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NEW ZEALAND ECONOMICS
ANZ PROPERTY FOCUS

FEBRUARY 2016

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ZERO-SUM GAME

SUMMARY

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

THE MONTH IN REVIEW

RBNZ Governor Wheeler acknowledged that a lower OCR may be needed over the coming year, though they look to be on hold for now. Offshore funding costs are on the rise. Despite ongoing strong net immigration and low interest rates, the Auckland property market remained in something of a hiatus, with prices down, volumes well below year-ago levels, and the median days to sell higher than the nationwide average for the first time in nine years. But it's full steam ahead for other regions. Households continue to exhibit leveraging-style behaviour with borrowing outstripping income growth.

PROPERTY GAUGES

Record-low mortgage interest rates, tight dwelling supply and booming net immigration continue to support the housing market. Nevertheless, prices remain stretched relative to both incomes and rents, particularly in our largest city, where prices have started to recede. Attention is now shifting to the regions, which are playing catch-up. Mortgage interest rates were broadly unchanged over the month, with a two-way risk profile given the influence of potential OCR cuts versus upward pressure on bank funding costs.

ECONOMIC OVERVIEW

The economy is performing well right here and now, and we generally expect respectable growth over 2016; New Zealand is more than dairying, there are other bright spots, and the economy has better structural foundations now. But this central scenario is looking more precarious by the day, given the global scene. Risks are elevated and weaker export prices and higher global funding costs are a nasty mix for a commodity-dependent borrowing nation. It now looks like the OCR will head even lower as challenges mount.

MORTGAGE BORROWING STRATEGY

Carded mortgage interest rates have barely budged since the end of last year. The cheapest part of the curve (particularly for lower-deposit borrowers) remains the one to two year tenors, where rates are historically very low and offer the best value. Borrowers could choose to spread fixed terms across one to two year tenors to stagger roll-overs, but we continue to have a preference for the two-year rate, which offers greater certainty at a historically low rate and offers slightly higher protection if pressures in credit markets filter through into fixed-term rates. With OCR cuts on the cards and no OCR hikes on the horizon, longer-term rates don't offer the same value at present.

FEATURE ARTICLE: BANK FUNDING COSTS

The future direction of mortgage interest rates is not clear cut at present. While additional OCR cuts from the RBNZ could see mortgage interest rates fall (the accepted wisdom), increases in global funding costs are pointing to higher mortgage rates (the under-appreciated newbie). Banks are less reliant on offshore funding than they were prior to the GFC, but New Zealand is still a savings-deficient nation. The longer global funding pressures persist (and it is likely they will), the more likely it is that they translate into rising deposit rates and subsequently mortgage interest rates (which would be a likely force the RBNZ into offsetting action). Even if new mortgage rates were to rise, it would take a while to flow through into average borrowing costs, as the lagged impacts of a lower OCR – and borrowers rolling off higher fixed rates – flow through. However, the message is simple. There is greater-than-normal uncertainty over the path of borrowing costs. It is no longer a case of slavishly following what the central bank does.

THE MONTH IN REVIEW

RBNZ Governor Wheeler acknowledged that a lower OCR may be needed over the coming year, though they look to be on hold for now. Offshore funding costs are on the rise. Despite ongoing strong net immigration and low interest rates, the Auckland property market remained in something of a hiatus, with prices down, volumes well below year-ago levels, and the median days to sell higher than the nationwide average for the first time in nine years. But it's full steam ahead for other regions. Households continue to exhibit leveraging-style behaviour with borrowing outstripping income growth.

GOVERNOR WHEELER SPEECH ON PTA FLEXIBILITY

RBNZ downplays the impact of low headline inflation and warns against taking a 'mechanistic approach' to policy.

A speech by RBNZ Governor Wheeler ("Reserve Bank will draw on... flexibility") reiterated that its focus was on medium-term inflation and that a flexible approach was necessary given broader considerations including asset prices, financial stability and efficiency, and the need to avoid unnecessary volatility in output, interest rates, and the exchange rate. With core inflation at 1.6% and broad measures of annual inflation expectations averaging around 2%, current policy settings were considered appropriate. The speech did, however, acknowledge that a lower OCR may be needed over the coming year if global events were to worsen.

REINZ, HOUSE SALES – JANUARY

Lull in Auckland continues, with other regions outperforming

Volumes fell 10.3% sa in January (-7.5% 3m/3m). The fall was regionally broad based, with declines in 11 of 12 regions, and Auckland falls on par with the nationwide average. However, on an annual basis sales volumes in Auckland were 13.5% lower than 12 months ago, whilst annual sales volumes outside of Auckland were 14.5% higher, with strong growth in North Island centres outside of Auckland. The nationwide days to sell ticked up 0.7 days to 34.1, with the Auckland days to sell (35) above the nationwide average for the first time in nine years. Prices from the REINZ House Price Index were flat over the month (+10.7% y/y), but were down 1.1% 3m/3m, with Auckland prices down 3.1% 3m/3m (+11.7% y/y).

STATISTICS NZ, BUILDING CONSENTS – JANUARY

Nationwide trend drops

The number of residential dwelling consents fell 8.2% m/m sa in January. The fall was led by the volatile multi-dwelling component, but a 5.6% drop was evident for housing consent numbers. Some context around this fall is needed given that the January fall followed a reasonable run of monthly increases and given the inherent volatility, some degree of pull-back in itself is not overly surprising. But the Statistics NZ trend measures did show nationwide issuance is now falling (down 0.5% m/m), with softening evident in Auckland, Wellington and Canterbury.

STATISTICS NZ, EXTERNAL MIGRATION – JANUARY

December lull looks something of an aberration

January saw a strong net inflow of 6,130 migrants, taking annual inflows to 65,900 persons, another record high. The strong result was attributable to both soaring arrivals and low departures, with the composition of arrivals – more students, people on work visas and returning kiwis – suggesting less of a net positive impact on inflationary pressure than historically has been typical. Nevertheless, it will underpin strong demand for shelter.

RBNZ, HOUSEHOLD CREDIT GROWTH – DECEMBER

Strong credit growth, but tailing off in mortgage approvals could be holiday related

The value of mortgage lending to households rose 0.7% sa in December (+8.5% q/q) with annual credit growth (7.7% y/y) hitting an eight-year high.

