NEW ZEALAND PROPERTY FOCUS

April 2018

INSIDE

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SOLID FOUNDATIONS

SUMMARY

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

FEATURE ARTICLE: SOLID FOUNDATIONS

New home building is at a high level. While rebuild activity in Canterbury has waned, overall housing demand is being driven by strong population growth, a shortfall of housing, and low interest rates. And despite rising construction and land costs, high existing house prices have made building attractive relative to buying. With demand expected to remain solid, we expect residential building activity will remain at high levels. But capacity in the construction industry is constrained and labour shortages are acute. Government initiatives intended to improve housing affordability will also contribute to demand, but we expect impacts on both the rate of home building and house prices will be relatively small. We have reached a more difficult phase in the construction cycle and rising costs and delays could put pressure on firms in the industry. Pockets of pressure could emerge, particularly around cash flow.

PROPERTY GAUGES

Housing market activity has stabilised in recent months, after increasing over the second half of 2017. House price inflation and credit growth have been broadly steady too. Regional housing markets continue to play catch up, but affordability constraints are biting hard in Auckland. There are opposing forces at play. Strong population growth coupled with a challenged supply backdrop argues that a fundamental supply-demand imbalance will continue to support prices. Yet this is going head-to-head with tighter lending standards, LVR restrictions (although these have been eased slightly), affordability constraints and possibly more restrictive government policy changes. We expect price growth will remain contained – with continued regional divergence expected.

ECONOMIC OVERVIEW

Generally, recent economic developments have been positive. Firms and households are getting on with it, the terms of trade remains high and population growth is strong. Less favourably, funding costs and market volatility have increased, while the economy continues to face some late-cycle challenges. Nonetheless, the economic picture remains positive. We expect the economy to continue growing at around-trend pace of 2-3% over the medium term. These are reasonable rates of growth, but achieving above-trend growth will be a challenge. We expect inflation will rise gradually over the medium term, with OCR hikes in time. But with evidence of a lift in domestic price pressures lacking, the OCR looks to be on hold for some time yet.

MORTGAGE BORROWING STRATEGY

There has been some movement in average mortgage rates over the past month. However, it hasn't altered our favoured view. The 1-year rate remains the low point on the mortgage curve and offers the most value in our eyes. However, we are watching the recent lift in bank funding costs, but don't believe pressures will escalate and affect mortgage rates significantly. But for borrowers concerned by that possibility, or the possibility of the OCR moving up within the next year (which is not our expectations), they may wish to spread risk by borrowing over a number of fixed terms (which is always a strategy that makes sense from a risk-management perspective).

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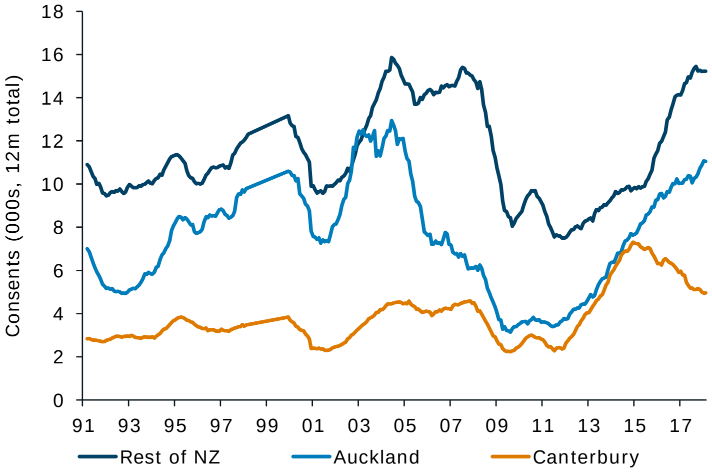
LOTS OF NEW HOMES ARE BEING BUILT

New home building is at a high level. Over the year to February, 31,100 new homes were consented. Annual consent issuance has been flat at this high level for the past seven months (but still 6% below the mid-2004 peak of 33,200). Residential construction activity in Canterbury is declining as rebuild-related residential work wanes. But home building in both Auckland and the rest of New Zealand is getting close to the highs reached last cycle. Consistent with this, our discussions with businesses suggest that construction industry activity is very strong across the entire North Island and the sector is "overloaded" in Auckland. Consents data show home building is up strongly in Taupo, Thames-Coromandel, Western Bay of Plenty, Greater Wellington region, Nelson-Tasman and Queenstown over the past year.

Figure 1: New dwelling consents by region



Source: ANZ, Statistics NZ

Solid demand for new houses is being driven by strong population growth, a shortfall of housing from previous under-building, and low interest rates. High-density building is an important source of housing supply in the face of strong demand. Over the year to February 2018, a third of all new dwelling consents were for multi-dwelling consents. This compares with a historical average of 26%.

Despite rising construction and land costs, high existing house prices have made building attractive relative to buying. We can compare the cost of building (based on the cost of a section and a new dwelling) with the cost of an existing house – a measure known as "Tobin's Q for housing". Building tends to increase when the cost of a new build becomes cheaper relative to buying an existing dwelling. Prices for existing houses have increased 50% since the start of 2012, whereas we estimate that the cost of a new dwelling (including land and construction) has increased 30% over the same period. The location and composition of new versus existing housing can differ, of course, but this comparison gives a general indication of how relative costs have evolved. Building has become more attractive relative to buying and consents have risen accordingly.

Despite recent increases in land and construction costs, building a new home remains an attractive option in situations where sections are available. We expect solid housing demand and the relative attractiveness of building over buying will continue to support the pipeline of new residential construction going forward.

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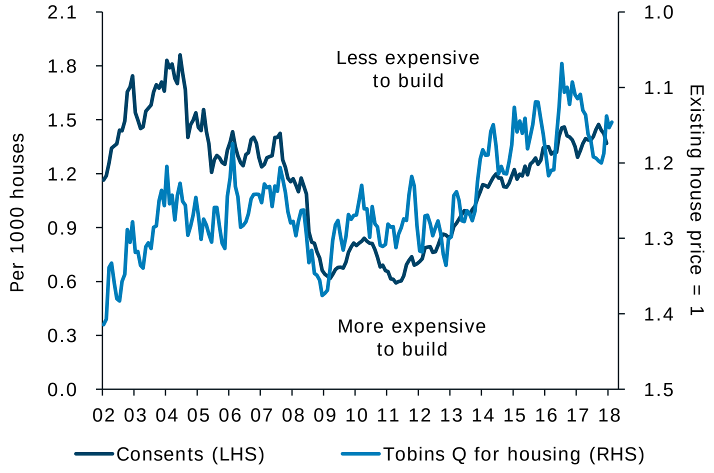
Figure 2: Tobin's Q for housing and consents



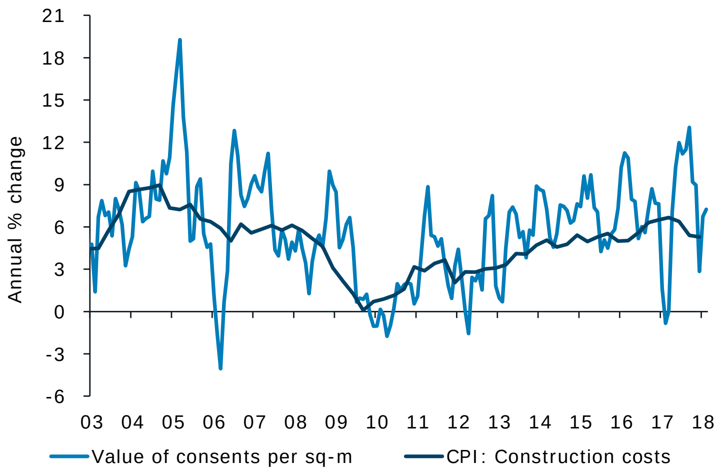
Source: ANZ, REINZ, Statistics New Zealand

THE CONSTRUCTION INDUSTRY IS CONSTRAINED

With activity at a high level, the construction industry is now running up against significant constraints – including those related to capacity, costs and credit. In the March QSBO, building firms reported capacity utilisation of 93% compared with a historical average of 90%. Capacity constraints limit firms' ability to increase activity above current levels in response to high levels of demand.

