around 7% over 2022, even as the economy continues to grow (see Overview). But the housing and economic cycles in New Zealand are very closely related. When the housing market is booming, the economy usually is too – and when house prices drop sharply, it's always been at the same time as an economic recession (figure 1). Given the strength of the historical correlation between house prices and economic momentum, is it even possible to experience a period of declining house prices without seeing domestic demand stall?

Figure 1. House prices and consumption



Source: Stats NZ, REINZ, Macrobond, ANZ Research

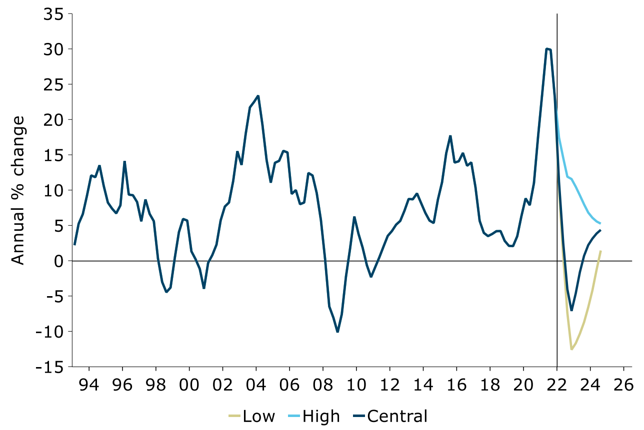
It's a difficult question to answer – not least because causality between housing and the business cycle flows both ways. For example, a strong housing market can reinforce a booming economy by driving construction activity, boosting consumer confidence to make big purchases, and creating equity to borrow for said purchases. In the other direction, a robust economy can support the housing market through rising domestic demand, higher incomes, and more willingness to lend and borrow money.

So it's not immediately obvious how dependent household consumption actually is on house prices alone. A starting point is to take the historical relationships in the data, and ask what would happen to household consumption if house prices:

1. Fell further and faster than expected, ending up about 20% lower than current levels by end-2024 (low scenario),
2. Gradually declined over 2022 before rising (closer to our official forecast), ending up about 2% lower than current levels by the end of 2024 (middle scenario), or
3. Kept rising, with house price inflation proving much more persistent than forecast, up about another 20% on current levels by end-2024 (high scenario – figure 2).

Our model is estimated from 1992 (start of the REINZ data) to 2019 Q4 in order to avoid capturing the unprecedented data volatility due to COVID. An important note – these aren't our official forecasts, they're just what the model thinks will happen based on the house price scenarios we feed into it.

Figure 2. House price scenarios

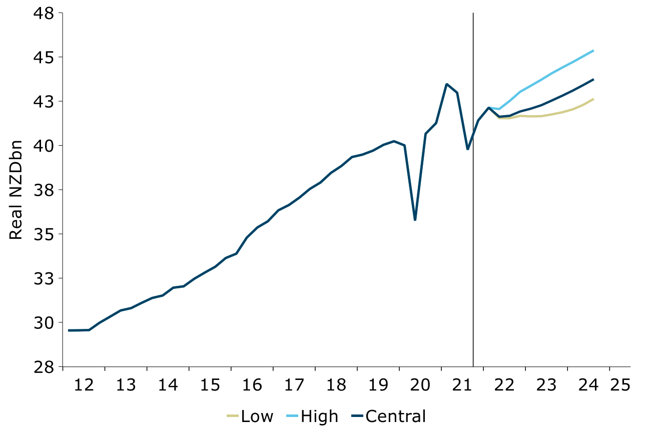


Source: REINZ, Macrobond, ANZ Research

Not surprisingly, the different house price scenarios have a significant impact on the evolution of household consumption over the next few years, with consumption surging ahead under the high scenario, but struggling to grow at all at first under the low scenario (figure 3). Under the central scenario, consumption does wobble a bit initially as house prices decline, but it rapidly returns to an upwards trend as prices stabilise and start rising.

Probably the most surprising result from the model is that while consumption does slow significantly in our low scenario, it doesn't fall anywhere near as much as you might think, looking at the last period of falling house prices in figure 1. And that's because the falls in 2009 coincided with a global recession – which impacted both house prices and consumption simultaneously. In the absence of such a shock, it's clearer that the impact of house prices on consumption, while still significant, likely isn't as large as a simple chart like figure 1 would suggest.