RBNZ, MORTGAGE APPROVALS – MID-FEBRUARY

Approval values and numbers have slowed over the last few weeks, and by mid-February were 7% and 25% lower respectively than this time last year. This could be holiday weekend related, with approvals to January signalling steady, but solid, credit growth.

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PROPERTY GAUGES

Record-low mortgage interest rates, tight dwelling supply and booming net immigration continue to support the housing market. Nevertheless, prices remain stretched relative to both incomes and rents, particularly in our largest city, where prices have started to recede. Attention is now shifting to the regions, which are playing catch-up. Mortgage interest rates were broadly unchanged over the month, with a two-way risk profile given the influence of likely OCR cuts versus upward pressure on bank funding costs.

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 existing mortgage payments.

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 both key gauges of activity in the property market.

LIQUIDITY. We look at growth in private sector credit relative to GDP to assess the availability of credit in supporting the property market.

GLOBALISATION. We look at relative property price movements between New Zealand, the US, UK and Australia in recognition of the important role that global factors are playing in NZ’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.

RENTAL GROWTH. We look at growth in the median market rent as an indication of whether it is a better time to buy versus rent, and how rental yields are shaping up for the property investor.

Indicator	Level	Direction for prices	Comment
Affordability	Chasing your tail	↔/↓	Houses severely unaffordable in Auckland despite recent price falls. Regions still okay, with scope to outperform.
Serviceability/ indebtedness	Hard work	↔/↓	Lower mortgage interest rates are helping contain debt-servicing costs despite growing debt-to-income ratios.
Interest rates / RBNZ	Watch & wait	↔	Historically low mortgage rates supportive. Pressures in bank funding costs to be offset by OCR cuts.
Migration	Record high	↔/↑	Regularly hitting new records, with few signs of turnaround.
Supply-demand balance	Akld vs Rest of NZ	↔/↑	A moving target. Auckland shortages are growing; Canterbury shortages are declining; more balanced elsewhere.
Consents and house sales	Catching up	↔/↑	Amidst monthly volatility, consents are trending up. More houses are needed in Auckland; Canterbury issuance has topped out.
Liquidity	Firming	↔/	Credit is rising faster than incomes, but high debt levels will limit how long this can continue.
Globalisation	In synch	↔/↓	Moderation in some global markets; Auckland is one of the most expensive cities globally relative to domestic incomes.
Housing supply	Low	↔/↑	Inventory falling in Auckland, rising elsewhere.
House prices to rents	Squeeze	↔/↓	Rents drifting up, given strong demand. Auckland prices elevated to rents, other regions less so.
On balance	**Holding**	↔	**Regions strengthening and Auckland toppy.**

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PROPERTY GAUGES

FIGURE 1: HOUSING AFFORDABILITY

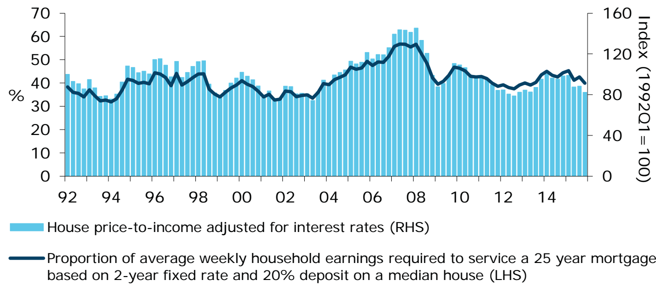


FIGURE 2: SERVICEABILITY AND INDEBTEDNESS

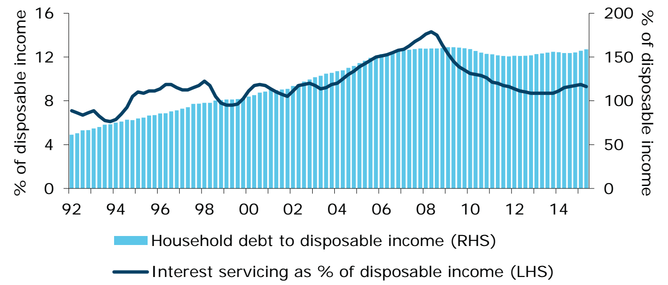


FIGURE 3: NEW CUSTOMER AVERAGE RESIDENTIAL MORTGAGE RATE (<80% LVR)

