# NEW ZEALAND ECONOMICS
# ANZ PROPERTY FOCUS

May 2016

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CONTRIBUTORS


**Cameron Bagrie**
**Chief Economist**
Telephone: +64 4 802 2212
E-mail: Cameron.Bagrie@anz.com
**Twitter @ANZ_cambagrie**


# ACCENTUATE THE POSITIVE

## SUMMARY

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

## THE MONTH IN REVIEW

The property market is hot; regions are playing catch-up and Auckland is lifting again. Households are once more borrowing with gusto. That combination means greater risk of a macro-prudential response from the RBNZ. While it did not announce any additional measures in its latest Financial Stability Report, something looks to be around the corner. This will help dampen demand, but it does nothing to alter supply, which is where much of the problem resides. Residential consent issuance looks to be tailing off, with elevated cost increases indicative of resource constraints. High net PLT immigration merely adds to demand pressures.

## PROPERTY GAUGES

Historically low mortgage interest rates, existing dwelling supply at a record low in relation to sales and strong net immigration continue to support the nationwide housing market. Existing house prices are, however, becoming increasingly stretched relative to both incomes and rents, with Auckland the notable standout.

## ECONOMIC OVERVIEW

The economy is showing plenty of vigour across multiple sectors. While the dairy sector is struggling, there is more than enough momentum across construction, migration, housing and non-dairy exports to compensate. We are forecasting 2½-3% growth over the next three years. Amidst huge uncertainties, businesses are getting on with it, and we're expecting more of the same. The RBNZ looks set for a sabbatical, though the risk remains that it will end up cutting the OCR again – not that the housing market needs it!

## MORTGAGE BORROWING STRATEGY

Despite wholesale interest rates now being fractionally higher than they were a month ago, this month has seen mild falls in average fixed mortgage interest rates beyond the one-year window. Looking forward, the combination of a market reassessment of the RBNZ (more people thinking no more OCR cuts), prospects for the Fed lifting rates (influences the long end) and likely more aggressive pricing competition for deposits (which could flow into borrowing rates) means that the low in rates may have been seen. Rates for one and two year fixed rate specials are around multi-decade lows and continue to offer the best value according to our break-evens. We see the OCR remaining low for an extended period, which dampens the attractiveness of longer-term rates.

## FEATURE ARTICLE: FORCES SHAPING THE MORTGAGE RATE OUTLOOK

Mortgage rates may have troughed. While there is a case for the OCR to move down, it does not automatically imply that retail rates will follow. Technically we are still calling the OCR lower. However we are mindful that housing market strength and a lower OCR are a somewhat incongruous combination. The past few weeks has seen a repricing of the monetary policy outlook given strength in housing, diminishing global risks and strength across the economy, which is showing tentative signs of feeding into inflation. We do not consider current rates of credit and deposit growth to be sustainable – the former needs to slow and aggressive competition for the latter will come more to the fore. This means the relative price needs to shift more towards deposits. Banks' average cost of funds continues to rise, which means the same for retail rates if wholesale rates do not fall. We still expect the OCR to hit new lows, but not necessarily borrowing rates.

# THE MONTH IN REVIEW

The property market is hot; regions are playing catch-up and Auckland is lifting again. Households are once more borrowing with gusto. That combination means greater risk of a macro-prudential response from the RBNZ. While it did not announce any additional measures in its latest Financial Stability Report, something looks to be around the corner. This will help dampen demand, but it does nothing to alter supply, which is where much of the problem resides. Residential consent issuance looks to be tailing off, with elevated cost increases indicative of resource constraints. High net PLT immigration merely adds to demand pressures.

## MAY FINANCIAL STABILITY REPORT

Housing risks growing, but no imminent measures to slow demand posed

The RBNZ classified the financial system as "resilient" and "functioning effectively", although risks posed by the global backdrop, the dairy sector and excessive housing market strength were seen as having increased since November. House price strength has broadened to other regions, but "house price-to-income ratios are generally much lower than in Auckland". However, "a resurgence of house price inflation in Auckland would be of real concern."

## REINZ, HOUSE SALES – APRIL

Housing market resurgence, not just an Auckland issue

National house sales volumes surged 9.8% sa in April (+6.6% 3m/3m, +18.4% y/y), with the level of monthly sales (8,581 sa) the highest in nine years. Strength was particularly evident in Waikato/BOP (+32%), Hawke's Bay (+45% y/y), Nelson/Marlborough (+29% y/y) and Otago (+35% y/y). Nationwide prices continued to accelerate, up 2.2% sa m/m according to the REINZ stratified measure (+4.8% 3m/3m, +14.5% y/y), with house price levels hitting new record highs.

## STATISTICS NZ, BUILDING CONSENTS – APRIL

Annual consent issuance hits 11 year high, but recent trend is one of moderation

The number of residential dwelling consents bounced 6.6% m/m sa in April, a partial rebound from March's 9.7% m/m fall. Issuance has been volatile of late, but looking through this volatility, it can be best described as flat. In fact, Statistics NZ estimate the underlying trend is now running at a -0.5% m/m pace. One of the possible reasons for this moderation is increased signs of capacity constraints, with the value of residential consents per square metre (on a three-month average basis) sitting at 8.0% y/y. Rising costs are consistent with our internal anecdotes highlighting increased capacity pressures in the construction sector.

## STATISTICS NZ, EXTERNAL MIGRATION – MARCH

Net PLT inflows look to have peaked

A net inflow of 5,520 (sa) migrants was seen in April, with the annualised three-month average easing to 67,400, below the recent peak of close to 72,000. PLT inflows have remained elevated, but there are tentative signs of a lift in PLT departures, which rose to the highest level in close to 12 months.

## RBNZ: MARCH HOUSEHOLD CREDIT

Lending growth strong and investors in the market

The value of mortgage lending to households rose 0.6% sa in March, with annual credit growth at 7.5%. Household debt has been rising relative to incomes over the last four years and is currently at historic peaks (162.3%). Due to record-low mortgage interest rates, debt serviceability remains around historical averages.

