NEW ZEALAND PROPERTY FOCUS

June 2018

INSIDE

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ISSN 2624-0629

RENT-SEEKING BEHAVIOUR

SUMMARY

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

FEATURE ARTICLE: RENT-SEEKING BEHAVIOUR

The Government has implemented or proposed a number of policies that will affect investment in residential property. Outcomes are uncertain, but the policies being proposed are no magic bullet to fix New Zealand's housing affordability issue, though they will likely have a temporary dampening effect on house price inflation. The most important factors underpinning housing demand have been strong immigration and low interest rates, and these factors are expected to persist. There are also crucial issues for affordability related to the supply side: high construction costs, construction industry productivity, restricted supply of land, and provision of infrastructure – and it is important that focus remains on addressing these issues, although quick fixes are in short supply here too. As with all policies, there may be unintended consequences, including potential upward pressure on rents, or negative impacts on housing supply at the margin – particularly for apartments. On the other hand, the proposed policies could have other benefits, like encouraging households to diversify their assets.

PROPERTY GAUGES

The housing market is about as stable as it gets, with sales flat and price pressures gradually moderating. Underlying this, a number of opposing forces are at play. Strong population growth, pent-up demand, supportive financial conditions and further eventual easing of loan-to-value ratio restrictions will support prices. Bank prudence, affordability constraints, and government policy changes are expected to keep prices and activity contained. Our current forecast is for stability in the housing market, but we suspect there could be some bumps in the road ahead.

ECONOMIC OVERVIEW

The economic dataflow has been fairly lacklustre of late. Business sentiment remains subdued, household spending has taken a hit, and indicators of economic activity into 2018 have been on the softer side. Growth momentum in the economy continues to slow, and we expect GDP growth is currently tracking below trend. Nonetheless, we think this economic cycle has some way to go yet. Strong income growth (in part a result of our elevated export prices) and fiscal expansion are expected to see the economy grow around trend over the next couple of years. But it is fair to say that downside risks to the outlook for GDP and inflation have increased a little of late. In this environment, the RBNZ will remain cautious – with interest rates on hold for some time yet.

MORTGAGE BORROWING STRATEGY

Average fixed mortgage rates have hardly changed over the past month. We still favour the 1-year fixed rate, although it remains a close call with the 2-year rate, particularly if you are concerned about a faster lift in inflation (perhaps driven by stronger wage growth) that spurs the RBNZ into earlier rate hikes. That is not our view though, and we prefer fixing for shorter durations at present. But ultimately, borrowers may wish to spread risk by borrowing over a number of fixed terms, which is always a strategy that makes sense from a risk-management perspective.

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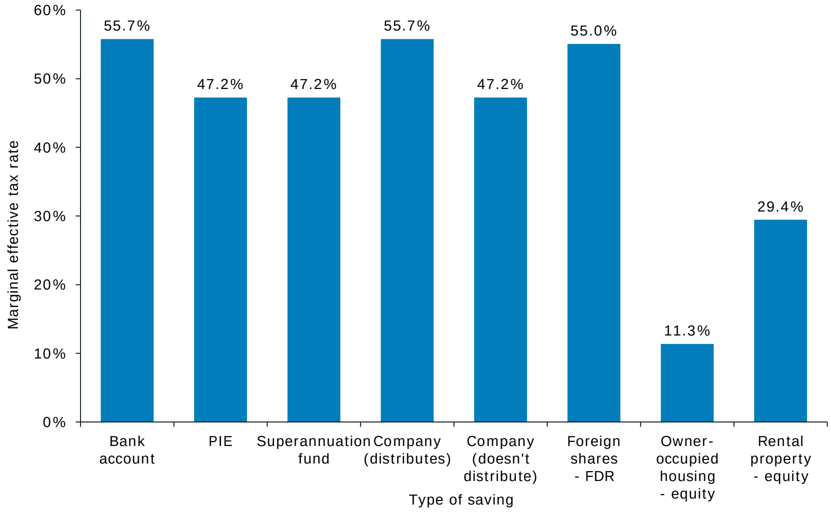
CHANGING THE CALCULUS OF PROPERTY INVESTMENT

Looking back over history, investment in residential property has been a good bet in New Zealand. Since 2012, house prices have risen 70%, and investing in residential property has provided favourable returns relative to other asset classes (although nowhere near as favourable as owner-occupied housing).

Figure 1: Marginal effective tax rates on different types of savings



Source: Tax Working Group, ANZ Research

Since taking office, the Government has implemented or proposed a number of policies that will directly affect investment in residential property (table 1). This month we take an in-depth look at the policies that have been proposed, focusing on their macroeconomic effects, including their potential implications for rents, house prices and housing affordability.

Table 1: New Government policies that will directly affect property investment

Policy	How it works	Status / timing
Foreign-buyer restriction	Restricts foreign buyers from purchasing existing homes, directly reducing demand.	**In progress:** Recommended amendments from the Finance & Expenditure Committee now released.
Extending the bright-line capital gains test	Imposes a capital gains tax on investors who sell an investment property within five years (rather than two previously).	**Complete:** Effective from 29 March 2018.
Ring-fencing	Stops investors from using rental property losses to offset their other income, making the tax treatment of investment property less favourable.	**Proposed:** Submissions have been sought by IRD. Proposal is that the policy would take effect in the 2019/20 income year.
Renter rights	Makes conditions more favourable for renters, including housing quality and security of tenure.	**In progress:** insulation required by year end. Other proposals (such as banning letting fees and increasing notice periods) will take longer.

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RESTRICTING FOREIGN BUYERS

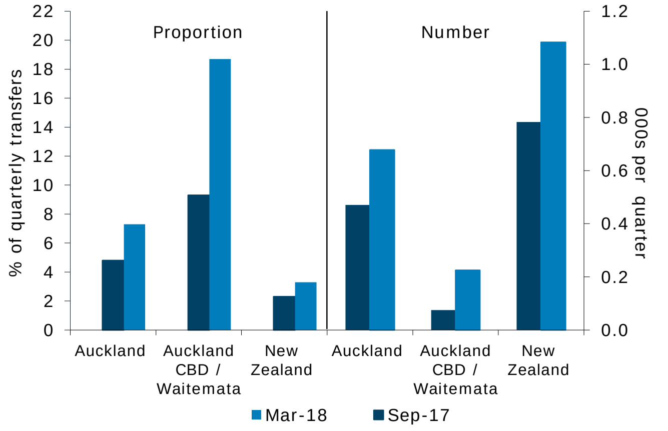
The Government's proposed amendment to the Overseas Investment Act **will restrict foreign buyers from purchasing residential property in New Zealand** (with an exemption for Australians and Singaporeans).The bill prohibits any person who is not a New Zealand resident or citizen, unless special consent is given, from purchasing residential property (including through a company or a trust), **unless the property is for non-residential use or will increase housing supply and will be on-sold once built (with exceptions, such as an allowance for hotel units and pre-sales of large projects).** The exact details of the policy are subject to some uncertainty; recommended changes from the Finance & Expenditure Committee have just been released that soften the bill.

The impact foreign buyers have had on the property market in recent years is subject to uncertainty. Foreign purchases, defined as the proportion of property transfers where no New Zealand citizens or residents are buyers, are currently around 3% nationally, although about a quarter of these are likely to be Australians (based on tax residency data). One proviso is that it is possible that non-residents could be funding transactions through (or with) residents, meaning the proportion of foreign buyers may be understated. **We expect restricting foreign buyers will eliminate only a small portion of current demand.** While the impact of foreign buyers is subject to uncertainty, the proportion of property transfers to foreigners appears small both in absolute terms and also when compared to Australia. Foreign buyers are estimated to comprise 7-13% of transactions in Australia (despite build-to-buy restrictions on foreign residential property ownership there).

Our expectation is that the new policy will reduce house price inflation – although probably not by much. Estimates are subject to considerable uncertainty, but the effect of the restrictions on house prices in New Zealand is likely to be small. There were just fewer than 20,000 house sales in New Zealand in the March quarter, and we know that foreign buyers comprised just over 3% of property transfers, with some of them being Australians and Singaporeans. Making reasonable assumptions about the impact on house sales, we estimate that the restriction might reduce house prices by less than half a percentage point, relative to a counterfactual scenario where foreign buyers were still in the market.[1] This is not a large amount, especially in the context of house price rises of 9% per year on average since 2012. It is also possible that foreign investors will find ways to get around the policy, eg by purchasing via New Zealand residents. **To the extent that there is policy avoidance, the effect will be muted.**

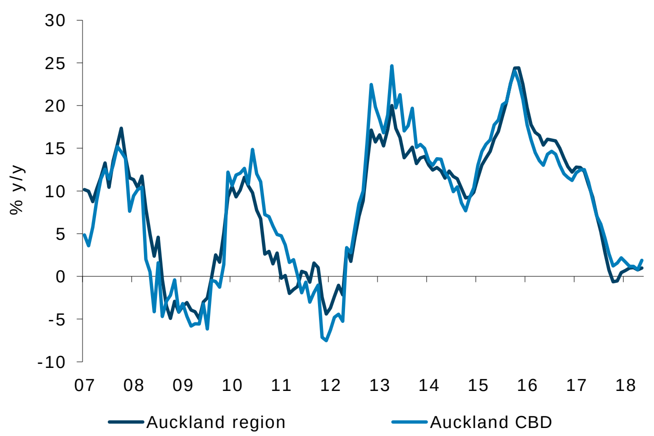
Estimates are subject to considerable uncertainty because domestic and foreign buyers may have different attributes. Foreign buyers are less likely to be funded through the New Zealand banking system, they are less likely to be constrained by the high level of house prices relative to New Zealand incomes, and the calculus by which foreign buyers make decisions is probably different (eg comparing New Zealand to other international markets). It's possible that usual relationships with sales and prices don't capture these differences.