Capacity pressures are leading to cost increases and delays. Construction cost inflation is high relative to the general rate of inflation. Firms are reporting that cost pressures remain acute, and continue to increase, especially for projects that are yet to be started. High levels of activity are also leading to delays, pushing the backlog out further. Delays do not necessarily increase costs, but they can make projects riskier from a cash flow point of view and make financing more difficult.

Figure 3: Construction cost inflation



Source: ANZ, Statistics NZ

Cost increases, uncertainty and credit constraints are squeezing profits and limiting the degree to which the industry can increase activity further. While activity levels are high, construction firms bear some of the burden of increasing cost pressures. In some cases, cost increases cannot be passed on to customers because contracts have already been negotiated. Unexpected cost increases or delays can squeeze profits and make the outlook uncertain, making it more difficult for firms to bear risks and make financing decisions.

Banks are not necessarily willing to fund all projects, partly because of this uncertainty. Bank credit is thus a constraint for some, and due to the demise of the finance company sector, non-bank financing is not available to the extent it was last cycle. So although firms are very busy, profitability in the sector is strained, with firms struggling to pass on higher costs in a timely fashion. The QSBO measure of experienced profits fell 23%pts for builders in the March quarter to net -24% (compared with -7% economy-wide).

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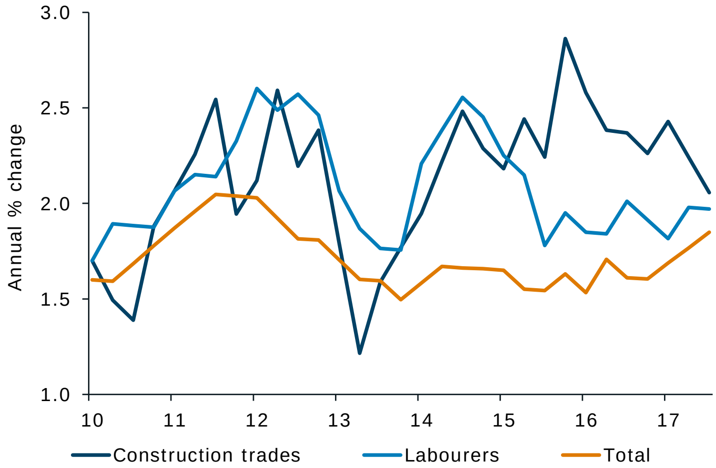
COULD BUILDING ACTIVITY GO HIGHER?

In the face of capacity constraints, there are three ways the construction industry can achieve higher levels of activity: increasing labour input, capital investment, or productivity.

There is evidence that building firms are increasing investment and have their eye on productivity. Investment intentions of manufacturers and builders in plant and machinery have been elevated since 2014, according to the QSBO. And firms are working to improve productivity, with anecdotes from businesses that new products are emerging to speed up residential construction. Investment and productivity initiatives are helpful, but they can only do so much because construction activity is reasonably labour intensive compared with other industries.[1] And if profits continue to be squeezed and credit constrained, this could make such initiatives difficult.

But labour availability is the more important constraint. Hiring and hiring intentions of builders are both very high relative to average, with shortages of both skilled and unskilled labour reported to be acute. Difficulty finding skilled staff is the biggest problem facing construction firms according to our ANZ Business Microscope. In the QSBO, a net 18% of building firms employed more workers over the past three months and net 13% expect to hire more workers in the next three months. But labour is difficult to find and we are hearing anecdotes from firms in the industry that labour availability is a significant and widespread problem. Our ANZ Job Ads release for March showed that job ads in the 'construction, utilities, manufacturing and transport' category have increased 49% since 2015 compared with 23% in other industries. **As a result of labour shortages, wage inflation is elevated across the construction industry.** Wages for labourers and people in construction-related trades have outpaced those in the economy more generally since 2011. Given the labour input required by construction firms, this represents a significant increase in costs.

Figure 4: LCI wage inflation



Source: ANZ, Statistics New Zealand

Migration has been a crucial source of labour for the construction industry. Construction firms have become accustomed to being able to source skilled labour from overseas relatively easily and the pipeline of new apprentices is currently insufficient. Discussions with businesses suggest that tougher visa requirements for immigrants would be a concern. The KiwiBuild visa will bring in 1,500 construction workers, but this is a small number in the scheme of things. MBIE estimates that the construction industry is short 30,000 workers.[2]

New hiring has broader benefits for productivity. Work from Motu has found that labour churn in construction is good for industry productivity. Firms that hire new workers in a given year tend to have higher productivity because productive workers tend to disperse ideas and techniques across firms, irrespective of the source of that labour (migrant or not).[3] Firms need to be dynamic in terms of their regional orientation, too. As the composition of demand changes, workers may need to move to different regions where demand is stronger.

In cities like Auckland, high housing costs may deter workers, making it difficult for the industry to adapt. This is not a minor issue: MBIE estimates that construction-related employment will need to increase by

[1] Jaffe, A., Le, T. & N. Chappell (2018), 'Productivity distribution and drivers of productivity growth in the construction industry ', *Motu Working Paper*, 2016-08.
[2] http://www.newshub.co.nz/home/shows/2018/04/construction-minister-jenny-salesa-confident-kiwibuild-targets-will-be-met.html
[3] Jaffe, A. & N. Chappell (2018), 'Worker Flows, Entry, and Productivity in NZ's Construction Industry', *Motu Working Paper*, 2018-02.

approximately 49,000 employees between 2015 and 2021, with 65% of these workers needed in Auckland.[4] Related to this, some firms report that it can be difficult to secure accommodation for foreign construction workers (a visa requirement).

Overall, we think it will be difficult for firms to achieve significantly higher levels of activity given current constraints. Investment and productivity initiatives by firms are useful, but may be not be viable given squeezed profits and credit constraints. More importantly, labour shortages remain prevalent and don't look like they are going away any time soon.

SO WHAT ABOUT GOVERNMENT INITIATIVES?

The new Government intends to build 100,000 affordable homes over the next 10 years through KiwiBuild as part of its policy agenda aimed at improving housing affordability**.** Recently, the first KiwiBuild homes were announced, with the Government purchasing 29 hectares of land at the Unitec campus in Mt Albert. This development is for 4,000 new homes, with the Government aiming for 40% of these to be "affordable" KiwiBuild homes (priced between $500,000 and $600,000). The Government intends to do this by:

- undertaking development projects (in partnership); converting Crown land and purchasing land from the private sector;
- purchasing and under-writing new affordable homes off the plan;
- leveraging existing Government opportunities for procurement (e.g. through Housing New Zealand); and
- undertaking related initiatives to streamline planning and consent processes.

The Government's target of supplying 100,000 affordable homes is ambitious. Increasing supply is good for affordability, but doing so will be difficult in practice.

The issue is that the Government is competing with the private sector for resources, with demand and construction costs high. The construction industry is under significant capacity pressure already. Without significant efficiency and cost improvements, Government involvement may increase costs further, and thereby crowd out private sector investment, potentially implying only a small net impact on supply. In its November 2017 *Monetary Policy Statement*, the RBNZ assumed that the KiwiBuild initiative would crowd out 50,000 houses that would otherwise have been built, meaning a net gain of only 50,000 homes, even if targets are reached.[5] Ensuring that sufficient labour is available (through migration and training) will be crucial for demand to be met.

