NEW ZEALAND PROPERTY FOCUS

HOLDING THE KEY

INSIDE

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SUMMARY

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

FEATURE ARTICLE: HOLDING THE KEY

It is widely known that housing is expensive in New Zealand. But we think the effects of unaffordable housing might be much more pervasive than generally appreciated. Not only does the high hurdle to purchasing homes have important implications for wealth equality, generational equity and financial stability, but it also impacts the economy’s productive potential. High house prices make it more difficult for younger households to invest in businesses, limiting the entrepreneurial endeavours of younger people. They also create barriers to labour mobility and social mobility, both of which matter for achieving our productive potential. And to the degree that high house prices are a symptom of excess domestic demand pressure, they will be associated with upward pressure on the real exchange rate, stifling exporting and import-competing activity. The challenges of low productivity growth and housing unaffordability are both complex and difficult to solve, but in our view these issues are inextricably linked.

PROPERTY GAUGES

The housing market has softened recently, with house prices flat and sales down in the June quarter. Affordability constraints, uncertainty around new Government policies, prudence on the part of banks, and a softer pulse in the economy are providing headwinds, and there is a risk that recent softening could persist. However, we see the downside as being limited. Population growth, pent-up demand and low interest rates are still supportive of demand for housing, and softening in the housing market would be consistent with the RBNZ further loosening loan-to-value ratio restrictions. While there could be some bumps in the road ahead, conditions are supportive of continued price increases, even if it is at a more moderate pace than previously.

ECONOMIC OVERVIEW

Economic momentum has slowed and downside risks to growth have increased. Business pessimism is impacting firm’ decisions, spending growth has moderated, and the housing market has softened. While commodity prices are elevated, the shine has started to come off recently. That said, we don’t expect growth is about to roll over just yet. And while inflation is low in the scheme of things, core inflation is on the rise, with cost pressures set to see inflationary pressures increase further from here. Nonetheless, the outlook for inflation is far from certain, justifying continued caution from the RBNZ. In recent communications the RBNZ has sent a very clear message that it is determined to meet its inflation target, with a move up or down in interest rates equally likely. If inflation materialises as we expect, the RBNZ will eventually increase the OCR – but that’s a long way away yet and any moves will be gradual.

MORTGAGE BORROWING STRATEGY

Average fixed mortgage rates have fallen a little further over the past month. We still favour the 1-year fixed rate, and actually have a little more conviction in this view relative to last month given that we see even further reduced chance of an RBNZ interest rate hike any time soon (we have pushed out when we see the first RBNZ OCR hike to November 2019 from August). Some borrowers may want to spread risk over a number of fixed terms, but ultimately, we continue to see the most value in fixing for shorter durations.

FEATURE ARTICLE: HOLDING THE KEY

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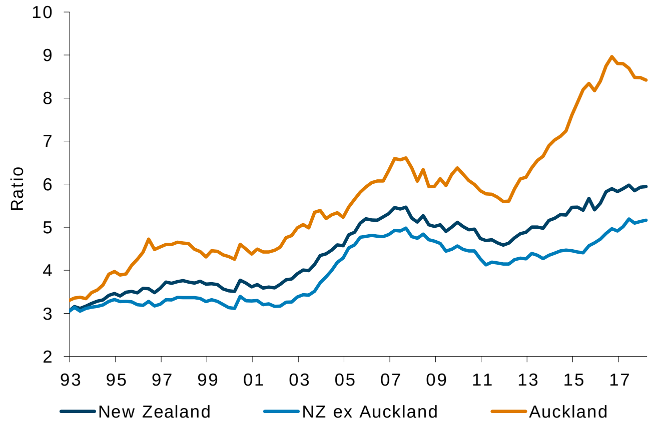
THE IMPACTS OF EXPENSIVE HOUSING

It is widely known that house prices in New Zealand are high and unaffordable for many. House prices have more than tripled in real terms since the early 1990s, and are high relative to incomes and on an international basis. But not only that, rents have increased more than incomes over this time as well, meaning renting has become more expensive too, particularly for those in the lower part of the income distribution.[1]

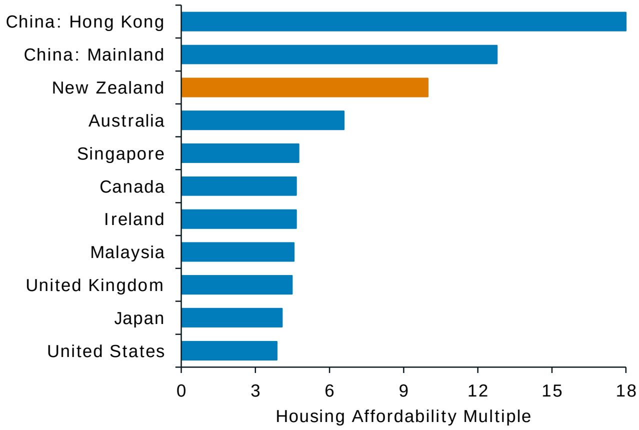
It will come as no surprise, but 'housing' on the whole is expensive in New Zealand.

Figure 1. House prices relative to incomes in New Zealand



Source: Statistics NZ, REINZ, ANZ Research

Figure 2. International housing affordability



Source: Demographia, E-House, Kazannah Research Institute, ANZ Research

High house prices have important implications for wealth equality, generational equality and financial stability:

Wealth equality

High house prices exacerbate existing wealth inequalities; they create an obstacle to entering the market, increasing the divide between those who own and those who do not. As house prices have risen, home ownership rates have declined. In 2001 55% of people owned their own home, compared with 50% in 2013. High house prices and declining rates of home ownership are important from the perspective of fairness – but also for outcomes in society. Home ownership is associated with greater stability, better educational outcomes and income prospects (controlling for other factors), and more favourable living standards in retirement.[2] Moreover, expensive housing creates a significant fiscal cost, with the Government providing support to those in need.

Generational equality

The fall in home ownership has been starker for those aged between 30 and 49 years – with declines in home ownership rates for these cohorts between 10 and 12 percentage points (since 2001). Interest rates are lower in real terms than a few decades ago, making mortgage servicing more manageable for a given level of debt. But people purchasing homes in New Zealand today still have to take on near-record levels of debt to buy a house. And not only this, they have to save longer to cobble together a deposit. When it comes to access to housing, younger generations are worse off than their parents were.

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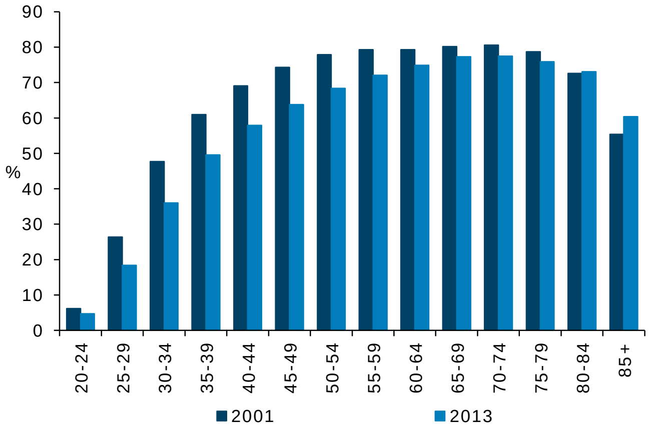
[1] Briefing for the Incoming Minister of Housing & Urban Development (2017).
[2] See New Zealand Productivity Commission (2012) for more details and references.