Figure 3. Household consumption scenarios[1]

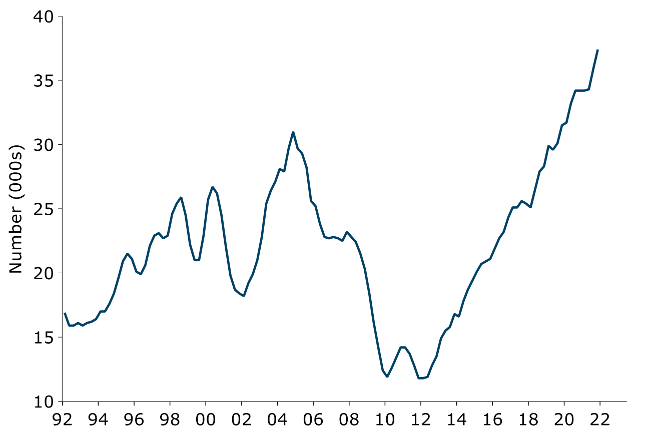


Source: Stats NZ, Macrobond, ANZ Research

So based on the historical data, the answer is yes – house prices can probably fall without derailing the economy.

But there's an important caveat – our model assumes that the fall in house prices isn't triggered by some other massive income shock (eg another recession). In reality, it's difficult to imagine house prices falling significantly in the absence of such a crisis. If prices dropped too far and home owners weren't forced to sell, then it's more likely that people would simply stop putting their properties on the market until market conditions became more favourable. That said, there are still an awful lot of new builds entering the housing stock, which combined with many other headwinds (see Overview), will still weigh on prices for some time (figure 4).

Figure 4. Annual change in private dwellings



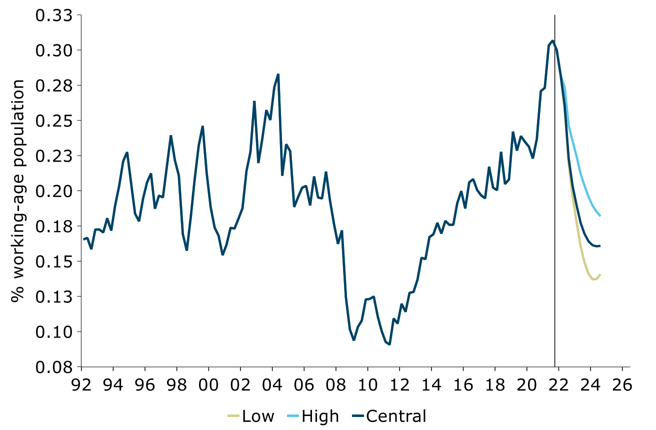
Source: Stats NZ, Macrobond, ANZ Research

Falling house prices would reduce building activity

While household consumption may escape relatively unscathed from a moderate decline in house prices, it's a different story for the construction industry. Even if house prices simply grow at a slower rate, rather than falling as in the central and low scenarios, consents would be expected to slow significantly over the next few years. That's not too surprising – building consents have been setting back-to-back records in recent months, so some moderation is expected (not least due to the extreme capacity constraints weighing on activity in the industry).

But the model does show that the slowdown in new building consents is likely to be considerably faster if house prices are also declining rapidly (figure 5). Construction has been a key driver of economic momentum over the course of the pandemic – and even in the year to November, the 8.6% y/y rise in construction jobs was the largest of any industry. A larger contraction in construction activity could therefore act as a significant drag on overall economic momentum.

Figure 5. Building consents scenarios



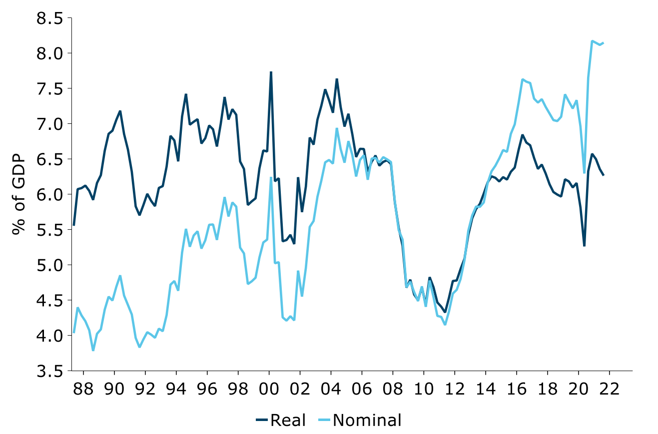
Source: Stats NZ, Macrobond, ANZ Research

At this point, it's worth remembering that the economy is more than just the housing market and construction industry, with residential investment making up less than 10% of the economy (figure 6). With jobs growth and labour shortages widespread across many industries, it's not clear that a softening in the housing market will actually take the rest of the economy with it. Labour shortages are widespread across most industries – primary industries in particular. So if a slowdown in construction did cause job losses, they would most likely be short lived as firms desperate for staff snap up anyone that lost their job. And that

[1] Note: we estimate our model using the quarterly percent change in household consumption, and then apply those to the level of actual consumption to create figure 3.

means the overall economic damage from construction activity slowing likely would be less in the medium term.