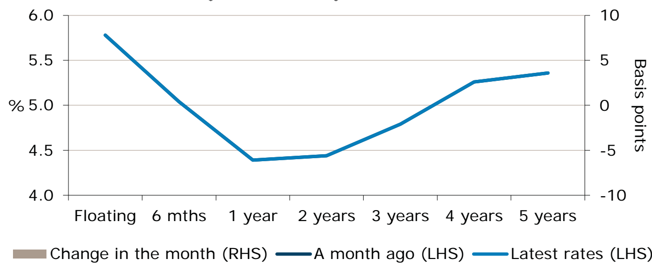


FIGURE 4: NET MIGRATION

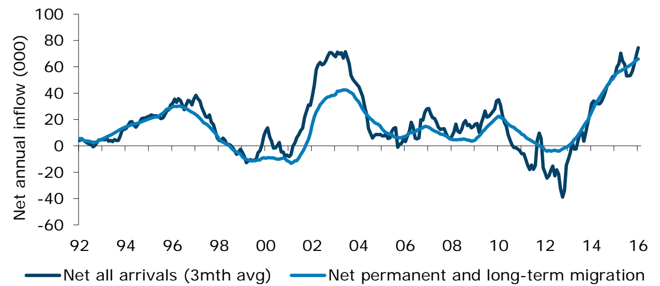


FIGURE 5: HOUSING SUPPLY-DEMAND BALANCE

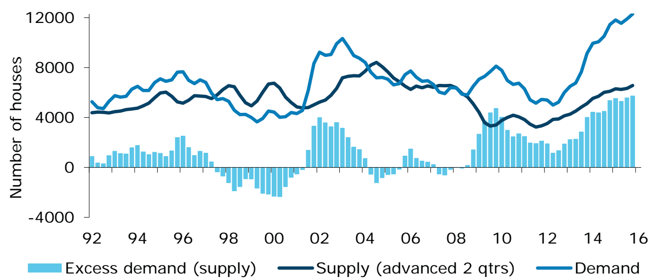


FIGURE 6: BUILDING CONSENTS AND HOUSE SALES

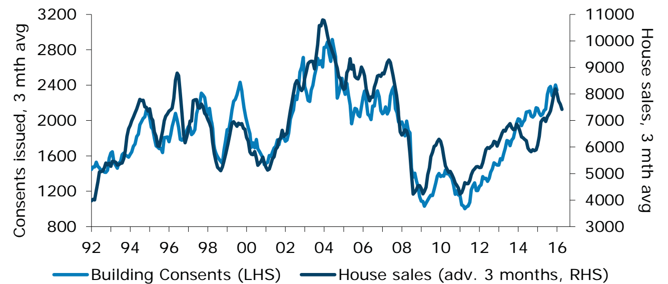


FIGURE 7: LIQUIDITY AND HOUSE PRICES

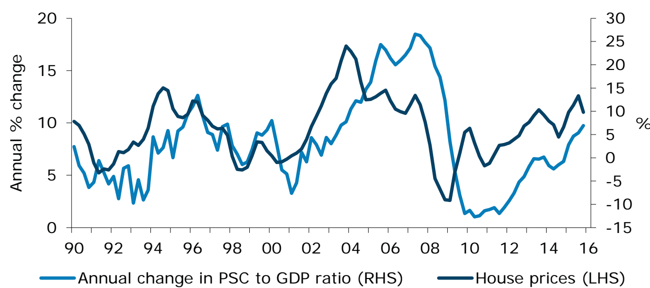


FIGURE 8: HOUSE PRICE INFLATION COMPARISON

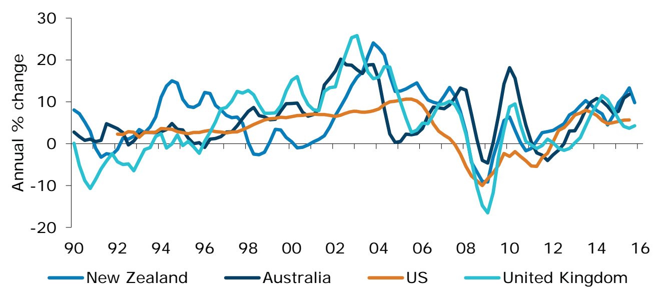


FIGURE 9: HOUSING SUPPLY

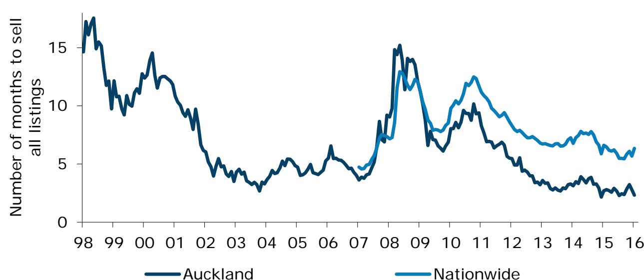
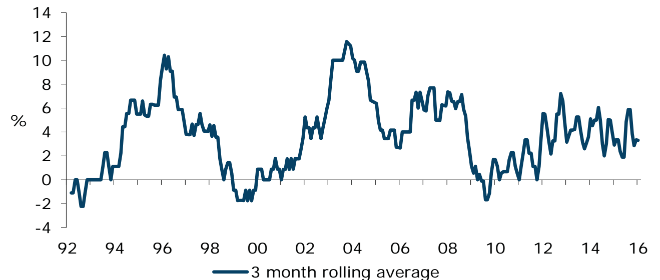


FIGURE 10: MEDIAN RENTAL, ANNUAL GROWTH



Source: Statistics NZ, REINZ, RBNZ, www.interest.co.nz, QVNZ, Nationwide, Bloomberg, Barfoot & Thompson, www.realestate.co.nz, Department of Building and Housing, ANZ

ECONOMIC OVERVIEW

SUMMARY

The economy is performing well right here and now, and we generally expect respectable growth over 2016; New Zealand is more than dairying, there are other bright spots, and the economy has better structural foundations now. But this central scenario is looking more precarious by the day, given the global scene. Risks are elevated and weaker export prices and higher global funding costs are a nasty mix for a commodity-dependent borrowing nation. It now looks like the OCR will head even lower as challenges mount.

Right here and now, the economy is showing good momentum. Sentiment is still pretty solid. House prices are playing 'close the gap' (to Auckland) in the regions. Construction sector activity is strong. Tourism figures are booming. A net migration inflow of 60k plus is huge. Unemployment has fallen to 5.3%. Employment growth is solid. Firms are investing. Building consents are on the ascent.

Our base case remains that the economy will register solid, if not stellar, growth over 2016. The full impact of OCR cuts in 2015 has yet to fully flow through the economy. A host of exporters are benefiting from a lower NZD despite it being elevated relative to commodity prices. The export sector is more competitive now. New Zealand is amidst a construction boom, despite activity in Christchurch peaking. Firms have been getting on with it. **Forward-looking indicators (consumer and businesses' beliefs about their own prospects) are consistent with a solid growth story.**

However, it's been a rough start to the year for the global economy. Equities and bond yields have tumbled, and credit markets have deteriorated. Commodity prices have been belted. Sentiment towards prospects in China is souring by the day. Credit market developments in particular are bearing an eerie resemblance to 2008 and a groundhog day of repeating nightmares.

New Zealand is not immune to global forces. We are a small, commodity-dependent, debtor nation. The dairy sector is under pressure. In fact, falling export prices (and not just dairy), a stubborn NZD and rising local funding costs have delivered a meaningful tightening in local financial conditions, which typically precedes a turn in actual growth. Absent a lower OCR there is a real likelihood borrowing rates could move up!