Financial stability

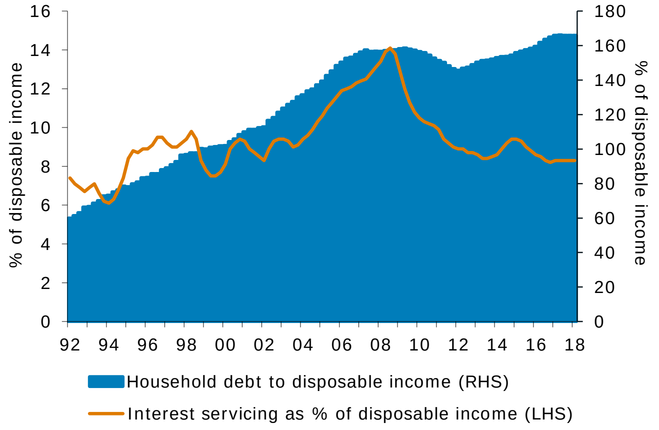
High house prices and high debt levels go hand in hand. The causality goes both ways: high debt levels allow people to purchase expensive homes, and purchasing expensive homes requires high debt levels. As a result, the exposure of both households and the banking system to the housing market is high, and financial distress could result if house prices were to fall sharply, which could have systemic effects on New Zealand's financial system as a whole. Macroeconomic instability could also impact business investment and long-term economic prospects.

Figure 3. Home ownership rates



Source: Statistics NZ, ANZ Research

Figure 4. Household debt to disposable income



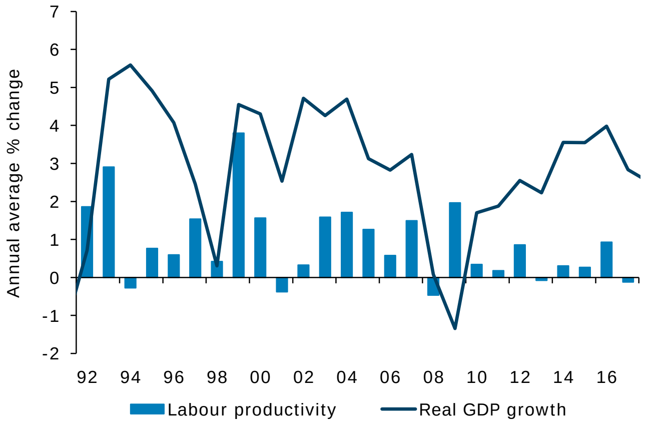
Source: RBNZ, ANZ Research

THE PRODUCTIVITY LINK

In addition to the implications for wealth equality, generational equality and financial stability, which are the factors most commonly cited when talking about the 'problem' of high house prices, we suspect the negative impact of high house prices goes deeper than that. High house prices impact the productivity of the economy.

Productivity growth is crucially important for our economic performance and prosperity. The most significant determinant of differences in per capita incomes between countries is their productivity performance – and productivity growth in New Zealand has been lacklustre in recent decades. The Productivity Commission has discussed this issue at length.[3] In their work, they note that productivity growth was strong from the mid-1980s until 2000, following the onset of economic reform. But in more recent decades, productivity growth has slowed – and New Zealand has consistently been an underperformer relative to its OECD peers. We estimate that labour productivity grew 1.6% per annum on average through the 1990s, 1.0% per annum through the 2000s, and a very subdued 0.3% on average from 2010 until present.

Figure 5. Labour productivity and real GDP growth



Source: Statistics NZ, ANZ Research

[3] Conway & Meehan (2013)

The impact that high house prices has on the economy's productivity performance is through a number of channels. In our view, these productivity effects are more important and pervasive than generally appreciated.

Lack of social mobility

In a similar way to wealth inequality, when housing is expensive, it makes it difficult for people to get ahead, and 'break the cycle' so to speak. It has been shown that poor housing outcomes are associated with poor health and educational outcomes, which in turn then impacts on productivity.[4] Those effects create the risk that undesirable economic outcomes becoming persistent across generations, with younger cohorts limited in achieving their potential.

Lack of labour and business mobility

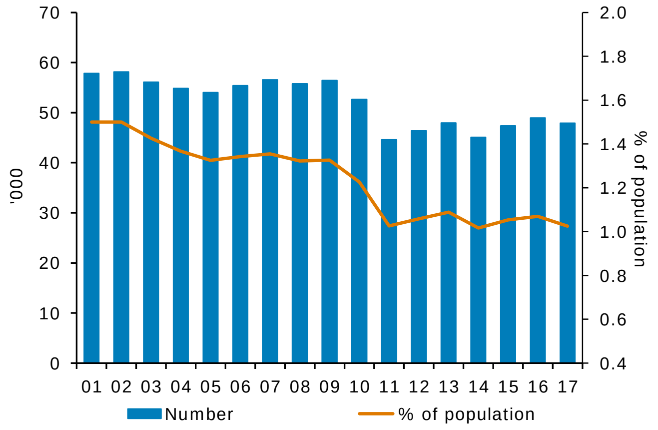
High house prices make it difficult for both workers and businesses to move to locations that will prove more productive, meaning that resources are not allocated in the most efficient way possible. This makes the economy less flexible and dynamic, and limits the scope for urbanisation and agglomeration benefits. A nice example of the detrimental impact of housing costs on labour mobility is the Canterbury earthquakes. In a perfect world, with the Canterbury rebuild effort maturing, resources would relocate to other regional pressure points, such as Queenstown or Auckland. Now that may be happening to a small degree, but given those workers are most likely to take an effective pay cut to move to these regions given the costs of housing, we suspect many are questioning the incentives to do so.

Barriers to investing in businesses

High house prices and housing costs make it more difficult for some households to invest in businesses. Why is that important? Well, for one, businesses require capital to expand, and the marginal cost of capital will be higher than it would have been otherwise if a greater share of the domestic pool of saving is being pulled in to fund housing to meet excess demand pressures. Those that already own houses can use wealth gains to invest in businesses. But because they are typically older and instead are looking to use this equity to fund retirement, we suspect this is not happening to the degree it would otherwise.