Figure 2: Residential property transfers to non-New Zealand residents or citizens



Source: Statistics New Zealand, ANZ Research

Figure 3: House price inflation in Auckland



Source: QV, ANZ Research

[1] We assume 2-2.5% of buyers are shut out and that some are replaced by other domestic buyers at the same price (a third, say), meaning house sales might be 1-2% lower in the near term. RBNZ modelling has found that a 5% drop in sales is associated with 1.5% lower house prices – so house prices could be a half percentage point lower nationwide, assuming no policy avoidance.

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While the nationwide impact is likely to be small, effects of the restrictions will be felt more in regions with more foreign buyers, like Auckland CBD. Prices could fall in central Auckland if domestic buyers do not fill the gap. In other regions, house prices may not be affected at all. It is worth noting that the relative stability of rental yields in central Auckland suggests that a significant "speculative" dynamic is not at play there, despite foreigners participating more heavily in that market. The central Auckland market is dominated by apartments and prices there have been flat since mid-2017 (with Auckland CBD house prices moving in line with those in the wider Auckland region). The moderation in Auckland house price inflation from late-2016 pre-dates the proposed restriction, and was driven by generalised softening in the market, due to affordability constraints starting to bite, credit headwinds, investor caution, and loan-to-value restrictions. **There has been no discernible impact on house prices in central Auckland as a result of the proposed restriction of foreign buyers to date.**

Any effect on house price inflation is likely to be temporary, though the impact on the house price level should be more persistent (albeit small, based on current sales numbers). In some ways, the loan-to-value ratio restrictions that were imposed by the RBNZ on investors in 2016 worked in a similar way to the foreign-buyer restriction in that they eliminated a chunk of buyers from the market. In a similar way, we expect a one-off adjustment in the price level is likely to occur until a new "equilibrium" is reached, implying a temporary moderating effect on house price inflation.

With the estimated impact on house prices small due to relatively small numbers of foreign buyers at present, **we expect the policy will have a negligible immediate impact on housing affordability. However, importantly, this does not mean that the policy could not have a bigger impact in the future (or equally, that it would not have had a bigger impact if introduced earlier).** Data produced by LINZ goes back to end-2015 and suggest the proportion of foreign buyers was flat between then and end-2017. However, we do not know the percentage of houses that were being bought by foreigners prior to this or during previous cycles – it could have been larger. The causality between foreign purchases and house price inflation runs both ways, of course, with foreign buyers likely to be attracted by capital gains just as domestic investors are, and the new policy therefore may well contribute to a smaller peak in house price inflation next time round. Without complete data on their impact on sales over the last housing cycle, it is very hard to know. And as we have mentioned, non-residents could have been funding transactions through (or with) residents, so the true impact of foreign buyers could be larger than the data suggests.

With any new policy, one must be wary of unintended negative consequences. As currently drafted, the new legislation would have a carve out for foreign purchases of non-residential property – it will be important for this to operate smoothly, so that the restrictions do not impinge on business operations or reduce the desirability of New Zealand as an investment destination. In another quirk, foreigners are probably less likely to fund their purchases through the New Zealand banking system. To the extent that foreign buyers are replaced by domestic purchasers, credit growth in New Zealand could increase – but probably only marginally.

If foreigners can only invest in new builds, restricting foreign buyers also has the potential to increase cyclicality in apartment building. In Australia, foreign investors are only allowed to invest in new builds (or substantial renovations), which appears to have led to a risk of over-supply of apartments in certain markets. **As it is currently drafted, the amended Overseas Amendment Act would restrict all foreign purchases of residential property, unless the property was built by the investor and on-sold promptly to a New Zealander (with some exceptions)** – this is in practice stricter than in Australia (where foreign investors are not required to sell). This may be an unappealing proposition for investors; indeed, it is probably designed to be. Given this difference, and also given that the concentration of foreign buyers is much smaller in New Zealand to start with, we do not expect any more (or less) of a boom-bust apartment supply dynamic to play out as a result of the proposed restrictions.

Indeed, a greater risk would seem to be that, rather than leading to a building boom, housing supply could be impinged as a result of the restriction. A key question is the degree to which foreign investors will be willing to participate in the development and construction of new homes. We are told that foreign investors participate significantly in the Auckland apartment market, and given that finance for large development projects can be difficult to obtain, a restriction on foreign buyers could significantly curb supply by making pre-sale targets more difficult to achieve. **Some changes to the bill have been recommended by the Finance & Expenditure Committee acknowledging this risk.** Additionally, even if foreign investors are not heavily involved in new building directly, their contribution to demand could be playing an important role in contributing to confidence amongst property developers.

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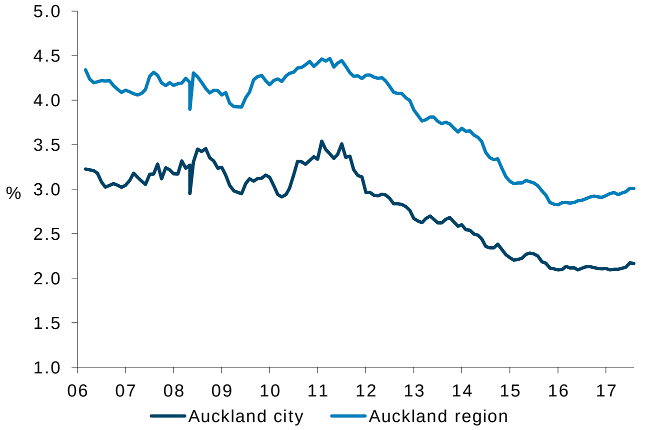
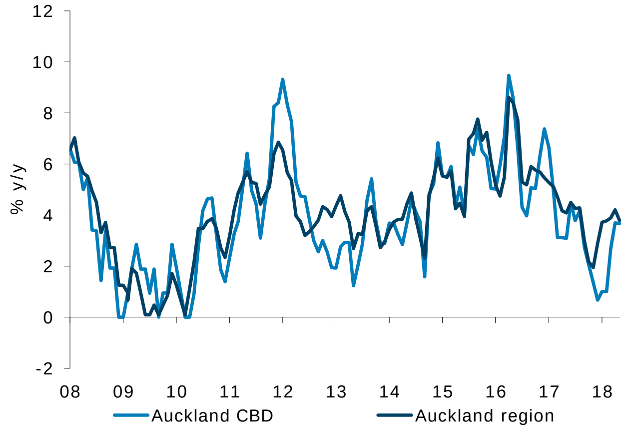
Figure 4: Gross rental yields in Auckland



Source: MBIE, QV, ANZ Research

Figure 5: Rental inflation in Auckland



Source: MBIE, ANZ Research

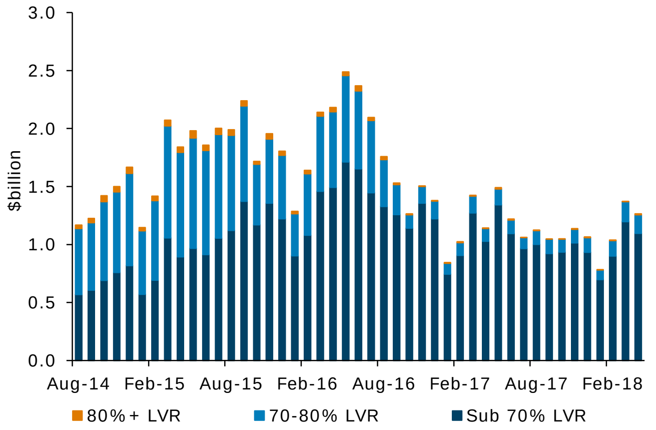
Another unintended consequence could be that rents increase. The foreign-buyer restriction, combined with other proposed policies, may make capital gains look less assured or investment look more risky. Investors may seek to offset this by charging higher rents. Demand to live in a house is relatively inelastic compared to demand to purchase a house. This means that increases in costs can flow through into rents relatively easily, as long as household income growth and the housing supply balance are amenable. Indeed it is possible that this is already happening in advance of policy changes, with rental inflation having increased through late 2017. The increase in rental inflation in Auckland CBD (and the recent tick up in rental yields) suggests the current environment is conducive to rent increases.

Amongst the debate about foreign ownership it is important not to lose focus on other important issues pertaining to housing affordability, particularly on the supply side. And it is also important to view the issue of foreign ownership in a broader economic context. The fact is: we have a poor saving record, and we are reliant on foreign investment to do business. In a global economy where trade and free-flow of capital have large benefits, we need to be careful that we do not send a signal that New Zealand is closed for business, or that foreigners – and foreign capital – are not welcome here.