Building "affordable" houses will be difficult, given elevated costs. Given the current costs of land and construction in Auckland, it is difficult to deliver new housing for less than $900,000 – the price of the median house. The cost of construction (not including land) was $2,100/m^2 on average for new dwellings consented in February. But even if the Government's targets are met, the houses will still be unaffordable for many, with $600,000 just under 6 times the average income in Auckland. Compared with a median price of $900,000, this is certainly an improvement. With a 20% deposit, this equates to 33% of disposable income going to mortgage payments, rather than 50%. But $600,000 is ambitious, given high costs and strong demand. Tweaks such as multi-level "walk-ups" (no lifts) and cutting out car parks will help at the margin but aren't a game-changer.

And 100,000 homes, while ambitious, isn't actually going to solve the housing shortage. Demand has outpaced new supply for a number of years, leading to a significant shortfall. And population growth remains strong. New Zealand's population is estimated to have increased by 100,000 people over the year to December 2017 to reach 4.8 million people. Ironically, the promise of these houses may have had a dampening impact on housing demand and hence prices already – why buy a $900,000 house today if a $600,000 option will be available in a year or two? Ultimately, though, we suspect any direct effect on house prices of the KiwiBuild initiative will be small. (But as is often the case in economics, we will never have the counterfactual to be sure.)

That said, there well may be some positive spin-offs from the Government's initiatives:

- **Sharing the financial burden:** The Government's books are in a solid shape and the Crown can borrow more cheaply than corporates, so government financing of projects may ease that constraint by sharing risk.
- **Procurement:** Government procurement could help reduce construction costs, though competition for labour resources will work in the opposite direction.

[4] MBIE (2016, 'Future demand for construction workers', Projections for the National Construction Occupations Model, July 2016.
[5] https://www.rbnz.govt.nz/monetary-policy/monetary-policy-statement/mps-november-2017

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- **Productivity:** Use of prefabricated housing and modular units at scale could provide the productivity kicker that the residential construction sector so desperately needs (if it is consistent with buyers' preferences).
- **Streamlining consents:** Initiatives to review council regulations and streamline consent processes would be useful for reducing costs and delays, but only if they are widespread.
- **Land supply:** Freeing up land for new building (or loosening land use restrictions) is the most important step the Government can make towards improving housing affordability.

But it's like the old joke when you ask the local for directions: "Well son, I wouldn't start from here." **Auckland is faced with a housing shortage that was years in the making, and it won't be turned around overnight.** In addition, exceptionally high house prices, particularly in Auckland, have become embedded in the financial system, something the Reserve Bank has been talking about in a financial stability context for years.

Increasing land supply is crucial in the face of strong demand. High house prices have been driven significantly by rising land values, with effective land supply relatively unresponsive to changes in demand. Increasing land supply is therefore crucial to making houses more affordable, in the face of strong population pressures. Estimates suggest that "In Auckland, land use regulation could be responsible for up to 56% or $530,000 of the cost of an average home".[6] This issue is not confined to the Auckland market, though. Land use regulation could be responsible for up to 48% of the cost of an average home in Wellington, 39% in Queenstown, and 32% in Christchurch.

Uncontrolled urban sprawl makes for unliveable cities. However, land costs can be reduced by making more new land available, allowing higher density land use, and adjusting legislation to minimise NIMBY-ism while appropriately protecting property rights. Without reducing land costs, other initiatives can only have marginal impacts in an environment of strong population growth.

CONSTRUCTION INDUSTRY OUTLOOK

Housing demand is expected to remain solid, but constraints are at play. We expect residential building activity will remain at high levels. Underlying demand remains strong, with a significant number of houses needed to keep pace with demand. Regional housing markets are playing catch up, filling the gap as rebuild-related activity in Canterbury continues to wane. The Canterbury market is expected to slow further going forward. The Government initiatives described above will also contribute to demand, while inevitably causing a degree of crowding out of private sector activity.

The construction industry more broadly is closely connected to economic activity. Construction industry activity (which includes residential and non-residential investment along with other construction) is quite 'cyclical': it tends to pick up considerably when economic activity is strong and pare back a lot in downturns. Construction industry activity is currently elevated as a share of total economic activity – and we expect this will continue for some time yet, with GDP continuing to grow at about-trend pace. It's not just the outlook for residential building supporting this solid outlook for construction; demand for commercial property is also expected to hold up. Commercial and residential construction firms compete to some extent for workers (but perhaps not as much as one might expect).

We are arguably reaching a more difficult phase in the construction cycle. Activity levels are high, but we expect continued upward pressure on costs at a time when house prices are no longer increasing significantly – meaning cost miscalculations won't come out in the wash. Cost pressures and delays could squeeze profits and put cash-flow pressure on firms in the industry. Current high levels of construction activity may also be allowing less competitive companies to stay in business, so the industry will need to adjust if growth softens. And if construction activity were to slow significantly, such firms could face difficulty.

So the outlook is solid, with demand expected to remain supportive. But pockets of pressure could emerge, particularly if house prices were to start to turn south. Given such pronounced housing shortages in Auckland, that is not our expectation. But nor can it be ruled out. House prices could start to fall if household debt serviceability were to take a hit, either due to reduced job security or interest rate rises. For now though, it's all hands on deck.

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[6] Lees, K (2017), Quantifying the impact of land use regulation: Evidence from New Zealand', Sense Partners Report for Superu, Ministerial Social Sector Research Fund, June 2017.

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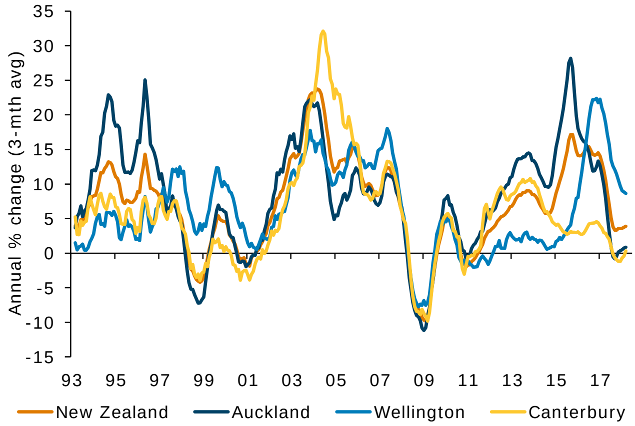
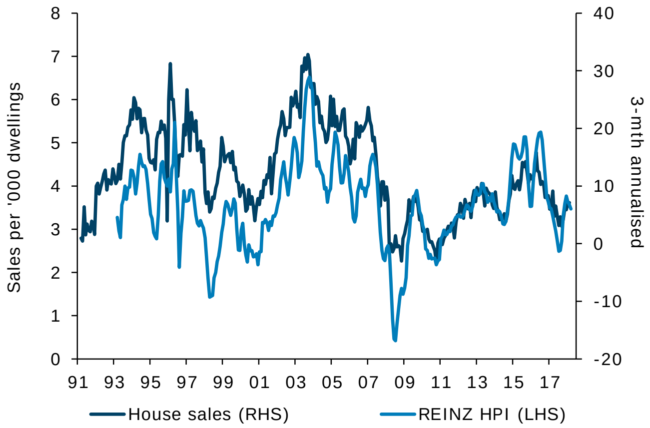
Figure 1. Regional house price inflation



Source: ANZ, REINZ

The REINZ House Price Index rose again in March, lifting 0.5% m/m. In 3-month average terms, annual growth ticked up to 3.9% y/y. Overall, we would describe the pace of annual house price inflation as broadly stable. House price inflation has been hovering in the 3-4% range for the past eight months. On the same basis, Auckland prices were up a subdued 0.9% y/y. In the rest of New Zealand, house prices are up 6.9% y/y. House price inflation in Canterbury remains subdued, while Wellington prices are up 9% y/y. In the regions, price pressures are broad based, with a "catch up" dynamic at play. Particular pockets of pressure continue in Hawke's Bay (+15% y/y), Manawatu-Whanganui (+11% y/y) and Southland (12%y/y).