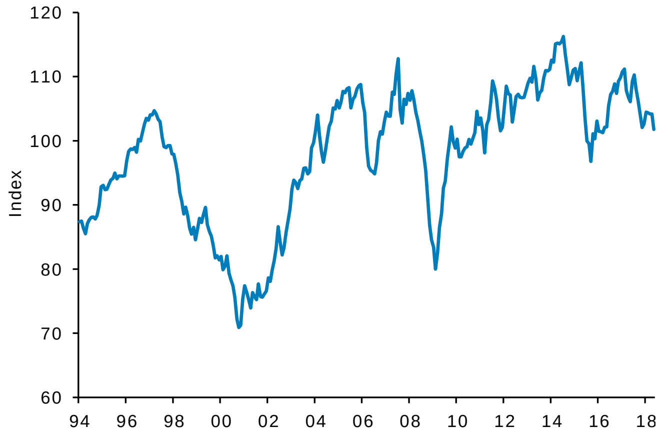
But the issue goes broader than that. The ongoing establishment of new businesses has an important influence on productivity as new firms tend to be more innovative.[5] And while accessing figures on this is difficult, we suspect new businesses are more likely to be created and owned by younger people, which as mentioned above, are facing more and more capital constraints these days due to housing costs. In addition, our discussions with businesses reveal that succession planning is also an issue for existing businesses, and we suspect housing affordability and the impact this is having on younger generations is a factor. Succession issues can constrain profitable businesses from continuing to operate. And to the extent that business interests are inherited through families while others are locked out, wealth inequality is prolonged and exacerbated as a result.

Figure 6. People who are self employed



Source: Statistics NZ, ANZ Research

Figure 7. Real exchange rate



Source: BIS, ANZ Research

It is difficult to find definitive evidence of the impact expensive housing may be happening on business ownership in the New Zealand data. But one observation that may be a consequence of this phenomenon is a declining rate of self-employment amongst the population (figure 6).

[4] OECD (2010) & World Bank (2008)
[5] OECD (2015)

Crowding out

To the extent that high house prices are a symptom of excess demand pressure (perhaps exacerbated by strong population growth for example), for a given level of domestic saving (which is low in New Zealand – hence our persistent current account deficits), this will tend to push up real interest rates. And all else equal, these higher interest rates will result in a higher real exchange rate than would otherwise be the case, potentially stifling exporting and import-competing activity.

There is debate surrounding the extent to which excess demand has contributed to upward pressure on the real exchange rate in New Zealand compared with other factors like our low rates of saving, the remoteness and perceived riskiness of the economy, and our shallow capital markets.[6] But we suspect the exchange rate is higher than would otherwise be the case as a consequence of a combination of these factors. To the extent that excess demand pressures are at play, housing unaffordability may be impacting our broader productivity by crowding out the tradables sector through this channel.

OUR PRODUCTIVITY PROBLEM

Admittedly, New Zealand's poor productivity performance is a complex problem, and the impact from high house prices and housing unaffordability is only one part of the issue. Quick fixes are not easy to come by. In fact, there is nothing quick about fixing this at all.

In addition to the housing issues we discuss above, the Productivity Commission has also highlighted some other important issues explaining New Zealand's 'productivity problem':[7]

- **There is a lack of technology diffusion into New Zealand.** Those firms that are on the frontier in terms of productivity performance in New Zealand are one third less productive than international peers. And firms that are not at the frontier tend to perform even worse. Increased international connectedness would help and New Zealand is additionally challenged on this front because it is quite remote.[8] Our high real exchange rate does us an impediment too, related to our high levels of interest rates relative to other developed nations.
- **Resources are not well allocated.** Productive firms do not necessarily have greater market share in New Zealand compared with less productive firms, and there is evidence that productive capital has a tendency to accrue to relatively unproductive firms. Contrary to expectations, productive firms do not outperform and laggards do not shrink to the extent that would happen in more competitive markets offshore. Increased competition would help. Well-targeted migration and targeted upskilling of New Zealand workers is beneficial in the allocation of resources.
- **Business investment and capital available per worker is quite weak.** More investment and innovation would useful, especially if firms are well connected and knowledge is diffused. It is possible that business investment is weak because our market is small and isolated, but another important factor is that interest rates are quite high in New Zealand. As discussed previously, high interest rates likely reflect a mixture of excess demand pressures and low rates of saving. Addressing these would help.

The Productivity Commission notes that improving the responsiveness of housing supply is an important element to addressing excess demand pressures, particularly given strong population growth. More responsive housing supply would improve productivity by dampening interest rates and by improving housing affordability. We agree that improving the responsiveness of housing supply would be beneficial for productivity growth. Indeed, we would emphasise more broadly that improving housing affordability is an important part of any solution to tackle our productivity problem.

Like other aspects of our low productivity, improving housing affordability is difficult. People have made long-term plans based on house prices where they are, or on the assumption that they will continue rising. Rising house prices are bad, or at least they are when they rise strongly over a prolonged period. But for those who own homes, falling house prices are also problematic, especially when debt levels are high. It appears to be an irreconcilable tension, which means that any policy action needs to balance impacts on a range of different people.

[6] See Reddell (2013) & Treasury (2010).
[7] These issues and more are discussed in Conway (2016).
[8] See OECD (2015).

To keep house prices in check, a steady stream of new supply and greater responsiveness of supply is crucial. A long-term solution requires that more supply can be made available in future, not just that more houses are available now. To do this, more land needs to be made available, with a steady future pipeline in train, and measures need to be taken to improve the capacity and flexibility of the construction sector so that it can respond to demand pressures. Productivity improvements in construction would help.

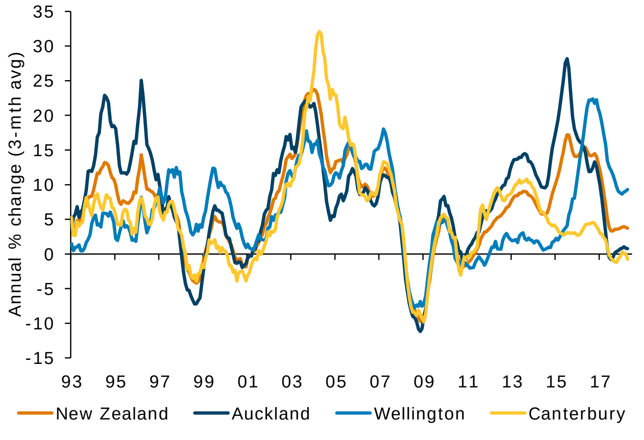
Making housing supply more responsive would also have the benefit of making any price adjustment more orderly, which would be beneficial from a financial stability perspective; supply constrained markets are associated with not only high but also more variable house price inflation.[9] A clear plan for migration (with well-targeted skill matching) is also an important aspect of managing housing market pressures, with investment in housing supply and infrastructure needed in order to accommodate migration policy settings.

The other important aspect of improving housing affordability is improving incomes – and the most important long-term determinant of income growth is productivity. Ultimately, the issues of low productivity growth and unaffordable housing are inextricably linked. More affordable housing would be good for productivity, and better productivity could help improve housing affordability, provided the market is responsive and house prices don't increase in tandem. Measures aimed at tackling both issues would have positive impacts on the long-term performance of the economy and those impacts may be reinforcing.

[9] See Huang & Tang (2012).