MAKING PROPERTY INVESTMENT LESS ATTRACTIVE

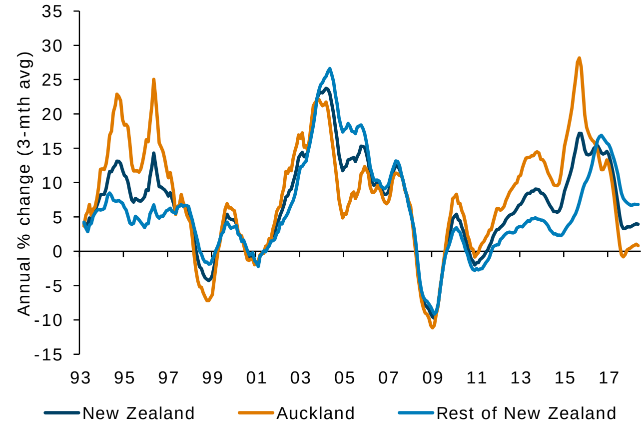
A number of other policies will make property returns less attractive for domestic investors. Some change the tax treatment of property investment, including the extension of the bright-line capital gains test (which has already been implemented) and ring-fencing (which has been proposed). The Government also intends to introduce a number of regulatory changes to make conditions better for renters, although these may take a while to all be introduced. These policies will alter the calculus of property investment by increasing both costs and uncertainty.

Figure 6: New lending to investors



Source: RBNZ, ANZ Research

Figure 7: House price inflation by region



Source: RBNZ, ANZ Research

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By making property investment less favourable, these policies are likely to weigh on investor demand to some degree. But the impacts are not clear cut. The policies could work in a similar way to the introduction of a capital gains tax (by directly affecting returns); welfare impacts for these types of policies are ambiguous though. It is possible that more people may be able to own their own home, but this effect may not be large – and it may be more than offset (from a welfare perspective) by increases in rents.[2] Requiring better insulation and heating will also improve the quality of the rental stock but may also lift rents. Other policies such as shifting the burden of rental agents fees from new tenants to landlords will clearly benefit tenants; whether the landlord or the agents themselves (through less business) will bear the bulk of the cost is unclear.

On balance, we suspect that policies targeted at domestic investors will have more of an impact on housing demand than the foreign-buyer restriction. They could also weigh on credit growth. Arguably, the policy to ring-fence losses is a more fundamental change, since it will affect expected returns for many investors across the country. It is unclear when (or if) this policy will be implemented – and the effects are uncertain – but we expect it could have a meaningful impact on house price inflation. **But any impacts would be short lived.** This is consistent with Australian Treasury conclusions regarding a similar ring-fencing ("negative gearing") policy proposed in Australia; a "relatively modest" impact on house prices is expected over the long term.[3] The Australian Treasury also conclude that **timing is important: changes in policy could have a larger (albeit temporary) impact if the housing market is already weak.**

The proposed changes – and uncertainty about the policy environment – have been contributing to weaker demand from investors more recently, which has contributed to the moderation in house price inflation from late 2016**.** Reduced credit availability and the RBNZ's loan-to value ratio restrictions have been at play – with lending by New Zealand banks to investors having halved since late 2016. But proposed policy changes and uncertainty about the policy environment have been contributing more recently. **It is hard to know how much proposed policy changes are already "priced in".** To the extent that they are already being reflected in prices, it is possible that the impacts of any policy changes will be negligible at the time they are implemented. And indeed, pent-up demand could be building; demand could rebound once policy becomes clearer, if it isn't as "bad" for landlords as expected.

The upshot: though they will help affordability at the margin, the Government's policies won't significantly reduce house prices or curb the housing cycle. Countries around the world have varied tax regimes regarding residential property. Yet, high and cyclical house prices are common, particularly amongst countries with supply-constrained markets.

Ring-fencing losses could encourage New Zealand households to diversify their assets. This could lead to deeper capital markets. This would have the benefits of making households less vulnerable to a correction in housing, and making funds easier to access for firms. But without changing the tax treatment of owner-occupied housing, **property will still be favoured as a vehicle for savings and so the benefits in terms of capital market deepening may be limited. Some argue that making property investment less attractive will divert resources towards more productive investment. That is a misconception.** At the margin, capital deepening could result in more readily available capital for firms. But ultimately, the amount of real investment undertaken by firms is determined by the incentives faced in the business environment (with the financial system allocating funds) – not by how households allocate their portfolios. And on the housing side, real investment in the housing stock still needs to happen. We have a shortage of houses; who owns the property doesn't change that.

Investors are likely to bid up rents. We often hear anecdotes that increases in costs faced by landlords simply flow through to higher rents. But it is not just a matter of passing on costs. If expected capital gains are lower, rents might increase in order for property investment to remain profitable. As with the foreign-buyer restriction, these policies can be expected to make capital gains look less assured or property investment look more risky. Investors may seek to offset this by charging higher rents. Relative to the foreign-buyer restriction, we expect these policies will have a greater impact on costs and expected returns, which will flow through to higher rents, as long as the housing demand-supply balance and household incomes are amenable to that.

And again, housing supply could be affected. Making property investment less attractive will have little impact on the supply of housing, unless the physical stock of housing decreases (or increases) or if more (or fewer) houses are standing empty – and more houses still need to be built. Property investors provide homes for rent, but do not necessarily impact the supply of housing unless they are building new homes. To the extent that

[2] Coleman (2009)
[3] Australian Treasury (2018)

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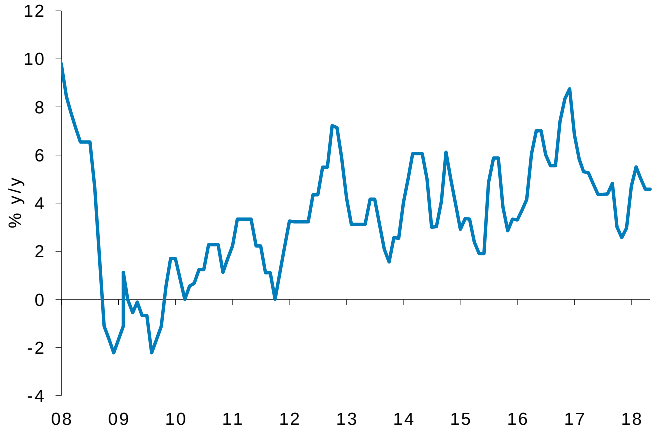
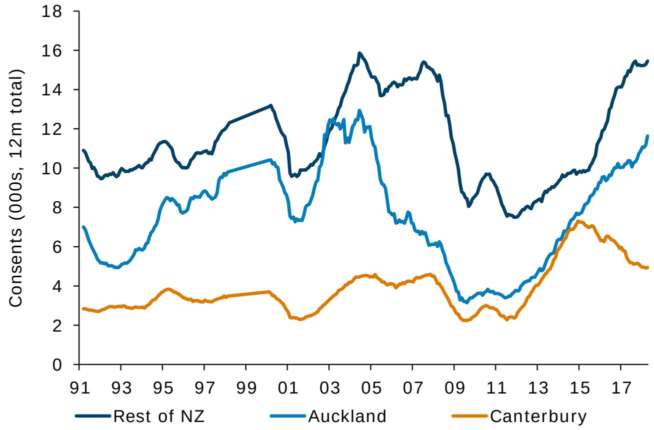
property investors are involved in new building, the supply of housing could be affected by these policies. **This could create offsetting upward pressure on house prices, while exacerbating any impact on rents.**

Figure 8: Rental inflation (for new bonds lodged)



Source: MBIE, ANZ Research

Figure 9: New dwelling consents



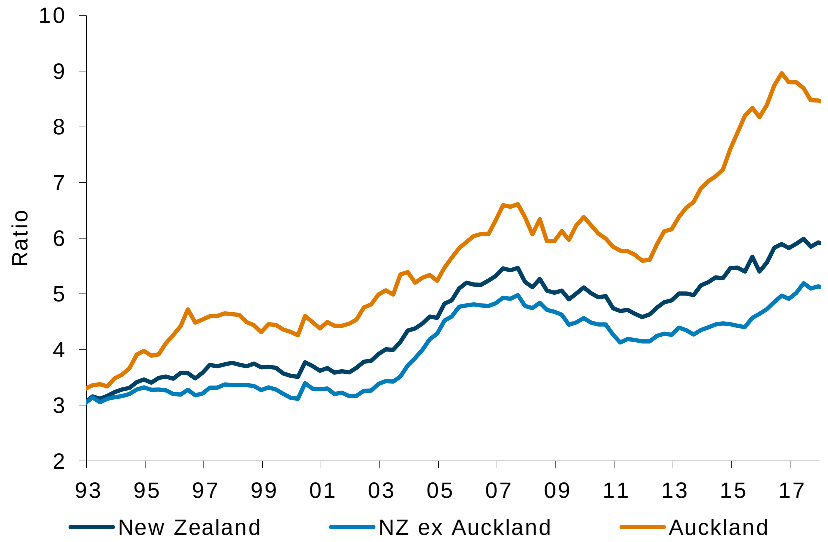
Source: Statistics New Zealand, ANZ Research

WILL HOUSING AFFORDABILITY IMPROVE?