## MORTGAGE APPROVALS AND NEW MORTGAGE LENDING

RBNZ figures for April showed new lending to borrowers with less than a 20% deposit at 7.6% of total new lending, although lending to investors has increased to 37% of total new lending. The regional split showed Auckland accounted for 54% of the value of new residential lending, with 46% of lending to investors. But of the latter, only 0.2% of lending was to investors with an LVR above 70%, comfortably under the new speed limit criteria.

# PROPERTY GAUGES

Historically low mortgage interest rates, existing dwelling supply at a record low in relation to sales and strong net immigration continue to support the nationwide housing market. Existing house prices are, however, becoming increasingly stretched relative to both incomes and rents, with Auckland the notable standout.

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 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.

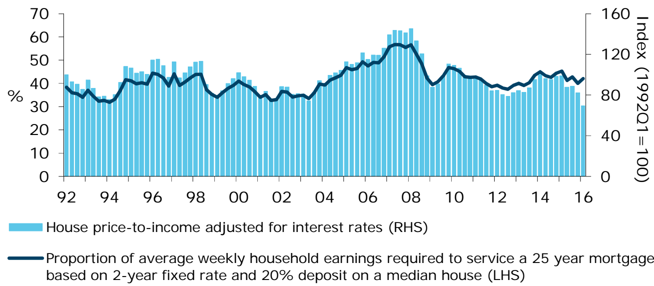
**HOUSING SUPPLY.** We look at the supply of housing listed on the market, recorded as the number of months needed to clear the housing stock. A high figure indicates that buyers have the upper hand.

**HOUSE PRICES TO RENTS.** We look at median prices to rents as an indicator of relative affordability across the regions.

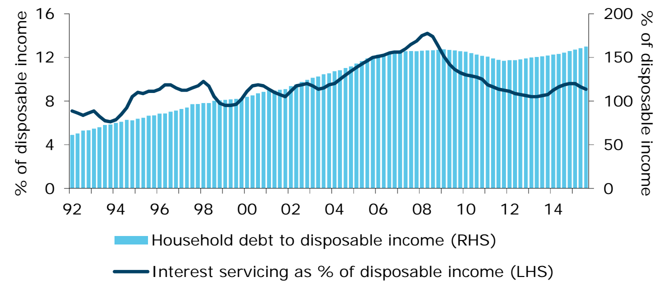
| Indicator | Level | Direction for prices | Comment |
|---|---|---|---|
| Affordability | Chasing your tail | ↔/↓ | Houses severely unaffordable in Auckland. Becoming increasingly less affordable in most regions. |
| Serviceability/ indebtedness | Hard work | ↔/↓ | Low mortgage interest rates are helping contain debt-servicing costs somewhat, despite a debt-to-income ratio at a record high. |
| Interest rates / RBNZ | Watch & wait | ↔/↑ | Historically low mortgage rates supportive. Pressures on bank funding costs likely to be offset by OCR cuts going forward. |
| Migration | Record high | ↔/↑ | At record annual high, but likely to be close to peaks. |
| Supply-demand balance | Akld vs Rest of NZ | ↔/↑ | Auckland shortages are growing; so are those in Wellington. Canterbury shortages have eased; more balanced elsewhere. |
| Consents and house sales | More to do | ↔/↑ | Annual issuance at 11-year high. Auckland issuance at 9.5k is too low to meet population needs. Canterbury issuance tailing off. |
| Liquidity | Firming | ↔ | Credit is rising faster than incomes, but already-high debt levels should eventually cap the market. |
| Globalisation | In synch | ↔/↑ | NZ houses expensive to us but cheap to everyone overseas. |
| Housing supply | Low | ↔/↑ | At just three months of sales, a record low nationwide, with the regions catching up to Auckland. |
| House prices to rents | Squeeze | ↔/↓ | Rents drifting up, given strong demand. Auckland prices elevated to rents, other regions less so. |
| **On balance** | **Pushing up** | ↔/↑ | **Regionally broad-based strength, with Auckland valuations stretched.** |