PROPERTY MARKET IN PICTURES

Figure 1. Regional house price inflation

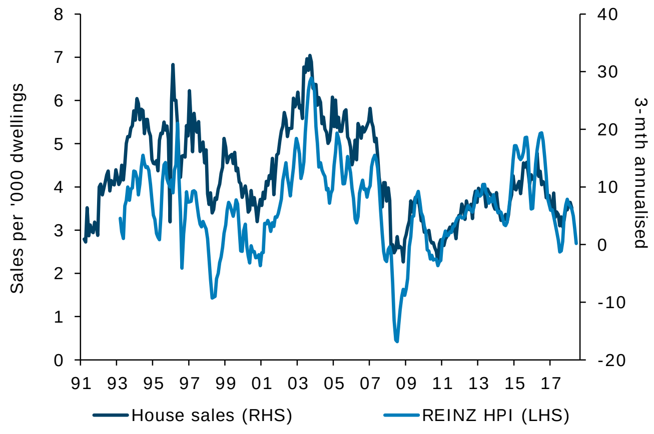


Source: ANZ, REINZ

The June quarter was on the softer side, with house prices flat on average over the quarter. The REINZ House Price Index (HPI) was flat in the June month, after falling 0.3% and 0.2% in each of the previous two months. In 3-month average terms, house prices were flat over the quarter and annual growth moderated slightly from 3.8% to 3.7% y/y. Annual house price inflation has been hovering in the 3-4% range since August last year.

Underlying this, regional divergence is stark. House prices in Auckland continue to fall, while other markets remain tight. In Auckland, house prices were down 0.3% m/m to be down 1.5% in the quarter and up 0.8% y/y. In the rest of New Zealand, prices increased 0.3% m/m to be up 1.6% in the quarter and 6.6% y/y. There were particular pockets of strength in Hawke's Bay, Manawatu-Whanganui, Wellington and Otago over the quarter.

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 pared back in June to 6,100 sales in the month (sa) after running at about 6,500 per month since November. House sales volumes fell 7.5% m/m (sa) to be down 3.9% over the quarter (3-month average) and down 1.7% y/y. Declines were broad based, with sales down in all regions except Hawke's Bay and Taranaki.

Housing markets are generally tight outside of Auckland. While sales have fallen, so too have listings – and inventories and days to sell are low. In this environment, regional divergence is likely to continue.

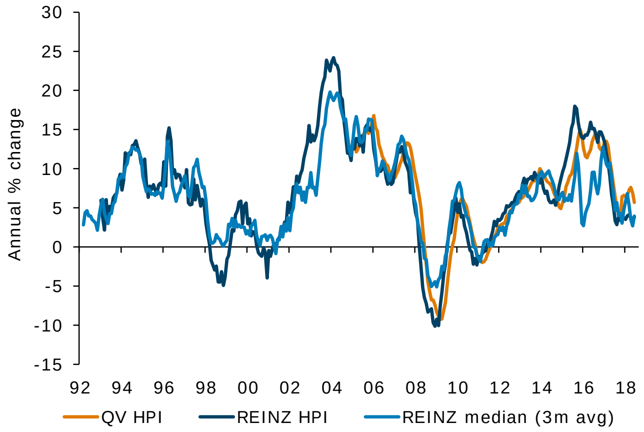
Figure 3. Sales and median days to sell

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. Nationwide the median time to sell a house increased 1 day to 38 days in June (sa), reflecting an increase from 39 to 41 days in Auckland, while the rest of the country was broadly stable. Market tightness is broad based across a range of regions and supportive of further price growth, even if at a more moderate rate than previously nationwide.

Figure 4. REINZ and QV house prices

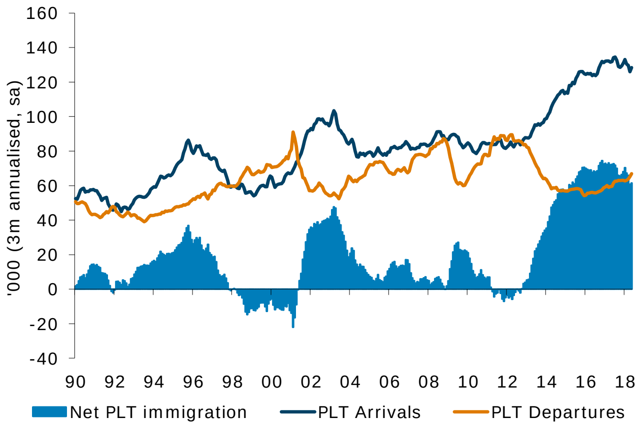


Source: ANZ, REINZ, QVNZ

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 0.9% m/m (sa) in June. Annual growth is running at 4.0% y/y (3mma). The QVNZ measure of price growth has moderated to 5.7% y/y. The REINZ HPI – our preferred measure – is sitting a touch below the other two series (3.7% y/y 3mma).

Figure 5. Net permanent/long-term immigration

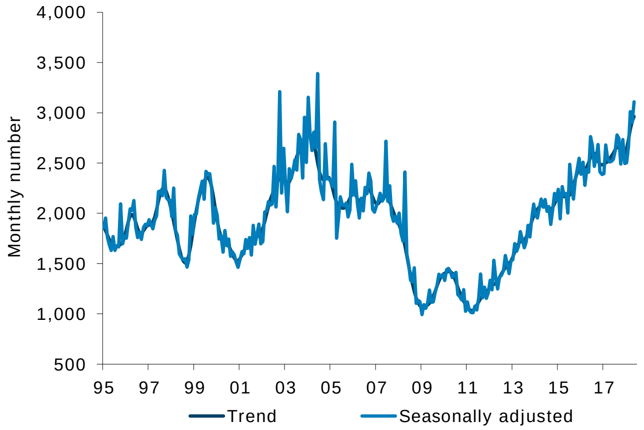


Source: ANZ, Statistics NZ

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.

In seasonally adjusted terms, a net inflow of 5,090 migrants was recorded in May, as arrivals partially rebounded their April dip and departures continued to rise. **Despite the monthly increase, the cycle is continuing to ease gradually from high levels.** Annual net permanent long-term net migration was sitting at 66,000 in May, down from more than 67,000 in April and its peak of 72,400 in July last year.

Figure 6. Residential building consents

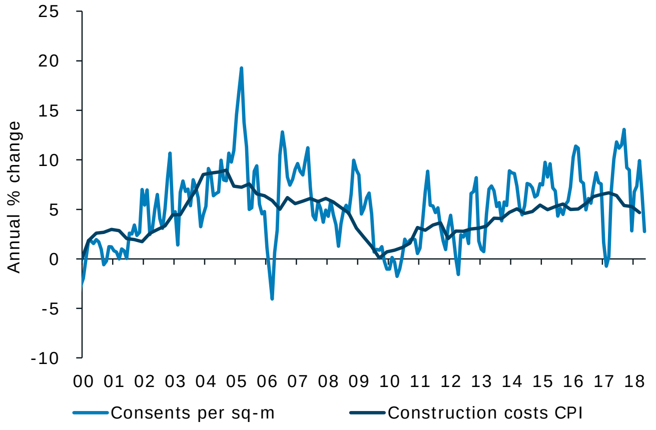


Source: ANZ, Statistics NZ

Dwelling consent issuance increased 7.1% m/m in May. This followed a 3.6% fall in April. Apartment consents have been volatile of late, with multi-dwelling consents up 7.9%, following a 7.4% fall in April. But consents for houses, which tend to be less volatile, were up 6.5%, after dipping 1.0% in April. There were 32,600 residential dwelling consents issued in the year to May. Annual consent issuance is below its record of 33,200, which was reached only briefly in 2004.