Figure 6. Residential investment share of GDP



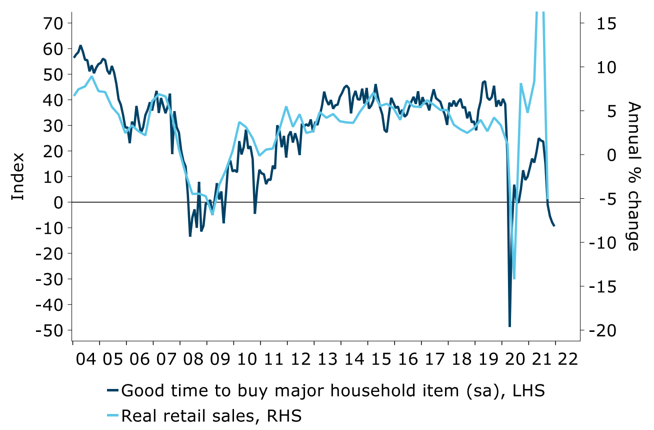
Source: Stats NZ, Macrobond, ANZ Research

Domestic demand is strong – and with the unemployment rate sitting at a record low of 3.4% in Q3 (and likely to dip even further over 2022), rising incomes should provide a more sustainable source of economic momentum than the housing-induced GDP rebound we saw over 2020.

Confidence is key

Without some trigger like a global recession, one of the most realistic ways that a drop in house prices could feed into a generalised slowing in the wider economy would be through the impact on consumer and business confidence. If the mood deteriorates significantly, that could be enough for households to pull back on spending, and for businesses to delay investment plans. The housing market is one of the most visible parts of the economy for many people, so a slowdown here could cause many people to become pessimistic about the economic outlook, essentially causing a self-fulfilling prophecy.

Figure 7. Good time to buy major household item and retail sales



Source: Stats NZ, Roy Morgan, Macrobond, ANZ Research

And the link between the real economy and confidence is solid (looking-through COVID data volatility). For example, whether consumers think it's a good time to buy a major household item (from our consumer confidence survey) is usually a very reliable indicator for actual retail sales (figure 7).

The recent decline in consumer confidence shows that even in an economy that is ostensibly doing very well (with record-low unemployment), consumer sentiment can still deteriorate – and risk taking actual economic activity down with it.

A housing-specific slowdown

As we've noted previously in this Feature, significant house prices declines in New Zealand have previously coincided with global recessions. But in 2022, we're expecting, for the first time, to see a period of house price declines without an associated recession.

And that really reflects that the New Zealand housing market is in a unique place. A convergence of factors, including market forces (massive supply response), COVID disruption (the closed border), and regulatory responses (LVRs and consumer protections legislation) mean that house prices are quite likely to decline due to factors specific to the housing market, rather than a wider economic shock.

The question we've tried to disentangle in this article is whether this kind of house price decline is predestined to take economic momentum down with it. And the answer appears to be no. Sure, house prices are a key driver of household consumption spending – but so is household income, which is being supported by a record level of labour market tightness. So long as the labour market remains robust, and the economy isn't hit by some unforecastable global or domestic shock, the modest house price declines we're expecting over 2022 seem unlikely to derail the economy in and of themselves.

Feature Article: Correlation or causation?

To be clear, lower house prices will probably weigh on demand for consumption and building activity compared with a scenario where the market continues to boom. However, the economy is so supply constrained that weaker demand may just mean less inflation, but similar growth. This kind of slowdown could do some of the RBNZ’s job for them, by taking heat out of the domestic economy at a time when underlying inflation pressures are at the risk of rising even further than expected at the end of 2021.

There are downside risks to keep track of. In particular, lower house prices will weigh on the construction industry, and could see large enough falls in consumer confidence that households pull back too much on spending. But at this point, these remain as risks to our central view that the economy can handle a period of moderately declining house prices.

