NEW ZEALAND PROPERTY FOCUS

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SENSE AND SERVICEABILITY

SUMMARY

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

FEATURE ARTICLE: SENSE AND SERVICEABILITY

The conventional economic wisdom in New Zealand is that a strong housing market supports consumption. But recently, this relationship has weakened, with households in aggregate seemingly no longer feeling good about rising house prices. Houses are unaffordable for many, servicing a large mortgage is a stretch, even at low interest rates, and the home ownership rate has declined. We suspect that the relationship between house price inflation and consumer confidence has changed as a result of these affordability concerns, in combination with the policy-driven slowdown in the housing market. Going forward, the relationship between the housing market and spending is expected to be more nuanced, with housing affordability concerns unlikely to recede any time soon.

PROPERTY GAUGES

Housing market acridity and price pressures remain broadly stable. But underlying this, a number of opposing forces are at play in the property market. Affordability constraints are biting hard in Auckland, while markets elsewhere continue to play catch-up. Strong population growth, pent-up demand and supportive financial conditions will continue to support prices. But prudence on the part of banks, continued caution in easing LVR restrictions, affordability constraints, and more restrictive government policy changes are expected to keep prices and activity contained. We expect house price inflation to moderate over the medium term, with regional divergence expected to persist.

ECONOMIC OVERVIEW

The economic outlook remains positive, but the economy is navigating some challenges. Firms remain pessimistic and growth indicators are a bit less positive, with concerns about the economic environment lingering beyond the election. Capacity pressures, costs increases, margin pressure and credit constraints are evident as the economy grapples late-cycle headwinds. Sentiment amongst households has pared back recently too, but remains around average. Despite these challenges, the terms of trade remains high, population growth is strong, and monetary policy is expected to remain accommodative for an extended period. The economy is expected to continue growing at (but not above) its trend pace of 2-3% over the medium term. We expect inflation will rise gradually over the medium term, and that the OCR will eventually need to rise. But with inflation pressures lacking and uncertainty about the outlook for wage inflation, the RBNZ will remain cautious for some time yet.

MORTGAGE BORROWING STRATEGY

Average fixed mortgage rates have generally fallen over the past month (particularly for longer terms). We still favour the 1-year fixed rate, although the gap to the 2-year fixed rate has narrowed modestly and may be attractive for some, particularly those concerned about any escalation in bank funding pressures or a surprise lift in inflation (perhaps driven by stronger wage growth) that spurs the RBNZ into earlier rate hikes. 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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SUMMARY

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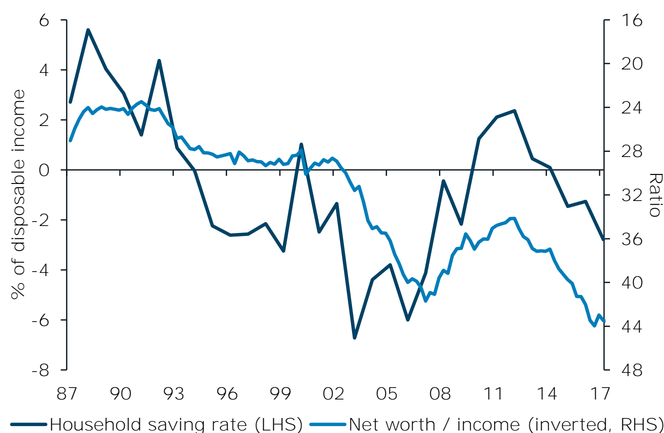
OR SO THE STORY GOES

"It is a truth universally acknowledged, that a person in possession of a good house, must be in want of a boat."[1]

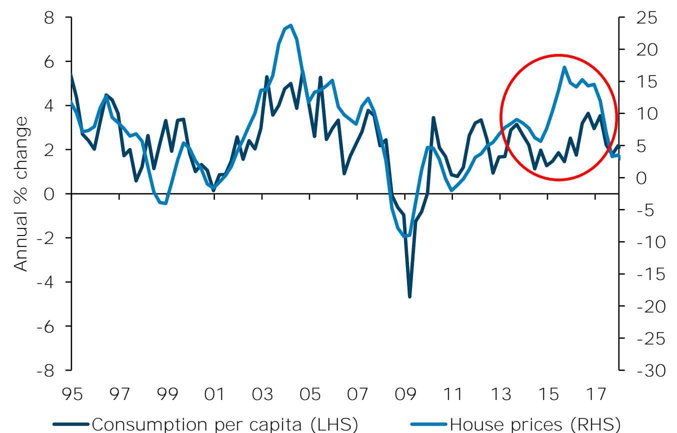
Or that's how the usual story goes in New Zealand, anyway. **The conventional wisdom regarding the economic cycle is that a strong housing market supports consumption.** The 2000s is the classic example. From 2002 until 2007, house price inflation ran at 13% y/y on average, peaking at 24% y/y in 2004. This lifted household net worth relative to incomes, and household saving went very negative (figure 1). Households withdrew equity from their homes, and consumption grew strongly.[2] But this relationship is not isolated to the 2000s experience. Figure 1 shows a long-running (inverse) correlation – if your house is making money for you, why save? And showing the same phenomenon from another angle, figure 2 shows that real house price inflation and consumption per capita generally move together.

Figure 1: Net worth and household saving



Source: RBNZ, Statistics New Zealand, ANZ Research

Figure 2: House prices and consumption per capita



Source: REINZ, Statistics New Zealand, ANZ Research

But recently, the relationship between house prices and consumption has weakened. Since 2012, when house price inflation started to rise, consumption per capita has not followed developments in the housing market quite so closely; a divergence opened up, particularly in 2014-2016 (circled in figure 2).

A bunch of received wisdom about economic "truths" has come into question since the Global Financial Crisis, in particular about inflation. So it's worth examining other "givens" too. In this article, we take a look at the relationship between the housing market and the behaviour of consumers, examining the possible causes and implications of what appears to be a change.