Consent issuance is testing capacity constraints and the sustainability of these levels will be tested in coming months. The construction industry is experiencing significant constraints and is dealing with a number of challenges. Issuance could try to push higher, but we think the scope of this will be limited.

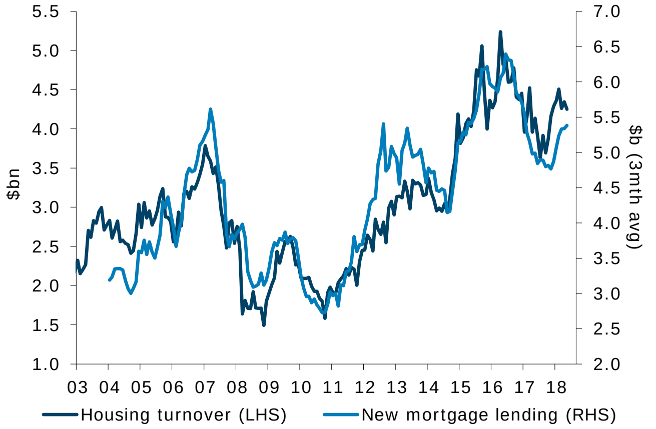
Figure 7. Construction cost inflation



Source: ANZ, Statistics NZ

Construction cost inflation remains evident. The CPI inflation measure of construction costs was up 3.9% y/y in June 2018. This is down from the recent peak of 6.7% in March 2017. The value of consents per square metre – a proxy for construction cost inflation – moderated to 2.8% y/y (3mma). This is a volatile proxy of cost pressures, so we are not reading too much into the recent moderation and expect it is consistent with construction cost inflation continuing at its current rate. Construction costs pressures continue on the back of skilled worker shortages, squeezed margins and capacity constraints. Anecdotes are beginning to suggest that impetus to building cost inflation may be waning, but we are not seeing weakness, at least at this stage.

Figure 8. New mortgage lending and housing turnover



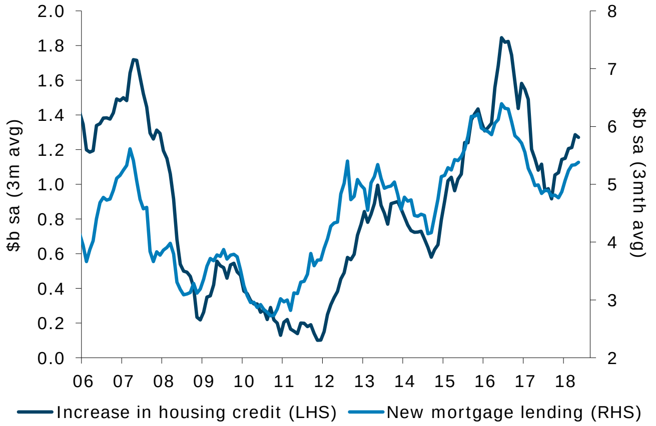
Source: ANZ, RBNZ

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 2.6% m/m in April in seasonally adjusted terms to be up 0.8% on a 3-month average basis (as in the figure). **New mortgage lending appears to be stabilising, following the recovery in housing market turnover late last year. This is consistent with stability in housing credit.**

New lending to first-home buyers is up strongly over the past year, rising 31% y/y in May. First-home buyer lending has stabilised at around 17% of overall lending.

Figure 9. New mortgage lending and housing credit

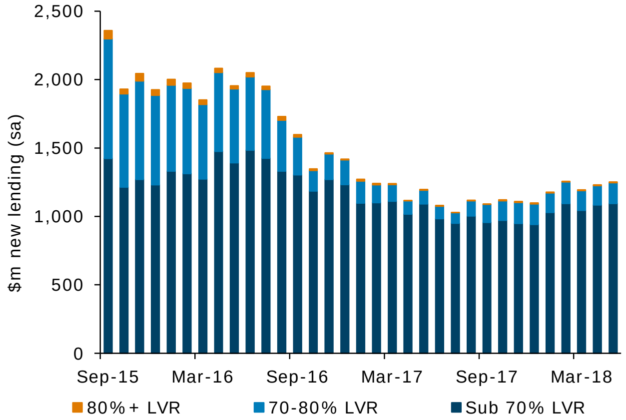


Source: ANZ, REINZ, RBNZ

In seasonally adjusted terms, total housing lending increased 0.4% m/m in May. In annual terms, credit growth is running at 5.8% 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 broadly stable), we expect the more moderate pace of lending growth will persist for the foreseeable future.

Figure 10. Investor lending by LVR

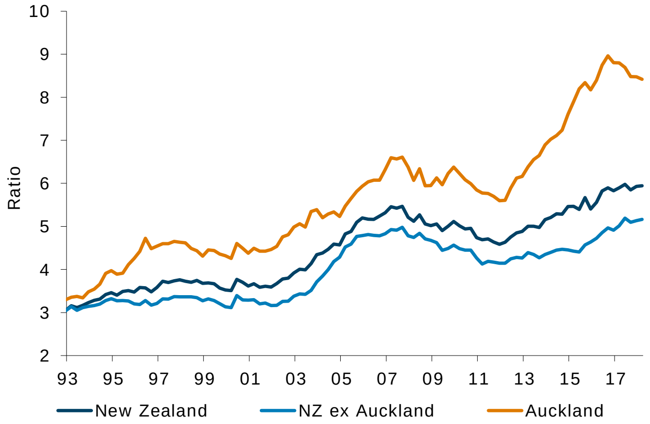


Source: ANZ, RBNZ

On a seasonally adjusted basis, new lending to investors increased 2.7% m/m in May. **New lending to investors has been broadly 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 88% (seasonally adjusted). That is a far greater share than in late-2014, when it was less than half.