# PROPERTY GAUGES

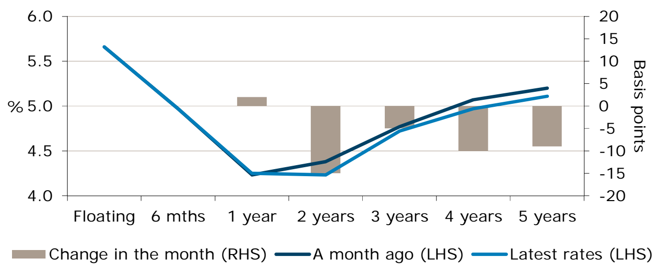
### FIGURE 1: HOUSING AFFORDABILITY



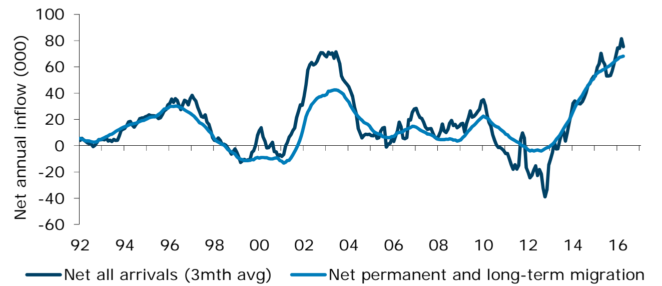

### FIGURE 2: SERVICEABILITY AND INDEBTEDNESS



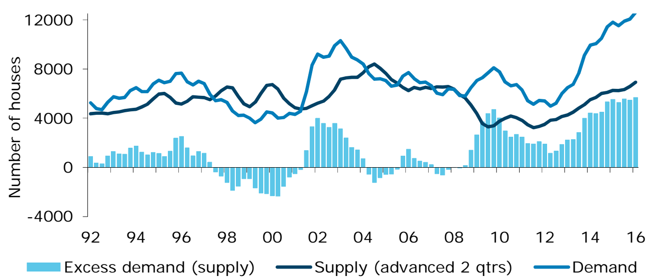

### FIGURE 3: NEW CUSTOMER AVERAGE RESIDENTIAL MORTGAGE RATE (<80% LVR)



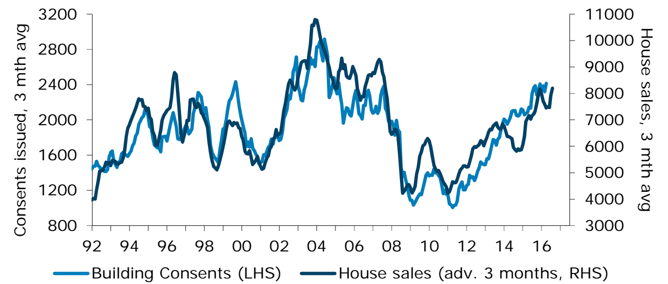

### FIGURE 4: NET MIGRATION



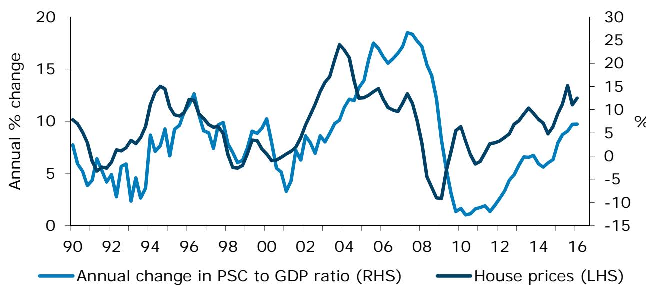

### FIGURE 5: HOUSING SUPPLY-DEMAND BALANCE



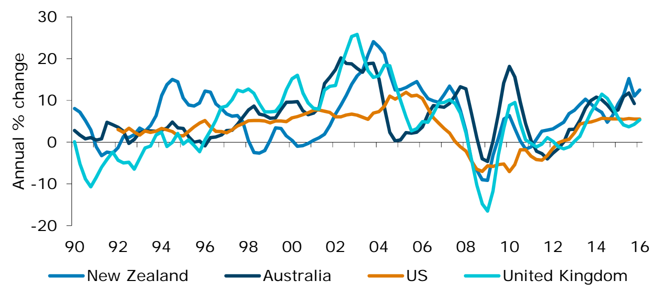

### FIGURE 6: BUILDING CONSENTS AND HOUSE SALES



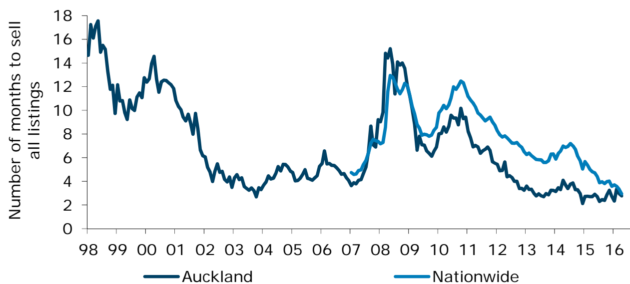

### FIGURE 7: LIQUIDITY AND HOUSE PRICES



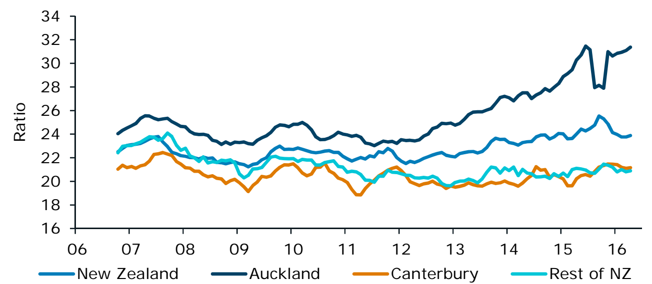

### FIGURE 8: HOUSE PRICE INFLATION COMPARISON




### FIGURE 9: HOUSING SUPPLY




### FIGURE 10: MEDIAN HOUSE PRICES TO RENTS




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

# ECONOMIC OVERVIEW

## SUMMARY

The economy is showing plenty of vigour across multiple sectors. While the dairy sector is struggling, there is more than enough momentum across construction, migration, housing and non-dairy exports to compensate. We are forecasting 2½-3% growth over the next three years. Amidst huge uncertainties, businesses are getting on with it, and we're expecting more of the same. The RBNZ looks set for a sabbatical, though the risk remains that it will end up cutting the OCR again – not that the housing market needs it!

## OUR VIEW

**The economy continues to grow solidly.** Quarterly GDP growth looks to have slowed a tad in early 2016 but indicators still point to a brisk rate of expansion. Our confidence composite, financial conditions and *Truckometer* are indicating annual GDP growth tracking around 3%. That's above trend and putting more strain on capacity in sectors such as construction. This is turn has the potential to exacerbate the supply-demand imbalance within the market and in regions such as Auckland.

**There are still a host of good news stories out there.** Momentum continues to be supported by favourable financial conditions, surging migration, strong activity within the construction and tourism sectors, and housing market strength across both the main city centres (ex-Christchurch) and the regions (notably anything close to Auckland, but more recently across the whole country). While dairying hogs the export limelight, the likes of pipfruit, kiwifruit, wine, other horticulture, and Manuka honey, to name but a few, are going incredibly well. Collectively they have some punch.

**We can see some notable upside risks across the economy:**

- **Booming migration**; it could strengthen further given NZ's economic credentials, although it does risk a political response.
- **Some signs of borrow-and-spend behaviour** filtering into spending trends given housing strength. The wealth effect from rising house prices is a powerful influence on spending.