The historical experience is not surprising: there are a number of reasons why rising house prices might encourage greater spending. It's likely that a combination of these have contributed to the "usual" relationship seen in the data:

- Low interest rates, income gains, and favourable economic conditions can spur both;
- Credit constraints can ease as collateral values rise; and
- Higher house prices make households feel wealthier, so they spend out of their windfall gains.

[1] With apologies to Jane Austen.
[2] See Smith, M. (2006).

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Regardless of the exact cause, one of the key links between house prices and consumption must logically be confidence. In previous cycles, higher house prices have contributed to a feeling of confidence that has encouraged households to borrow and spend.

THE CONFIDENCE FACTOR

Until 2014 there was a positive relationship between house price inflation and our ANZ Consumer Confidence Index. When house prices went up, households – in aggregate – felt good. The reasoning: homeowners felt better off – either because they had greater wealth on paper, more borrowing capacity available to them, or they felt good about economic conditions more broadly – and so they spent more on boats, holidays, and nice dinners out.

But that relationship has changed in recent years. Figure 3 shows that over 2014 house price inflation eased, but confidence went up. Later in 2015, house price inflation rose and confidence went down. And since 2016, house price inflation has dropped precipitously, while consumer confidence has risen again.

Figure 3: ANZ Consumer Confidence Index and house price inflation

Source: REINZ, ANZ Research

Econometric testing suggests that a "structural break" has occurred. It is not just that the relationship has weakened – the relationship has turned from positive to negative.[3] Before the end of 2013, 1%pt higher house price inflation tended to increase consumer confidence by 1.2 points – and variation in house price inflation could explain almost three quarters of the variation in consumer confidence. But more recently, 1%pt higher house price inflation has been associated with consumer confidence easing 0.8 points, with housing market developments explaining half of the variation in consumer confidence (although the sample is short).

It is likely that this new-found love-hate relationship with the housing market has contributed to the weaker link between house prices and consumption of late, and the fact that consumption has not been as high as house prices per se would suggest. It is important to note that we expect other factors are also at play. We have talked in our recent Market Focus about how households are constrained by high debt levels and modest saving buffers. But we suspect this confidence link has been an important part of the story.

If we break down consumer confidence into more granular components, the change in this relationship has some interesting characteristics:

- **It is broad-based across regions:** Housing market developments in Auckland and the rest of the country have diverged this cycle, but the relationship between house price inflation has changed in a consistent way across regions.
- **Adults in all age cohorts have been affected:** There is evidence of a structural break across all age cohorts over the age of 18. In the recent period, consumers 18-24 years old have been the most pessimistic about higher house price inflation (not typically house-owners, note), followed by those 50+, and then those 35-49 years old.

[3] Based on a Quandt-Andrews unknown breakpoint test at the 99% confidence level.

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- **It is perceptions about current conditions that have changed:** Breaking down our ANZ Consumer Confidence Index into perceptions about current and future conditions reveals that it is perceptions about current conditions that tend to move with house price inflation, and which are now evolving differently.

We would caution against making too much of the granular breakdowns above, given the perils associated with small, short samples. But they illustrate that **changes in the relationship between house price inflation and consumer confidence reflect households' feelings about their current conditions and are not isolated to certain regions or age cohorts.**

So why might the relationship between house prices and consumer confidence have changed? There are a few potential explanations for the change in this relationship, and they are not mutually exclusive.

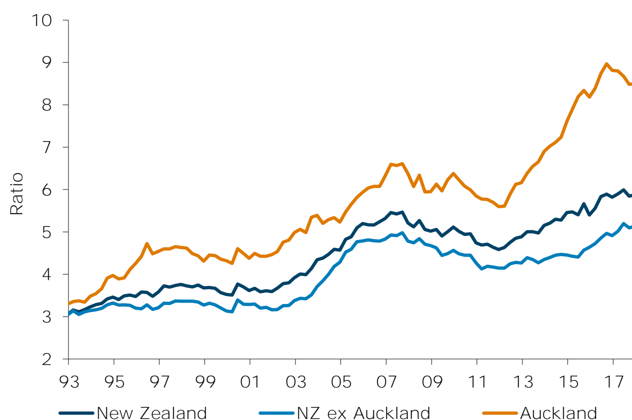
One possibility is that broader economic conditions have become a more important determinant of consumer confidence, and that this has offset recent housing market developments. Typically, higher (lower) interest rates reduce (boost) both house price inflation and consumption, ie house prices are not 100% the cause. Interest rate variation has been missing this cycle – and that could have changed things. But interest rates have been more or less flat since 2008, and it is only since 2014 that the confidence correlation has changed. Similarly, the variation in consumer confidence does not correspond with movements in income growth, net migration or credit conditions. **Overall, there's no evidence that broader economic conditions have caused the observed change in relationship.** While there is a clear statistical relationship with house price inflation, other economic factors are not found to be statistically significant drivers of consumer confidence.

One suspects that the *level* of house prices might have something to do with it. Higher house prices make households feel better off – but only those who own a home already. **Housing affordability has worsened.** Figure 4 shows that housing affordability has deteriorated significantly, particularly in Auckland but also nationwide. Since 2014 in Auckland and 2016 elsewhere, house prices relative to incomes have been higher than achieved last cycle – or indeed over the entire history of the series.

And for those who can purchase a home, it's not always easy. To purchase the median home, mortgage repayments are 48% of the average income in Auckland and 29% in the rest of New Zealand. $170,000 is the median deposit needed in Auckland and $90,000 in the rest of New Zealand. While debt-servicing costs are contained with interest rates low, debt levels are high – and households are vulnerable should interest rates increase.