This means the risk profile is more elevated than normal. There are three primary focal points:

- **Global funding costs are rising.** New Zealand is reliant on offshore capital to funds a savings shortfall. Our feature article looks at what is going on across funding markets and what increases could mean.
- **Export prices are weakening.** Another tough year beckons for the dairy industry. Projections for a recovery in dairy prices continue to be pushed out with global supply outweighing demand.
- **China is teetering.** A top-two trading partner for New Zealand and critical for the other top-two nation (Australia). Debt levels are high, non-performing loans are on the rise, the return on equity is slipping and growth is slowing. Asia more broadly is in the midst of a trade recession already. That's a nasty mix. The nation has a huge balance sheet and monetary policy firepower at hand. However, lots of questions surround whether policymakers can actually remain in control, given the headwinds that excess leverage, mis-pricing of risk and misallocation of capital bring.

The New Zealand economy still has a lot of torque. Lagging indicators are flagging good momentum; the economy was moving up through the gears in late 2015. That's important. It's easier to navigate challenging times when the wheels are turning to start with. Moreover, the housing market around the country has built up a fair head of steam; Auckland has slowed but the rest of New Zealand is playing some catch-up (more like 'close the gap') and history shows this can take a couple of years.

International red flags mean we need to be alert to subtle shifts in sentiment locally though. Movement in financial variables are one thing; people need to feel it on the ground before you see real impact. Time and time again, business confidence has proven adept at picking turning points in the economy. And given it has recently receded off high levels, we're on notice. With inflation already so low, growth even a little below trend would be a problem for the RBNZ. As a result, we see the OCR being cut twice more this year to a new low of 2%.

New Zealand is fortunate in the sense that we have a) a floating currency – it will drop if the global scene worsens; b) scope to lower the OCR; and c) fiscal firepower, with government debt low. These are important shock absorbers as we eye uncertainties around the globe. They are not complete palliatives but give us reasonable confidence that forward momentum can be maintained at a respectable pace. The year ahead does promise to be a volatile one though.

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MORTGAGE BORROWING STRATEGY

SUMMARY

Carded mortgage interest rates have barely budged since the end of last year, with a kink evident in the borrowing curve. The cheapest part of the curve (particularly for lower-deposit borrowers) remains the one to two year tenors, where rates are historically very low and offer the best value. Borrowers could choose to spread fixed terms across one to two year tenors to stagger roll-overs, but we continue to have a preference for the two-year rate, which offers greater certainty at a historically low rate and slightly greater protection if pressures in credit markets filter through into fixed-term rates. With OCR cuts on the cards and no OCR hikes on the horizon, longer-term rates don't offer the same value at present.

OUR VIEW

Carded mortgage interest rates from the major lenders have barely budged since the end of last year. Our estimates are showing no change in the average 'special' rate offered by the big four banks, whilst standard rates rose 4bps in the four and five year tenors. The prevalence of mortgage specials have resulted in average carded rates for lower LVR lenders being 40-60bps lower on average for one to three year rates.

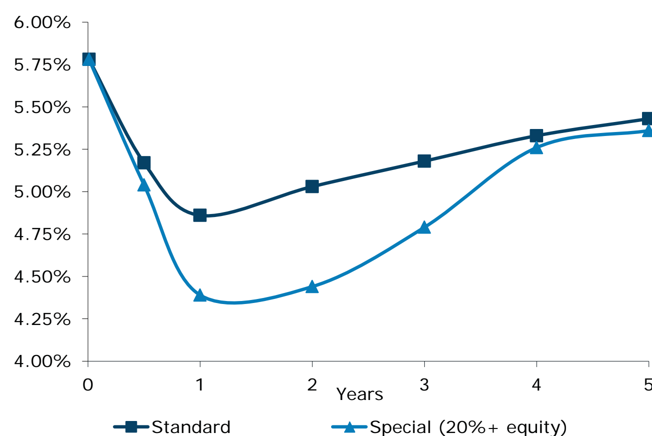
The lowest part of the curve is one to two year fixed rates, particularly mortgage specials, with average rates around multi-decade lows. Fixed carded terms for all maturities are below current average borrowing rates (around 5.50%).

The prospect of further OCR cuts and competitive pressures are keeping further downward pressure on fixed mortgage interest rates, with one lender now offering a sub-4% special in the sub 2-year space. This is coming at a time where intensifying credit pressures in global markets threaten to push fixed borrowing rates higher, which is putting pressure on deposit rates to move up – typically a precursor to borrowing rates following.

So what should borrowers do? **This will largely depend on individual circumstances and attitudes to risk**, but our breakeven analysis is useful in comparing various options. **For those accessing specials, one and two-year terms (top table) remain the standout.** Borrowers could choose to spread fixed terms across both tenors to stagger rollovers, but because of the **additional certainty afforded, we have a preference for locking in a greater proportion for two years, offering greater protection should fixed rates move up.**

Locking in for terms longer than two years would provide more certainty, but it is more costly, with our breakeven analysis showing fixed rates would have to rise by more than 150bps in two years' time to make it more attractive to fix for four years rather than two. Of standard rates, the one-year fixed rate looks preferable, although the jump in rates that would make it more attractive to fix for longer is milder. With the OCR likely to move down over the next few months and with no hikes until at least late 2017 by our reckoning, fixing for longer is risky, but we're watching domestic deposit rates for signs of funding pressures.

AVERAGE CARDED MORTGAGE RATES^
Current rates



Special Mortgage Rates		Breakevens for 20%+ equity borrowers			
Term	Current	in 6mths	in 1yr	in 18mths	in 2 yrs
Floating	5.78%				
6 months	5.04%	3.74%	4.47%	4.52%	5.32%
1 year	4.39%	4.10%	4.49%	4.92%	5.49%
2 years	4.44%	4.51%	4.99%	5.48%	6.08%
3 years	4.79%	5.02%	5.55%	5.76%	5.97%
4 years	5.26%	5.34%	5.60%		
5 years	5.36%	#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	5.78%				
6 months	5.17%	4.55%	5.12%	5.29%	5.41%
1 year	4.86%	4.83%	5.20%	5.35%	5.48%
2 years	5.03%	5.09%	5.34%	5.45%	5.55%
3 years	5.18%	5.27%	5.49%	5.60%	5.70%
4 years	5.33%	5.41%	5.57%		
5 years	5.43%	*may be subject to a low equity fee			

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

FEATURE ARTICLE: BANK FUNDING COSTS

SUMMARY

The direction of mortgage interest rates is not clear cut at present. While additional OCR cuts from the RBNZ could see mortgage interest rates fall (the accepted wisdom), increases in global funding costs are pointing to higher mortgage rates (the under-appreciated newbie). Banks are less reliant on offshore funding than they were prior to the GFC, but New Zealand is still a savings-deficient nation, so a degree of dependence remains. The longer global funding pressures persist (and it is likely they will), the more likely it is that they translate into rising deposit rates and subsequently mortgage interest rates (and a factor likely forcing the RBNZ into offsetting action). Even if new mortgage rates were to rise, it would take a while to flow through into average borrowing costs, as the lagged impact of a lower OCR, and borrowers rolling off higher fixed rates, flow through. However, the message is simple: there is greater than normal uncertainty over the path of borrowing costs. It is no longer a case of slavishly following what the central bank does.