**We continue to pay close attention to some key downside risks too.** These include:

- **The global scene:** We remain wary over the endgame for asset values, which are being supported by ample liquidity but not backed up by economic fundamentals. Prospects in China remain somewhat of an enigma. The US Fed needs to hike but this risks setting off markets again in a similar fashion in January.
- **Another negative cash-flow year for the dairy sector beckons.** 'Low for longer' remains our view on global dairy prices.
- **House prices are extended** and we are now seeing more froth across the country. On some levels, it's a sign of a vibrant economy, but valuation metrics need to be remembered. The bigger the party, the bigger the hangover. We're on amber alert as opposed to red right now.
- **Borrow-and-spend behaviour is showing up in deteriorating structural metrics.** Household debt (163% of income) is now higher than prior to the GFC, although admittedly debt servicing levels are lower due to lower interest rates. Debt brings forward activity; it still needs to be paid back. Some of the recent enthusiasm for debt is healthy; people have a greater belief in NZ's economic future. That said, extended house prices, rapid debt accumulation and less saving (households are running down the precautionary saving buffer) are worrying signs that need to be monitored.

**This combination of upside and downside risks is slightly skewed towards the latter but not materially so.**

**An emerging theme we are watching globally is political fragmentation across the globe.** This risks driving poor microeconomic policy outcomes, which could undermine economic growth over time. Things like the TPP deal look likely to become sacrificial pawns to political posturing, with populism trumping leadership. A flipside to this is the potential for NZ's migration numbers to keep surging!

**We expect the RBNZ to pause in June; the economy doesn't need another rate cut at present.** Down the track we suspect the combination of global unease, the high NZD and prospects for increased competition for deposits (which will force up borrowing rates if the OCR does not fall) will bring the RBNZ back to the table.

# MORTGAGE BORROWING STRATEGY


## SUMMARY

Despite wholesale interest rates now being fractionally higher than they were a month ago, this month has seen mild falls in average fixed mortgage interest rates beyond the one-year window. Looking forward, the combination of a market reassessment of the RBNZ (more people thinking no more OCR cuts), prospects for the Fed lifting rates (influences the long end) and likely more aggressive pricing competition for deposits (which could flow into borrowing rates) means that the low in rates may have been seen. Rates for one and two year fixed rate specials are around multi-decade lows and continue to offer the best value according to our break-evens. We see the OCR remaining low for an extended period, which dampens the attractiveness of longer-term rates.


## OUR VIEW

**This month has seen small falls in longer-term carded mortgage lending rates.** Our estimates show that the average rates for both standard and special rates from the 'Big 4' Australasian banks were broadly unchanged out to the one-year tenor, but have eased by approximately 3 to 15bps for longer maturities.

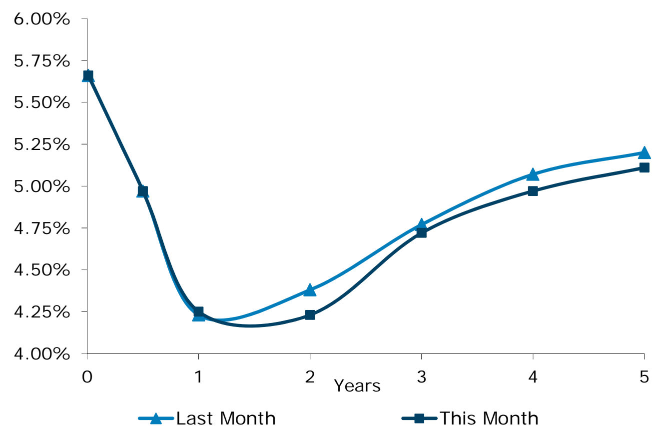
**Looking forward there is upward pressure on rates from three sources.** The market is reassessing prospects for the RBNZ cutting rates, which has seen wholesale rates lift. Certainly the property market does not seem to need lower rates! Long-end rates are being nudged up by their US equivalents. And credit growth in excess of deposit growth is unsustainable. It seems inevitable some sort of pricing battle for deposits will emerge later this year, which will put upward pressure on borrowing rates, all else equal.

**We're not getting too excited – borrowing rates are unlikely to ratchet up quickly.** However, recent developments suggest we are likely to be close to (or at) the trough for local rates. While we can quibble about whether the OCR goes down and drags the floating and 1 to 2 year rates down with it, the reality is that it's hard to see the OCR moving up for a considerable period. The consequences for the NZD would be shattering for the economy.

According to our breakeven analysis, **one and two-year terms remain the standout for those accessing specials and for standard rates.** Borrowers could choose to spread fixed terms across both tenors to stagger rollovers, but we have a preference for locking in a greater proportion for two years given that these offer historically very low rates for a longer period. As we see a modicum of upside risk to current wholesale interest rates, it is possible that we are approaching the lows of this cycle.

While it is tempting to consider locking in for longer terms, this will attract a significant premium. Our breakeven analysis shows fixed rates would have to rise by close to 150bps in two years' time to make it more attractive to fix for four years rather than two. Given that we do not expect OCR hikes until well into 2018 and there is the likelihood that the OCR could move lower still, certainty comes at a cost.