Figure 11. Regional house prices to income

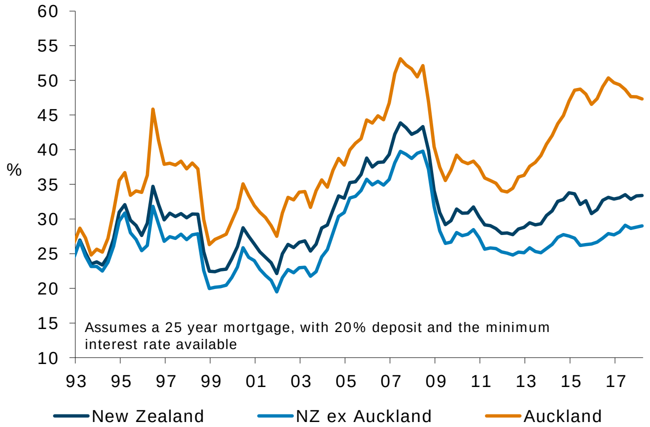


Source: ANZ, REINZ, Statistics NZ

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 Q1 2018. While still extremely high, the easing reflects the recent moderation in house price growth. Outside of Auckland, the ratio has continued to rise; at 5.2 times incomes this is at record highs.

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, this 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 has softened recently, with house prices flat and sales down in the June quarter. Affordability constraints, uncertainty around new Government policies, prudence on the part of banks, and a softer pulse in the economy are providing headwinds, and there is a risk that recent softening could persist. However, we see the downside as being limited. Population growth, pent-up demand and low interest rates are still supportive of demand for housing, and softening in the housing market would be consistent with the RBNZ further loosening loan-to-value ratio restrictions. While there could be some bumps in the road ahead, conditions are supportive of continued price increases, even if it is at a more moderate pace than previously.

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 income growth is solid. 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 be easing gradually. But population growth is still solid and 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. Pent-up demand is supporting price increases.
Consents and house sales	Shortage	↔/↑	We expect consents issuance will struggle to push higher, with the construction sector reaching its limits.
Liquidity	Tight	↔/↓	Credit availability is very relevant. Closure of the bank funding gap means there is more wriggle room, but resurgence is not expected.
Globalisation	Mixed bag	↔	Non-resident buyers aren't very influential, but policy changes may dampen demand. The housing market is weak in Australia.
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, with housing shortages apparent, although these are not the only game in town.
On balance	**In recent ranges**	↔	**There could be some bumps in the road ahead, but conditions are supportive of continued price increases.**

PROPERTY GAUGES

Figure 1: Housing affordability

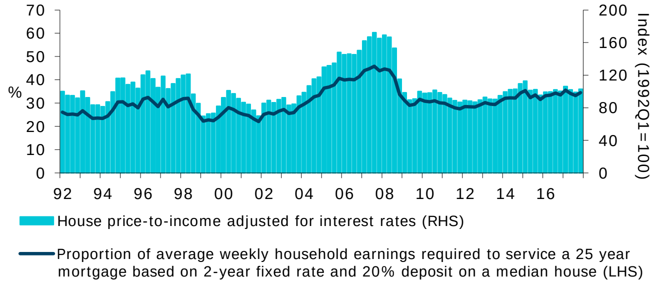


Figure 2: Household debt to disposable income

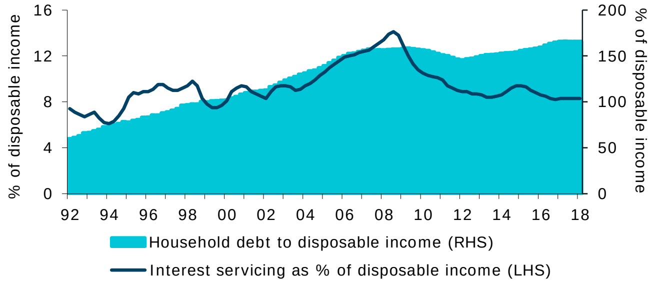


Figure 3: New customer average residential mortgage rate (<80% LVR)