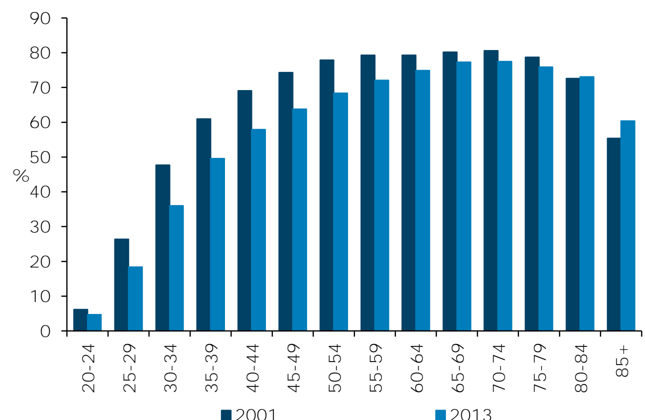
The proportion of the working-age population who own a home has declined from 55% in 2001 to 50% in 2013. The decline has been particularly large for those aged 30-49 years old; home ownership fell more than 10%pts in 12 years for this cohort. Those who do not own a house do not feel better off watching houses get less and less affordable. Indeed, a recent survey showed that housing is the single biggest concern for New Zealanders: "More than 40 per cent of people surveyed for the Ipsos' Issues Monitor said they were concerned about the cost and lack of supply of housing". **And with the ratio of owners to renters falling, then the votes of the "have nots" get louder in both consumer confidence surveys and in spending decisions.**

Figure 4: House price to income ratios



Source: REINZ, Statistics New Zealand, ANZ Research

Figure 5: Working-age population who own their primary dwelling by age



Source: Statistics New Zealand, ANZ Research

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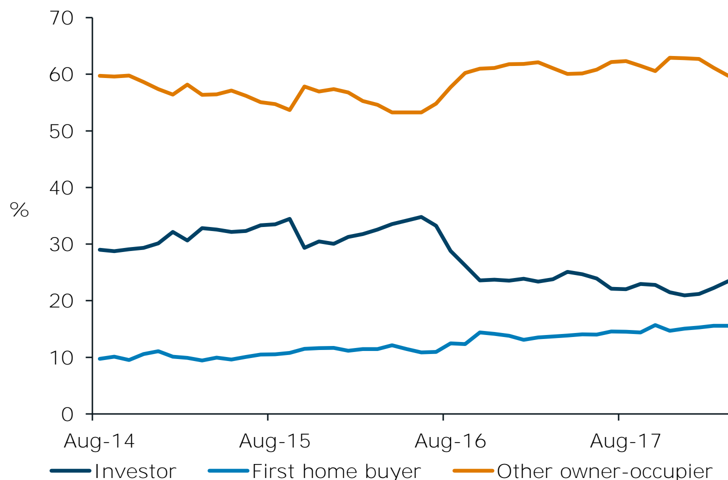
Over the past year, some will have been relieved to see house price inflation take a breather, allowing incomes and deposit-savings to catch up a little, particularly in Auckland. Nonetheless, houses remain highly unaffordable – and without a significant change in market conditions, they are expected to remain so for some time. First home buyers have stepped into the gap left by locked-out investors to a small extent, but they still comprise only a low share of mortgage lending.

Figure 6: Lending by type (share of new mortgage lending)



Source: RBNZ, ANZ Research

The source of the housing market developments also matters. The recent slowdown in the housing market was deliberately engineered via LVR restrictions put in place, rather than being due to rising interest rates or slowing immigration. If it had rather been driven by higher interest rates, due to the impact of that on mortgage payments, we suspect the link between house price inflation and consumer confidence might have been maintained or at least not flipped as strongly.

The Reserve Bank's restrictions on high loan-to-value ratio lending were first put in place since 2013 – coinciding with the "structural break" in the relationship between house price inflation and consumer confidence. More recently, tax changes proposed by the new Government have also weighed on the housing market. These tax changes are designed to decrease the attractiveness of housing as a financial investment, and this has weighed on investor demand.

But policy changes are not the only game in town. RBNZ work suggests that the effects of loan-to-value ratio restrictions were short-lived – meaning that a reversion to the previous relationship between house price inflation and consumer confidence would have been expected if the policy change were the only underlying cause.[4] **We suspect that affordability concerns alongside the fact that the housing market slowdown was policy-driven (while debt serviceability remained good) have worked in combination – altering the relationship between house price inflation and consumer confidence.** Put another way, a housing slowdown that for once has not been driven by higher interest rates has enabled us to separate out how households feel about house price inflation from how they feel about interest rates. And all else (read: interest rates) equal, it seems households have been pleased in aggregate about house prices rising less quickly – presumably in light of affordability concerns.

IMPLICATIONS

Going forward, we are forecasting that annual house price inflation will remain pretty steady over the next year, and then moderate over the medium term. Population growth and pent-up demand, in the face of constrained housing supply, are expected to provide a floor, while affordability constraints, high debt levels, policy uncertainty and credit rationing will continue to act as headwinds. The opposing forces at play in the housing market are expected to be keep house price inflation contained.

[4] See Armstrong, J, H. Skilling & F. Yao (2018) & Price, G. (2014).

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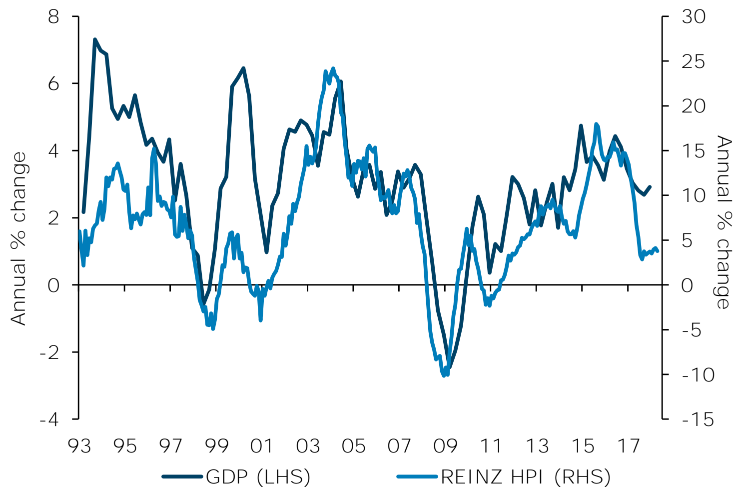
Because of the different dynamics we are now seeing, we expect the relationship between the housing market and GDP growth will be different to that seen in previous cycles. However, the outlook is unclear. Despite the recent slowing in the housing market, we expect that GDP will continue to grow around trend (but not above) – an important factor in that forecast is that we are not experiencing rising interest rates, which would tend to dampen economic activity more broadly.