While the details and potential impacts are uncertain, we expect that the housing policies currently being proposed will have only a small effect on housing affordability. We expect there could be a dampening effect on house price inflation – and we could even see house prices fall in some places. However, the impact is expected to be small and short lived. We expect that household income growth will be unaffected.

The proposed policies could lead to a shift in ownership, with more first home buyers entering the market. But even if some investors are dissuaded from purchasing property, there's no guarantee that owner-occupiers will fill the gap. Investors may still be the marginal buyers in the market. Certainly, investor demand has been impacted recently, but that may be temporary, with some investors waiting for the policy environment to become clearer. Indeed, some pent-up demand may be building. The fact is: property investment remains a good bet. Even with these changes, investing in multiple homes is still likely to stack up favourably relative to other assets.

Figure 10: House prices to incomes



Source: REINZ, Statistics New Zealand, ANZ Research

Even if ownership does shift towards owner-occupiers, we expect this move will be minimal, with houses still very expensive. Any improvements will only be felt by marginal entrants into the market – but those who continue renting may be worse off if rents rise. This could impact household discretionary income with lower-income households more likely to feel the pinch.

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Strong population growth, low mortgage rates and solid household income growth mean demand for housing is not likely to roll over any time soon. And on the supply side, important issues affecting the affordability of housing include the high costs of building, construction industry productivity, restricted supply of land, and provision of infrastructure. Population growth in the context of constrained housing supply has seen house prices increase significantly over the past two decades – as has happened in other supply-constrained housing markets internationally.

To address housing affordability, a more fundamental change in market structure is needed. The issue of constrained housing supply needs to be addressed, and land availability is crucial. Increasing the supply of residential land and relaxing restrictions on how land can be used would help. Lower levels of immigration could also help stem rising house prices, but would make it more difficult for businesses to source labour and operate effectively, particularly in industries like construction. **It is not simple to increase the rate of house-building because construction industry capacity is constrained. And increased housing supply needs to occur alongside provision of infrastructure.**

Policies aimed at expanding construction industry capacity and reducing costs would help. Construction costs are high by international standards, contributing to elevated house prices and housing supply that is slow to respond. This includes materials costs, but also processes and red tape – with bureaucratic delays adding to uncertainty and contributing to cost escalation. **Initiatives to boost construction industry productivity are a step in the right direction.** On that front, some of the initiatives associated with KiwiBuild (such as prefabricated housing) could be useful, though are unlikely to be game changers in themselves.

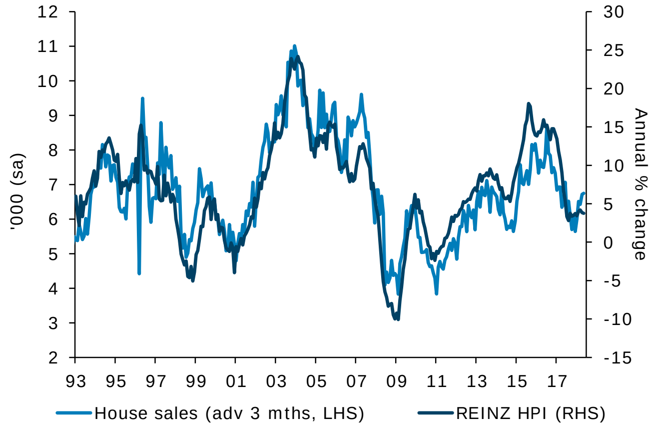
Overall, the policies proposed by the Government could have some benefits, but they are not going to be the magic bullet that improves housing affordability. It's a complicated problem that needs a multifaceted solution addressing both the demand and supply side.

THE OUTLOOK

A number of offsetting forces are affecting the housing market. The factors that have been dampening house price inflation – investor caution, credit availability and affordability constraints – are expected to be continuing headwinds, over coming quarters at least. But strong population growth and pent-up demand remain supportive. Interest rates also remain low, although we suspect that the effects of current low interest rates have largely played out. There is also a catch-up dynamic at play. We expect that demand will continue to be robust outside of Auckland, supporting nationwide house price inflation, while the Auckland market remains subdued. In previous cycles, regional catch-up has taken a long time to play out, so this dynamic may be a persistent theme.

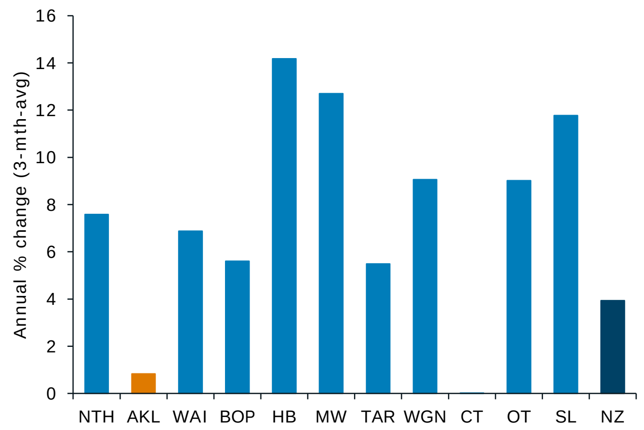
Our current forecast is for stability in the housing market – but we suspect there could be some bumps in the road ahead. We expect that offsetting forces will continue to balance out, leading to stability in house sales and gradually moderating house price inflation. But we acknowledge that stability cannot persist indefinitely – and a change in conditions could easily tip the balance in either direction.

Figure 11: House prices and sales



Source: REINZ, Statistics New Zealand, ANZ Research

Figure 12: House price inflation by region



Source: REINZ, Statistics New Zealand, ANZ Research

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Risks are probably skewed to the downside. Investor caution is having a dampening influence and may continue for some time until policy uncertainty is resolved – in an environment where we expect credit availability will continue to be a constraint for some. It is possible that policy uncertainty could have a more important impact than the policy changes themselves. Another risk is that tightening in credit conditions in Australia (including stricter loan-to-value ratio requirements, reduced estimates of rental returns, and higher expense estimates) could flow though to New Zealand more than currently anticipated, particularly if banks came under increased political pressure or if recent weakening in the Australian housing market led to increased caution.

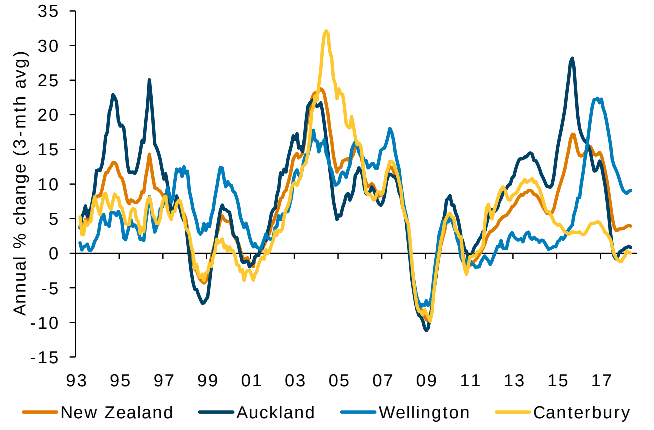
That said, we think the downside is limited by other supportive factors, including population growth, pent-up demand, and constrained supply. And if we saw the housing market moderate significantly, we expect loan-to-value ratio restrictions would be loosened further, which could spur activity and create additional variability in house price inflation. It is also possible that pent-up demand is building, with investors biding their time until policy uncertainty is resolved – at which time, demand could rebound. **So although we are cognisant of downside risks, we are waiting to see how developments play out.**

Rental inflation is likely to be higher, which would have a positive impact on inflation. But it would also impact household discretionary spending, with lower-income households more likely to feel the pinch. This may weigh on GDP growth, particularly since lower-income households are more likely to adjust their spending out of remaining income.

Policy changes could have negative effects on housing supply and this could reduce the downward pressure on house prices, while exacerbating any impact on rents. This is particularly relevant for the central Auckland market, since property development there is aided by foreign participation in the market. It is already the case that those in the construction and property development sector are reporting difficulties, with cost pressures and delays squeezing margins, capacity constraints making operating difficult, and credit headwinds weighing. Despite these reported difficulties, we see strong housing demand continuing to contribute to robust residential building activity. But there are clearly risks around this view.

THE PROPERTY MARKET IN PICTURES

Figure 1. Regional house price inflation

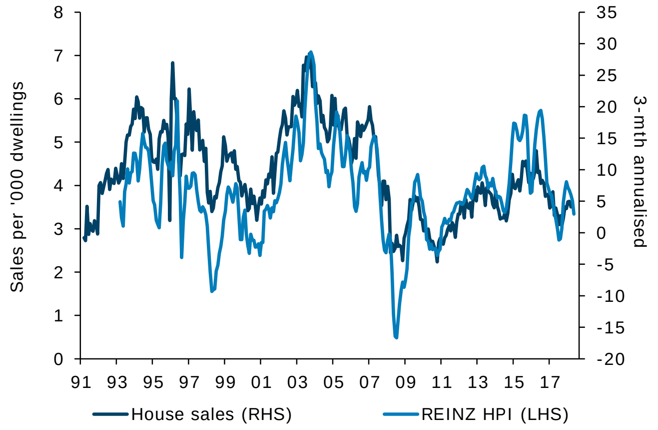


Source: ANZ, REINZ

The REINZ House Price Index fell 0.2% m/m in May, consistent with continued stability in price pressures. In 3-month average terms, annual growth moderated slightly from 3.9% to 3.8% y/y. Annual house price inflation has been hovering in the 3-4% range since August last year.