Mortgage borrowing strategy

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Summary

Average mortgage rates are unchanged compared with last month. Although this is the first month of no changes seen since rates started rising in the middle of last year, with the OCR on track for 3% (from a current level of 0.75%) and wholesale rates up sharply since the beginning of the year, mortgage rates are likely to remain on an upward trajectory for the time being. It is not just local interest rates that are on the rise, so too are global interest rates, and that brings with it the risk of higher longer term wholesale and mortgage rates. When we look at where breakevens sit, now that we expect the OCR to go much higher (we had thought it would top out at 2% but we now think 3%), the idea of fixing for longer now looks more compelling. The 1yr rate remains the lowest rate, but if the OCR reaches 3%, 1yr mortgages are on track for around 5%, and that could make for some expensive rollovers. It may thus be worth considering fixing for 2 to 3 years.

Our view

Mortgage rates are unchanged (on average across the major banks) this month compared with when we last sampled them in December. That marks the first break in the pattern of rising rates seen since May last year. While that will be welcome news for many borrowers, given the extent of mortgage rate rises seen recently, the upward sloping shape of the mortgage curve, recent rises in wholesale interest rates here and abroad, and recent inflation trends, there is little else for borrowers to cheer.

Readers may be aware that we recently upgraded our OCR forecasts. For most of the second half of last year, we were comfortable that it would only need to rise to 2%, mindful of that increased leverage would make rate rises more potent, the fragility of the housing market, and the role unwinding of QE abroad would have on liquidity and long term interest rates. These factors remain in play, but what has changed is the outlook for inflation and employment. Both have surprised to the upside of late, and we expect those trends to continue. A strong labour market is good for the economy, but it does pose upside risks to wages and it does pose upside risks to already-high inflation readings. As a consequence, we now expect the OCR to rise to 3%, reaching that level in the first half of 2023.

Given historic trends, a 3% OCR would be consistent with floating mortgage rates above 6% and 1-year rates nudging on 5% (that's around where they were in 2015, which was the last time the OCR was 3%). Back then though, the RBNZ was in easing mode and they were having trouble achieving their 2% inflation target (CPI inflation ended up being below 0.5% for throughout 2015). However, right now inflation is at 4.9%, and it is proving to be much more difficult to rein in (because it's more symptomatic of supply-side issues than it is a reflection of excess demand). All of this is going down very badly in global markets. Indeed, as bond investors start to demand compensation for inflation (which is running at a whopping 7% in the US), that is putting upward pressure on interest rates everywhere.

All of that leaves us wary of where NZ mortgage rates are headed. Last month, we didn't see much appeal in fixing for longer than a year. However, when we throw an extra 100bps (1%pt) of OCR hikes into the mix, all of a sudden, that suggests it might not be cheaper in the long run to just fix for 1-year (which is the lowest rate) with a view to re-fixing one year from now.

Breakeven analysis bears this out. Let's consider, for example, the choice between a 3.66% 1-year fixed rate or a 4.30% 2-year rate. Over a 2-year horizon, back-to-back 1-year fixes will end up being cheaper if the 1-year rate is below 4.94% in a year (that's the 1 year/1year breakeven). That's still a big increase, but whereas we were thinking that was a high hurdle a month ago, we now think it could be a real possibility. Being fixed for longer also brings certainty with it, and many borrowers may place a value on that.

Figure 1. Carded special mortgage rates^

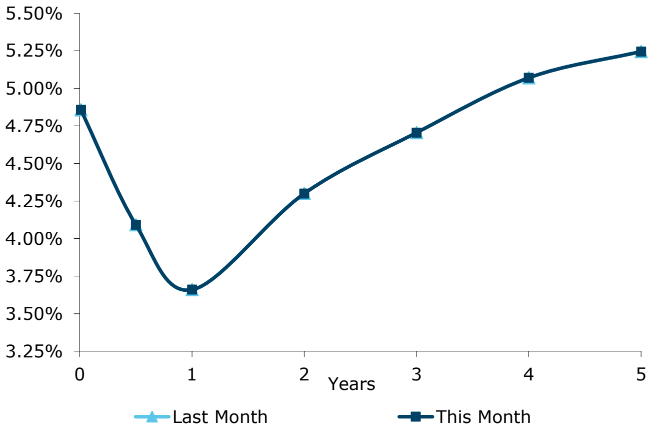

Table 1. Special Mortgage Rates

		Breakevens for 20%+ equity borrowers			
Term	Current	in 6mths	in 1yr	in 18mths	in 2 yrs
Floating	4.86%				
6 months	4.09%	3.23%	5.00%	4.89%	5.31%
1 year	3.66%	4.11%	4.94%	5.10%	5.52%
2 years	4.30%	4.61%	5.23%	5.47%	5.84%
3 years	4.71%	5.02%	5.54%	5.68%	5.88%
4 years	5.07%	5.29%	5.64%		
5 years	5.25%	#Average of "big four" banks			