A TWO-WAY STREET

Mortgage debt, at $221bn, accounts for approximately 60% of total private sector credit and is equivalent to around 90% of our nationwide GDP. In New Zealand, mortgages are funded largely via the local banking system, which accounts for more than 95% of total mortgage debt.

Banks have a diverse funding base but it can be broken down into some key components – capital, deposits, short-term wholesale debt (defined as debt maturing within one year) and long-term wholesale debt (defined as debt maturing beyond one year). Given these components of funding, the following influences are key:

- **Wholesale interest rates.** Short-term wholesale interest rates are closely linked to OCR settings and expectations. The longer the horizon of the borrowing, the less the likely influence of the current OCR on wholesale interest rates, but the greater the impact that global considerations and longer-term expectations have.
- **Deposits and deposit growth.** Bank deposits are a key source of funding, reducing the need for banks to issue debt in wholesale markets. Although lending growth has picked up, deposit growth has largely kept pace, helping maintain strong bank funding positions. Household deposits of around $150bn are smaller than mortgage debt ($211bn), but have increased at around $15bn over 2015 (11% y/y), in a similar ballpark to the growth of mortgage debt (7.7% y/y). Higher bank deposit growth may be partly the consequence of households substituting towards this form of saving. However, persistent current account deficits and our high external debt signify a nationwide savings shortfall, which needs to be funded by other means, namely offshore saving.
- **Global funding conditions.** New Zealand banks fund a reasonable proportion of their balance sheets by accessing offshore wholesale debt markets, and the cost of this borrowing can have important implications for domestic interest rates. The banks access this funding by borrowing in foreign currency, then 'swapping' it back into NZD to eliminate FX risk. Changes in these offshore funding spreads tend to impact domestic funding costs and could see mortgage interest rates go up or down.
- **Capital requirements.** The requirement for banks to hold more capital to guard against the risk of default could in principle flow through into higher mortgage interest rates. The RBNZ imposes risk-based capital requirements on mortgage loans. Required capital ratios have increased in the years following the GFC and remain above Basel III regulatory requirements, but are due to be reviewed again this year. With the RBNZ concerned over the financial stability risks of elevated debt levels and the Auckland housing market, capital requirements are increasing on residential investment lending.

SO WHAT HAS BEEN GOING ON?

Recently, local mortgage rates have fallen to (or close to) 50-year lows. This has been on the back of wholesale interest rates across most maturities also falling to (or close to) historic lows. Short-term interest rates (which have accompanied OCR cuts) and long-term global interest rates have been working in tandem to drive this outcome.

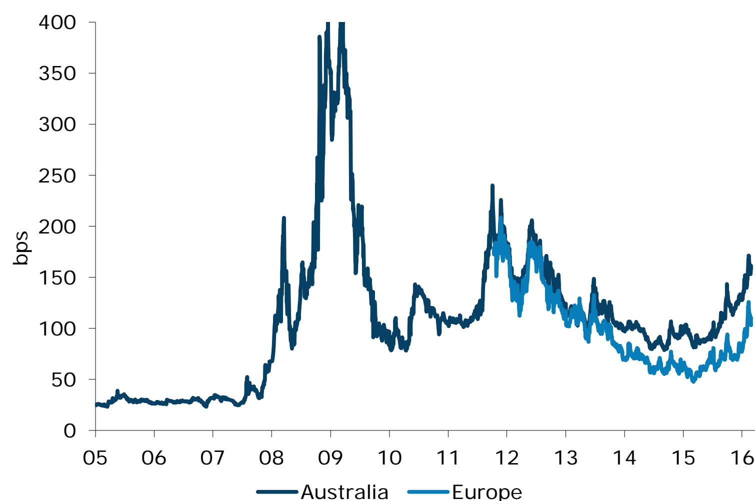
There are two competing influences that will likely impact on the direction of local mortgage rates from here. On the one hand, pressure on mortgage rates to fall further is likely to intensify if the RBNZ were to act on its current easing bias and cut the OCR again, further reducing wholesale interest rates. **However, there is a clear competing force in that conditions in global funding markets have deteriorated meaningfully and this could actually push mortgage rates in the opposite direction.**

FEATURE ARTICLE: BANK FUNDING COSTS

Various proxies for credit conditions have worsened and that is having an impact on the cost at which local banks are able to raise foreign currency debt in offshore markets.

- Credit default swaps for large Australian corporates – a proxy for risk – have risen about 30bps since the start of the year and are around 70bps higher than this time last year. And while they remain well below GFC peaks, they are still sitting at around their highest level in three years.
- Credit default spreads for the major Australian banks more specifically have widened by about 50bps since the start of the year and signal a more difficult funding environment.
- Global swap spreads have collapsed as markets have become sceptical regarding the credit quality of sovereigns. Having averaged around +10bps over 2014 and much of 2015, US 10-year swap spreads have plunged through zero and now stand at around -16bps.
- Australian FRA-OIS spreads (a proxy for short term bank funding spreads) have widened from an average of around +25bps over the first 3 quarters of 2015 to +35bps currently.
- The number of distressed bonds traded in the US bond market (i.e. bonds trading at a spread of more than 1000bps) has more than tripled since mid-2015, having jumped sharply in January.

