ANZ RESEARCH

NEW ZEALAND PROPERTY FOCUS

July 2017

INSIDE

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WHEN THE TIDE FLOWS OUT……

SUMMARY

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

CHIEF ECONOMIST CORNER: INFLATION WATCH

Worried about your interest bill? Then keep an eye on inflation trends. We noted in January that inflation in New Zealand would lift off lows, but that the RBNZ would not respond and hike anytime soon. Six months on, and inflation signals are more mixed and convoluted, which will reinforce the RBNZ's cautious neutral tone and expectations that the OCR is firmly on hold. Global deflationary forces have reappeared and there is scant evidence of inflation pressures building outside of housing. Not only this, but some housing-related pockets have turned lower again. Technology continues to deflate firms' pricing ability. Looking forward, a key influence on inflation looks set to be the labour market, which is tightening, and the risk of a bow-wave of catch-up wage settlements is real. If that transpires (and at the moment it is still an 'if'), stronger productivity growth will be needed to cap adverse inflation consequences and mitigate how far the OCR will need to rise. We continue to expect the RBNZ to lift the OCR in mid-2018. However, risks are skewed towards later, and we are only expecting a gradually removal of stimulus, pencilling in two x 25bps rises per year in 2018 and 2019.

PROPERTY GAUGES

The property market continues to soften, particularly in Auckland. While housing shortages remain and natural population growth and migration is putting pressure on the balance between supply and demand, these drivers are being usurped. The interest rate cycle has turned, credit is harder to come by and LVR restrictions have knocked the investor market. That's a powerful combination, especially when some regions have severely stretched affordability metrics. Housing activity has slowed, and we expect the market to remain subdued into year-end.

ECONOMIC OVERVIEW

Momentum is picking up from a lull over late-2016 to early-2017. This pick-up will be modest, with the economy facing capacity constraints and late-cycle economic challenges, two of which are finding skilled labour and keeping excesses (namely inflation and house prices) in check. Business and consumer confidence are elevated, the terms of trade buoyant, fiscal policy is set to turn more expansionary, financial conditions supportive, tourism booming and migration strong. We expect solid, but not stellar growth. The OCR will rise eventually, in a slow manner.

MORTGAGE BORROWING STRATEGY

Average mortgage rates remain virtually unchanged compared with a month ago. The mortgage curve is (and has been) "tick-shaped" for a long time, and the 1 year rate remains the "sweet spot". Wholesale term interest rates have been more volatile, but we see limited scope for them to rise far. Low inflation has bought the RBNZ more time to keep the OCR on hold for longer and the market continues to push out expectations when the OCR might rise. Term rates remain historically low and offer certainty; but 1-2 year terms are cheaper.

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SUMMARY

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LOWER FOR LONGER

If you are worried about your interest bill and where interest rates might go, you need to look no further than the outlook for inflation. The RBNZ is mandated to keep inflation low and it changes the OCR to do so. This is one key influence on short-term interest rates.

We noted in January that inflation in New Zealand would lift off lows, but that the RBNZ wouldn't respond. This was due to the fact that a) banks and regulators were tightening policy and that would impact the housing market; b) after two failed attempts at tightening policy already, the RBNZ would want to see the whites of the eyes of inflation before responding this time around; and c) it doesn't respond to headline inflation anyway, rather the signals from core measures. Headline inflation has lifted from the sub-1% rates seen over 2015/16. But it is not a broad-based story, especially outside of housing, and there are now signs that some of the factors that contributed to the lift are waning. Inflation pressures over the June quarter were on the soft side, with prices actually falling 0.1% q/q in seasonally adjusted terms.

But our focus is on the outlook, so how do inflationary signals look right here and now?

- **Various core inflation measures tell a mixed story (see table below).** After rising in Q1 to sit in a 1.5% to 2.2% range, core measures (trimmed mean, weighted median, factor model, sectoral factor model, CPI ex food, energy and fuel) showed signs of softening a touch in Q2. Notably, the RBNZ's Sectoral Factor Model (a more stable measure) dipped to 1.4% after holding at 1.5% for six consecutive quarters.

Table 1. Various core/underlying inflation measures (annual % change)

	Q2 2017 (Q1 2017)	Recent direction	Comment
Tradable	0.9% (1.6%)	↓	NZD deflationary. Petrol sliding. Food prices up.
Non-tradable	2.4% (2.5%)	↓	Housing still the main (and only) impetus.
CPI ex food, energy, fuel	1.4% (1.6%)	↓	On the slide again.
Housing & household utilities	3.1% (3.3%)	↓	Main thrust of overall inflation
Central & local government charges	0.9% (1.0%)	↓	ACC levy falls offset other lifts in government charges. Eased in Q2.
Non-tradable less housing	1.8% (1.9%)	↓	Broad based inflationary pressures still missing.
Non-tradable less govt charges & tobacco	2.2% (2.3%)	↓	Stuck in range for past 12 months.
Trimmed mean (10%)	1.8% (2.2%)	↓	Unable to sustain above 2% target.
Weighted median	2.0% (2.2%)	↓	Eased first time in two years.
Factor Model	1.7% (1.8%)	↓	Turning back from the high in Q1 2017.
Sectoral Factor Model	1.4% (1.5%)	↓	First dip below 1.5% since September 2015.

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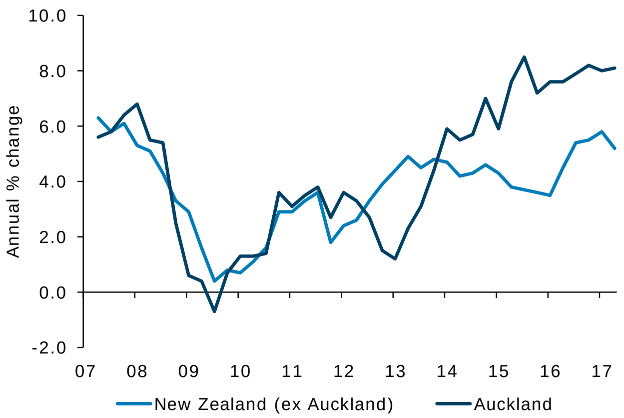
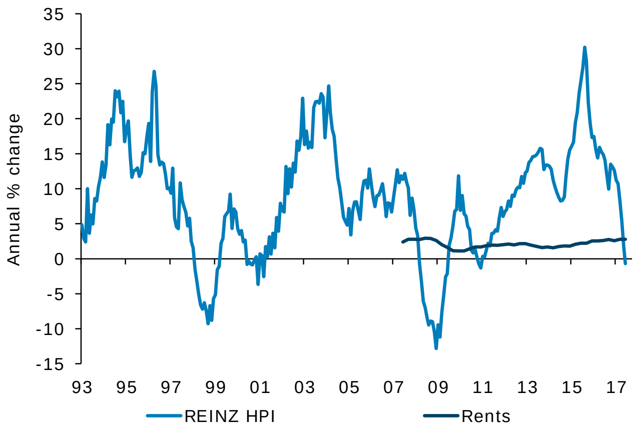
- **The economy had a soft patch in late 2016 and early 2017.** GDP grew at a sub-2% annualised rate in the six months to March and contracted modestly in per-capita terms. With growth below trend, that relieved some demand-pull impetus to inflation. However, prospects are firmer for activity growth in the later part of 2017, as some of the factors that earlier weighed on growth dissipate (weather disruptions and the initial drag from the introduction of LVR restrictions). **We see GDP growth accelerating and holding around 3%, which should continue to put pressure on capacity.** Historically, that has been inflationary.
- **Construction cost inflation is still rampant, although it is now climbing at a slower rate.** Capacity pressures are evident in the construction sector. Prices in the purchase of housing group (effectively an implied construction cost measure) rose 1.8% q/q in Q2, with annual growth at 6.4%. Pressures in Auckland are especially strong, with prices rising 3.0% q/q (8.1% y/y) in Q2, which continues a theme that has been evident for a number of years now.
- **But the housing market is now slowing – rapidly.** Annual house price inflation is running at its slowest rate since 2011, and prices are actually heading modestly backwards in the previous hot-spot – Auckland. Asset prices are not directly in the CPI, but asset prices do impact peoples' desire and willingness to spend via the wealth effect. When people spend, it's easier to expand margins. At present, we continue to see pressure on margins. "Specials" and "sales" are almost an everyday occurrence. Additionally, if house prices continue to cool, that could be a factor limiting further upside in construction costs.