If the balance of the tailwinds and headwinds in the housing market were to change, the implications for spending and GDP growth would be nuanced. Further slowing caused by higher interest rates would likely see the historical correlation between house price inflation and GDP growth return. But a slowing caused by implementation of proposed tax policies would likely see further divergence between house price inflation and GDP growth. On the other hand, a resurgence in the housing market due to receding policy uncertainty could see the usual relationship between house price inflation and GDP growth resume.

Amongst this uncertainty, one thing seems clear: housing affordability concerns aren't going away any time soon and we can no longer rely on rising house prices per se to support spending. We will have to be watchful as conditions evolve, since these economic relationships may continue to change. And in light of that, it is important that we continue to test our assumptions about the way the economy "usually" works.

Figure 7: House price inflation and GDP growth



Source: Statistics New Zealand, ANZ Research

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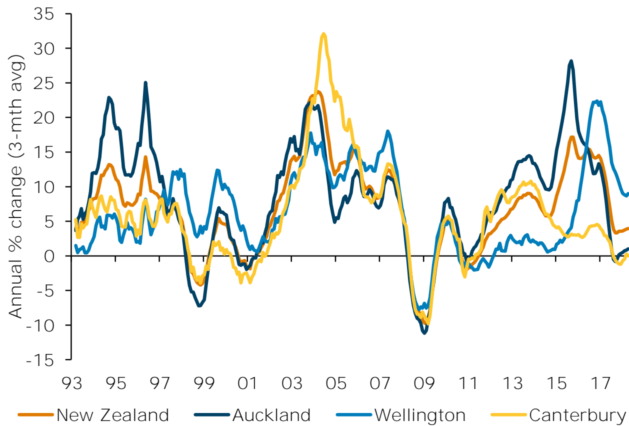
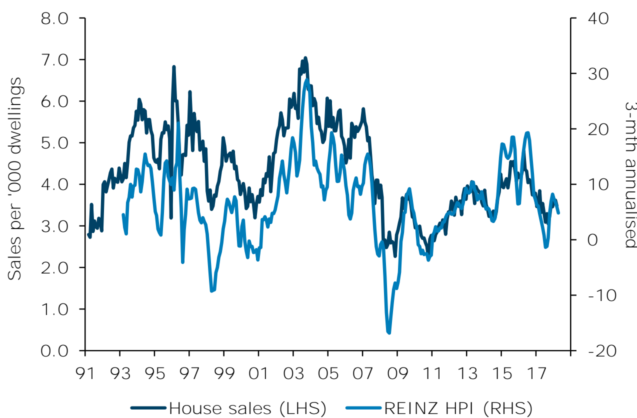
Figure 1. Regional house price inflation



Source: ANZ, REINZ

The REINZ House Price Index fell 0.1% m/m in April, pointing to a broadly stable housing market. In 3-month average terms, annual growth held at 3.9% y/y. House price inflation has been hovering in the 3-4% range for the past nine months. On the same basis, Auckland prices ticked up to 1% y/y, having languished as low as -0.8% y/y in September 2017. Wellington is still recording strong gains at 9% y/y; the capital even managed a small lift in momentum in April. Canterbury remains subdued. Growth in the smaller regions continues as Hawke's Bay/Gisborne (+15% y/y), Manawatu-Whanganui (+12% y/y) and Southland (12%y/y) set the pace. At the lower end of the regional spectrum, annual growth in Taranaki (6% y/y) and Bay of Plenty (6.3%) is still very respectable.

Figure 2. REINZ house prices and sales

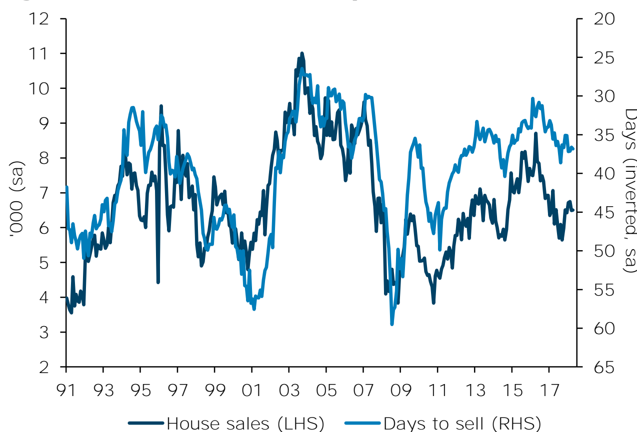


Source: ANZ, REINZ

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

We estimate that seasonally adjusted house sales volumes rose 0.2% in April, barely making a dent in the 3.8% m/m fall seen in March. Sales are stable at 0.6% y/y on a 3-month moving average basis. Looking through the monthly noise, we are of the view that the housing market has stabilised. House sales are up 15% since September 2017 and are hovering around 6,500 sales per month. From a regional perspective, Auckland sales are down 1.1% (3-month moving average) over the year, while across the rest of the country they are up 1.4%.

Figure 3. Sales and median days to sell



Source: ANZ, REINZ

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

Nationally, the median time to sell a house was 37 days (sa) for the fourth consecutive month. Days to sell has stabilised at this level after increasing since mid-2016 (when it was 31 days). Nonetheless, days-to-sell is still below its historical average of 39.5 days, due to market tightness in the regions. In fact, Auckland is the only region where it is currently taking longer to sell (38 days) than the historical average (36 days).