FIGURE 1. 5 YEAR CORPORATE CDS SPREADS (ITRAXX)



Source: ANZ, Bloomberg

There are several reasons why we remain cautious about global credit conditions and the ability of debt capital markets to function smoothly. For example, we note that:

- **A host of problems brought to a head during the GFC of 2008/09 have not really gone away.** They were simply put under the mattress. Instead of making tough choices that would have seen weak businesses (and sovereigns) hit the wall, authorities have opted for bail-outs, debt restructuring and zero or negative interest rates. While these decisions have avoided a systemic financial collapse, they have not imposed the correct disciplines on borrowers and allowed moral hazard to creep in.
- **The credit cycle has turned.** Corporate non-financial debt has mushroomed in emerging markets and the oil and gas sector post-GFC. Now that oil prices have collapsed (and are showing no signs of recovering) and Chinese growth is slowing, markets are concerned about borrowers' ability to remain profitable and repay debt. Given the importance of the Chinese economy to both the New Zealand and Australian economies it is not surprising to see overseas investors show a little more caution.
- **The world is still stumbling on the growth front.** Debt and leverage issues tend to be exposed when growth is absent. Debt ratios tend to be more stable when growth in profitability goes hand in hand with rising interest rates or rising funding costs. But when growth slows and funding costs increase, "negative jaws" take hold.

FEATURE ARTICLE: BANK FUNDING COSTS

- **USD denominated debt has mushroomed outside the US (especially in China) as borrowers have taken advantage of low interest rates.** Much of this is unhedged (from a foreign exchange perspective) and not held against assets or businesses cyclically correlated to US growth. Businesses as a whole in the US can cope with Fed rate hikes now that growth there is recovering, but can borrowers in emerging markets? Markets don't believe they can, and the problem will only get worse if the CNY depreciates further, which it must to bolster growth in China.
- **Liquidity in global bond markets has reduced as a result of regulatory changes aimed at curbing risk-taking by banks in the wake of post-GFC bank bail-outs.** Reduced liquidity has, in turn, led to wider spreads. Banks now have to hold more capital against bonds (sovereign and corporate) held on their balance sheets for the purpose of market-making (i.e. facilitating secondary market trading); which in turn reduces the incentive to own bonds, which in turn has led to wider bid/offer spreads and wider margins. Recent falls in bank share prices have also created the perception that banks are riskier credits, driving up the premium demanded by investors for buying bank bonds. This "downward spiral" in market conditions is showing no signs of abating, and is occurring against a backdrop of increased, not decreased, overall debt levels across the corporate sector, particularly in emerging markets.
- **Current market conditions.** Wider US swap spreads have been a big driver of bank funding spreads. The fall in outright interest rates has seen longer term buy and hold investors pull back their demand for funds, with spreads increasing as a result.

RISKS ARE PRESENT, BUT WE ARE NOT SET FOR A REPEAT OF 2008

As a debtor nation (i.e. there is a shortage of domestic saving to fund investment), New Zealand is dependent on global funding markets. The deteriorating credit conditions experienced described above certainly brings back some (rather unpleasant) memories of the challenging conditions seen at times over recent years.

However, we are nowhere near the extreme conditions of 2008. Funding markets are still operating, albeit at a higher price. Volatility and market unease have picked up, but not to 2008 extremes. Put simply, the pendulum has swing away from the borrowers and towards the investors and arguably some of this movement is a good thing. It also represents an important wake-up call and suggests that a host of GFC style issues have not gone away.

Importantly, and in part due to regulatory changes, New Zealand is now less exposed to offshore funding markets (particularly at short-terms) than previously.

- **There is more reliance on resident domestic funding.** Retail bank funding has increased from around 60% of total funding a decade ago to above 70% of total system funding now.
- **There is now less reliance on offshore wholesale funding.** The share of non-resident funding has fallen from around 37% a decade ago and 40% at the time of the GFC to around 28% now.
- **The maturity of funding has lengthened.** A decade ago about 10% of non-resident funding was for longer than one year, with 70% under 90 days. Now around 35% of funding is for greater than one year, whilst around half is for less than 90 days. By the same token, the country's share of international debt liabilities maturing in less than 90 days has fallen from half of the total in 2008, to less than a quarter now (see Figure 5). That is not to say that banks have moved away from relying on short-term funding. System wide funding is still predominantly short-tern, with about 70% of funding for less than 90 days, but around 70% of this funding is from retail sources.

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FIGURE 2. REGISTERED BANK FUNDING BY SOURCE