Figure 1: Regional construction cost inflation



Source: ANZ, Statistics NZ

Figure 2: Auckland house price and rental inflation



Source: ANZ, Statistic NZ, REINZ

- **Rental inflation is modest, despite a so-called housing shortage.** Annual rental inflation across the country is only sitting at 2.1%, which is broadly where it has held since 2012. In Auckland, where housing shortage pressures are supposedly most prevalent, rents are growing at a slightly stronger 2.9% y/y pace. However, that is down from 3.5% just 12 months prior. Modest rental inflation is a signal that housing shortages was not the key reason house prices exploded in Auckland between 2010 and 2016.
- **Our Monthly Inflation Gauge – a timely proxy for domestic-generated inflation – is subdued.** Annual growth in the Gauge was just 2.1% in June and price growth remains largely confined to housing. The Underlying Ex-housing Gauge was up just 0.9% y/y in June, which was also a clear theme within the Q2 CPI figures. Non-tradable excluding housing prices actually fell 0.3% q/q in Q2. While that partly reflects seasonal forces, annual inflation in this group eased to just 1.8% y/y. Since 1999, it has averaged 2.6%.
- **Firms' pricing intentions have picked up, but are not alarming, and we've typically seen them overshoot reality for years.** Our June Business Outlook survey showed a net 31% of firms intended on lifting their prices over the coming 12 months, which is actually the highest since February 2014. It also compares with an average of net 21%. Intent to raise prices is not matching the reality though with the power in consumers' hands.
- **New Zealand's commodity prices have lifted and that typically means the same for food prices at the retail level.** Mother Nature has certainly played a role in lifting the former of late, with fruit and vegetable prices up 8.8% y/y in Q2 and at least some of this spike is likely to unwind. But New Zealand's

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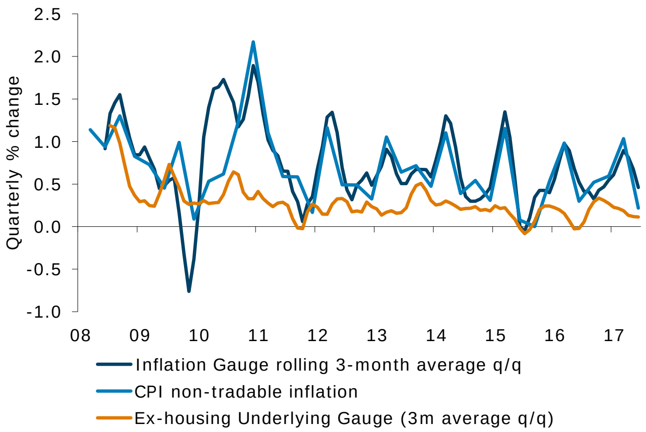
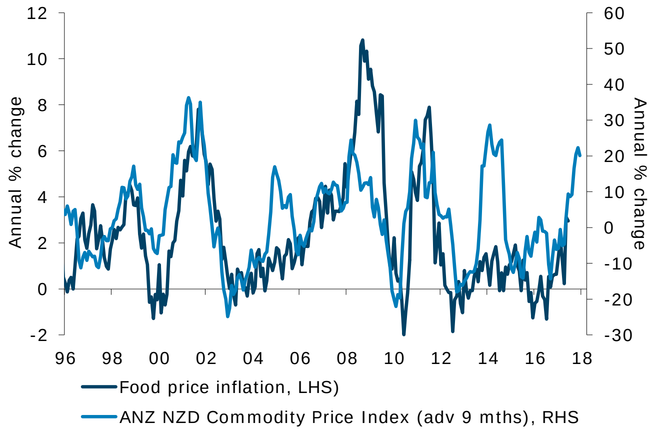
soft commodity export prices are up 20% y/y in NZD terms. The prices of dairy products have been on the move at the supermarket.

Figure 3: Monthly Inflation Gauge and Non-tradable CPI



Source: ANZ, Statistics NZ

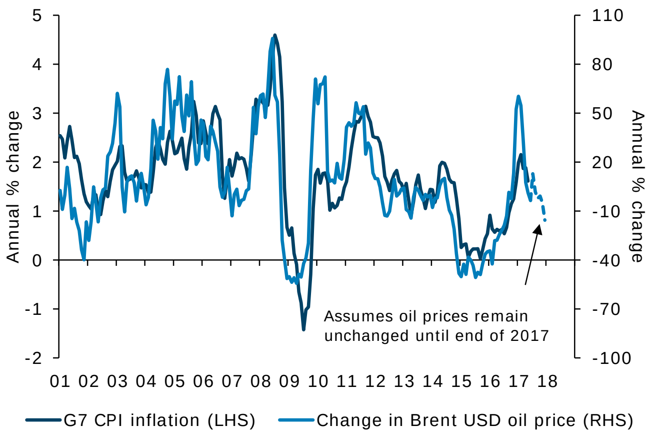
Figure 4: Food prices and export commodity prices



Source: ANZ, Statistic NZ

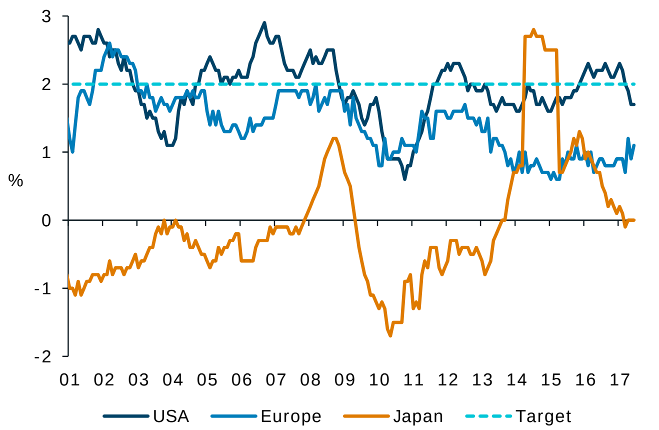
- **Industries continue to compete with technological change and disruptive technologies, which is removing pricing power.** It's far broader than just the impact of online shopping. Pricing for more and more items (and services) is being challenged via technology platforms and delivery mechanisms.
- **The global inflation cycle turned up in late 2016, but that impulse is now fading.** Oil prices are a key influence. The price of crude oil has fallen roughly 15% since mid-April. Together with a stronger NZD and reduced fuel retailer margins, lower crude prices have seen local discounted petrol prices fall from an average of $1.90/litre over the March quarter, to around $1.70/litre currently. As such, if prices hold at this level for the remainder of the September quarter, they will knock around 0.3%pts off headline inflation, after dragging by 0.1%pts in Q2. This factor alone will likely see headline inflation head to the bottom of the RBNZ's 1-3% target band again over the coming 12 months. But it is not just about oil. Core inflation around the globe continues to languish. And even in countries where there were some signs it was picking up (US), it has rolled over of late. US core CPI inflation sat at 2.3% y/y at the start of the year. It is now 1.7%.