Figure 2. REINZ house prices and sales

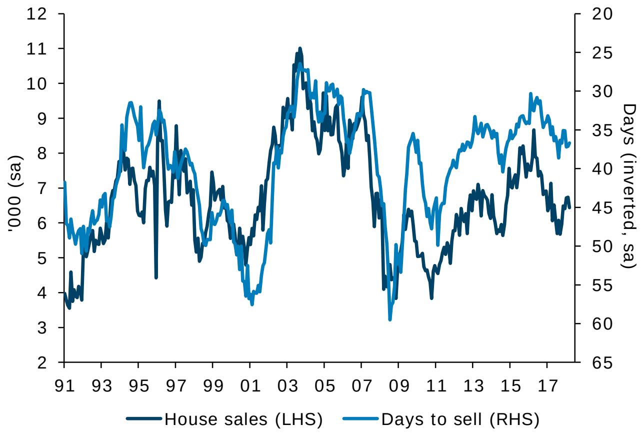


Source: ANZ, REINZ

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

We estimate that seasonally adjusted house sales volumes fell 4.5% in March to be down 0.3% y/y on a 3-month moving average basis. Looking through the monthly noise, we are of the view that housing market has stabilised. House sales are up 13% since September 2017 and have plateaued at close to 6,500 sales per month. From a regional perspective, Auckland sales are down 1.2% (3-month moving average) over the year, while across the rest of the country they are up 0.2%.

Figure 3. Sales and median days to sell



Source: ANZ, 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.

Nationally, the median time to sell a house was stable at 37 days (sa) in March. Days-to-sell has stabilised at this level after increasing since mid-2016 (when it was 31 days). Nonetheless, days-to-sell is still below its historical average of 39.6 days, due to market tightness in the regions. The median time to sell a property is currently 37 days in Auckland – above the historical average of 36 days.

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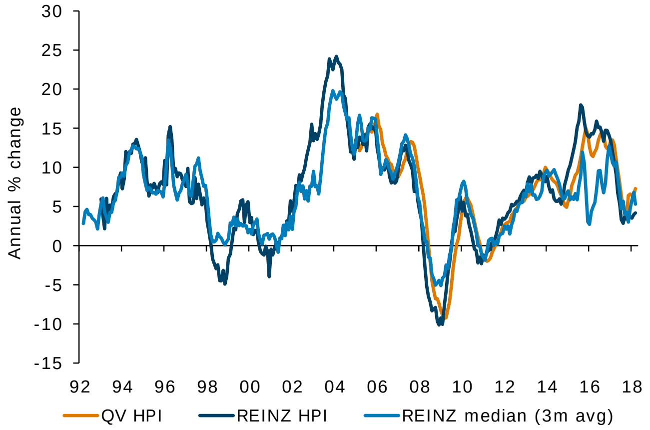
Figure 4. REINZ and QV house prices

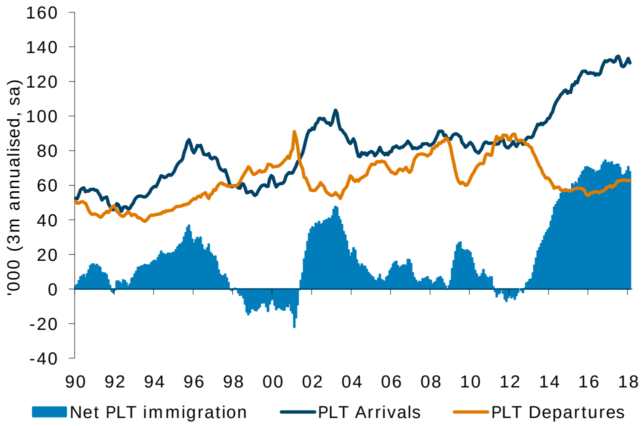


Source: ANZ, REINZ, QVNZ

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 median sale price fell 2.9% (sa) in February and annual growth fell to 1.8% y/y. This is weaker than the REINZ HPI (4.2% y/y). The REINZ median can get thrown around due to changes in composition of sales. The QVNZ measure of price growth is running at 7.3% y/y but tends to lag.

Figure 5. Net permanent/long-term immigration



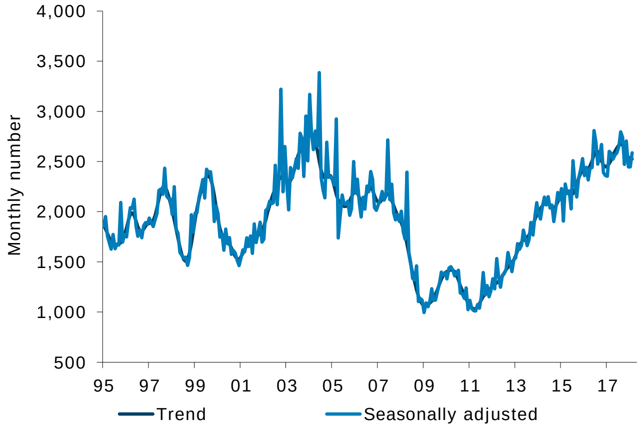
Source: ANZ, Statistics NZ

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.

Net migrant inflows are gradually easing. In seasonally adjusted terms, a net inflow of 4,970 migrants was recorded in February, down sharply from a high 6,270 person inflow in January. Inflows are gradually easing, with long-term arrivals now at a 3-year low.

The increase in departures of non-New Zealand and Australian citizens (due to a natural cycling effect as previously large numbers of arrivals leave) already speaks to a likely 'peak' in net migration.

Figure 6. Residential building consents



Source: ANZ, Statistics NZ

Dwelling consent issuance has been volatile of late and increased 5.7% in February m/m, driven by multi-dwelling consents. The multi-dwelling component increased 14.6% m/m. Issuance for 'houses' was up 2%, following a 4.1% increase in January. Consent issuance is high historically, with levels of construction high in Canterbury and Auckland.

Looking through monthly volatility, consents are chopping about at an elevated level. We struggle to see issuance pushing much above current levels as the economy grapples with cost, capital and capacity constraints. While the demand picture remains solid, and strong population growth requires ongoing lifts in housing supply, we don't see capacity pressures easing any time soon.