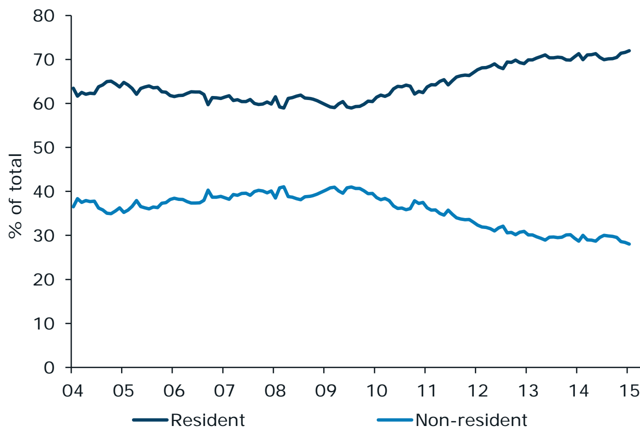


FIGURE 3. NON-RESIDENT FUNDING BY MATURITY

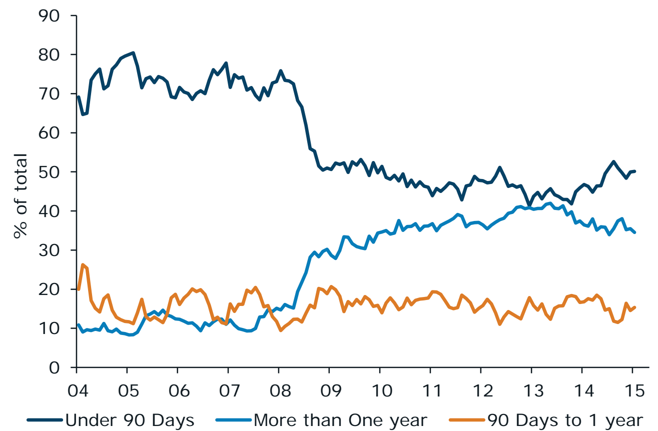


FIGURE 4. REGISTERED BANK FUNDING BY TYPE

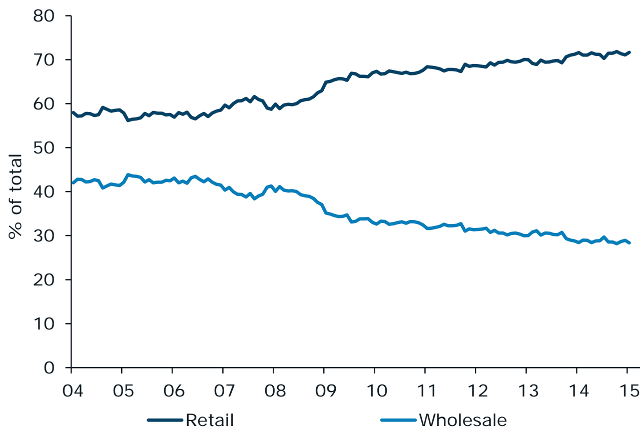
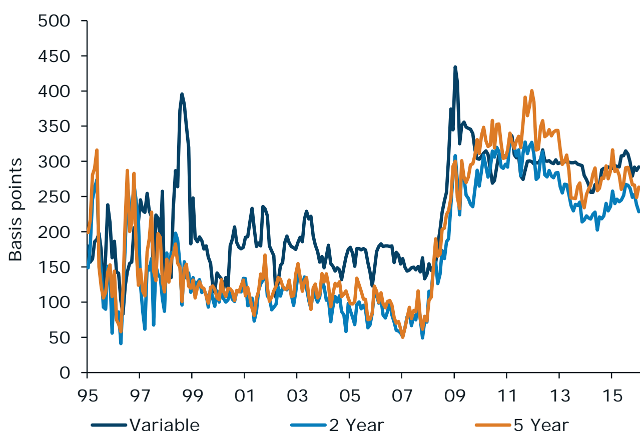


FIGURE 5. NZ GROSS SHORT-TERM DEBT LIABILITIES (LESS THAN 90 DAYS

Source: ANZ, RBNZ, Statistics NZ

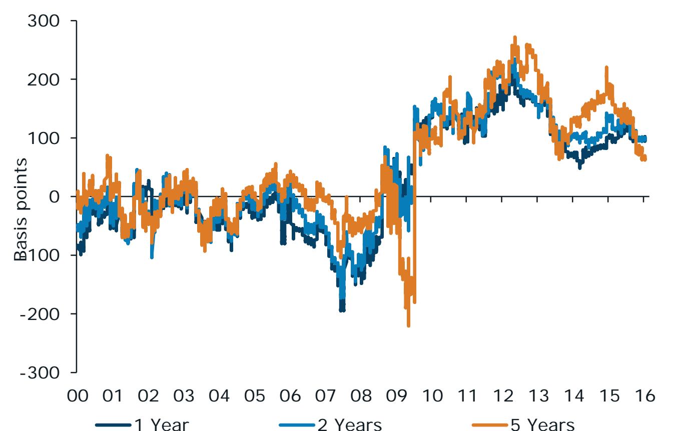
As such, bank funding has edged away from short-term wholesale debt towards increasing reliance on more stable sources of funding, including retail deposits and long-term wholesale debt. Long term wholesale debt, however, is typically more expensive and one of the reasons we've see post the GFC borrowers face an upward sloping curve (i.e. 5 year rates above 2 year rates). Viewing the gap between retail rates and wholesale interest rates (Figures 6 and 7) show a structural break in spreads. Given that bank net interest margins have not moved much since the GFC – they are in fact narrower than 20 or so years ago – this widening in spreads to wholesale rates is reflective of higher costs.

FIGURE 6. CARDED MORTGAGE RATES LESS SWAPS



Source: ANZ, RBNZ, Bloomberg

FIGURE 7. RETAIL DEPOSIT RATES LESS SWAPS



Source: ANZ, RBNZ, Bloomberg

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MARGINAL VERSUS AVERAGE COST OF FUNDS

So the above factors reduce the immediate pass through of increased global funding costs (the marginal cost of bank funding) more than they have in the past. However, the longer the period in which wholesale funding costs stay elevated, the more likely it is that banks will increase retail rates and a higher marginal cost of funding begins to lift banks' average cost of funding. Once this occurs, the pressure will quickly flow on to new borrowing rates to go up too.

The key is the extent to which banks can obtain funding from other sources and whether greater competition for non-wholesale funding will have an impact on costs of funding from these sources. Greater competition for retail funding, for example, will force deposit rates up. Given the greater reliance on this form of funding, higher retail funding costs will have a correspondingly more significant impact on overall funding costs and hence borrowing rates offered by banks.

As noted above about 70% of funding is shorter than 90 days so an increase in both wholesale and retail funding costs is likely to filter though into overall funding costs reasonably quickly. **The exact timing of when this will occur is uncertain, but there have been a few tell-tale signs.** The recent scaling down of cash back offers, gifts and fee waivers for mortgage lending is a sign something is up. We are keeping close tabs on retail deposit rates for signs of movement. When these move up, independent of moves (rises) in wholesale interest rates, it signifies greater competition for funding from this source. Eventually carded mortgage interest rates will follow.

THERE ARE ALSO SOME OTHER MITIGATING FACTORS

While implied higher funding costs are putting pressure on borrowing rates, there are some other forces that could offset the impact this could have on domestic mortgage rates. These include:

- **An official policy response.** Higher retail borrowing rates can be countered by a lower OCR. At 2.50% there is still scope for it to move lower. We expect 50bps of cuts through till the end of the year, and for the OCR to remain on hold for most of 2017.
- **The New Zealand banking system continues to hold capital and liquid assets well in excess of regulatory requirements.** So financial intermediaries could absorb a margin squeeze. The flipside to this though would be greater financial stability risks with a smaller buffer.
- **Credit growth.** Increases in credit costs could take longer to filter through into mortgage rates if the demand for credit slows. The plateauing of mortgage approvals provides tentative support of a levelling off in the demand for credit.