Price pressures remain stable on a regional basis. Outside Auckland, prices are up 0.6% m/m, and have hovered around 7% y/y since November (3mma). Particularly strong rates of house price inflation are evident in Hawke's Bay (14% y/y 3mma), Manawatu-Whanganui (13%) and Southland (12%). In Auckland, house prices are down 1.1% m/m, increasing just 0.8% y/y (3mma). Auckland house prices have been increasing around 1% y/y since February.

Figure 2. REINZ house prices and sales



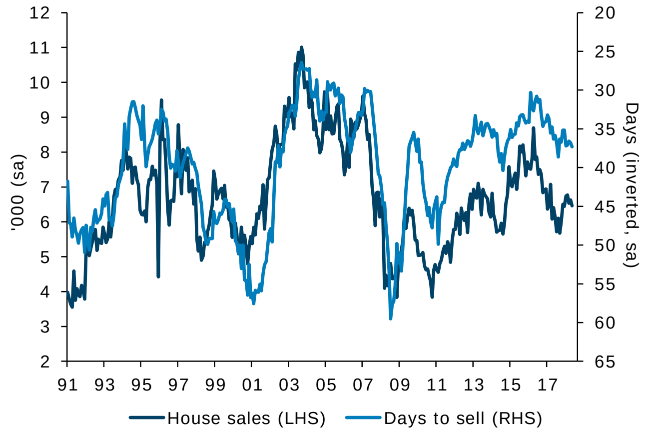
Source: ANZ, REINZ

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

We estimate that seasonally adjusted house sales volumes fell 2.5% in May (to be up 0.9% y/y), with 6,500 sales in the month. **National sales volumes are about as stable as it gets**, with about 6,500 sales each month since November (seasonally adjusted), following their recovery from the recent trough in September last year.

Sales have been steady on a regional basis recently too, despite some monthly volatility. The recovery in sales late last year was seen across most markets outside Auckland – and stability has been evident since.

Figure 3. Sales and median days to sell



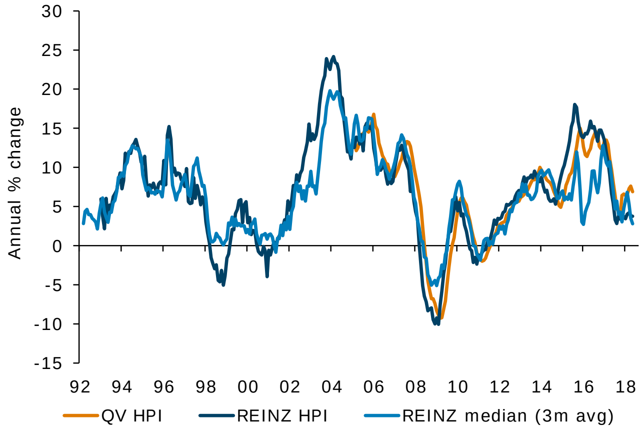
Source: ANZ, REINZ

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

Housing markets outside Auckland remain tight, with days to sell below average in all regional markets except Auckland. Nationwide the median time to sell a house continues to sit at 37 days (sa) – below its historical average of 39.5. Days to sell have been stable at this level since mid-2017, after increasing across the country from mid-2016 (when it was 31 days nationwide). In Auckland, it currently takes 39 days to sell a home – compared with a historical average of 36 days.

THE PROPERTY MARKET IN PICTURES

Figure 4. REINZ and QV house prices

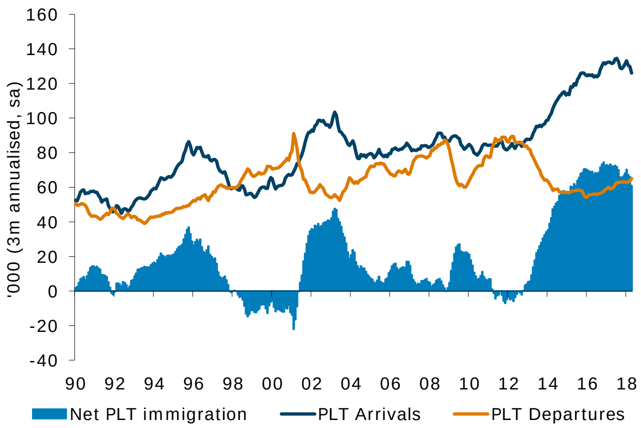


Source: ANZ, REINZ, QVNZ

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

The REINZ median sale price rose 1.1% (sa) in May and annual growth fell to 2.6% y/y (3mma). The QVNZ measure of price growth is running at 6.9% y/y. The REINZ HPI – our preferred measure – is sitting between the other two series (3.8% y/y 3mma).

Figure 5. Net permanent/long-term immigration



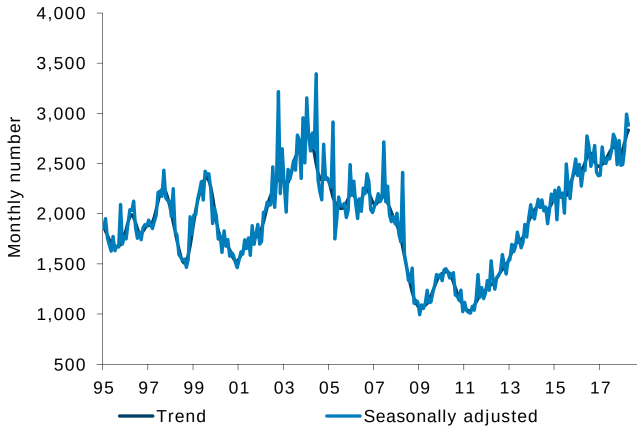
Source: ANZ, Statistics NZ

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

Net migrant inflows continue to gradually ease, but remain high. Annual net permanent long-term immigration remains high, but has eased off the 70,000+ peak seen in late 2016/early 2017 (3-month, annualised). We expect it to settle around 40,000 by 2020, still well above its historical average of 12,000.

In seasonally adjusted terms, a net inflow of 4,930 migrants was recorded in April, on par with February but down from 5,380 in March.

Figure 6. Residential building consents



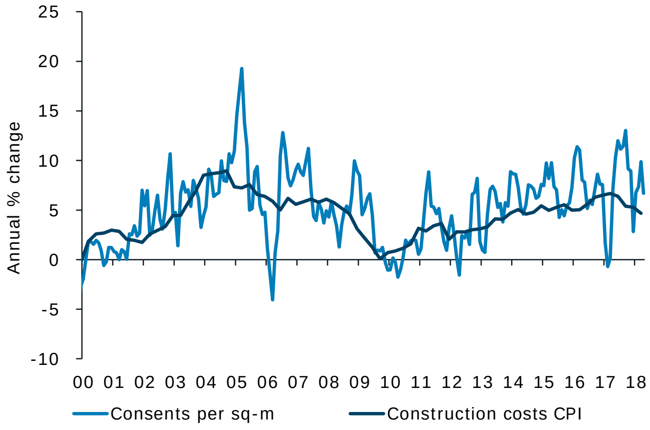
Source: ANZ, Statistics NZ

Dwelling consent issuance fell 3.7% mm/ in April. Some payback was expected after very strong growth in March (+13% m/m). Apartment consents have been volatile of late, with multi-dwelling consents down 6.9% m/m in April, following a 38.7% increase in March. Consents for 'houses' fell 1.4% m/m after holding at 0.1% m/m in March.

We expect consent levels will continue to stabilise. In trend terms, growth in dwelling consent issuance eased from 2.8% m/m in March to 1.7% in April. We expect this trend of moderating growth will continue, particularly given already-high levels. Dwelling consent issuance is running at a high level of 32,000 consents per annum and testing the limits of capacity constraints.

THE PROPERTY MARKET IN PICTURES

Figure 7. Construction cost inflation

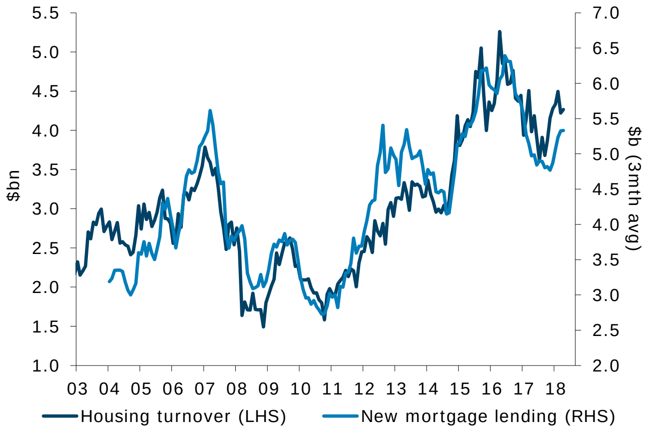


Source: ANZ, Statistics NZ

CPI construction costs have eased. The CPI inflation measure of construction costs eased to 4.7% in March 2018 (from 6.7% in March 2017) despite ongoing skilled worker shortages, squeezed margins and capacity constraints.