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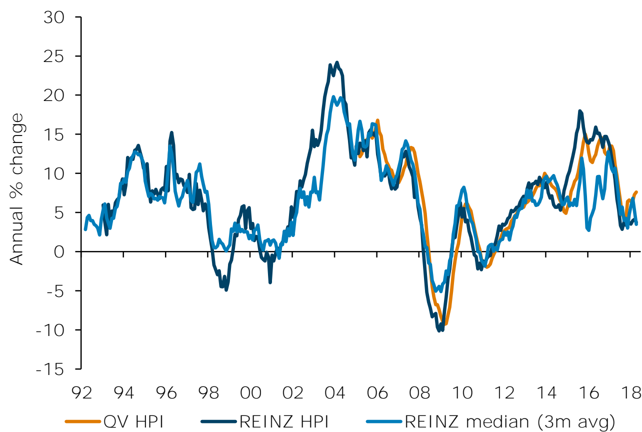
Figure 4. REINZ and QV house prices

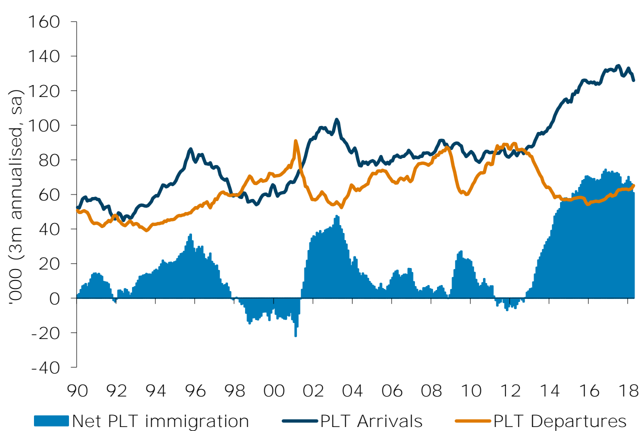


Source: ANZ, REINZ, QVNZ

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

The REINZ median sale price rose 0.5% (sa) in April and annual growth fell to 1.7% y/y. This is weaker than the REINZ HPI (3.8% y/y). The REINZ median can get thrown around due to changes in composition of sales. The QVNZ measure of price growth is running at 7.6% y/y, and has been picking up steam since October 2017.

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. Annual net permanent long term migration remains high, but has eased off the 70,000+ peak seen in late 2016/early 2017. 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 has been volatile of late and jumped 14.7% in April m/m, driven by multi-dwelling consents (up 44.2% m/m). The housing component has been broadly stable since the end of 2015, whereas the multi-dwelling component has more or less doubled in that time. Consent issuance is high historically, with levels of construction high in Canterbury and Auckland.

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

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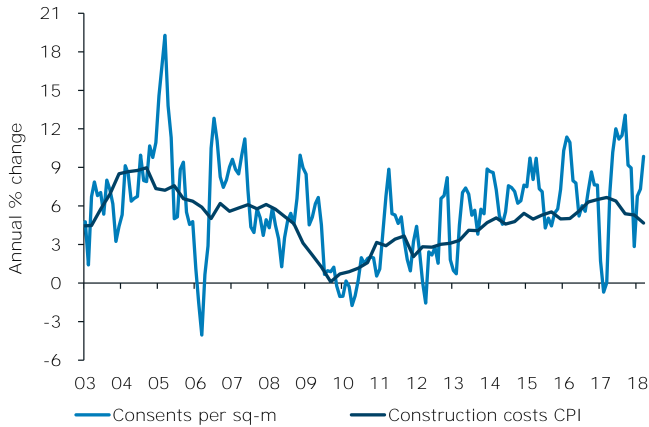
Figure 7. Construction cost inflation



Source: ANZ, Statistics NZ

CPI construction costs are easing for home builds, but consents show cost pressures are still evident. The value of residential consents per square metre – a proxy (albeit a volatile one) for construction cost inflation – is running at 10% y/y (3-month average), up from 3% in December. The inflation measure of construction costs has eased to 4.7% (from 6.7% in March 2017) despite ongoing skilled worker shortages, squeezed margins and capacity constraints.

Despite disruptions in the construction industry, the construction activity pipeline is strong and should keep construction costs from falling too far.

Figure 8. New mortgage lending and housing turnover

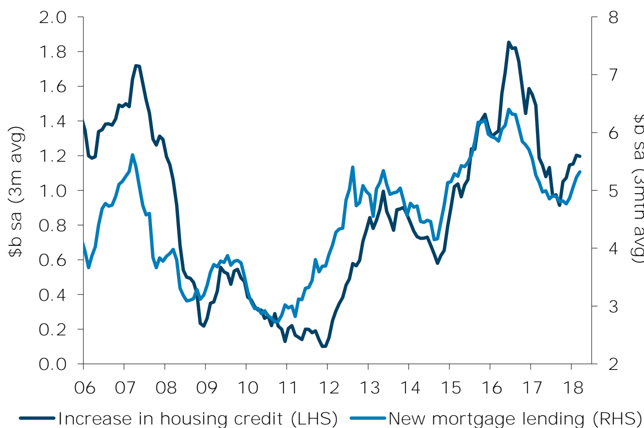
Source: ANZ, RBNZ

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 fell 3.7% m/m in March in seasonally adjusted terms (the chart is in 3-month average terms). This month partially unwinds the 9.2% m/m gain in January and momentum is starting to wane. New lending is now down 3.7% y/y, reflecting a similar fall in total housing turnover (down 8.2% y/y).

New lending to first-home buyers is up strongly, rising 11% y/y in March. First-home buyer lending has stabilised at around 16% of overall lending.

Figure 9. New mortgage lending and housing credit



Source: ANZ, REINZ, RBNZ

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

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

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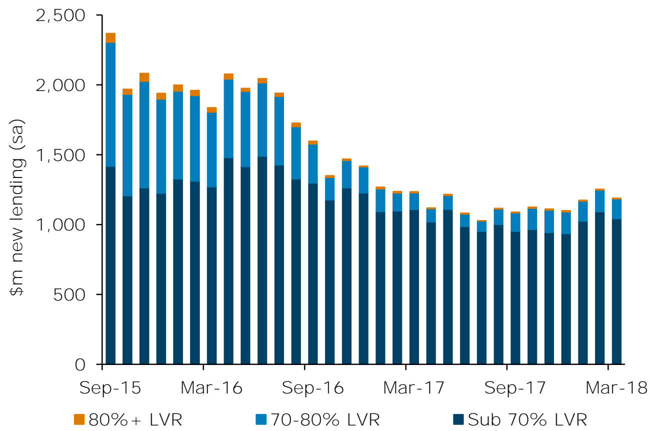
Figure 10. Investor lending by LVR