Figure 5: G7 CPI inflation and oil prices



Source: ANZ, Bloomberg

Figure 6: G3 core inflation



Source: ANZ, Bloomberg

- **The NZD rose over Q2 and continues to contain tradable inflation.** The impact of retail discounting and the deflationary impact of the NZD were evident in Q2. Tradable prices, excluding petrol, were flat in the quarter and that is before another lift in food prices is stripped out. After rising to 1.6% y/y in Q1, we forecast annual tradable inflation to reverse course and turn negative again by late this year. Annual tradable ex-petrol price inflation is forecast to be flat by year's end.

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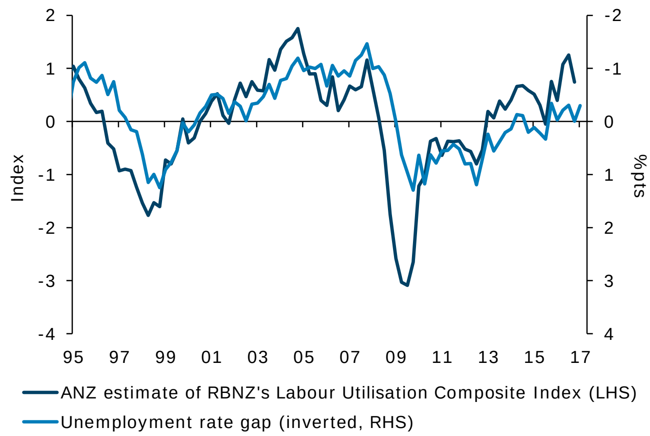
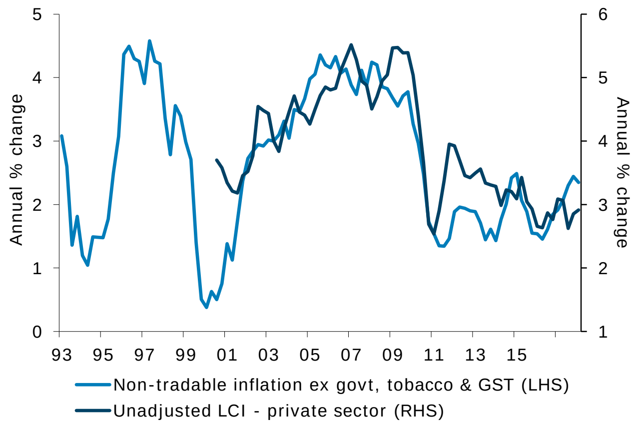
- **The labour market is tightening.** Job ads are growing at 14% y/y (on a three month average basis) and the job vacancy rate was the highest since 1994 (when our job ads series begins) in Q1, at 4.7%. Finding skilled employees is the biggest problem facing firms according to our Small Business Microscope. Strong net migration and lifts in the labour force participation rate have helped provide some offset to these pressures so far, but the former faces political push-back and each incremental lift in the latter is becoming more difficult (the participation rate already sits at an all-time high of 70.6%). We estimate that, at 4.9%, the unemployment rate is already below our current spot estimate of non-accelerating inflation rate of unemployment (NAIRU), and this is consistent with the tightening signal from our estimate of the RBNZ's Labour Utilisation Composite Index. We don't buy into the mumbo-jumbo that the NAIRU is currently in the low 4's; there are far too many frictions in the labour market for that.
- **Wage growth is lagging tightness in the labour market, but pressure is mounting.** Where skill shortages are most apparent (i.e. construction), wage inflation is outperforming. Not only will the aged-care gender equality settlement struck by the Government mechanically boost wage inflation figures from Q3, it appears to already be spilling-over into other sectors. Anecdotally, tighter residency visa eligibility is also having similar spill-over impacts in the likes of the hospitality sector, with wages being pumped up to satisfy criteria. Wage inflation has historically been a key influence on service sector inflation trends. But it should also be broader than this. With inflation expectations higher and headline inflation up around the 2% target mid-point (although it doesn't appear as though it will stay there admittedly), more workers will start to demand cost of living adjustments. Watch this space.

Figure 7: Unemployment gap and ANZ's estimate of RBNZ's Labour Utilisation Composite Index



Source: ANZ

Figure 8: Labour Cost Index and Non-tradable inflation



Source: ANZ, Statistics NZ

- **But a huge layer of uncertainty surrounds how the labour market is going to evolve.** On some levels (noted above) we have an inflationary cocktail. However, this is going head-to-head with structural shifts as technology removes jobs and lessens workers' bargaining power. This is a global theme. The Beveridge curve (the relationship between the unemployment rate and job vacancy rate) has shifted out, signalling a less efficient labour market and mismatches between jobs available and the skills workers possess. That results in greater dispersion across wages settlements; some do well, and others (where there is surfeit labour supply or technology is impacting) not at all.

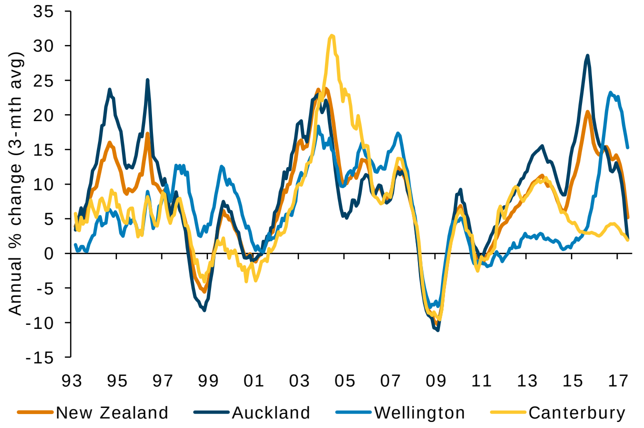
That's an undeniably more mixed picture than we detected in January. At a time when the RBNZ was already ultra-cautious given numerous uncertainties with the outlook, it reinforces that the OCR is set to remain low for quite a bit longer yet. Market expectations for the first OCR hike have moved from late 2017/early 2018 to mid-2018. The RBNZ is saying that it won't be hiking until perhaps 2019.

Ongoing low inflation challenges [our] view that the OCR will lift in mid-2018. That's been our view for some time and we're not inclined to shift it at present. However, **we acknowledge that the risks are increasingly being skewed towards hikes being delayed. Critical in our mind is how wage growth pressure evolves.** We expect some pick-up, but productivity growth will need to lift as well and mitigate pressure on margins.

Irrespective, there's little case for rates moving up sharply (which has tended to be the historical experience) and that should be of some comfort to borrowers.