But cost pressures are still evident. The value of consents per square metre – a proxy for construction cost inflation – is running at 6.7% y/y (3mma). This is a volatile proxy of cost pressures, but is consistent with construction cost inflation continuing at its current moderate pace of 4.7%, or perhaps even pushing a touch higher. Despite disruptions in the construction industry, the construction activity pipeline is strong and should see construction cost pressures continue.

Figure 8. New mortgage lending and housing turnover



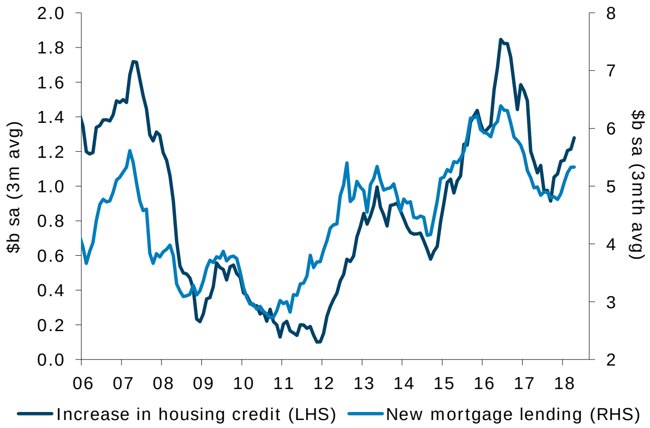
Source: ANZ, RBNZ

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

We estimate that new mortgage lending increased 3.8% m/m in April in seasonally adjusted terms (the chart is on a 3-month average basis). This increase reversed the similar sized fall seen in March. **New mortgage lending appears to be stabilising, following the recovery in housing market turnover late last year.**

New lending to first-home buyers is up strongly over the past year, rising 38% y/y in April. First-home buyer lending has stabilised at around 16% of overall lending.

Figure 9. New mortgage lending and housing credit



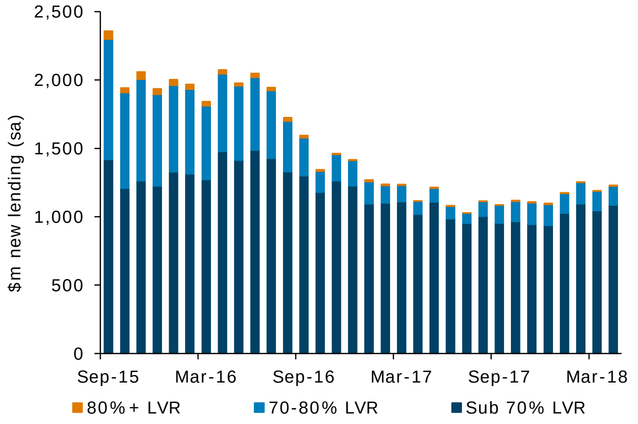
Source: ANZ, REINZ, RBNZ

In seasonally adjusted terms, total housing lending increased 0.5% m/m in April. In annual terms, credit growth is running at 5.7% y/y. **Housing lending has been growing at a consistent pace per month since early 2017.** Moderation is possible in coming months, given tentative signs of stabilisation in new mortgage lending.

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

THE PROPERTY MARKET IN PICTURES

Figure 10. Investor lending by LVR

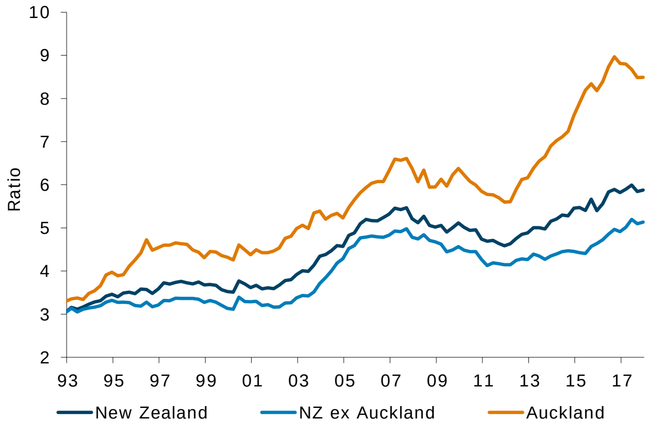


Source: ANZ, RBNZ

On a seasonally adjusted basis, new lending to investors increased 0.9% m/m in April. **New lending to investors has been flat since late 2016 –** increasing about $1.2bn per month. This is 40% below the $2bn of new lending per month seen through H1 2016.

Investor lending comprises 24% of new lending, down from 35% in mid-2016. This lower share relates, at least in part, to the impact of LVR restrictions (which came into force in October 2016). These restrictions were eased modestly at the start of the year and we expect further adjustments to be cautious. Investor lending is now on less-risky terms. In April, the share of total investor lending at LVRs of less than 70% was 91%. That is a far greater share than in late-2014, when it was less than half.

Figure 11. Regional house prices to income

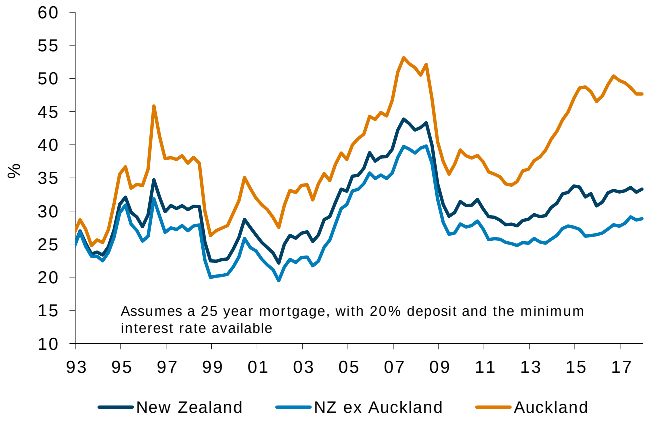


Source: ANZ, REINZ, Statistics NZ

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

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

Figure 12. Regional mortgage payments to income



Source: ANZ, REINZ, RBNZ, Statistics NZ

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

We estimate that for a purchaser of a median-priced home (20% deposit), the average mortgage payment to income nationally is around 33.3%. However, there are stark regional differences, with the average mortgage payment to income in Auckland just short of 50% for new purchasers. While (just) off its highs, it is still on par with the highs reached in 2007, despite mortgage rates being near historic lows currently. It highlights how sensitive some recent home-buyers in Auckland would be to even a small lift in interest rates.

PROPERTY GAUGES

The housing market is about as stable as it gets, with sales flat and price pressures gradually moderating. Underlying this, a number of opposing forces are at play. Strong population growth, pent-up demand, supportive financial conditions and further eventual easing of loan-to-value ratio restrictions will support prices. Bank prudence, affordability constraints, and government policy changes are expected to keep prices and activity contained. Our current forecast is for stability in the housing market, but we suspect there could be some bumps in the road ahead.

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

AFFORDABILITY. For new entrants into the housing market, we measure affordability using the ratio of house prices to income (adjusted for interest rates) and mortgage payments as a proportion of income.

SERVICEABILITY / INDEBTEDNESS. For existing homeowners, serviceability relates interest payments to income, while indebtedness is measured as the level of debt relative to income.

INTEREST RATES. Interest rates affect both the affordability of new houses and the serviceability of debt.

MIGRATION. A key source of demand for housing.

SUPPLY-DEMAND BALANCE. We use dwelling consents issuance to proxy growth in supply. Demand is derived via the natural growth rate in the population, net migration, and the average household size.

CONSENTS AND HOUSE SALES. These are key gauges of activity in the property market.

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

GLOBALISATION. We look at relative property price movements between New Zealand, the US, the UK, and Australia, in recognition of the important role that global factors play in New Zealand's property cycle.

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

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

Indicator	Level	Direction for prices	Comment
Affordability	Unaffordable	↔/↓	Affordability constraints are very relevant. It is the main reason we see the Auckland market underperforming over the next few years.
Serviceability/ indebtedness	High debt, low rates OK. High rates not.	↔/↓	Serviceability looks okay provided interest rates stay low and the unemployment rate keeps trending lower. Debt levels are high.
Interest rates / RBNZ	Slow ascent	↔/↓	The case can be argued that the OCR is not moving for a long time. We're still favouring a couple of OCR hikes eventually.
Migration	Peaked	↔	The cycle appears to have turned ahead of potential policy changes. But inflows are not set to fall sharply.
Supply-demand balance	Demand > Supply	↔/↑	MBIE estimates New Zealand is short 71k houses, with a shortage of 45k in Auckland.
Consents and house sales	Shortage	↔/↑	We expect consents issuance will struggle to push higher, with the construction sector reaching its limits.
Liquidity	Tight	↔/↓	Credit rationing is apparent. Closure of the bank funding gap means there is more wriggle room, but resurgence is not expected.
Globalisation	Mixed bag	↔	Non-resident buyers don't appear to be very influential. Other big global housing markets looking stable too.
Housing supply	Too few	↔/↑	The Government is going to take a more active role, but there are still questions about crowding out other work and labour shortages.
House prices to rents	Too high	↔/↓	Rents are moving up, but only gradually, suggesting that existing housing shortages aren't the only game in town.
On balance	**Flat-lining**	↔	**Positives offset the negatives, leaving the market steady. Auckland to remain weak as affordability bites hard.**