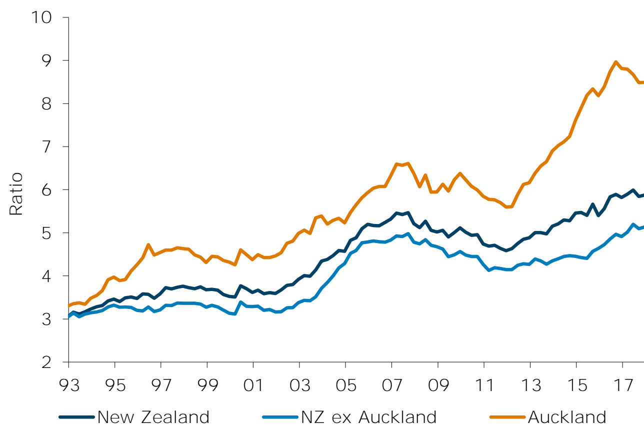


Source: ANZ, RBNZ

On a seasonally adjusted basis, new lending fell 5.1% in March, largely reversing the 6.7% increase seen in February. **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 currently 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). The RBNZ eased these restrictions modestly at the start of the year, it was only a tweak, and we expect further adjustments to be cautious.

Related to the LVR restrictions, a larger share of new lending is on less-risky terms. In February, the share of total investor lending at LVRs of less than 70% was 88%. That is a far greater share than in late-2014, when it was less than half.

Figure 11. Regional house prices to income

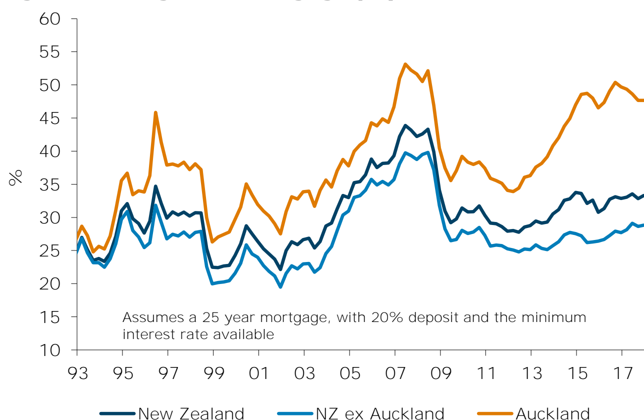


Source: ANZ, REINZ, Statistics NZ

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

Housing market acridity and price pressures remain broadly stable. But underlying this, a number of opposing forces are at play in the property market. Affordability constraints are biting hard in Auckland, while markets elsewhere continue to play catch-up. Strong population growth, pent-up demand and supportive financial conditions will continue to support prices. But prudence on the part of banks, continued caution in easing LVR restrictions, affordability constraints, and more restrictive government policy changes are expected to keep prices and activity contained. We expect house price inflation to moderate over the medium term, with regional divergence expected to persist.

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 no longer that influential. Other big global housing markets looking stable too.
Housing supply	Too few	↔/↑	The Government is going to take a more active role, but there are still questions about crowding out other work and labour shortages.
House prices to rents	Too high	↔/↓	Rents are moving up, but only gradually, suggesting that existing housing shortages aren't the only game in town.
On balance	**Flat-lining**	↔	**Positives offset the negatives, leaving the market steady. Auckland to remain weak as affordability bites hard.**

ANZ

PROPERTY GAUGES

Figure 1: Housing affordability

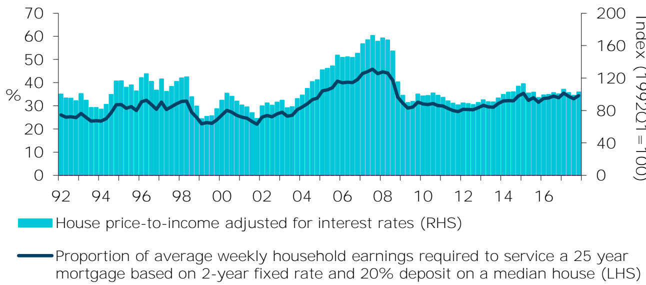


Figure 2: Household debt to disposable income

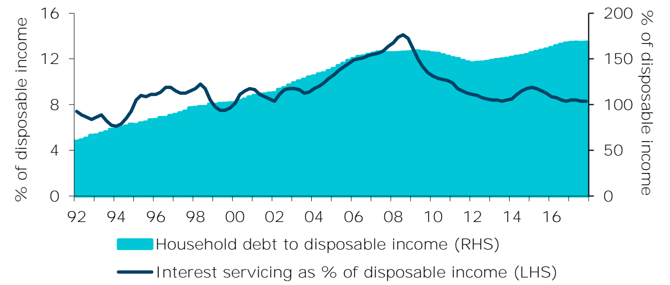


Figure 3: New customer average residential mortgage rate (<80% LVR)