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

Source: interest.co.nz, ANZ Research

Key forecasts

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

	Mortgage Rate (%)													
Mortgage Size ($000)	2.50	2.75	3.00	3.25	3.50	3.75	4.00	4.25	4.50	4.75	5.00	5.25	5.50	5.75
200	207	213	219	225	231	237	243	250	256	263	270	276	283	290
250	259	266	273	281	289	296	304	312	320	329	337	345	354	363
300	310	319	328	337	346	356	365	375	385	394	404	415	425	435
350	362	372	383	393	404	415	426	437	449	460	472	484	496	508
400	414	426	437	450	462	474	487	500	513	526	539	553	566	580
450	466	479	492	506	520	534	548	562	577	592	607	622	637	653
500	517	532	547	562	577	593	609	625	641	657	674	691	708	725
550	569	585	601	618	635	652	669	687	705	723	741	760	779	798
600	621	638	656	674	693	711	730	750	769	789	809	829	850	870
650	673	692	711	730	750	771	791	812	833	854	876	898	920	943
700	724	745	766	787	808	830	852	874	897	920	944	967	991	1,015
750	776	798	820	843	866	889	913	937	961	986	1,011	1,036	1,062	1,088
800	828	851	875	899	924	948	974	999	1,025	1,052	1,078	1,105	1,133	1,160
850	879	904	930	955	981	1,008	1,035	1,062	1,089	1,117	1,146	1,174	1,204	1,233
900	931	958	984	1,011	1,039	1,067	1,095	1,124	1,154	1,183	1,213	1,244	1,274	1,306
950	983	1,011	1,039	1,068	1,097	1,126	1,156	1,187	1,218	1,249	1,281	1,313	1,345	1,378
1000	1,035	1,064	1,094	1,124	1,154	1,186	1,217	1,249	1,282	1,315	1,348	1,382	1,416	1,451

Mortgage rate projections (historic rates are special rates; projections based on ANZ's wholesale rate forecasts)

	Actual			Projections						
Interest rates	Jun-21	Sep-21	Dec-21	Mar-22	Jun-22	Sep-22	Dec-22	Mar-23	Jun-23	Sep-23
Floating Mortgage Rate	4.5	4.5	4.9	5.1	5.5	6.0	6.5	6.8	7.0	7.0
1-Yr Fixed Mortgage Rate	2.2	2.7	3.6	3.9	4.2	4.6	4.7	4.9	4.9	4.9
2-Yr Fixed Mortgage Rate	2.6	3.1	4.3	4.7	4.8	4.9	5.0	5.0	5.0	5.0
5-Yr Fixed Mortgage Rate	3.6	4.0	4.9	5.4	5.4	5.4	5.4	5.5	5.5	5.5

Source: RBNZ, ANZ Research

Economic forecasts

	Actual			Forecasts						
Economic indicators	Mar-21	Jun-21	Sep-21	Dec-21	Mar-22	Jun-22	Sep-22	Dec-22	Mar-23	Jun-23
GDP (Annual % Chg)	3.3	17.9	-0.3	2.6	2.3	0.4	4.8	2.9	2.7	2.8
CPI Inflation (Annual % Chg)	1.5	3.3	4.9	6.0	*Currently under review*					
Unemployment Rate (%)	4.6	4.0	3.4	3.5	3.4	3.2	3.1	3.0	3.0	3.0
House Prices (Quarter % Chg)	7.9	6.6	5.6	4.2(a)	-1.5	-2.8	-1.9	-0.9	0.0	0.3
House Prices (Annual % Chg)	21.3	28.8	30.4	26.5(a)	15.6	5.3	-2.2	-7.0	-5.6	-2.6

Interest rates	Jun-21	Sep-21	Dec-21	Mar-22	Jun-22	Sep-22	Dec-22	Mar-23	Jun-23	Sep-23
Official Cash Rate	0.25	0.25	0.75	1.00	1.50	2.00	2.50	2.75	3.00	3.00
90-Day Bank Bill Rate	0.35	0.65	0.97	1.52	2.02	2.52	2.77	3.10	3.10	3.10
10-Year Bond	1.77	2.09	2.39	2.70	2.90	3.10	3.40	3.50	3.50	3.50

Source: ANZ Research, Statistics NZ, RBNZ, REINZ

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