THE PROPERTY MARKET IN PICTURES

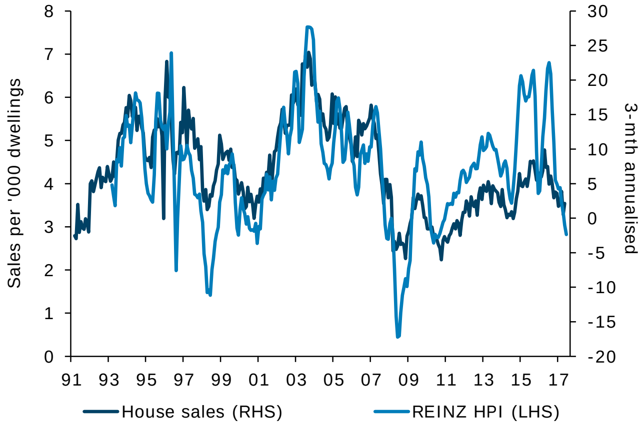
Figure 1. Regional house prices



Source: ANZ, REINZ

We estimate the nationwide REINZ House Price Index fell 0.7% m/m (seasonally adjusted - sa) in June, which saw annual growth fall to 2.7% (the chart is presented in 3-month average terms). That is the softest annual growth since 2011. Auckland is certainly bearing the brunt of the softening, with prices falling 1.0% m/m (sa) in June, which is the fourth fall in the past five months. In fact, Auckland prices are down 3.6% since January. Across the rest of the country, prices were flat in June (sa) and are still running at a 9.2% y/y pace. While off its highs, Wellington is still recording annual price growth of 13%.

Figure 2. REINZ house prices and sales

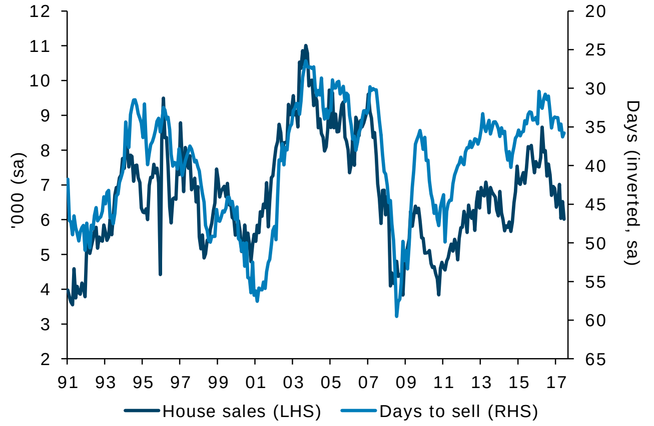


Source: ANZ, REINZ

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

Seasonally adjusted sales volumes fell 7.8% m/m in June. Although volatile of late, a weak trend remains, with sales volumes down 25% y/y. Again, Auckland is underperforming, with turnover down over 33% y/y, although most regions are now experiencing negative annual turnover growth. Excluding Auckland, sales volumes fell 8.0% m/m (sa) in June and are down 20% y/y.

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 dipped by half a day to 35.8 days (sa) in June. While that remains below its historical average (39.6 days), it is up from less than 31 days 12 months prior.

The median time to sell a property is below historical averages in every region with the exception of Auckland, Canterbury and the West Coast.

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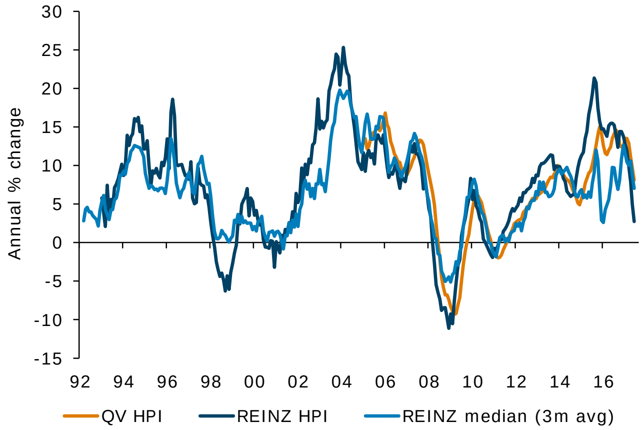
Figure 4. REINZ and QV house prices

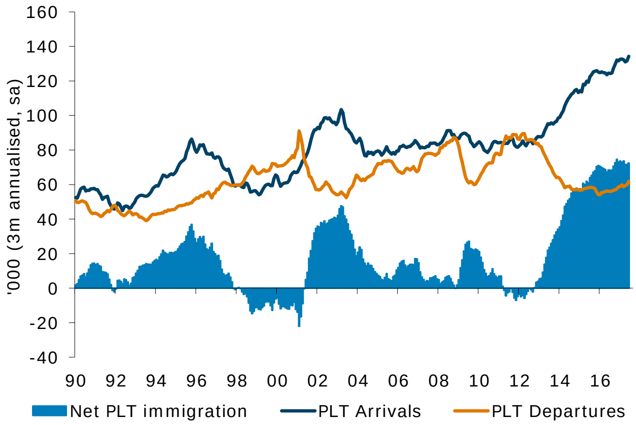


Source: ANZ, REINZ, QVNZ

There are three key 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, with the REINZ median typically more volatile as it is sensitive to the composition of sales taking place.

The REINZ median sale price dipped 0.4% m/m (sa) in June and is up 5.8% y/y. This is now a little stronger than the REINZ House Price Index (2.7% y/y) and a little lower than the QVNZ measure of price growth (8.1% y/y). The latter two measures adjust for changes in the quality of houses sold.

Figure 5. Net permanent/long-term immigration



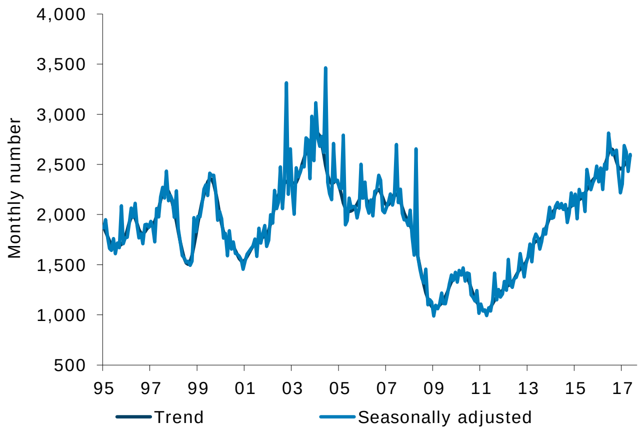
Source: ANZ, Statistics NZ

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 all coincided with large net migration inflows.

On a three-month annualised basis, net permanent and long-term migration rose over 72k in June. This is near-record levels and over 1½% of the resident population. Although departures look to have started trending higher off low levels, more arrivals over the past 12 months or so is dominating.

Migration inflows are expected to remain strong. New Zealand's current strong labour market (particularly relative to Australia, by far the most relevant comparator) will lure people home. In a world of fractured international politics (Brexit, US political uncertainty), there'll be no shortage of people with a desire to move to New Zealand.

Figure 6. Residential building consents



Source: ANZ, Statistics NZ

Seasonally adjusted dwelling consent issuance rebounded 7.0% m/m in May, following a 7.4% m/m drop in April, which Statistics NZ stated was in part due to the timing of Easter (and reduced processing days). But stepping back from the monthly volatility, the level of issuance has effectively been hovering around the same level for 12 months now. May issuance was in line with the average monthly issuance experienced over the past year.