**SPECIAL CARDED MORTGAGE RATES^**




| Special Mortgage Rates | | Breakevens for 20%+ equity borrowers | | | |
|---|---|---|---|---|---|
| Term | Current | in 6mths | in 1yr | in 18mths | in 2 yrs |
| Floating | 5.66% | | | | |
| 6 months | 4.97% | 3.53% | 4.22% | 4.20% | 5.46% |
| 1 year | 4.25% | 3.88% | 4.21% | 4.83% | 5.70% |
| 2 years | 4.23% | 4.35% | 4.96% | 5.30% | 5.71% |
| 3 years | 4.72% | 4.82% | 5.21% | 5.44% | 5.70% |
| 4 years | 4.97% | 5.05% | 5.33% | | |
| 5 years | 5.11% | #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 | 5.66% | | | | |
| 6 months | 5.06% | 4.48% | 4.83% | 4.87% | 5.21% |
| 1 year | 4.77% | 4.66% | 4.85% | 5.04% | 5.29% |
| 2 years | 4.81% | 4.85% | 5.07% | 5.21% | 5.37% |
| 3 years | 4.97% | 5.03% | 5.20% | 5.35% | 5.51% |
| 4 years | 5.09% | 5.17% | 5.35% | | |
| 5 years | 5.23% | *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: FORCES SHAPING THE MORTGAGE RATE OUTLOOK

## SUMMARY

Mortgage rates may have troughed. While there is a case for the OCR to move down, it does not automatically imply that retail rates will follow. Technically we are still calling the OCR lower. However we are mindful that housing market strength and a lower OCR are a somewhat incongruous combination. The past few weeks has seen a repricing of the monetary policy outlook given strength in housing, diminishing global risks and strength across the economy, which is showing tentative signs of feeding into inflation. We do not consider current rates of credit and deposit growth to be sustainable – the former needs to slow and aggressive competition for the latter will come more to the fore. This means the relative price needs to shift more towards deposits. Banks' average cost of funds continues to rise, which means the same for retail rates if wholesale rates do not fall. We still expect the OCR to hit new lows, but not necessarily borrowing rates.

## FORCES SHAPING THE RATES OUTLOOK

**In the March edition of the *Property Focus* we noted that the direction for mortgage interest rates was not clear cut.** While additional OCR cuts from the RBNZ could (and did) see mortgage interest rates fall (the accepted wisdom), increases in global funding costs were pointing to higher mortgage rates. The former held more sway, but it was notable that the March OCR cut was not fully passed on into retail rates, testament to wider forces.

**We thought it timely up update readers on the state of play, and various forces shaping the outlook for interest rates.**

### The housing market has taken off and the economy is in reasonable shape

**Housing is a very pro-cyclical part of the economy** and is influential in setting the scene for higher or lower interest rates. When the property market is strong it tends to coincide with more spending (the wealth effect), with construction price inflation and rental inflation leading into broader inflation, and interest rates moving up. Strong migration has certainly been an important factor leading to higher rates during the previous tightening cycles (the mid-1990s and mid 2000s). Migration flows are not delivering the same sort of demand stimulus this time around, for a range of reasons, but the flows are stronger.

**The housing market is not the be-all and end-all when it comes to setting monetary policy but it is a major consideration given the historical link.** This is reflected in the fact that there has historically been a pretty decent correlation between house price inflation and the exchange rate. This obviously isn't a direct relationship, but rather works through the output gap (house prices are generally associated with a strong economy and hence NZD) and monetary policy (strong house prices meaning the same for inflation, a higher OCR and NZD).

**Typically, the combination of a) double-digit house prices gains; and b) strong credit growth, have been signals that rates need to move up, not down!**

**Things are different this time around.** At present inflation is still low. The economy and inflation are not driven by housing alone. Some massive global secular forces are suppressing inflation (think technology of the disruptive variety, such as Uber taxis). The high NZD is suppressing inflation too. Sectors such as dairying are facing significant financial stress. Inflation expectations are low. Continued low inflation risks becoming embedded in pricing behaviour. The RBNZ and other central banks have been cutting rates to mitigate some of these risks and developments.

**While on some levels things are different, we need to be wary.** It could be a case of "the more things change, the more they stay the same". The disinflationary impact of these structural changes may well be highly persistent, but it will wane eventually. The last time we saw uniform lifts in house prices across the country was 2005-2007 and this coincided with inflation lifting and the RBNZ having a major inflation battle to fight.

### The RBNZ views risks to the financial system as having increased in the past six months

**Some of this reflects challenges across the dairy sector**.

**A lot reflects imbalances in the housing market.** This is partly owing to an outright shortage of housing. However, there is no doubting the demand channel is at work too. When interest rates fall, it's a signal to New Zealanders to get out and borrow and buy another house. Hey presto, monetary policy works! Maybe too well.

ANZ

# FEATURE ARTICLE: FORCES SHAPING THE MORTGAGE RATE OUTLOOK

The RBNZ can certainly get asset price inflation up, just not general inflation. Household debt levels are now higher than they were prior to the Global Financial Crisis (GFC). A lot of borrowing is interest only – around 35% for owner occupiers and more than 50% for investors. Investors are dominating the market more and more.

**Financial stability is both divorced from monetary policy and overlapping**. It's divorced because the RBNZ has an inflation target, not an asset price one (though asset prices are a consideration in setting policy). It's overlapping because if asset bubbles get out of control and pop they can ultimately destabilise the economy. Witness the post GFC mess.

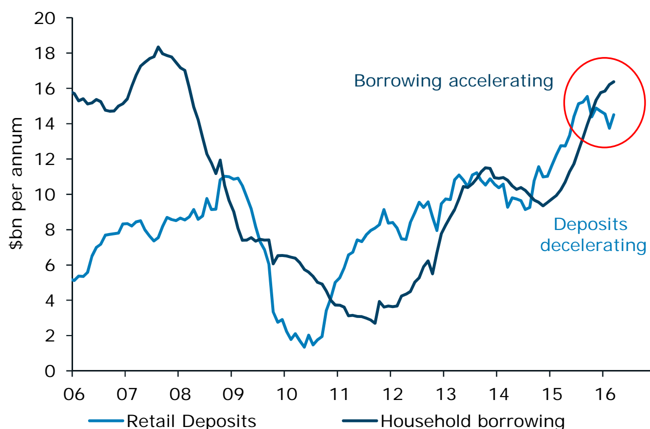
**The real issue here is the basic smell test.** The RBNZ cut rates in March noting that the Auckland property market had cooled. Some strength in the regions was noted but it was largely contained. A few months on and both assessments are looking very dated.