PROPERTY GAUGES

Figure 1: Housing affordability

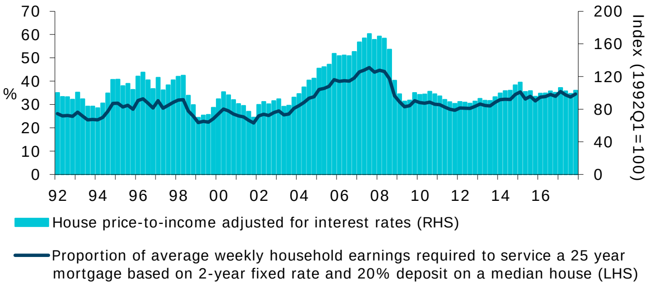


Figure 2: Household debt to disposable income

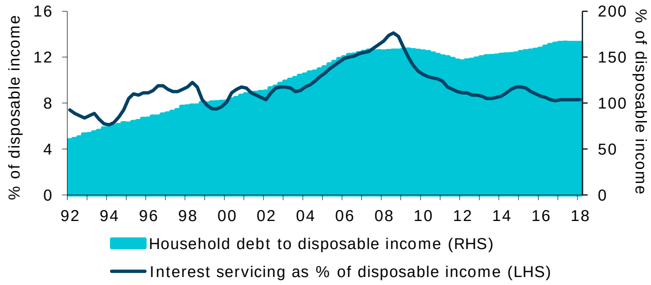


Figure 3: New customer average residential mortgage rate (<80% LVR)

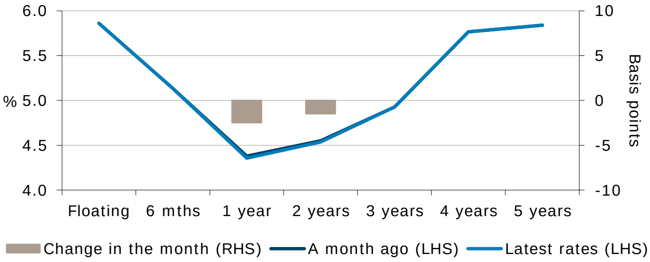


Figure 4: Net immigration

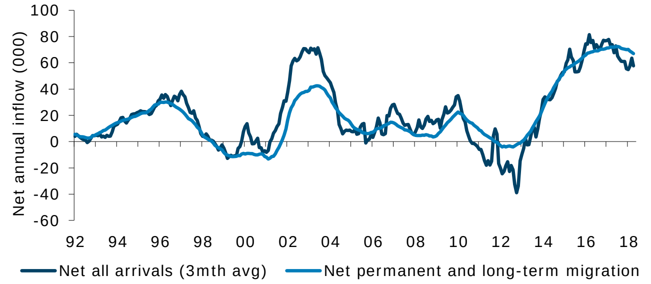


Figure 5: Housing supply-demand balance

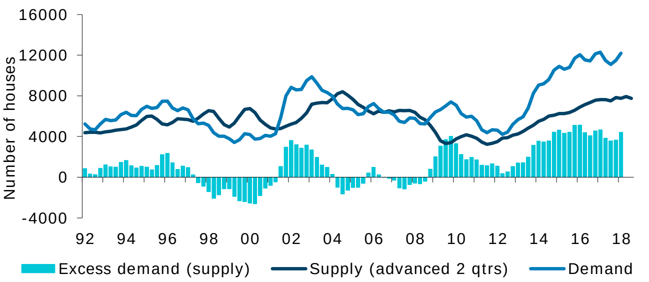


Figure 6: Building consents and house sales

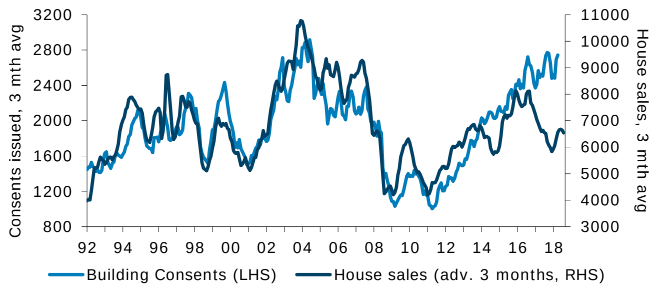


Figure 7: Liquidity and house prices

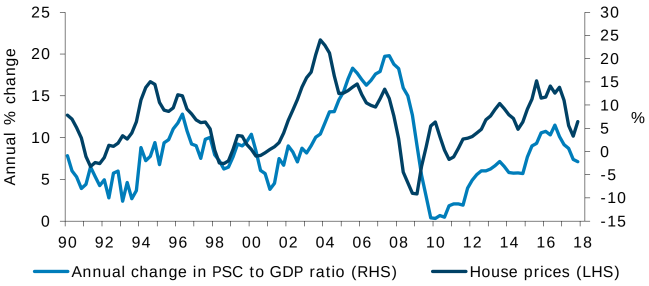


Figure 8: House price inflation comparison

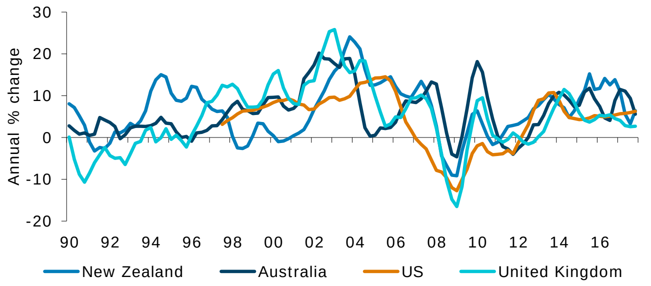


Figure 9: Housing supply

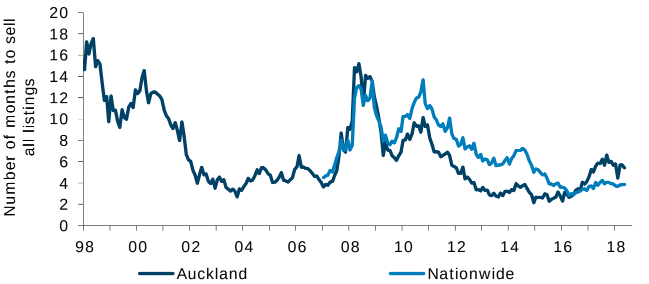
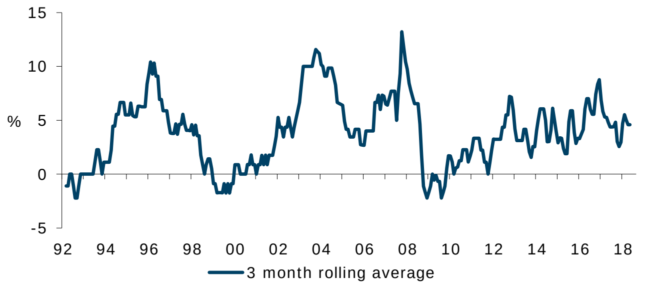


Figure 10: Median rental, annual growth



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

ECONOMIC OVERVIEW

SUMMARY

The economic dataflow has been fairly lacklustre of late. Business sentiment remains subdued, household spending has taken a hit, and indicators of economic activity into 2018 have been on the softer side. Growth momentum in the economy continues to slow, and we expect GDP growth is currently tracking below trend. Nonetheless, we think this economic cycle has some way to go yet. Strong income growth (in part a result of our elevated export prices) and fiscal expansion are expected to see the economy grow around trend over the next couple of years. But it is fair to say that downside risks to the outlook for GDP and inflation have increased a little of late. In this environment, the RBNZ will remain cautious – with interest rates on hold for some time yet.

OUR VIEW

The domestic economic dataflow has been fairly lacklustre of late:

- **Business sentiment remains subdued.** Business confidence has remained pessimistic well beyond the election, and this is being reflected in employment and investment intentions.
- **Indicators of activity have been on the softer side.** GDP growth looks to have been on the softer side into 2018 and we expect this softness could persist in the near term, given the subdued business environment.
- **Household spending has taken a hit.** Electronic card spending data indicate that the trend in household spending growth has moderated, despite being propped up by population growth and tourist spending.

This is in the context of an economy grappling with challenges and a more moderate (albeit above trend) global growth picture. **It's fair to say that the economy is experiencing a softer patch.** Growth momentum in the economy continues to slow, and we expect GDP growth is currently tracking below its trend rate (of around 3%).

In the current environment, achieving strong rates of growth will be difficult. The economy is facing headwinds in the form of credit constraints, capacity pressures, margins squeeze, and policy uncertainty. Typical challenges to experience this late in the cycle. Construction, tourism and immigration – key drivers of recent growth – are expected to have topped out, meaning it will be difficult to achieve strong rates of growth from here. The housing market is stable, but there could be some bumps in the road ahead. A number of offsetting forces are at play and are currently balancing out, but downside risks are evident. We expect that consumption growth will continue to soften in the face of recent cooling in the housing market, particularly since we think households will be looking to rebuild their saving buffers.

Nonetheless, we think this economic cycle has some way to go yet. Strong income growth is supportive (in part a result of our elevated export prices, with the global backdrop positive) and fiscal expansion will provide a boost, while monetary policy is expected to remain accommodative for an extended period**.** The labour market is strong, which bodes well for household income growth and consumption – and potentially higher real wage growth. And we are not experiencing external imbalances or strong inflation (necessitating higher interest rates) that might usually stop the economy in its tracks.