NEW VERSUS AVERAGE BORROWING RATES

The $64,000 question for borrowers is whether upside or downward pressures on domestic mortgage rates will prevail. Either lower wholesale interest rates on expectations of a lower OCR push them down or higher credit costs push them up.

In practice it is likely to end up a zero-sum game. A key reason the OCR could move down will be in fact to eliminate pressure for mortgage rates to move up from higher funding costs. Market pricing has factored in close to 40bps of cuts by the end of the year, with a full 25bps cut priced in by June.

What really matters for economic activity and hence interest rate settings is the borrowing rate for the household sector on average as opposed to just the new (or marginal) mortgage rate. According to RBNZ figures, the average mortgage interest rate at the end of last year was 5.43%, considerably above the current rates on offer. The lagged impact of OCR cuts and falls in fixed rates in 2015 is still working its way through. Irrespective of any changes to mortgage rates in the near-term, there is scope for average borrowing costs to fall as borrowers roll off higher fixed rates and onto lower rates.

In the absence of moves in new mortgage interest rates, our estimates suggest 15-20bps or so of cuts to average borrowing costs are prospect, with borrowing rates troughing in the middle of the year. This will provide support to the household sector.

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THE UPSHOT

We see recent credit market moves as equivalent to perhaps 25bps of OCR hikes, but this assumes that such pressures will be persistent and flow through into retail (and well as wholesale) funding markets. While no one is sure how long the recent pressures will be sustained (we suspect they will be around for a while yet given the global scene), the extent of movement needs to be respected.

Given the importance of retail funding for banks, movements (rises) in deposit rates would confirm that increases to mortgage interest rates are coming.

However, even if new mortgage rates were to move up in relatively short order it would take time to flow through into average borrowing costs for the household sector, with our analysis suggesting that average borrowing costs are likely to continue falling over the next few months even if new borrowing rates were to increase modestly overnight. So we are not talking about an immediate brutal hit to the economy. **Borrowers might bemoan the potential for higher rates, but depositors will gain.**

Higher funding cost pressures are a strong argument for the RBNZ needing to cut the OCR as an offset. Our expectation of a further 50bps of OCR cuts this year is partly in recognition of the challenging environment for bank funding, but there are other considerations as well.

In short, monetary policy has a number of balls the air. Headline inflation has been persistently low, but core inflation is close to the inflation target midpoint and has risen of late. Inflation expectations have been falling for shorter-term horizons, but less so for longer-term ones. The economy is performing well, and the return of leveraging style behaviour is evident. However, the pending impact of tightening financial conditions and concerns over China and the wider global scene have us on notice. The NZD is too high for comfort. But then there are also asset prices and financial stability risks to consider. Central banks should be wary of pouring too much more on the housing market fire. Inevitable corrections can be destabilising. **So while it's convenient to say higher funding cost pressures should be offset by OCR cuts to keep actual borrowing rates stable, it's much more complicated than that.**

We are officially calling the OCR lower, but the call reflects a wider array of factors including, inflation trends, moderating growth prospects and a wobbly global scene as opposed to funding cost pressure alone.

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 January 2016 (based on REINZ data)

	House prices (ann % change)	3mth % change	No of sales (sa)	Mthly % change	Avg days to sell (sa)	Comment
Northland	2.0	-1.2	242	-6%	44	Sales volumes +30% y/y
Auckland	9.2	-1.4	2,249	-10%	35	Days to sell above NZ for the first time in 9 years.
Waikato/BOP/Gisborne	12.9	1.3	1,355	-7%	35	Market tight given days to sell has averaged 47 last decade.
Hawke's Bay	11.8	2.9	242	-13%	41	Median price at record high ($314k).
Taranaki	0.4	-1.1	310	-3%	40	Days sell at 5 month high
Manawatu/Whanganui	5.1	0.4	176	-11%	47	Days sell at 9 month high
Wellington	-0.9	0.1	670	-30%	34	Sales volumes +3.6% 3m/3m.
Nelson/Marlborough	6.6	-0.5	257	+1%	35	Median prices just 1.5% off peaks.
Canterbury/Westland	6.3	1.2	881	-5%	34	Sales volumes -2% 3m/3m
Central Otago Lakes	11.0	5.8	133	-3%	58	Second highest median sales price of the regions ($539k)
Otago	11.4	0.6	268	-13%	29	Median sales price at record high ($285k).
Southland	-8.7	-1.0	156	-10%	47	Days to sell at 7 month high.
NEW ZEALAND	5.2	-4.2	7,053	-10%	34	Sales volumes -7.5% 3m/3m, median prices 6% below peak.

Key forecasts

	Actual			Forecast						
Economic indicators	Jun-15	Sep-15	Dec-15	Mar-16	Jun-16	Sep-16	Dec-16	Mar-17	Jun-17	Sep-17
GDP (Ann Avg % Chg)	3.3	2.9	2.4(f)	2.2	2.2	2.3	2.5	2.6	2.7	2.8
CPI Inflation (%)	0.4	0.4	0.1	0.3	0.2	0.3	0.8	1.4	1.4	1.7
Unemployment Rate (%)	5.8	5.9	6.0	5.3	5.8	5.7	5.6	5.4	5.3	5.3
	Actual			Forecast (end month)						
Interest rates (carded)	Dec-15	Jan-16	Latest	Mar-16	Jun-16	Sep-16	Dec-16	Mar-17	Jun-17	Sep-17
Official Cash Rate	2.50	2.50	2.50	2.50	2.25	2.00	2.00	2.00	2.00	2.00
90-Day Bank Bill Rate	2.8	2.7	2.8	2.8	2.5	2.2	2.2	2.2	2.2	2.3
Floating Mortgage Rate	5.9	5.9	5.9	5.9	5.7	5.6	5.6	5.6	5.6	5.6
1-Yr Fixed Mortgage Rate	5.0	4.8	4.8	4.8	5.0	5.0	5.1	5.3	5.3	5.4
2-Yr Fixed Mortgage Rate	5.2	4.9	4.9	4.9	5.0	5.1	5.1	5.3	5.3	5.4
5-Yr Fixed Mortgage Rate	5.8	5.6	5.6	5.6	5.8	5.9	5.9	5.9	6.0	6.0

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