The sector is grappling with two clear opposing forces. The demand backdrop is clear, with a housing shortage (at least in Auckland) and strong population growth requiring ongoing lifts in housing supply. However, that supply response is being challenged by capacity and capital constraints in the construction industry.

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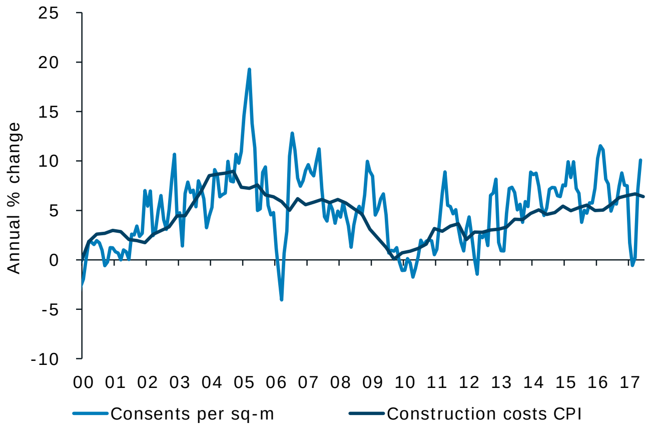
Figure 7. Construction cost inflation

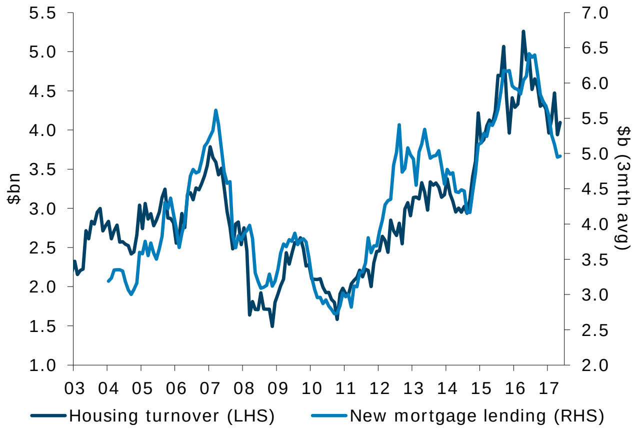


Source: ANZ, Statistics NZ

On a three-month average basis, **the value of residential consents per square metre rose 10.1% y/y in May.** This proxy for construction costs had shown surprising weakness in earlier months, which we felt was likely due to the composition of issuance more than anything. The sharp bounce-back corroborates this view.

Costs per square metre in Auckland (especially in the multi-dwelling space) have lifted especially strongly of late, and our internal anecdotes continue to highlight that capacity pressures in the construction sector are intense, with a severe shortage of labour.

Figure 8. New mortgage lending and housing turnover



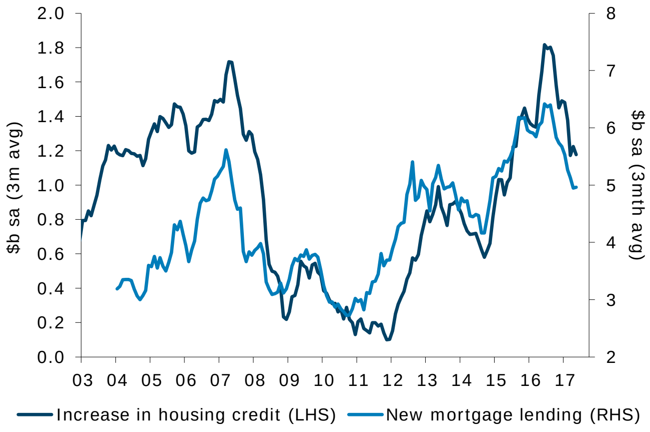
Source: ANZ, RBNZ

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

New mortgage lending lifted in May (the chart is presented in 3-month average terms). We estimate that in seasonally adjusted terms, new lending rose 10% m/m to $5.05bn, which followed a 13% m/m plunge in April. Overall, new lending is down 17% y/y, with the fall mirroring the fall in the value of housing turnover.

New investor lending continues to be weak. In May, lending to investors was down 40% y/y, making up 25% of total lending. Conversely, new lending to first home buyers was up 1.9% y/y, making up 14% of the total.

Figure 9. New mortgage lending and & housing credit



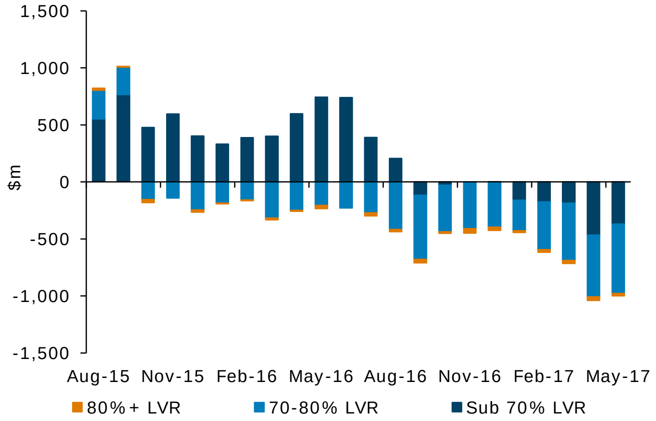
Source: ANZ, REINZ, RBNZ

Growth in the overall stock of mortgages has continued to cool, after a period of strong growth. In May, total housing credit growth rose just 0.4% m/m (sa), which is the softest monthly growth since mid-2015. In three-month annualised terms, lending growth eased to just 6.2%, well down from the 10% pace recorded in August 2016.

The latest tightening of the high-LVR lending restrictions – together with increased credit rationing by banks – appear to be having a marked impact on both house sales and credit availability. Add in the rise in mortgage rates seen at the end of last year (and widespread expectations of more to come), and we expect to see mortgage lending growth remain at this more moderate pace over the coming months.

THE PROPERTY MARKET IN PICTURES

Figure 10. Annual change in investor lending by LVR

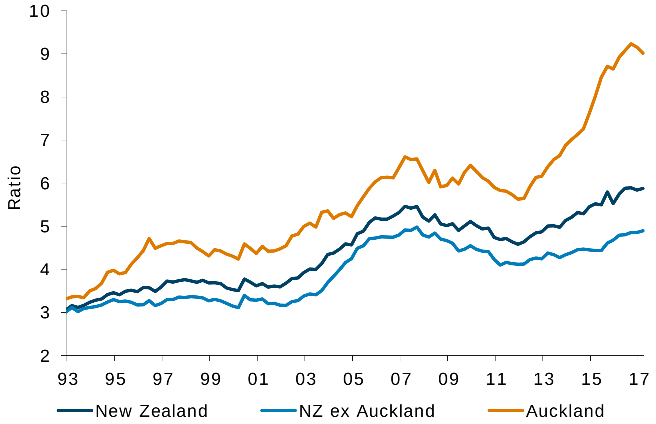


Source: ANZ, RBNZ

New lending to investors is well off its mid-2016 peak, down 40% y/y in May. Investors' share of overall new lending, at 25%, is well down from a peak of 38% in June 2016. This is no doubt related to the latest round of RBNZ LVR restrictions, which officially came into force on 1 October 2016 but influenced lending decisions in the months prior.