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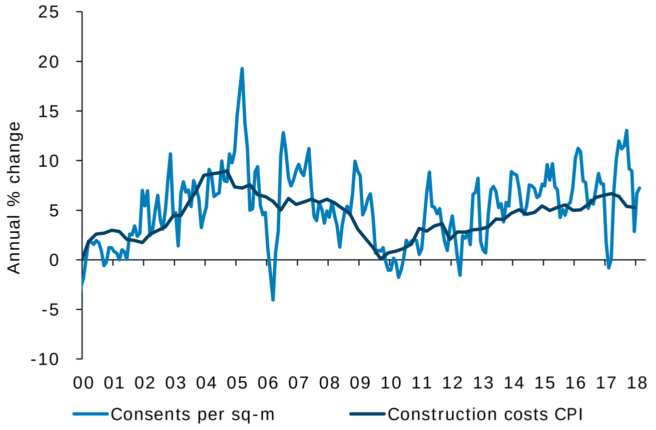
Figure 7. Construction cost inflation

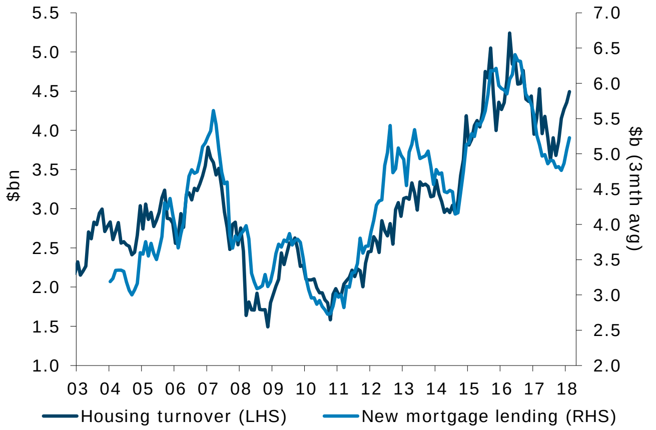


Source: ANZ, Statistics NZ

Consistent with capacity pressure in construction, one measure of cost pressures has increased. The value of residential consents per square metre – a proxy for construction cost inflation – is running at 7.2% y/y (3-month average), down from a recent peak of 13% but indicative of construction cost inflation continuing at its current moderate pace of 5.3%. The measure is volatile, but points to continued robust construction cost inflation.

That said, the measure of construction costs in the CPI has eased off its highs, falling to 5.3% y/y in Q4, from 6.4% y/y in Q2. It is going to be interesting to see whether, with house price growth cooling, construction cost inflation can continue to run at its earlier strong pace.

Figure 8. New mortgage lending and housing turnover



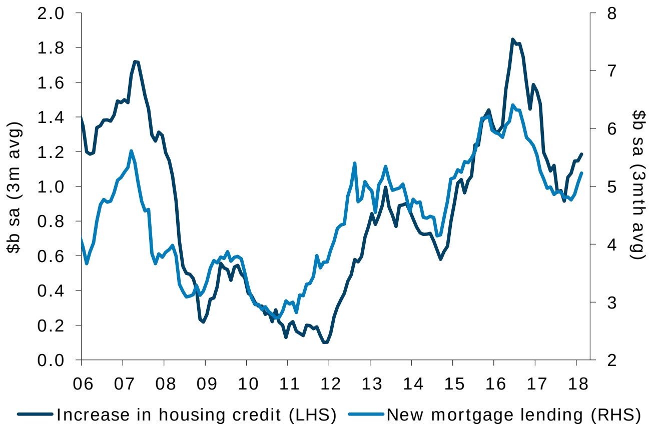
Source: ANZ, RBNZ

New residential mortgage lending figures are published by the RBNZ. They can provide leading information on household credit growth and housing market activity.

We estimate that new mortgage lending increased 0.6% m/m in February in seasonally adjusted terms (the chart is in 3-month average terms). That follows a strong increase of 9.3% in January. New lending is up 6.6% y/y. The increase is consistent with the pick-up in housing market turnover late last year.

New lending to first-home buyers is up strongly, rising 23% y/y in February. By contrast, new investor lending has stabilised after falling significantly since 2016.

Figure 9. New mortgage lending and housing credit



Source: ANZ, REINZ, RBNZ

Total housing lending growth was steady again in February, at 0.5% m/m (sa). Housing lending has been growing at this rate since the start of 2017. As such, growth in three-month annualised terms has been relatively steady of late, sitting at 5.8% y/y in February.

High-LVR lending restrictions, credit rationing by banks, housing affordability concerns, debt constraints, and evolving expectations regarding capital gains are all having an impact on house sales and credit availability. While we do not envisage the rate of housing lending growth slowing significantly from here (in fact LVR restrictions have eased a touch), we expect the more moderate pace of lending growth that is now occurring will persist for the foreseeable future.

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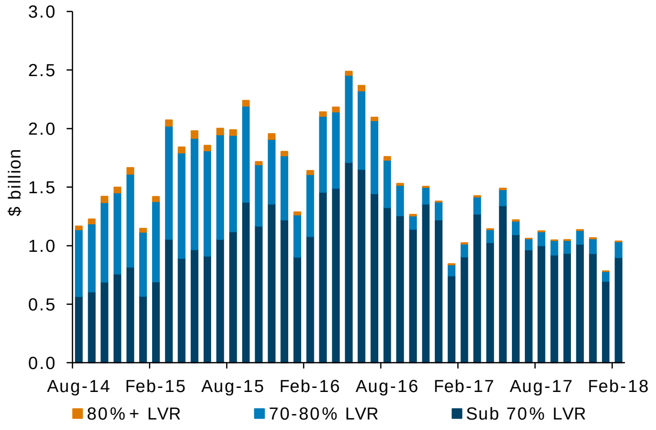
Figure 10. Investor lending by LVR

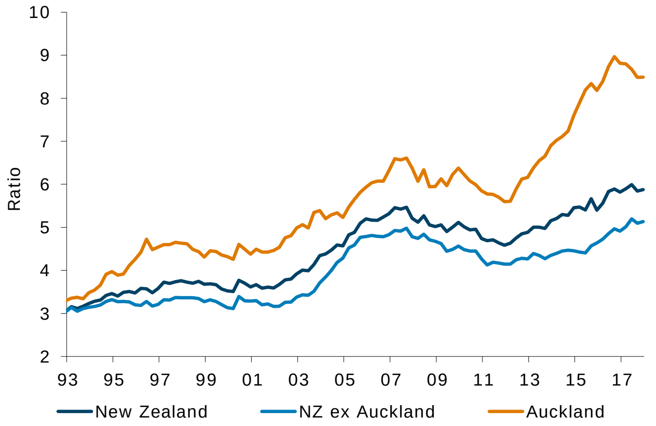


Source: ANZ, RBNZ

New lending to investors bounced back in February (+33% m/m), after taking a step down in January (-27% m/m). Looking through this volatility, lending to investors has stabilised to be up 1.4% y/y. Investor lending is sitting at 22% of new lending – down from 34% in September 2015. This lower share relates, at least in part, to the impact of LVR restrictions (which came into force in October 2016). The RBNZ eased these restrictions modestly at the start of the year, it was only a tweak, and we expect further adjustments to be cautious.

Related to the LVR restrictions, a larger share of new lending is on less-risky terms. In February, the share of total investor lending at LVRs of less than 70% was 87%. That is a far greater share than in late-2014, when it was less than half.

Figure 11. Regional house prices to income

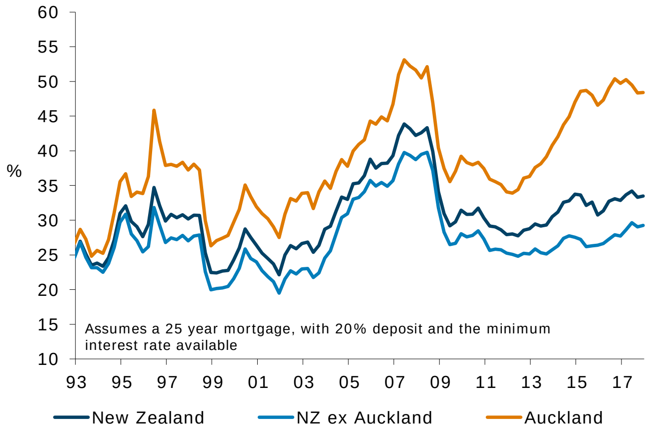


Source: ANZ, REINZ, Statistics NZ

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 broadly stable at around six times income for the past 12 months. Auckland has seen its ratio ease from a high of 9 times in Q3 last year to an estimated 8.5 times in Q4. While still extremely high, the easing reflects the recent moderation in house price growth. Outside of Auckland, the ratio has continued to rise, and at 5.1 times, is now a little over where it peaked in 2007.