**Financial stability risks surrounding the housing market have now increased such that further financial policy measures may be appropriate. Cutting the OCR in that environment seems counter-productive.** It seems inevitable a combination of tighter LVR restrictions and mooted debt to income limits will come into play.

## Credit growth is now outstripping deposit growth.

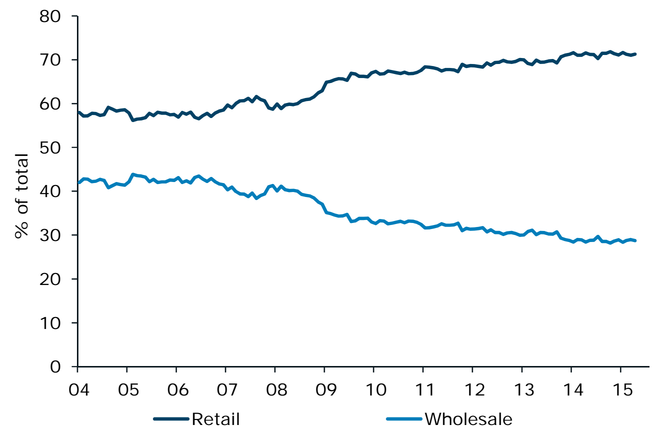
**A feature of the landscape post the GFC has generally been the matching dollar-for-dollar of deposit growth with lending growth.** This meant financial institutions didn't need to go looking offshore for funding, and in fact meant New Zealand's reliance on offshore funding eased. That reduced New Zealand's exposure to adverse movements in offshore credit markets. New Zealand is still exposed, but less so.

**BANK FUNDING AND CLAIMS GROWTH**




Source: ANZ, RBNZ

**RESIDENT FUNDING BY TYPE**




Source: ANZ, RBNZ

**Credit growth is now outstripping deposit growth by a considerable margin.** Each nudge lower in deposit rates makes deposits less attractive, while every nudge lower in rates makes borrowing more attractive – particularly when you overlay it with the surge in the property market we are now seeing.

As the RBNZ noted in the Financial Stability Report: *"Following the GFC, strong retail deposit growth and a moderation in credit growth from pre-GFC levels limited the need for banks to access higher cost long-term wholesale funding. However, over the past 18 months, credit growth has accelerated across the household, agriculture, and business sectors,* ***with aggregate credit growth now outpacing deposit growth. This may induce banks to compete more aggressively for retail deposits, or to increase their reliance on long-term wholesale funding, either of which could place upward pressure on bank funding costs. Higher funding costs would keep lending rates up relative to the OCR and short-term wholesale rates."***

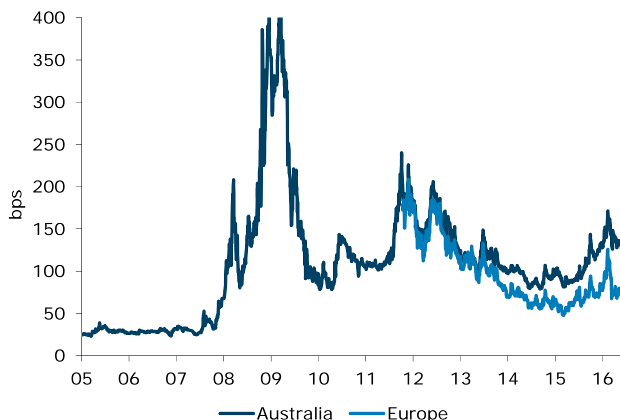
# FEATURE ARTICLE: FORCES SHAPING THE MORTGAGE RATE OUTLOOK

## Offshore funding markets have improved but funding is more expensive than it was in 2015

**Looking at various proxies for credit costs we note**:

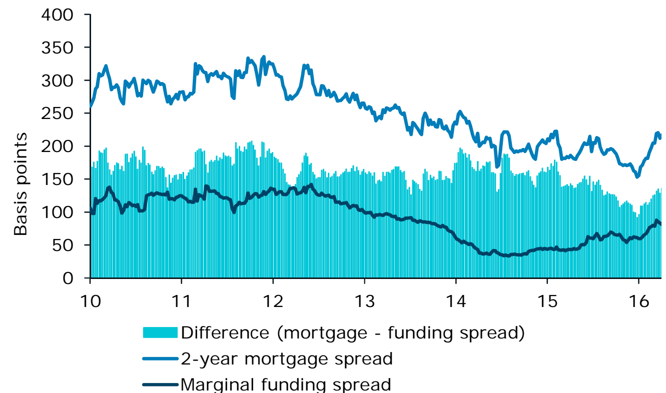
- **Credit spreads for large Australian corporates – using the iTraxx Australia index as a proxy – have retreated significantly since they peaked in February**, at the peak of Q1 market turmoil. **However, spreads** (currently around 126bps) **remain above their 2013, 2014 and 2015 averages** (114, 92 and 103bps respectively). Over time, old funding is being replaced by newer, more expensive funding. Banks have a lot more term funding in place now but it still slowly drags up average funding costs.
- **Local bank issuance spreads are much wider than where they were last year.** ANZ's latest 5 year domestic bond (issued in March) was priced at around +140bps over swap. To put this in perspective, a year ago, ANZ was issuing 5 year bonds at closer to +80bps over swap. Other financial institutions are seeing similar movements.
- **With deposits growing at a slower rate than credit, banks must look offshore to close the gap.** ANZ's latest offshore issue (in late May) was an EUR600m issue that swapped back to around +160bps over swap. That's wider than ANZ's most recent domestic issue (in March), yet during that time, credit spreads have generally narrowed (recall they spiked higher in February). Wider issue costs overseas will inevitably turn attention back towards the cheaper (at present) local market. It's simple arbitrage. However, New Zealand only has a limited domestic savings pool.
- **Spreads on Kauri bonds** (NZD denominated bonds issued by offshore entities) **have been widening steadily over the past 12 months**. This has a knock-on effect on spreads on domestic bond (issued by New Zealand banks and corporates), which compete against term deposits for funds in a market where there is a limited pool of savings.