Related to this, a larger share of new lending is on less-risky terms. In May, the share of total investor lending done at LVRs of less than 70% was over 90%. That is a far greater share than in late-2014 when it was less than half.

Figure 11. Regional house prices to income

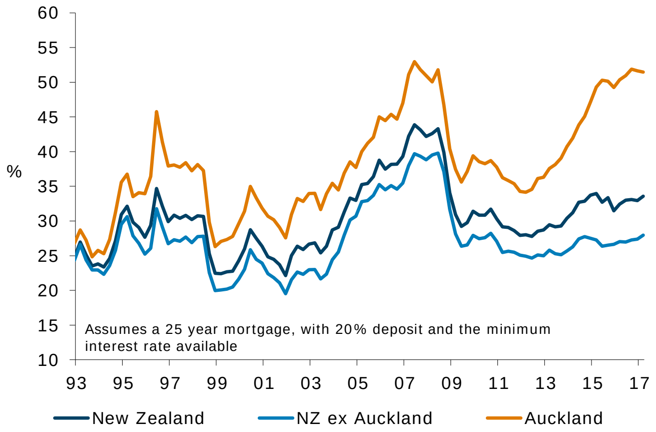


Source: ANZ, REINZ, Statistics NZ

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 sits just below 6, which is slightly above the previous highs recorded prior to the GFC. However, there is a stark regional divide. We estimate the average house price to income in Auckland sits at around 9 times, although this is off its recent high. Elsewhere, the ratio is around 5 times, which is back where it peaked prior to the financial crisis.

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 34% at the moment.

However, once again there are stark regional differences, with the average mortgage payment to income in Auckland around 52% for new purchasers. That is 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 property market continues to soften, particularly in Auckland. While housing shortages remain and natural population growth and migration is putting pressure on the balance between supply and demand, these drivers are being usurped. The interest rate cycle has turned, credit is harder to come by and LVR restrictions have knocked the investor market. That's a powerful combination, especially when some regions have severely stretched affordability metrics. Housing activity has slowed, and we expect the market to remain subdued into year-end.

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	Too high	↔/↓	You need a lot of debt or huge equity / deposit to buy.
Serviceability/ indebtedness	Will rise as interest rates do	↔/↓	Rising interest rates (albeit slowly) will bite into disposable income.
Interest rates / RBNZ	Slow ascent	↓	We've seen the lows for interest rates.
Migration	Booming	↔/↑	Will slow a bit but hard to see a material tailing off.
Supply-demand balance	Demand > Supply	↔/↑	We need to be building 35-40k plus dwellings, not ~30k.
Consents and house sales	Shortage	↔/↑	Consents have peaked as capacity constraints (builder availability) bite.
Liquidity	Tightening	↓	Money no longer easy to get.
Globalisation	Mixed bag	↔	Non-resident buyers no longer that influential.
Housing supply	Too few	↔/↑	Fewer builders + higher construction costs + less credit = supply struggles to keep up.
House prices to rents	Too high	↔/↓	Rents are not moving up much. That suggests housing shortages are the key market driver is fiction.
On balance	**Flat-lining**	↔	**Less credit + LVRs + no more rate cuts = a market plateau**

PROPERTY GAUGES

Figure 1: Housing affordability

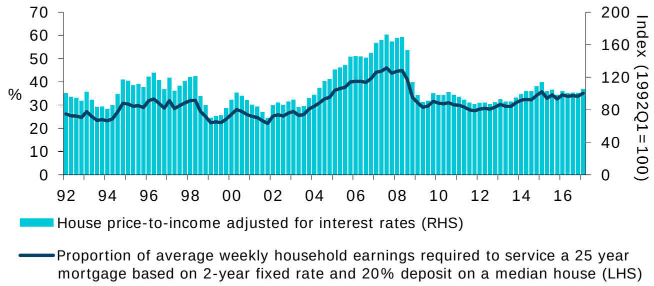


Figure 2: Household debt to disposable income

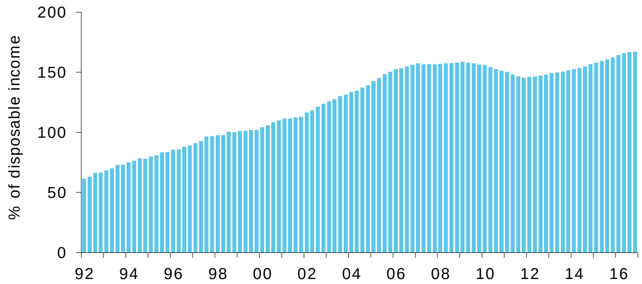


Figure 3: New customer average residential mortgage rate (<80% LVR)