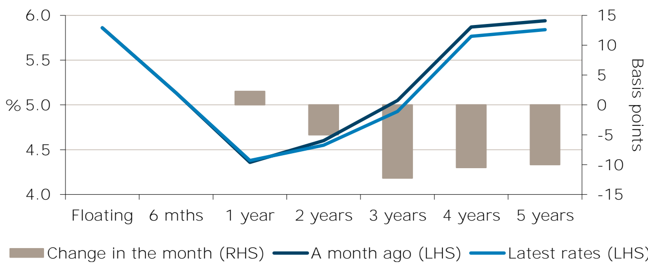


Figure 4: Net migration

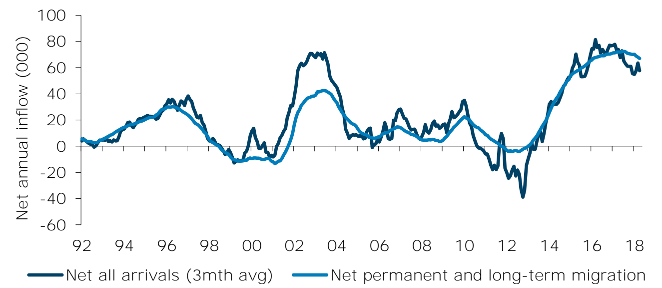


Figure 5: Housing supply-demand balance

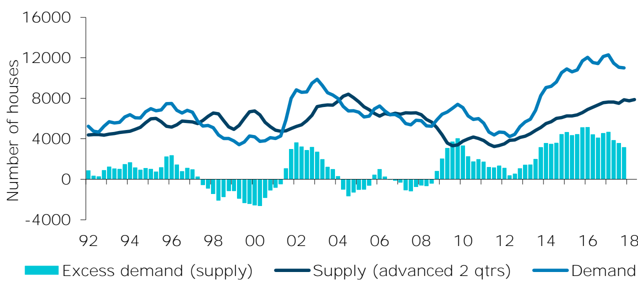


Figure 6: Building consents and house sales

Figure 7: Liquidity and house prices

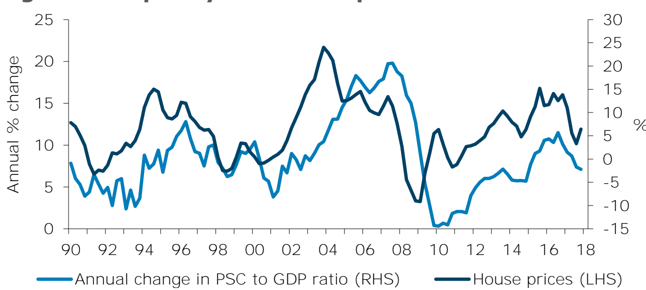


Figure 8: House price inflation comparison

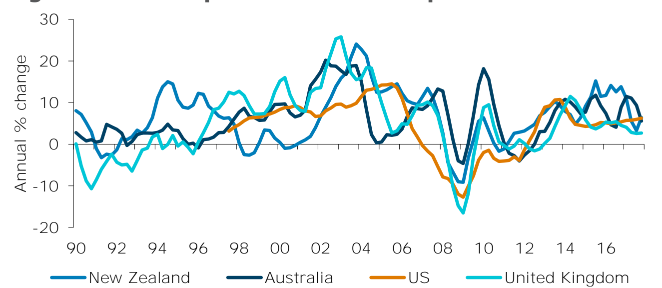


Figure 9: Housing supply

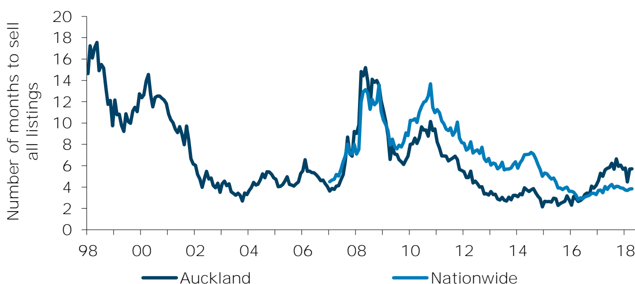


Figure 10: Median rental, annual growth

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

ECONOMIC OVERVIEW

SUMMARY

The economic outlook remains positive, but the economy is navigating some challenges. Firms remain pessimistic and growth indicators are a bit less positive, with concerns about the economic environment lingering beyond the election. Capacity pressures, costs increases, margin pressure and credit constraints are evident as the economy grapples late-cycle headwinds. Sentiment amongst households has pared back recently too, but remains around average. Despite these challenges, the terms of trade remains high, population growth is strong, and monetary policy is expected to remain accommodative for an extended period. The economy is expected to continue growing at (but not above) its trend pace of 2-3% over the medium term. We expect inflation will rise gradually over the medium term, and that the OCR will eventually need to rise. But with inflation pressures lacking and uncertainty about the outlook for wage inflation, the RBNZ will remain cautious for some time yet.

OUR VIEW

The economy is navigating some challenges:

- **Firms remain pessimistic and activity indicators are a bit less positive**, with concerns about the economic environment lingering beyond the election – pointing to some softening in near-term GDP growth, which may also weigh on employment and investment.
- **Sentiment amongst households has pared back too.** Housing affordability concerns and high debt levels are dampening household sentiment, and will weigh on the housing market and consumption. Housing market activity and price pressures remain broadly stable.
- **The economy is grappling with late-cycle headwinds, with capacity constraints, cost increases, margin pressure and credit constraints all evident.** These headwinds will limit the scope for growth from here, particularly in industries like construction where pressures are most evident.
- **Global conditions have moderated slightly.** As a small, open economy, New Zealand is often buffeted by external events. Since the start of 2018, financial market volatility has increased, global liquidity has tightened, and activity indicators have softened. Nonetheless, we expect that global growth will remain above trend.

Despite these challenges, the outlook remains positive:

- **The terms of trade remain high, boosting household incomes** – with commodity prices remaining high through 2018 and supporting the NZD, despite interest rate differentials encouraging some recent depreciation.
- **Population growth is strong.** Migration inflows remain elevated, but are declining gradually. Strong rates of population will continue to support consumption and GDP growth.
- **Fiscal policy is supportive.** While Budget 2018 emphasised prudence over promises, Government spending is expected to support economic activity over the medium term, with pressure on spending expected to continue, as the economy grapples with an infrastructure deficit in the face of recent population growth.
- **Monetary policy is expected to remain accommodative for an extended period.**

We expect the economy to continue growing at (but not above) its trend pace of 2-3% over the medium term. Recent drivers of economic growth – migration, construction and tourism – are all expected to have reached their limits, and are unlikely to contribute to growth from here. And late-cycle headwinds will continue to temper the outlook. However, we are not seeing inflationary pressures that would usually be evident at this late in the cycle, necessitating higher interest rates and contributing to a sharper downturn.