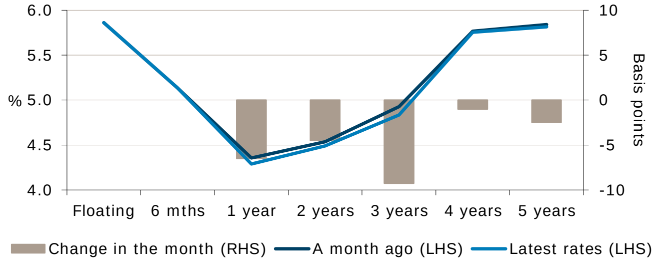


Figure 4: Net immigration

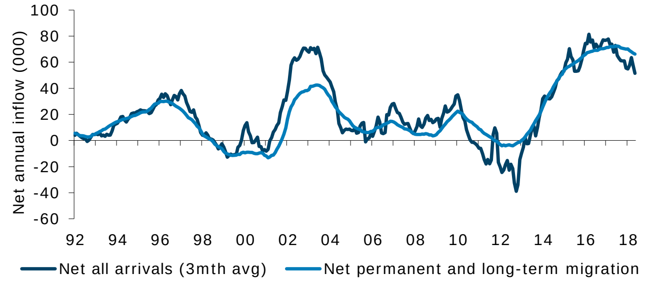


Figure 5: Housing supply-demand balance

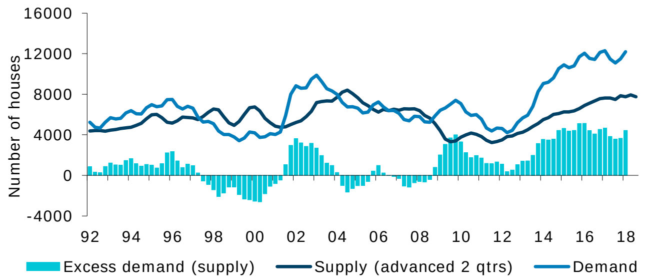


Figure 6: Building consents and house sales

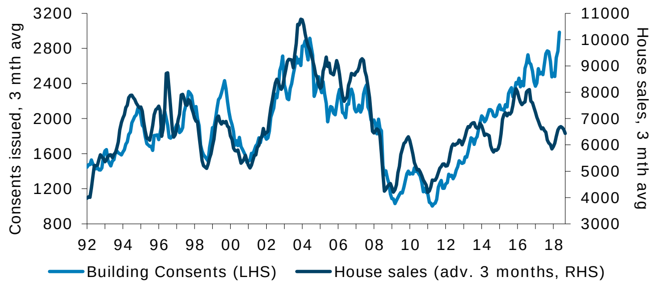


Figure 7: Liquidity and house prices

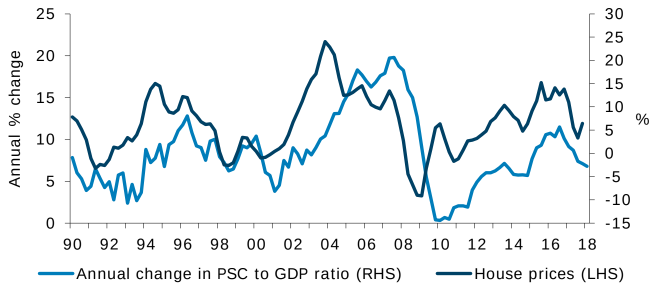


Figure 8: House price inflation comparison

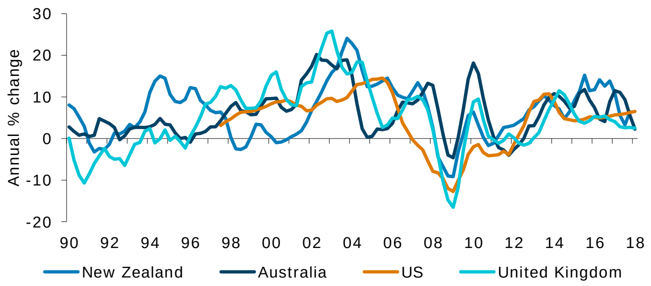


Figure 9: Housing supply

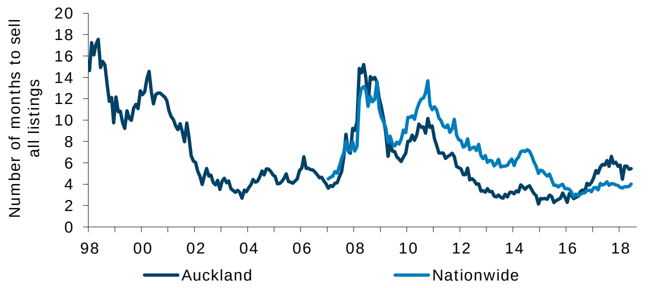
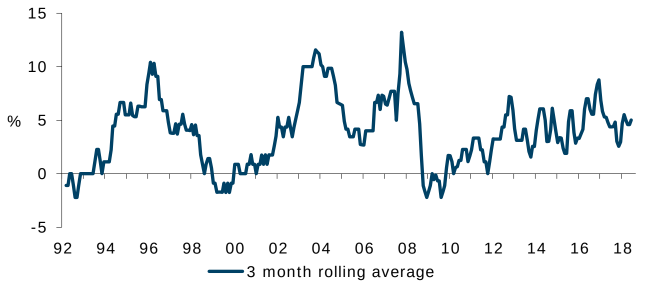


Figure 10: Median rental, annual growth



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

ECONOMIC OVERVIEW

SUMMARY

Economic momentum has slowed and downside risks to growth have increased. Business pessimism is impacting firm' decisions, spending growth has moderated, and the housing market has softened. While commodity prices are elevated, the shine has started to come off recently. That said, we don't expect growth is about to roll over just yet. And while inflation is low in the scheme of things, core inflation is on the rise, with cost pressures set to see inflationary pressures increase further from here. Nonetheless, the outlook for inflation is far from certain, justifying continued caution from the RBNZ. In recent communications the RBNZ has sent a very clear message that it is determined to meet its inflation target, with a move up or down in interest rates equally likely. If inflation materialises as we expect, the RBNZ will eventually increase the OCR – but that's a long way away yet and any moves will be gradual.

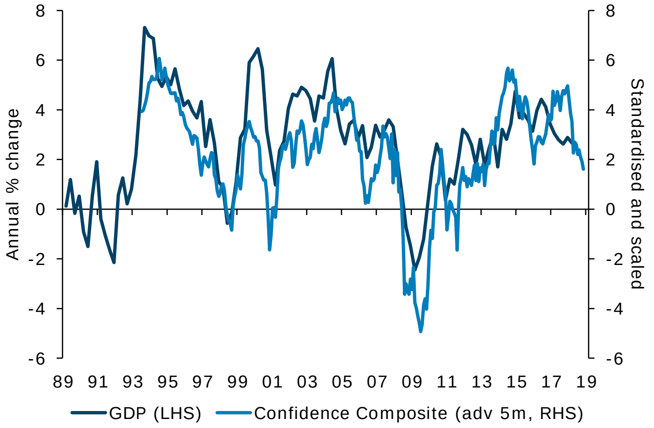
OUR VIEW

Economic momentum has slowed and downside risks have increased. GDP growth has slowed to around 2½% from its recent peak of 4½%. Business sentiment is subdued, with firms grappling with a number of challenges, including credit constraints, capacity pressures, margins squeeze, and policy uncertainty. This pessimism appears to be flowing through into firms' decisions, contributing to our expectations for below-trend GDP growth, and modest employment and investment growth. A key risk is that business pessimism lingers persistently and has a greater dampening impact on the economy than we currently expect. Spending growth has also been more moderate over the year and the housing market has been a bit softer, with some headwinds weighing. Meanwhile, the shine has started to come off our commodity prices of late, against a backdrop of a softer global picture, which is particularly a concern in light of escalating global protectionism. **It is fair to say that the economy is experiencing a softer patch, but we don't expect that growth is about to roll over just yet.** We expect GDP growth will grow around trend over the next few years, with fiscal expansions and income growth supportive, with our export prices still elevated. Financial conditions are expected to remain supportive of further growth, with the RBNZ cautious and willing to act if the outlook deteriorates.

Inflation is low in the scheme of things but core inflation is on the rise and cost pressures expected to see inflationary pressures increase. Annual inflation was 1.5% y/y in the June quarter, with housing-related inflation remaining at the fore. Underlying and core inflation measures have strengthened of late, with the RBNZ's sectoral factor model increasing to 1.7% y/y, from 1.4% in the September quarter last year. Going forward, we expect that inflation will increase little-by-little to reach the RBNZ's 2% target midpoint in time, with costs increasing (particularly labour costs) and margins being squeezed.

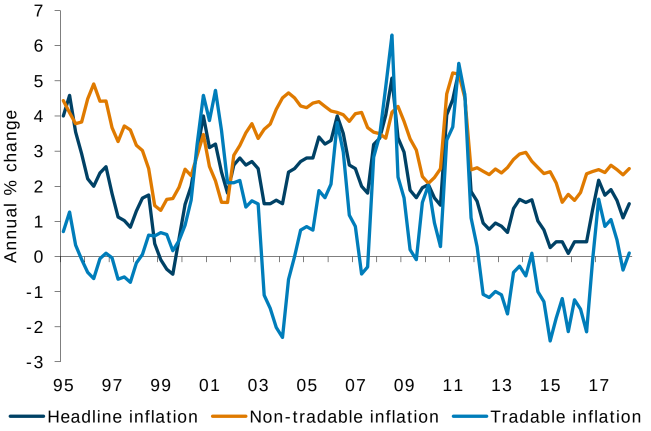
But the outlook is far from certain and recent developments justify continued caution from the RBNZ. Although inflation looks set to rise, downside risks remain in light of the softer economic picture and the outlook is far from certain. We expect the RBVNZ will remain cautious until it sees inflation rise in a consistent, broad based way from here. In recent communications the RBNZ has sent a very clear message that it is determined to meet its inflation target. If inflation materialises as we expect, the RBNZ will eventually increase the OCR – but that's a long way away yet and any moves will be gradual. We currently have a hike pencilled in for November 2019. But it will be quite some time before an OCR increase will be on the cards. And although inflation looks set to rise, downside risks are still relevant.