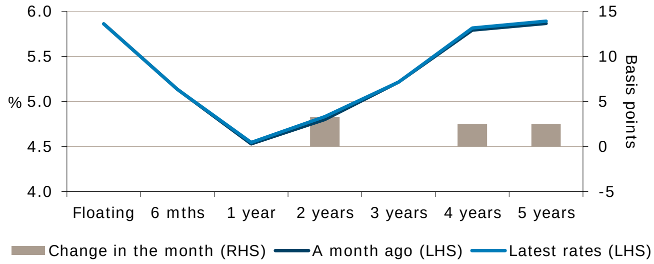


Figure 4: Net migration

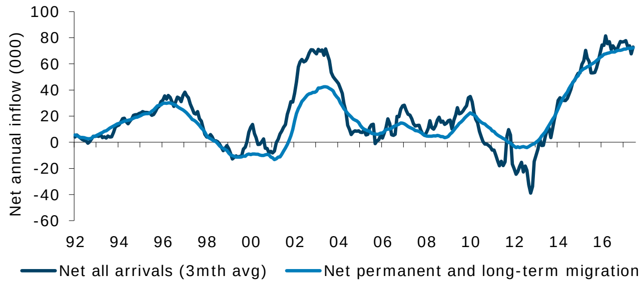


Figure 5: Housing supply-demand balance

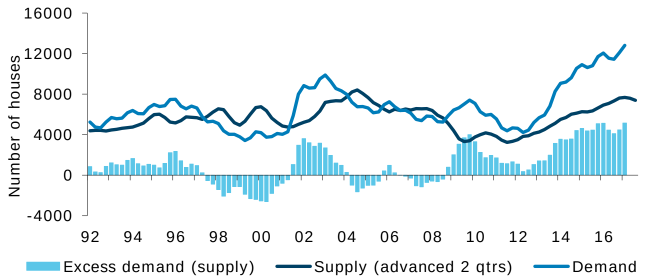


Figure 6: Building consents and house sales

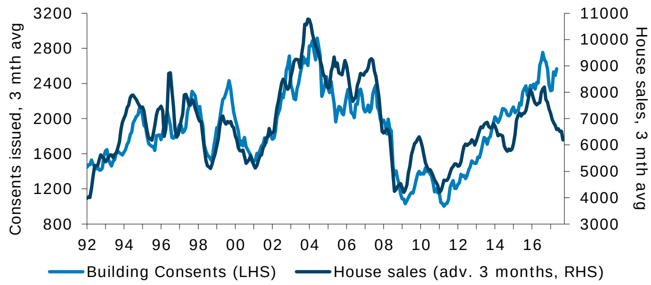


Figure 7: Liquidity and house prices

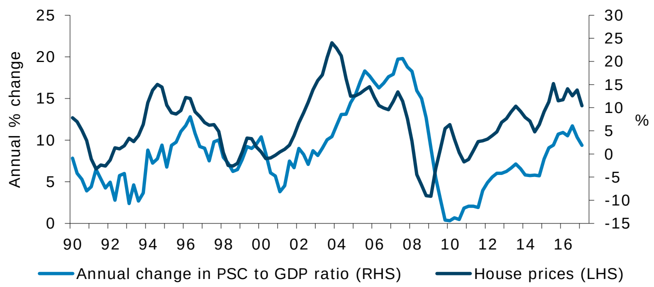


Figure 8: House price inflation comparison

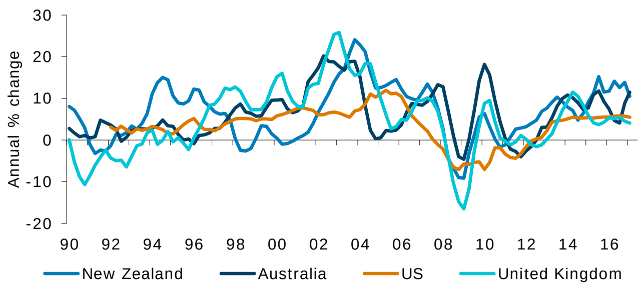


Figure 9: Housing supply

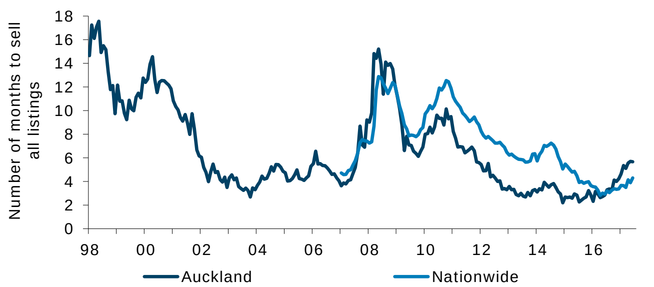
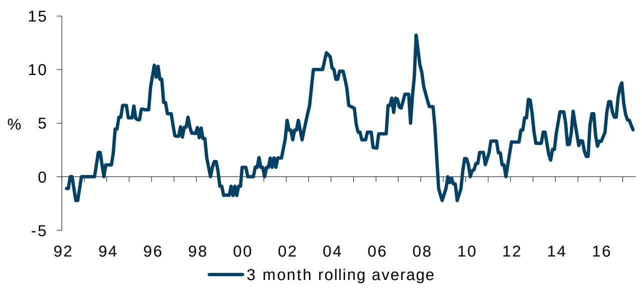


Figure 10: Median rental, annual growth



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

ECONOMIC OVERVIEW

SUMMARY

Momentum is picking up from a lull over late-2016 to early-2017. This pick-up will be modest, with the economy facing capacity constraints and late-cycle economic challenges, two of which are finding skilled labour and keeping excesses (namely inflation and house prices) in check. Business and consumer confidence are elevated, the terms of trade buoyant, fiscal policy is set to turn more expansionary, financial conditions supportive, tourism booming and migration strong. We expect solid, but not stellar growth. The OCR will rise eventually, in a slow manner.

OUR VIEW

Momentum is picking up from a lull over late-2016 to early-2017. This pick-up will be modest, with the economy facing capacity constraints, a sustained slowdown in house prices and late cycle challenges.

There are numerous tailwinds. These include a terms of trade set to hit all-time highs (with growing evidence we are moving up the export value-added chain), a strong policy platform (and one that has far more flexibility than many of our trading partners), fiscal policy that is set to turn modestly expansionary, persistently strong net migration inflows, decent household income growth, a further lift in business investment, and a continuation of ongoing strong performance from the likes of construction and tourism (notwithstanding capacity challenges).

Importantly, the "worry" variables, which can alert of pending corrections, are not so worrying. Historically, New Zealand's business cycle (and housing market) has come to an abrupt end as the combination of valuation excesses, leverage build-up, inflation, and current account profligacy result in a correction. While we have some excesses in the Auckland property market, and households have been leveraging again, this is being managed more proactively by LVR restrictions and tighter credit conditions. Inflation is low so the OCR will remain the same for a while yet, and the current account deficit is contained at 3% of GDP.

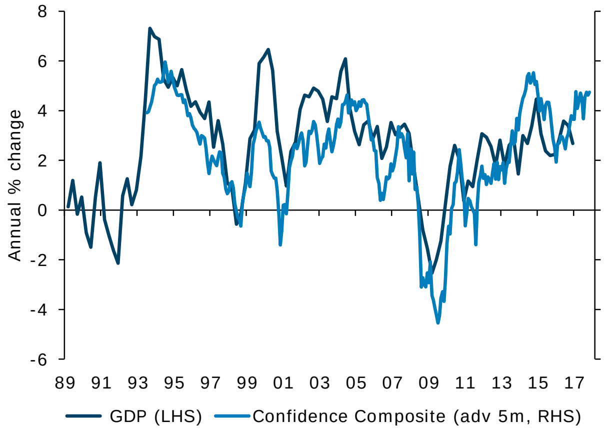
Policymakers are being more proactive with prudential policy to cool the housing market and that's taming one "worry". The latest round of LVR restrictions has slowed the property market (in Auckland especially where prices are falling) and more prudential options are being put on the table. Debt-to-income limits are being proposed and the RBNZ is looking at bank capital requirements. There is always the risk that interventions carry more cons than pros. However, removing excesses (if policy is well targeted) dilutes the potential for an adverse correction and takes pressure off the RBNZ to use its primary weapon, namely the OCR.

More broadly, the credit cycle has turned. Annual growth in private sector credit has slowed from 8% to 6%; which is only now on par with national income growth and further slowing is likely. We view that as a positive. Credit booms tend to be followed by busts.

There are challenges and tensions. Skill shortages are crimping the economy's ability to grow, and we suspect this will manifest in wage demands over the coming years. A strong focus on productivity will be critical to ensure it doesn't undermine competitiveness.

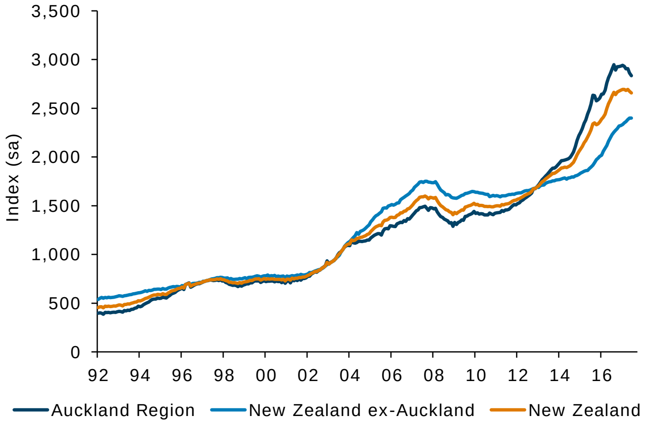
GDP growth is forecast to run at an annual pace of around a 3% pace over the next 18 months. House price inflation is expected to remain subdued. The RBNZ will lift the OCR, but not until mid-2018.