**CORPORATE BOND CDS SPREADS (5 YEAR ITRAXX)**




Source: ANZ, Bloomberg

**BANK MORTGAGE AND FUNDING SPREADS**




Note: 2-year mortgage spread is the 2-year mortgage rate less the 2-year swap rate. Marginal funding spread is the marginal funding cost estimate less the 90-day bank bill rate.

Source: ANZ, RBNZ, interest.co.nz

**Still-expensive funding costs carry two implications.** First, if it's more expensive to fund overseas, **it makes economic sense to pay up locally in the deposit market**. Second, while the marginal cost of funds has oscillated over the past couple of months, it's still more expensive on average. This means **banks' average cost of funds is increasing**.

**All else equal, this means pressure for retail rates to move up, not down, in the absence of corresponding falls in wholesale rates.**

## We still expect the OCR to hit new lows, though the case is not overwhelming by any means

**That's our core economic view. However, a strong case can be made for no more moves down.**

- **Housing is booming.** Pouring more fuel on that fire hardly makes sense. While financial stability and monetary policy are separate in theory, their impacts clearly overlap.
- There is **little sign of weakness** across the economy, outside of dairy.

# FEATURE ARTICLE: FORCES SHAPING THE MORTGAGE RATE OUTLOOK

- We are starting to see **signs of demand-pull inflation in anything housing-related**, and non-tradable inflation has surprised on the upside for the past two quarters. **Wage inflation is also showing tentative signs of lifting.**
- **Oil prices have risen markedly** and this will more than negate the deflationary impact of a higher NZD in the near term. Dairy prices are being dragged along for the ride, though levels remain less than stellar.
- **The global scene looks far less worrisome** than three months ago; we doubt the tranquillity will last but we'll take it for now. Prospects of the Fed hiking are taking some pressure off the NZD/USD, although a higher NZD/AUD is not helping.
- **Dairy is a problem, but housing looks the bigger one now.** The RBNZ has been bouncing between the two over the past few years.
- The political pressure argument (which is mused as the reason for the RBNZ to cut rates) has been turned on its head. We typically shy away from it, though some think it is relevant to monetary policy decision-making. But we'll still offer our two cents worth: **with housing affordability now front and centre, the RBNZ is doing the Government few favours by cutting rates and fuelling more speculative fire!**

**That combination would typically see us scorching any notion of rate cuts altogether. However, we're still picking a lower OCR, but further down the track.** There are a few reasons for that:

- **Credit growth is outstripping deposit growth at a time when there is little appetite to raise offshore funding profiles, for the reasons discussed above.**
- **The global scene; we're expecting more fireworks, particularly with the market now starting to re-entertain prospects of the Fed lifting rates before too long.** Of course, the Fed won't want to create volatility and unease, but it is going to have to bite the bullet at some point. Financial markets need to be progressively taken off the low interest rate opioids. Detox isn't fun but it's necessary for long-term health. **China – New Zealand's and Australia's major exposure – still faces massive headwinds.**
- **The NZD is going to continue frustrating the RBNZ for a while yet.** As we've noted time and time again, monetary policy is now implicitly being expressed through currencies, and that makes them diverge from localised fundamentals. In that world there will be pressure for interest rates to converge to keep exchange rates within acceptable bounds. The performance of the NZX and commercial property market (declining cap rates) is reflective of an insatiable thirst for yield, any yield, in a world of more and more negative rates. **And those flows are NZD supportive.**

### Global nuances are shifting more towards the limits monetary policy faces

**The past few years have seen global interest rates generally push lower**. A lack of inflation and wobbly growth has seen central banks deliver more policy stimulus. In some jurisdictions, rates have been pushed into negative territory. This has kept local longer-term interest rates biased lower. The same low global inflation dynamic has also been apparent here, which has contributed to local short-term interest rates falling to (or close to) record lows as the RBNZ also eased policy.

But there have been other factors beyond just the inflation dynamic influencing the RBNZ's decisions. A significant source of pressure on New Zealand rates has been the policy settings of other central banks. Putting it bluntly, were New Zealand not to follow other central banks in taking their policy settings lower, increasing yield differentials would act to drive the NZD to the stratosphere, eventually crimping the economy.

It is a theme that is ongoing. Some central banks' rigid fixation with inflation is driving them to more extreme policy settings. The ECB is undertaking more quantitative easing, as is the Bank of Japan.

**However, we are starting to detect a subtle shift in attitudes of late, and it is notable that the adverse side effects of negative policy rates and even looser policy settings are being more actively debated.** There is now more open dialogue about the consequences of a persistent mispricing of risk and the resulting misallocation of capital; the lack of general consumer price inflation but soaring asset prices; liquidity, as opposed to fundamentals, driving asset allocation; and the lack of price tension in some key market instruments – the BoJ and ECB still dominate their respective bond markets as price-insensitive buyers, in effect mispricing those instruments.

# FEATURE ARTICLE: FORCES SHAPING THE MORTGAGE RATE OUTLOOK

**We have also seen a whole host of central bankers recently being more open about the limits to what central banks can, and should, do.** RBA Governor Stevens, BoE Governor Carney, some Fed Presidents (as opposed to the Governors) and Bundesbank President Weidmann have all been vocal of late. The BIS has been noting for some time that the financial stability risks of ultra-loose monetary policy are underappreciated. Even the IMF has been on the record asking if the unfettered free movement of capital, which is the mechanism of global monetary policy transmission, is the best policy.