Figure 12. Regional mortgage payments to income



Source: ANZ, 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 around 33.5%. However, there are stark regional differences, with the average mortgage payment to income in Auckland just short of 50% for new purchasers. While (just) off its highs, it is still on par with the highs reached in 2007, despite mortgage rates being near historic lows currently. It highlights how sensitive some recent home-buyers in Auckland would be to even a small lift in interest rates.

PROPERTY GAUGES

Housing market activity has stabilised in recent months, after increasing over the second half of 2017. House price inflation and credit growth have been broadly steady too. Regional housing markets continue to play catch up, but affordability constraints are biting hard in Auckland. There are opposing forces at play. Strong population growth coupled with a challenged supply backdrop argues that a fundamental supply-demand imbalance will continue to support prices. Yet this is going head-to-head with tighter lending standards, LVR restrictions (although these are gradually being eased), affordability constraints and possibly more restrictive government policy changes. We expect price growth will remain contained – with continued regional divergence expected.

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.

Indicator	Level	Direction for prices	Comment
Affordability	Unaffordable	↔/↓	Affordability constraints are very relevant. It is the main reason we see the Auckland market underperforming over the next few years.
Serviceability/ indebtedness	High debt, low rates OK. High rates not.	↔/↓	Serviceability looks okay provided interest rates stay low and the unemployment rate keeps trending lower.
Interest rates / RBNZ	Slow ascent	↔/↓	The case can be argued that the OCR is not moving for a long time. We're still favouring a couple of OCR hikes eventually.
Migration	Peaked	↔	The cycle appears to have turned ahead of potential policy changes. But inflows are not set to fall sharply.
Supply-demand balance	Demand > Supply	↔/↑	We need to be building 35-40k plus dwellings, not ~30k. Capacity constraints are biting.
Consents and house sales	Shortage	↔/↑	Dwelling consent issuance ultimately flat-lining at high levels (~30k annualised), with the construction sector reaching its limits.
Liquidity	Tight	↔/↓	Credit rationing still apparent. Closure of bank funding gap suggests there is now more wriggle room, but resurgence not expected.
Globalisation	Mixed bag	↔	Non-resident buyers no longer that influential. Other big global housing markets looking stable too.
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	↔/↓	Rents are moving up, but only gradually, suggesting that existing housing shortages aren't the only game in town.
On balance	**Flat-lining**	↔	**Positives offset the negatives, leaving the market steady. Auckland to remain weak as affordability bites hard.**

PROPERTY GAUGES

Figure 1: Housing affordability

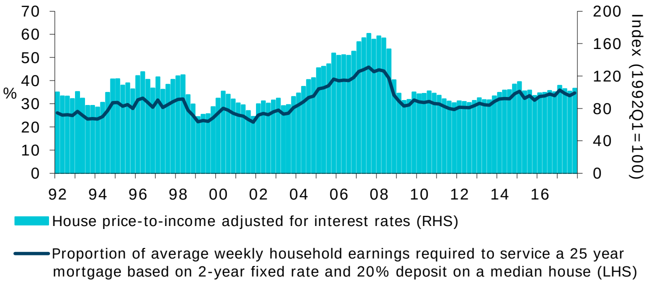


Figure 2: Household debt to disposable income

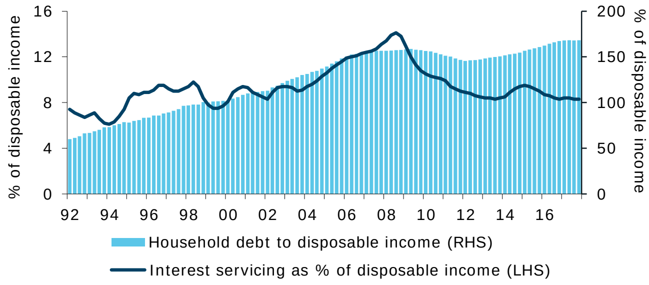


Figure 3: New customer average residential mortgage rate (<80% LVR)