Figure 1. GDP vs Confidence Composite



Source: ANZ, Roy Morgan, Statistics NZ

Figure 2. CPI inflation components



Source: Statistics NZ, ANZ Research

MORTGAGE BORROWING STRATEGY

SUMMARY

Average fixed mortgage rates have fallen a little further over the past month. We still favour the 1-year fixed rate, and actually have a little more conviction in this view relative to last month given that we see even further reduced chance of an RBNZ interest rate hike any time soon (we have pushed out when we see the first RBNZ OCR hike to November 2019 from August). Some borrowers may want to spread risk over a number of fixed terms, but ultimately, we continue to see the most value in fixing for shorter durations.

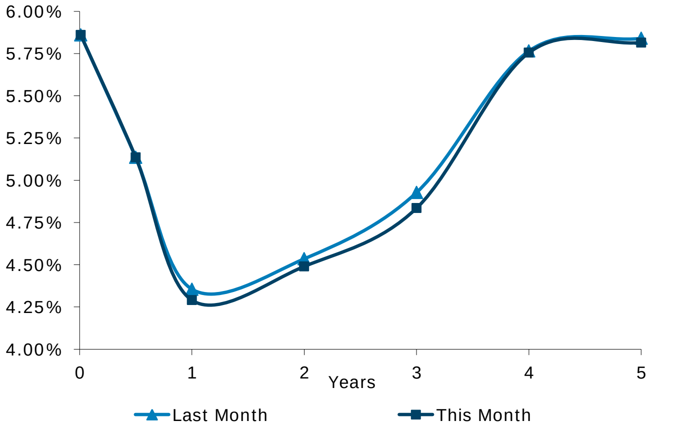
OUR VIEW

Average mortgage rates across the 'big four' banks fell modestly over the past month. With the exception of the floating and 6-month rates, average special mortgage rates were lower across all tenors (by an average of 0.05%pts). The 1-year rate remains the lowest point on the curve, at 4.29%.

By-and-large, our favoured view remains unchanged. Over recent months we have continued to think that the 1-year fixed rate offers the most value, although have felt that it was a close call with the 2-year rate. But if anything, now we are more inclined to the 1-year rate given we see reduced risks of an OCR hike any time soon. On the back of activity growth looking more mixed, we have pushed out when we see the first OCR hike to November 2019 (from August 2019). In fact, if growth continues to slow, there is a (small) chance that the next move could be a rate cut. While that could sway some borrowers to floating-rate borrowing, given the large difference between the floating and 1-year rates, that move does not seem worth it just yet for those not necessarily needing the flexibility of floating-rate borrowing.

Breakeven analysis supports our view. For instance, the average 2-year special rate is 20bps above the 1-year rate. That doesn't seem high, but it means that the 1-year rate would need to rise by 40bps (from 4.29% to 4.69%) over the next year in order for it to be cheaper fixing for 2 years at 4.49% than rolling two 1-year terms. **That degree of jump in the 1-year rate is not out of the question but certainly not our view.** It would require a meaningful surprise in the economy's performance and/or inflation pressures to build more aggressively than expected. The reasonable lifts in longer-term breakevens also sway us away from those tenors.

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%	3.45%	4.59%	4.79%	5.35%
1 year	4.29%	4.02%	4.69%	5.07%	5.53%
2 years	4.49%	4.54%	5.11%	5.97%	7.02%
3 years	4.84%	5.32%	6.24%	6.48%	6.70%
4 years	5.76%	5.87%	6.20%		
5 years	5.82%	#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%	4.47%	5.31%	5.00%	5.93%
1 year	4.84%	4.89%	5.15%	5.46%	6.11%
2 years	5.00%	5.17%	5.63%	6.07%	6.72%
3 years	5.37%	5.68%	6.19%	6.42%	6.74%
4 years	5.86%	6.04%	6.34%		
5 years	6.04%	*may be subject to a low equity fee			

In contrast to last month where our views were a little more nuanced, we now have a little more conviction. We see reduced risks of an interest rate hike by the RBNZ any time soon, which should keep the attraction of rolling shorter-dated hedges. As always though, each individual borrower should consider their own circumstances. 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 June 2018 (based on REINZ data)

	House prices (ann % chg)	3mth % chg	No of sales (sa)	Mthly % chg	Avg days to sell (sa)
Northland	5.9	4.4	189	-5%	48
Auckland	-0.9	-2.2	1,763	-10%	41
Waikato	11.4	1.9	599	-7%	39
Bay of Plenty	4.1	3.9	442	-8%	45
Gisborne	26.6	1.5	54	-11%	32
Hawke's Bay	15.4	-0.1	283	+12%	30
Manawatu-Whanganui	7.4	4.3	408	-1%	32
Taranaki	3.3	2.8	185	+8%	34
Wellington	12.0	4.2	676	-9%	29
Tasman, Nelson and Marlborough	2.2	0.3	208	-25%	35
Canterbury	0.0	-1.6	776	-14%	37
Otago	7.7	4.8	349	-9%	31
West Coast	-9.5	10.5	29	-44%	84
Southland	8.2	1.9	166	-1%	35
NEW ZEALAND	**5.6**	**0.3**	**6,086**	**-8%**	**38**

Key forecasts

	Actual			Forecasts						
Economic indicators	**Sep-17**	**Dec-17**	**Mar-18**	**Jun-18**	**Sep-18**	**Dec-18**	**Mar-19**	**Jun-19**	**Sep-19**	**Dec-19**
GDP (Ann % Chg)	2.6	2.9	2.7	2.3	2.5	2.6	2.7	2.9	2.8	2.7
CPI Inflation (Annual % Chg)*	1.9	1.6	1.1	1.5(a)	1.3	1.6	1.6	1.9	2.0	2.0
Unemployment Rate (%)	4.6	4.5	4.4	4.3	4.3	4.3	4.4	4.2	4.2	4.2
House Prices (Annual % Chg)	3.3	3.6	3.9	3.7(a)	4.1	2.6	1.6	2.0	2.0	2.0
Interest rates (RBNZ)	**Dec-17**	**Mar-18**	**Jun-18**	**Sep-18**	**Dec-18**	**Mar-19**	**Jun-19**	**Sep-19**	**Dec-19**	**Mar-20**
Official Cash Rate	1.75	1.75	1.75	1.75	1.75	1.75	1.75	1.75	2.00	2.00
90-Day Bank Bill Rate	1.9	2.0	2.0	2.0	2.0	2.0	2.0	2.1	2.4	2.4
Floating Mortgage Rate	5.8	5.8	5.8	5.8	5.8	5.8	5.8	5.8	6.0	6.0
1-Yr Fixed Mortgage Rate	4.9	4.9	4.9	4.9	4.9	5.0	5.0	5.1	5.2	5.2
2-Yr Fixed Mortgage Rate	5.1	5.1	5.0	5.1	5.2	5.2	5.3	5.4	5.5	5.5
5-Yr Fixed Mortgage Rate	5.9	5.9	5.9	6.0	6.1	6.1	6.3	6.4	6.4	6.4

Source: ANZ, Statistics NZ, RBNZ, REINZ; * forecasts as at 16 July 2018.

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