**At the same time, it is becoming obvious that the world's most important central bank – the US Federal Reserve – intends to lift rates again.** Admittedly not by much, but barring a global markets accident, the next few moves will be up. This is important, as the likes of US 10-year Treasury yield is the global benchmark for the cost of capital and heavily influences other long-term interest rates around the globe, including in New Zealand.

**To be fair, none of this portends interest rates moving up significantly, or quickly.** There are too many uncertainties around the globe for that. The world has significantly more debt than prior to the Global Financial Crisis and China in particular is getting a lot of attention given the level of indebtedness it has built up over the past six years. Statistically there tends to be about a 10-year gap between each global hiccup. The Asian Crisis occurred in 1998; the GFC in 2008/09. What might the next year or two bring?

**But the point is that while it might be hard to imagine interest rates moving up meaningfully around the globe, it doesn't necessarily follow that they will keep gravitating lower either**.

**The risk profile for interest rates is shifting as the costs of ultra-loose policy settings become more apparent and credit risk starts to be re-priced.**

## THE BOTTOM LINE

**Retail borrowing rates may well have seen their lows.** It doesn't mean that they are going to ratchet back up, but there are forces pushing against them moving down. The outlook from here looks to be somewhat of a tussle. That in itself means an altered risk profile which borrowers need to be cognisant of.

**There are now material restraining influences against pushes lower that are distinct from the outlook for the OCR.** New Zealand needs higher borrowing rates for housing but lower ones to drive the currency down. It seems inevitable that some sort of wedge is going to end up in place between retail and wholesale borrowing rates via a combination of credit costs, potential prudential action and a shift in the relative price of deposits versus borrowing.

# 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 April 2016 (based on REINZ data)

| | House prices (ann % chg) | 3mth % chg | No of sales (sa) | Mthly % chg | Avg days to sell (sa) | Comment |
|---|---|---|---|---|---|---|
| Northland | 0.5 | -1.4 | 265 | +3% | 45 | Sales volumes 9% y/y, a 15 month low. |
| Auckland | 12.1 | 4.6 | 2,831 | +15% | 32 | Volumes +1% y/y. Days to sell at 6m low. |
| Waikato/BOP/Gisborne | 18.6 | 5.6 | 1,643 | +10% | 35 | Record median sales price, sales volumes +30% y/y. |
| Hawke's Bay | 5.7 | 2.5 | 343 | +34% | 33 | Sales volumes 48% y/y, record median sales price. |
| Manawatu-Whanganui | 7.0 | 1.8 | 399 | +6% | 33 | Days to sell at 9-year low, sales volumes +32% y/y. |
| Taranaki | 14.0 | 5.4 | 182 | +27% | 34 | Days to sell at 4-month low, record median sales price. |
| Wellington | 10.2 | 6.0 | 890 | -3% | 29 | 2nd lowest days to sell of regions, volumes 24% y/y. |
| Nelson-Marlborough | 11.2 | 5.6 | 300 | +6% | 30 | Days to sell at 9-year low, volumes +30% y/y. |
| Canterbury/Westland | 0.2 | 1.3 | 1,034 | +2% | 33 | Sales volumes +23% y/y, record median sales price. |
| Central Otago Lakes | 23.5 | 19.6 | 157 | +13% | 39 | Median sales price at record high. Volumes +20% y/y. |
| Otago | 8.9 | -1.2 | 352 | +7% | 26 | Lowest days to sell of regions, sales volumes +33% y/y. |
| Southland | -1.0 | 5.3 | 220 | +27% | 34 | Days to sell back below historical averages (36). |
| NEW ZEALAND | 7.3 | 3.8 | 8,581 | +10% | 32 | Days to sell well below historical averages (37), volumes +17% y/y, median prices 1% below peaks. |

## Key forecasts

| | Actual | | | Forecasts | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| **Economic indicators** | **Sep-15** | **Dec-15** | **Mar-16** | **Jun-16** | **Sep-16** | **Dec-16** | **Mar-17** | **Jun-17** | **Sep-17** | **Dec-17** |
| GDP (Ann Avg % Chg) | 2.9 | 2.5 | 2.4(f) | 2.6 | 2.7 | 2.8 | 2.7 | 2.5 | 2.4 | 2.5 |
| CPI Inflation (Annual % Chg) | 0.4 | 0.1 | 0.4 | 0.4 | 0.5 | 1.0 | 1.4 | 1.4 | 1.7 | 1.9 |
| Unemployment Rate (%) | 6.0 | 5.4 | 5.7 | 5.5 | 5.4 | 5.4 | 5.3 | 5.2 | 5.2 | 5.1 |
| **Interest rates (carded)** | **Mar-16** | **Apr-16** | **Latest** | **Jun-16** | **Sep-16** | **Dec-16** | **Mar-17** | **Jun-17** | **Sep-17** | **Dec-17** |
| Official Cash Rate | 2.25 | 2.25 | 2.25 | 2.25 | 2.00 | 2.00 | 1.75 | 1.75 | 1.75 | 1.75 |
| 90-Day Bank Bill Rate | 2.3 | 2.4 | 2.5 | 2.4 | 2.2 | 2.1 | 2.0 | 2.0 | 2.0 | 2.0 |
| Floating Mortgage Rate | 5.7 | 5.7 | 5.7 | 5.7 | 5.5 | 5.5 | 5.2 | 5.2 | 5.2 | 5.2 |
| 1-Yr Fixed Mortgage Rate | 4.9 | 4.9 | 4.8 | 4.8 | 4.7 | 4.7 | 4.7 | 4.8 | 4.9 | 5.0 |
| 2-Yr Fixed Mortgage Rate | 5.1 | 5.0 | 5.0 | 5.0 | 5.0 | 5.0 | 5.0 | 5.1 | 5.3 | 5.3 |
| 5-Yr Fixed Mortgage Rate | 5.7 | 5.5 | 5.4 | 5.4 | 5.4 | 5.4 | 5.5 | 5.6 | 5.7 | 5.7 |

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