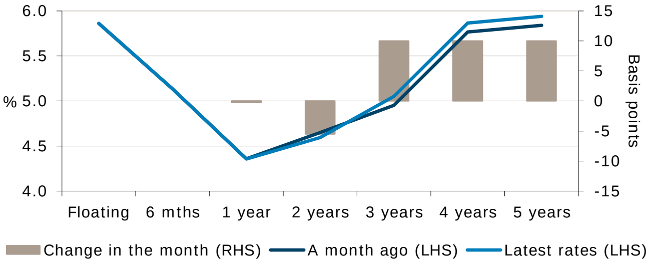


Figure 4: Net migration

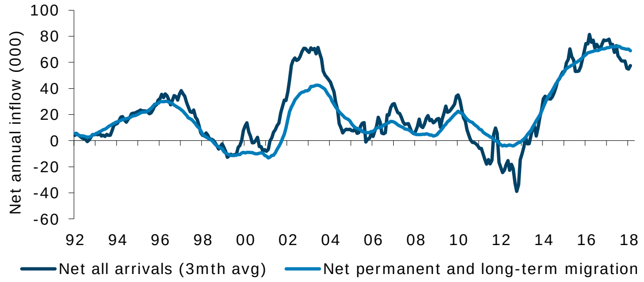


Figure 5: Housing supply-demand balance

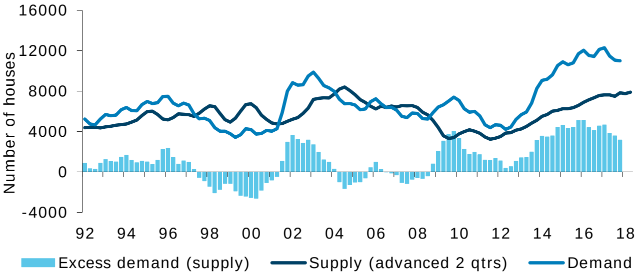


Figure 6: Building consents and house sales

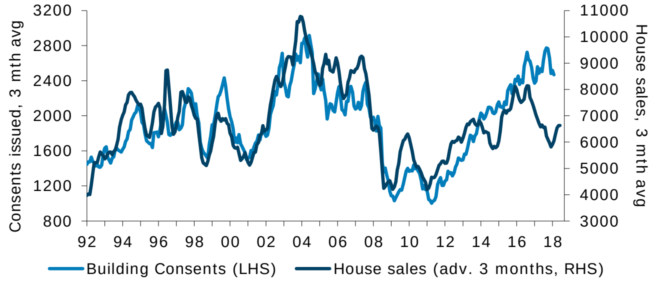


Figure 7: Liquidity and house prices

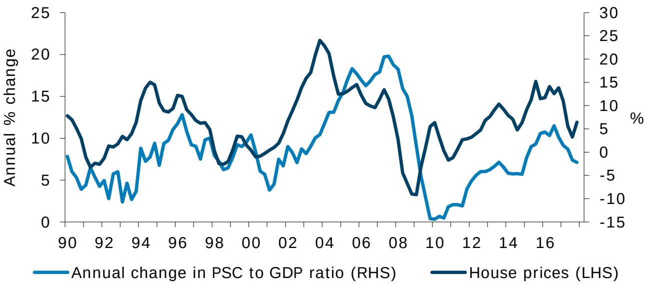


Figure 8: House price inflation comparison

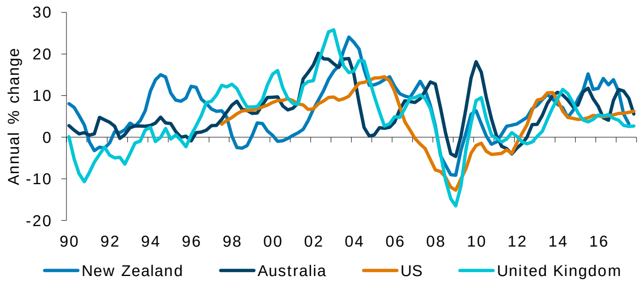


Figure 9: Housing supply

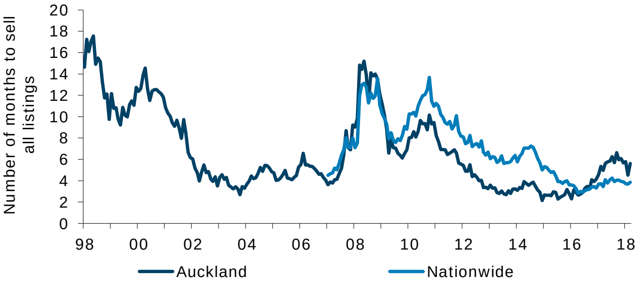
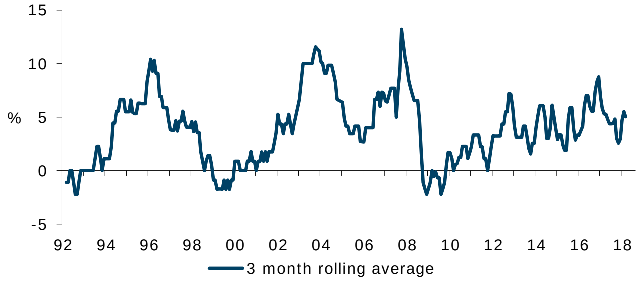


Figure 10: Median rental, annual growth



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

ECONOMIC OVERVIEW

SUMMARY

Generally, recent economic developments have been positive. Firms and households are getting on with it, the terms of trade remains high and population growth is strong. Less favourably, funding costs and market volatility have increased, while the economy continues to face some late-cycle challenges. Nonetheless, the economic picture remains positive. We expect the economy to continue growing at around-trend pace of 2-3% over the medium term. These are reasonable rates of growth, but achieving above-trend growth will be a challenge. We expect inflation will rise gradually over the medium term, with OCR hikes in time. But with evidence of a lift in domestic price pressures lacking, the OCR looks to be on hold for some time yet.

OUR VIEW

Generally, recent economic developments have been positive:

- **Firms are getting on with it** despite apparent pessimism. Activity indicators remain positive, with investment and employment intentions heading in the right direction.
- **Housing market activity has stabilised** with house price inflation growing at a stable, healthy rate; household sentiment remains solid.
- **The terms of trade remains high.** Commodity prices were up 4.8% in the March quarter, meaning a new high in the terms of trade could be on the cards in Q1.
- **Population growth is strong** although migration is now easing.

But a couple of developments have unfolded that may be less favourable for growth.

- **Funding costs have increased.** It remains to be seen whether this increase will be temporary. A persistent increase could result in a tightening in financial conditions.
- **Volatility in markets has increased.** Trade tensions and uncertainty pose risks to the global outlook and could lead to a stronger-than-expected NZD, which would dampen activity and inflation.

And the economy is navigating some challenges. Migration and construction – key drivers of recent strength – appear to have topped out. And late-cycle challenges are tempering the outlook going forward. Capacity pressures, housing excesses and margin pressure will temper activity – and household debt is high. Even in the best case scenario, high household debt will constrain consumption growth and overall activity growth in the future. That said, the current account is contained, the banking system is resilient, and credit growth is relatively subdued – the economy has strengthened its buffers against a bad scenario.

Nonetheless, the economic picture remains positive. We expect the economy to continue growing at around-trend pace of 2-3%. Stimulatory fiscal policy and supportive financial conditions both remain supportive. The fiscal position is strong – and indeed it has been stronger than expected – providing the Government with options. The fiscal stimulus over the next couple of years will be large, particularly since it will put additional money in the pockets of those who are most likely to spend it. Prospects for household income growth are solid, given our expectation that wage growth is set to finally increase (albeit modestly). We expect consumption to continue growing at moderate rates, but that household will rebuild their saving buffers in light of housing affordability and debt constraint. The high terms of trade will is also boosting national incomes. Interest rates are low and despite recent global financial market volatility, domestic financial conditions are supportive.

We expect reasonable rates of GDP growth over the medium term, but achieving above-trend growth will be a challenge. The economic cycle is tired, usual growth levers have already been pulled, population growth is set to slow and a productivity miracle is unlikely. That said, we are not seeing the same imbalances or inflationary pressures that have often been the catalyst for a sharper downturn. We expect capacity and cost pressures will continue to building, leading to a pick-up in inflation. With costs increasing and firms' already-thin margins being squeezed, something has got to give. We think that something will be prices.

We expect inflation will rise gradually over the medium term, with OCR hikes in time. But with evidence of a lift in domestic price pressures lacking, the OCR looks to be on hold for some time yet. We expect wage inflation to eventually increase as skill shortages bite, and that firms will increase prices to claw back margins. At the same time, we expect the NZD to face more downward pressure on narrowing interest rate differentials, which will also give inflation a nudge. But underlying inflationary pressures are low and we expect increases in inflation to occur only gradually, meaning that the RBNZ will take a cautious approach to tightening policy for some time yet. We have pencilled an eventual OCR increase in August 2019.

MORTGAGE BORROWING STRATEGY

SUMMARY

There has been some movement in average mortgage rates over the past month. However, it hasn't altered our favoured view. The 1-year rate remains the low point on the mortgage curve and offers the most value in our eyes. However, we are watching the recent lift in bank funding costs, but don't believe pressures will escalate and affect mortgage rates significantly. But for borrowers concerned by that possibility, or the possibility of the OCR moving up within the next year (which is not our expectations), they may wish to spread risk by borrowing over a number of fixed terms (which is always a strategy that makes sense from a risk-management perspective).

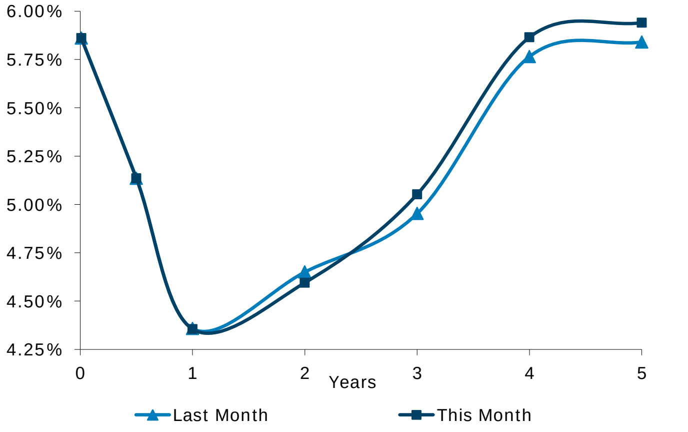
OUR VIEW

For the first time in a while, the past month has seen some changes in average mortgage rates across the 'big four' banks. The average special 2-year rate fell 6bps to 4.60%, while average 3-5 year rates all rose 10bps. The mortgage has therefore steepened modestly.

However, despite the changes, our favoured views on where to fix are largely unchanged. We say 'largely', because given the recent lift in bank funding costs, there are a few more things for borrowers to consider than just the future direction of the OCR. We discuss this more below. Ultimately though, we still believe that fixing for one year offers the most value. That is reinforced by our expectations for the OCR outlook. Despite the economy still performing relatively well and a labour market that continues to tighten, a lack of inflation pressure means that the RBNZ is going to be in no hurry to withdraw stimulus. We do not see the first OCR hike until August next year, and continue to expect that even when the tightening cycle begins it will be gradual, keeping the 'value' in rolling short-dated fixes.