Figure 1. GDP vs Confidence Composite



Source: ANZ, Roy Morgan, Statistics NZ

Figure 2. Regional house prices



Source: ANZ, REINZ

MORTGAGE BORROWING STRATEGY

SUMMARY

Average mortgage rates remain virtually unchanged compared with a month ago. The mortgage curve is (and has been) "tick-shaped" for a long time, and the 1 year rate remains the "sweet spot". Wholesale term interest rates have been more volatile, but we see limited scope for them to rise far. Low inflation has bought the RBNZ more time to keep the OCR on hold for longer and the market continues to push out expectations when the OCR might rise. Term rates remain historically low and offer certainty; but 1-2 year terms are cheaper.

OUR VIEW

Mortgage rates remain steady, with the overall level and term structure of the mortgage curve pretty much as it has been since January, when average term rates^ rose between 0.3-0.4%pts.

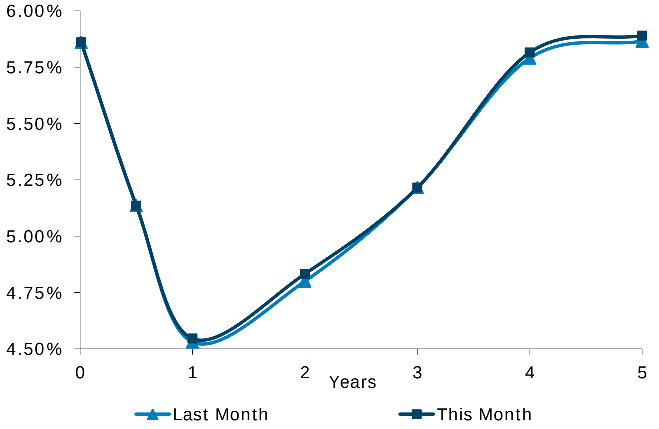
The 1 year rate remains the lowest point on the curve. It is also where we see the "sweet spot", on the view that the risk is that we see the RBNZ leave the OCR on hold for a longer, rather than shorter period. This is largely a reflection of the risks around the inflation profile – as noted below and in the Economic Overview page.

Against this backdrop, **we believe engaging in a strategy of rolling a string of back-to-back 1 year terms is appealing**, at least until we are confident that short term rates will rise; at which time it may be appropriate to lengthen the term of fixes. Consider, for example the choice between fixing for 2 years or a plan to fix for back-to-back 1 year terms. Breakevens show that you'd need to see the 1 year rate rise by 0.57%pts (from 4.55% to 5.12% over the next year) before you'd regret the back-to-back option. **That could happen, but it seems unlikely with the OCR on hold.**

Within the "back-to-back 1 year" strategy, **it may pay to stagger borrowings into perhaps 2-3 tranches** so that only a portion of debt is rolling over on any particular date, to avoid inflexibility.

Although mortgage rates have been steady, **this masks some fairly significant changes to market conditions** locally and globally. Global term rates (the major driver of long term rates here) rose sharply at the end of June, but have now fallen again. With global inflation coming off and the major central banks like the Fed and the ECB more attuned to tightening liquidity rather than lifting policy interest rates, **we see less scope for US and European bond yields to rise, which should keep a lid on longer term rates here.**

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%	3.96%	4.98%	5.26%	5.79%
1 year	4.55%	4.47%	5.12%	5.53%	5.98%
2 years	4.83%	5.00%	5.55%	6.13%	6.80%
3 years	5.22%	5.58%	6.24%	6.43%	6.60%
4 years	5.82%	5.94%	6.23%		
5 years	5.89%	#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	5.24%	4.71%	5.94%	5.29%	5.97%
1 year	4.97%	5.32%	5.62%	5.63%	6.11%
2 years	5.29%	5.48%	5.86%	6.08%	6.54%
3 years	5.57%	5.82%	6.23%	6.38%	6.66%
4 years	5.92%	6.11%	6.40%		
5 years	6.12%	*may be subject to a low equity fee			

Locally, two developments are noteworthy. **The first has been the string of benign readings from our Monthly Inflation Gauge, which was validated by the soft Q2 CPI reading.** All else equal that gives the RBNZ more "breathing room" and potentially elongates the period of policy stability, and should cap short term mortgage rates. **The second development has been the near closing of the household deposit/lending gap.** When this gap was wide, it added pressure on the banks to raise retail deposit and mortgage rates to encourage deposits and discourage borrowing. That pressure has now been alleviated somewhat, and together with lower inflation, should be good news for borrowers.

^ 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 June 2017 (based on REINZ data)

	House prices (ann % chg)	3mth % chg	No of sales (sa)	Mthly % chg	Avg days to sell (sa)
Northland	18.3	6.3	170	-14%	45
Auckland	2.3	-1.1	1,717	-7%	39
Waikato	8.2	5.2	657	-1%	34
Bay of Plenty	14.2	3.0	419	-8%	42
Gisborne	6.3	-3.7	56	+7%	37
Hawke's Bay	16.6	-0.5	251	+12%	27
Manawatu-Wanganui	18.9	4.9	349	-10%	30
Taranaki	3.3	0.2	169	+6%	35
Wellington	16.7	5.1	746	-3%	28
Tasman, Nelson and Marlborough	20.0	2.6	206	-23%	32
Canterbury	1.1	-0.3	801	-14%	38
Otago	12.6	6.6	380	-9%	30
West Coast	42.8	13.7	34	-12%	187
Southland	21.4	4.0	162	-4%	29
NEW ZEALAND	**5.8**	**2.3**	**6,014**	**-8%**	**36**

Key forecasts

	Actual			Forecasts						
Economic indicators	**Sep-16**	**Dec-16**	**Mar-17**	**Jun-17**	**Sep-17**	**Dec-17**	**Mar-18**	**Jun-18**	**Sep-18**	**Dec-18**
GDP (Ann Avg % Chg)	3.0	3.1	3.0	2.8	2.7	2.8	3.0	3.1	3.1	3.0
CPI Inflation (Annual % Chg)	0.4	1.3	2.2	1.7(a)	1.6	1.3	1.2	1.8	2.4	2.5
Unemployment Rate (%)	4.9	5.2	4.9	4.8	4.7	4.7	4.6	4.5	4.4	4.4
Interest rates (RBNZ)	**Sep-16**	**Dec-16**	**Mar-17**	**Jun-17**	**Sep-17**	**Dec-17**	**Mar-18**	**Jun-18**	**Sep-18**	**Dec-18**
Official Cash Rate	2.00	1.75	1.75	1.75	1.75	1.75	1.75	2.00	2.25	2.25
90-Day Bank Bill Rate	2.2	2.0	2.0	2.0	2.0	2.0	2.1	2.3	2.5	2.5
Floating Mortgage Rate	5.6	5.7	5.8	5.8	5.8	5.8	5.8	6.1	6.3	6.3
1-Yr Fixed Mortgage Rate	4.9	4.9	5.1	5.1	5.1	5.2	5.2	5.4	5.5	5.5
2-Yr Fixed Mortgage Rate	5.1	5.1	5.3	5.3	5.3	5.3	5.4	5.5	5.6	5.7
5-Yr Fixed Mortgage Rate	5.6	5.9	6.3	6.3	6.1	6.1	6.2	6.3	6.5	6.6

Source: ANZ, Statistics NZ, RBNZ

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