We expect that the economy will emerge from this soft patch and grow around trend for the next couple of years. But it is fair to say that downside risks have increased. On the other hand, stronger investment or productivity growth could tip the balance and see GDP grow above trend stronger than we expect. We suspect business investment will need to improve from here for that to come to pass.

The underlying inflation pulse remains muted, confirmed by the moderation in our ANZ Monthly Inflation Gauge of late. The softer outlook for GDP growth is of course relevant for the RBNZ; growth of at least at trend is needed to see resource pressures increase, which is important for the core inflation outlook. Depreciation in the exchange rate as global interest rates rise may put the wind up tradable inflation, spilling over to domestic price pressures. But the trade-weighted exchange rate remains elevated (albeit about 5% lower than a year ago), supported by our high export prices – and we expect it will decline only gradually.

Strength in the labour market should contribute to wage inflation, and Government policies are supportive of higher wage expectations. Given that firms' margins are already very thin, higher labour costs may contribute to a more generalised pick-up in inflation. But the outlook is uncertain. If the market would not otherwise have supported higher wage and price inflation, any pick-up could dissipate quickly.

With the inflation pulse muted and the GDP outlook a little softer, the RBNZ will remain cautious – with interest rates on hold for some time yet.

MORTGAGE BORROWING STRATEGY

SUMMARY

Average fixed mortgage rates have hardly changed over the past month. We still favour the 1-year fixed rate, although it remains a close call with the 2-year rate, particularly if you are concerned about a faster lift in inflation (perhaps driven by stronger wage growth) that spurs the RBNZ into earlier rate hikes. That is not our view though, and we prefer fixing for shorter durations at present. But ultimately, borrowers may wish to spread risk by borrowing over a number of fixed terms, which is always a strategy that makes sense from a risk-management perspective.

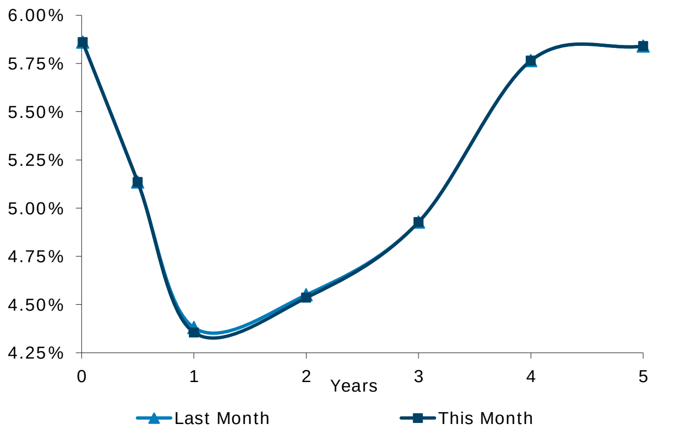
OUR VIEW

Average mortgage rates across the 'big four' banks have barely moved over the past month. There was some small movement in the average special 1- and 2-year rates, and as has been the case for some time, the 1-year rate remains the lowest point on the curve, at 4.36%.

Given that rates are little changed, so too is our favoured view. We continue to think the 1-year fixed rate offers value, although it is a close call with the 2-year rate. The RBNZ continues to emphasise that it is some way away from removing stimulus, and we haven't changed our own forecast that the first OCR hike won't occur before August 2019. In saying that, the outlook for the OCR is perhaps becoming a little more polarised. On the one hand, softer activity data of late, if sustained, increases the possibility of future interest rate cuts. On the other hand, the possibility that inflation pressures will build from here highlights the risk that if the data stabilises, the RBNZ may have to tighten more aggressively than currently priced. That makes for a somewhat nuanced story, but in our view, borrowing at the 1- or 2-year tenors help to best balance those risks.

Breakeven analysis supports this message. For instance, the average 2-year special rate is just 18bps above the 1-year rate. It means that the 1-year rate would need to rise by 36bps (from 4.36% to 4.72%) over the next year in order for it to be cheaper fixing for 2 years at 4.54% than rolling two 1-year terms. **That is not out of the question.** There continues to be a larger step-up between the 2 year and 3 year (39bps); the breakeven on a 2-year at 4.54% versus a 3-year at 4.93% is 5.21%. Again, that degree of lift in the 2-year rate is also not out of the question, although would require greater confidence that domestic inflation pressures are lifting in a sustained fashion in our view or see global rates continue to push higher.

Carded special mortgage rates^



Special Mortgage Rates		Breakevens for 20%+ equity borrowers			
Term	Current	in 6mths	in 1yr	in 18mths	in 2 yrs
Floating	5.86%				
6 months	5.14%	3.58%	4.63%	4.81%	5.52%
1 year	4.36%	4.10%	4.72%	5.16%	5.71%
2 years	4.54%	4.63%	5.21%	6.02%	7.00%
3 years	4.93%	5.38%	6.24%	6.48%	6.71%
4 years	5.77%	5.89%	6.21%		
5 years	5.84%	#Average of "big four" banks			

Standard Mortgage Rates		Breakevens for standard mortgage rates*			
Term	Current	in 6mths	in 1yr	in 18mths	in 2 yrs
Floating	5.86%				
6 months	5.21%	4.55%	5.45%	5.07%	5.96%
1 year	4.88%	5.00%	5.26%	5.52%	6.14%
2 years	5.07%	5.26%	5.70%	6.08%	6.66%
3 years	5.43%	5.72%	6.19%	6.41%	6.73%
4 years	5.87%	6.06%	6.36%		
5 years	6.07%	*may be subject to a low equity fee			

As we mentioned last month, the decision of where to fix is becoming more nuanced, as we can see both upside and downside risks to interest rates. It should therefore come down to borrowers' personal circumstances and relative preference for certainty or not. We still don't see the conditions necessary for the RBNZ to start to lift the OCR within the next 12 months. However, with the mortgage curve flattening a little, there is some value for those borrowers that are concerned by that possibility. Spreading borrowing over a number of fixed terms is always a strategy that makes sense from a risk-management perspective; having a number of 'tranches' rolling over more regularly does smooth interest expenses.

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

KEY FORECASTS

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

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

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

	House prices (ann % chg)	3mth % chg	No of sales (sa)	Mthly % chg	Avg days to sell (sa)
Northland	6.3	4.4	194	-11%	46
Auckland	-1.1	-2.3	1,886	+2%	39
Waikato	4.4	-0.5	649	-4%	40
Bay of Plenty	9.5	1.1	481	0%	43
Gisborne	-5.5	4.2	60	+4%	41
Hawke's Bay	13.3	2.0	246	+5%	30
Manawatu-Whanganui	12.4	5.4	409	0%	32
Taranaki	0.3	0.2	166	+7%	33
Wellington	7.9	2.9	714	+1%	29
Tasman, Nelson and Marlborough	1.0	2.5	271	+12%	35
Canterbury	1.7	-0.1	909	+7%	37
Otago	14.1	3.7	382	+3%	31
West Coast	25.6	15.4	46	+18%	90
Southland	-1.9	-0.8	165	+2%	32
NEW ZEALAND	**4.8**	**-1.1**	**6,462**	**-2%**	**37**

Key forecasts

	Actual			Forecasts						
Economic indicators	**Jun-17**	**Sep-17**	**Dec-17**	**Mar-18**	**Jun-18**	**Sep-18**	**Dec-18**	**Mar-19**	**Jun-19**	**Sep-19**
GDP (Ann % Chg)	2.8	2.7	2.9	2.6	2.6	2.9	3.0	3.3	3.1	2.8
CPI Inflation (Annual % Chg)	1.7	1.9	1.6	1.1(a)	1.4	1.6	1.7	1.9	2.1	2.1
Unemployment Rate (%)	4.8	4.6	4.5	4.4(a)	4.1	4.0	3.9	4.0	3.9	3.9
House Prices (Annual % Chg)	7.1	3.3	3.6	3.9(a)	4.2	4.6	3.0	2.0	2.0	2.0
Interest rates (RBNZ)	**Sep-17**	**Dec-17**	**Mar-18**	**Jun-18**	**Sep-18**	**Dec-18**	**Mar-19**	**Jun-19**	**Sep-19**	**Dec-19**
Official Cash Rate	1.75	1.75	1.75	1.75	1.75	1.75	1.75	1.75	2.00	2.25
90-Day Bank Bill Rate	2.0	1.9	2.0	2.0	2.0	2.0	2.0	2.1	2.3	2.5
Floating Mortgage Rate	5.8	5.8	5.8	5.8	5.8	5.8	5.8	5.8	6.0	6.3
1-Yr Fixed Mortgage Rate	4.9	4.9	4.9	4.9	4.9	4.9	4.9	5.0	5.2	5.3
2-Yr Fixed Mortgage Rate	5.1	5.1	5.1	5.0	5.1	5.2	5.2	5.3	5.5	5.5
5-Yr Fixed Mortgage Rate	6.0	5.9	5.9	5.9	6.1	6.2	6.2	6.4	6.5	6.6

Source: ANZ, Statistics NZ, RBNZ, REINZ

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