Breakeven analysis supports this message. For instance, the average 2-year special rate is 24bps above the 1-year rate. It means that the 1-year rate would need to rise by 48bps (from 4.36% to 4.84%) over the next year in order for it to be cheaper fixing for 2 years at 4.60% than rolling two 1-year terms. **While not out of the question, that degree of increase is not our expectation.** There is a larger step-up between the 2 year and 3 year (46bps); the breakeven on a 2-year at 4.60% versus a 3-year at 5.05% is 5.40%. Again, that degree of lift in the 2-year rate is not out of the question, but would require either more confidence that the OCR is moving up or the global inflation pulse is shifting. It is hard to have much conviction in that prospect right now.

Carded special mortgage rates^



Special Mortgage Rates		Breakevens for 20%+ equity borrowers			
Term	Current	in 6mths	in 1yr	in 18mths	in 2 yrs
Floating	5.86%				
6 months	5.14%	3.58%	4.72%	4.96%	5.74%
1 year	4.36%	4.15%	4.84%	5.35%	5.97%
2 years	4.60%	4.75%	5.40%	6.20%	7.14%
3 years	5.05%	5.51%	6.37%	6.62%	6.84%
4 years	5.87%	6.00%	6.34%		
5 years	5.94%	#Average of "big four" banks			

Standard Mortgage Rates		Breakevens for standard mortgage rates*			
Term	Current	in 6mths	in 1yr	in 18mths	in 2 yrs
Floating	5.86%				
6 months	5.21%	4.55%	5.71%	5.15%	5.90%
1 year	4.88%	5.13%	5.43%	5.53%	6.05%
2 years	5.16%	5.33%	5.74%	6.04%	6.58%
3 years	5.45%	5.73%	6.19%	6.37%	6.67%
4 years	5.87%	6.06%	6.36%		
5 years	6.07%	*may be subject to a low equity fee			

As mentioned, the one complication right now that could alter the picture for mortgage rates is a recent lift in bank funding costs (represented by a lift in bills-OIS spreads). We don't expect these pressures to escalate and impact significantly on mortgage rates. **However, if borrowers are concerned by this risk, or by the fact that we believe there is a greater chance that interest rates are likely to rise than fall, they may wish to spread their borrowing over a number of fixed terms.** That is always a strategy that makes sense from a risk-management perspective; having a number of 'tranches' rolling over more regularly does smooth interest expenses.

^ Average of carded rates from ANZ, ASB, BNZ and Westpac. Sourced from interest.co.nz

KEY FORECASTS

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

Mortgage Size ($'000) \ Mortgage Rate (%)	4.00	4.25	4.50	4.75	5.00	5.25	5.50	5.75	6.00	6.25	6.50	6.75	7.00	7.25
200	243	250	256	263	270	276	283	290	297	304	311	319	326	333
250	304	312	320	329	337	345	354	363	371	380	389	398	407	417
300	365	375	385	394	404	415	425	435	446	456	467	478	489	500
350	426	437	449	460	472	484	496	508	520	532	545	558	570	583
400	487	500	513	526	539	553	566	580	594	608	623	637	652	667
450	548	562	577	592	607	622	637	653	669	684	701	717	733	750
500	609	625	641	657	674	691	708	725	743	761	778	797	815	833
550	669	687	705	723	741	760	779	798	817	837	856	876	896	917
600	730	750	769	789	809	829	850	870	891	913	934	956	978	1,000
650	791	812	833	854	876	898	920	943	966	989	1,012	1,036	1,059	1,083
700	852	874	897	920	944	967	991	1,015	1,040	1,065	1,090	1,115	1,141	1,167
750	913	937	961	986	1,011	1,036	1,062	1,088	1,114	1,141	1,168	1,195	1,222	1,250
800	974	999	1,025	1,052	1,078	1,105	1,133	1,160	1,188	1,217	1,246	1,274	1,304	1,333
850	1,035	1,062	1,089	1,117	1,146	1,174	1,204	1,233	1,263	1,293	1,323	1,354	1,385	1,417
900	1,095	1,124	1,154	1,183	1,213	1,244	1,274	1,306	1,337	1,369	1,401	1,434	1,467	1,500
950	1,156	1,187	1,218	1,249	1,281	1,313	1,345	1,378	1,411	1,445	1,479	1,513	1,548	1,583
1000	1,217	1,249	1,282	1,315	1,348	1,382	1,416	1,451	1,486	1,521	1,557	1,593	1,630	1,667

Housing market indicators for March 2018 (based on REINZ data)

	House prices (ann % chg)	3mth % chg	No of sales (sa)	Mthly % chg	Avg days to sell (sa)
Northland	-0.2	2.2	221	0%	42
Auckland	-2.2	0.5	1,853	-9%	37
Waikato	5.6	3.0	710	+2%	39
Bay of Plenty	7.0	-0.4	457	0%	44
Gisborne	16.8	6.7	61	+4%	31
Hawke's Bay	11.7	5.6	234	+6%	29
Manawatu-Whanganui	12.8	3.3	389	-5%	31
Taranaki	-7.4	-3.8	172	0%	39
Wellington	9.7	2.9	681	-9%	33
Tasman, Nelson and Marlborough	5.5	5.0	312	+13%	29
Canterbury	0.1	0.5	814	-5%	39
Otago	11.4	2.7	350	-11%	34
West Coast	6.4	-13.5	36	-19%	87
Southland	4.6	0.7	164	-4%	27
NEW ZEALAND	**1.8**	**1.5**	**6,434**	**-4%**	**37**

Key forecasts

	Actual			Forecasts						
Economic indicators	**Jun-17**	**Sep-17**	**Dec-17**	**Mar-18**	**Jun-18**	**Sep-18**	**Dec-18**	**Mar-19**	**Jun-19**	**Sep-19**
GDP (Ann Avg % Chg)	3.3	3.0	2.9	2.8	2.8	2.9	3.0	3.1	3.2	3.1
CPI Inflation (Annual % Chg)	1.7	1.9	1.6	1.0	1.4	1.5	1.6	1.7	2.1	2.2
Unemployment Rate (%)	4.8	4.6	4.5	4.3	4.3	4.2	4.2	4.1	4.1	4.1
House Prices (Annual % Chg)	7.0	3.3	3.5	2.3	2.2	2.0	0.5	1.0	1.5	2.0
Interest rates (RBNZ)	**Jun-17**	**Sep-17**	**Dec-17**	**Mar-18**	**Jun-18**	**Sep-18**	**Dec-18**	**Mar-19**	**Jun-19**	**Sep-19**
Official Cash Rate	1.75	1.75	1.75	1.75	1.75	1.75	1.75	1.75	1.75	2.00
90-Day Bank Bill Rate	2.0	2.0	1.9	1.9	1.9	1.9	2.0	2.0	2.0	2.3
Floating Mortgage Rate	5.8	5.8	5.8	5.8	5.8	5.8	5.8	5.8	5.8	6.0
1-Yr Fixed Mortgage Rate	4.9	4.9	4.9	4.9	4.8	4.9	4.9	4.9	5.0	5.1
2-Yr Fixed Mortgage Rate	5.1	5.1	5.1	5.1	5.0	5.1	5.2	5.2	5.3	5.5
5-Yr Fixed Mortgage Rate	6.0	6.0	5.9	5.9	6.0	6.1	6.2	6.2	6.4	6.5

Source: ANZ, Statistics NZ, RBNZ, REINZ

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