The labour market is strong, which bodes well for household income growth and consumption. We expect consumption to continue growing at moderate rates, but that household will rebuild their saving buffers in light of housing affordability and debt constraints. **Strength in the labour market should also contribute to wage inflation, with Government policies also supporting an increase in wage expectations.** With costs increasing and firms' already-thin margins being squeezed, we think higher labour costs will contribute to a pick-up in inflation. At the same time, we expect the NZD to face more downward pressure on narrowing interest rate differentials, which will also give inflation a nudge. But with wage inflation weaker than one might usually expect, the outlook is very uncertain. Inflation is expected to lift, but only gradually.

We expect the OCR will eventually rise. But with evidence of a lift in domestic price pressures lacking and the outlook uncertain, the RBNZ will remain cautious for some time yet.

ANZ

MORTGAGE BORROWING STRATEGY

SUMMARY

Average fixed mortgage rates have generally fallen over the past month (particularly for longer terms). We still favour the 1-year fixed rate, although the gap to the 2-year fixed rate has narrowed modestly and may be attractive for some, particularly those concerned about any escalation in bank funding pressures or a surprise lift in inflation (perhaps driven by stronger wage growth) that spurs the RBNZ into earlier rate hikes. 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).

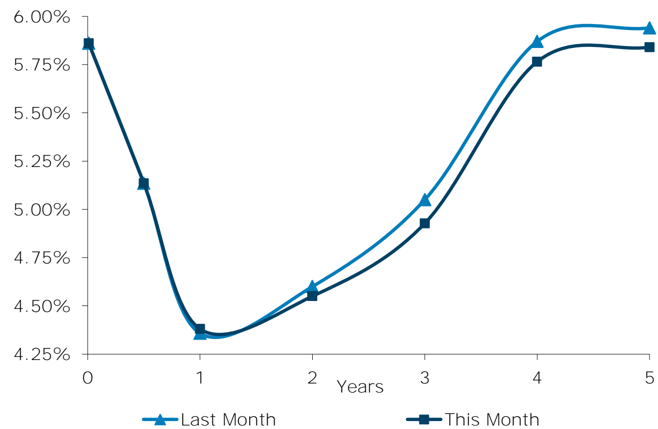
OUR VIEW

Average mortgage rates across the 'big four' banks have generally fallen over the past month. Average special rates for 3-5 year terms have fallen by around 0.1%pts, while the average 2-year special rate is 0.05%pts lower at 4.55%. The exception in the month was the 1-year rate, which rose slightly.

But despite its small rise, the 1-year term remains our favoured point to fix at present. It continues to be the lowest point on the mortgage curve and offers value given the RBNZ has recently reiterated emphatically that it is in no hurry to start to lift the OCR (in fact, it still highlights the non-trivial probability that the next move in the OCR could be a cut). We continue to pencil in the first OCR hike in August 2019, although can easily envisage scenarios where this is delayed further. In saying that, the gap between the 1- and 2-year fixed rates has narrowed, and may be attractive for those worried about an earlier rise in inflation pressures (perhaps led by strong wage inflation) or an escalation in bank funding costs.

Breakeven analysis supports this message. For instance, the average 2-year special rate is just 17bps above the 1-year rate. It means that the 1-year rate would need to rise by 34bps (from 4.38% to 4.72%) over the next year in order for it to be cheaper fixing for 2 years at 4.55% than rolling two 1-year terms. **That is certainly not out of the question.** There continues to be a larger step-up between the 2 year and 3 year (38bps); the breakeven on a 2-year at 4.55% versus a 3-year at 4.93% is 5.20%. 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%	3.63%	4.64%	4.81%	5.49%
1 year	4.38%	4.13%	4.72%	5.15%	5.68%
2 years	4.55%	4.64%	5.20%	6.01%	6.98%
3 years	4.93%	5.38%	6.23%	6.47%	6.70%
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%	4.60%	5.45%	5.09%	5.94%
1 year	4.91%	5.02%	5.27%	5.51%	6.11%
2 years	5.09%	5.27%	5.69%	6.07%	6.65%
3 years	5.43%	5.72%	6.19%	6.41%	6.72%
4 years	5.87%	6.06%	6.36%		
5 years	6.07%	*may be subject to a low equity fee			

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

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

	House prices (ann % chg)	3mth % chg	No of sales (sa)	Mthly % chg	Avg days to sell (sa)
Northland	8.2	3.2	218	-4%	39
Auckland	-0.6	-0.3	1,813	-3%	38
Waikato	2.6	1.6	675	-5%	38
Bay of Plenty	8.5	-0.1	482	+4%	42
Gisborne	14.2	11.9	55	-8%	41
Hawke's Bay	12.2	2.9	231	-2%	31
Manawatu-Whanganui	19.5	2.9	409	+4%	33
Taranaki	5.5	-0.5	152	-11%	35
Wellington	3.2	1.6	680	-2%	32
Tasman, Nelson and Marlborough	10.1	1.7	240	-25%	33
Canterbury	-1.1	0.2	828	+1%	36
Otago	19.3	-0.9	359	-2%	31
West Coast	4.1	8.4	36	-2%	64
Southland	19.9	-0.6	163	-2%	38
NEW ZEALAND	**1.7**	**0.3**	**6,502**	**0%**	**37**

Key forecasts

	Actual			Forecasts						
Economic indicators	**Jun-17**	**Sep-17**	**Dec-17**	**Mar-18**	**Jun-18**	**Sep-18**	**Dec-18**	**Mar-19**	**Jun-19**	**Sep-19**
GDP (Ann Avg % Chg)	3.3	3.0	2.9	2.8	2.8	2.9	3.0	3.1	3.2	3.1
CPI Inflation (Annual % Chg)	1.7	1.9	1.6	1.1(a)	1.4	1.6	1.7	1.9	2.1	2.1
Unemployment Rate (%)	4.8	4.6	4.5	4.4(a)	4.2	4.1	4.0	4.0	3.9	3.8
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	5.0	5.0	5.0	5.2	5.3
2-Yr Fixed Mortgage Rate	5.1	5.1	5.1	5.2	5.3	5.3	5.3	5.5	5.6	5.6
5-Yr Fixed Mortgage Rate	6.0	5.9	5.9	6.2	6.4	6.5	6.4	6.6	6.7	6.7

Source: ANZ, Statistics NZ, RBNZ, REINZ

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