NEW ZEALAND PROPERTY FOCUS

September 2017

INSIDE

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A FIRESIDE CHAT

SUMMARY

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

CHIEF ECONOMIST CORNER: A FIRESIDE CHAT

In this month’s feature article, our Chief Economist Cameron Bagrie provides some quick answers to topical housing market questions. He concludes 1) that LVR restrictions could be loosened from mid-2018, but likely in a staggered manner; 2) despite the economics (a supply shortage) telling us prices will keep rising in Auckland, the fact that rents haven’t moved to reflect the shortage shows us house prices have been heavily influenced by interest rates and credit – and these factors are set to be less supportive going forward; 3) the banks’ funding gap is still a key indicator and it has closed up, which suggests some of the extreme competitive pressure in the deposit space could ease and the credit wheels could turn a little faster; 4) falling Auckland house prices and rising construction costs could spell trouble in the developer space; and 5) while weaker housing activity has traditionally turned the broader economy lower, that link is expected to be broken to some degree this cycle.

PROPERTY GAUGES

Long-term fundamentals (population growth, migration) are going head to head with cyclical drivers (mortgage rates bottoming out, affordability, credit availability and LVR restrictions). While you can’t ignore the fundamentals, cyclical drivers – such as the ability to borrow and at what interest rate – are hugely relevant, particularly when they push the market up a long way in a short space of time. Auckland is the case in point, and we expect the cyclical drivers to work in a reciprocal manner and keep activity constrained, despite an obvious shortage. If rents were rising sharply, we’d have more sympathy for the fundamentals dominating over the coming year.

ECONOMIC OVERVIEW

Some key economic drivers have either peaked or are set to peak, and the housing cycle has turned. New drivers will come to fore in the form of commodity prices, fiscal policy and rising household incomes. We expect the economic expansion to extend further, with modest GDP growth over the years ahead. Inflation is expected to remain low and the same applies to the OCR. An extended period of election-related uncertainty would be unwelcome and would have the ability to derail the economy’s transition from the “old” drivers to the “new”.

MORTGAGE BORROWING STRATEGY

Average mortgage rates nudged a little lower in what we call the belly (2-3 year) of the curve but retained the familiar tick-shape. From a pure “lowest is best” assessment, the 1 year rate stands out. Slight movements lower in the 2 and 3 year rates have improved their break-evens but not sufficiently for us to move from favouring the 1 year rate as the sweet spot. Longer-term rates remain very low by historic standards and offer certainty. The downside is that we struggle to see where inflation is going to come from to necessitate major lifts in the OCR.

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In this month's feature article we put some topical housing market questions to our Chief Economist, Cameron Bagrie.

WHEN CAN LVR RESTRICTIONS COME OFF?

The case can be argued that they should come off soon. This is because:

- The case for implementing them in the first place was hardly overwhelming.
- House prices are now falling in Auckland.
- Household credit growth is now running below income growth; people are deleveraging and that's a sign the policy might have overcooked things.
- LVR restrictions were always intended to be a short-term tool; the longer you leave them in place, the greater the potential for seepage and for lending to be diverted into unregulated channels. We do note that housing lending by non-bank lending institutions is currently running at 28% y/y (as opposed to bank lending at 6.9% y/y).

That's balanced by the following:

- It's impossible to disentangle the impact of LVR restrictions from other forces that have weighed on the market. The interest rate cycle has turned. Banks have rationed credit to close the funding gap. Offshore buyers have been MIA. Additionally, the fact that Auckland is underperforming other parts of the country tells us that affordability has been a key issue.
- The risk – that recent history has taught us is entirely possible – is that the Auckland property market gets yet another wind and rises from the ashes after the initial negative response to restrictions.
- A number of demand-supportive forces are still evident. Net migration is still hovering around all-time highs and interest rates near historic lows.
- RBNZ rhetoric is still more directed at concern that the market could take off again. In its May Financial Stability Report the Bank stated that "A further resurgence in house prices would be of real concern, given existing affordability constraints."

Net on net, I do believe that we are closer to the day when these restrictions are relaxed, but the earliest that would be is mid-2018 after the RBNZ delivers the May Financial Stability Report. And what I mean by "relaxed" is a marginal tweak in the first instance, as opposed to removing them completely. This would likely involve investors' deposit requirements being eased to 30% from 40%, and perhaps some marginal relaxing of the speed limit for owner occupiers (i.e. allowing a few more +80% LVR loans).

THERE IS A SUPPLY SHORTAGE IN AUCKLAND SO ECONOMICS 101 TELLS US PRICES WILL KEEP RISING, RIGHT?

Not necessarily.

We put the shortage of housing in Auckland at around 20-25k units (although there is plenty of uncertainty around this estimate). So yes, the economics supports a view of rising prices. Auckland's population has grown 11% in five years (NZ ex-Auckland grew 5% over the same period) and regional projections are for that to continue, putting immense pressure on housing costs and broader infrastructure.

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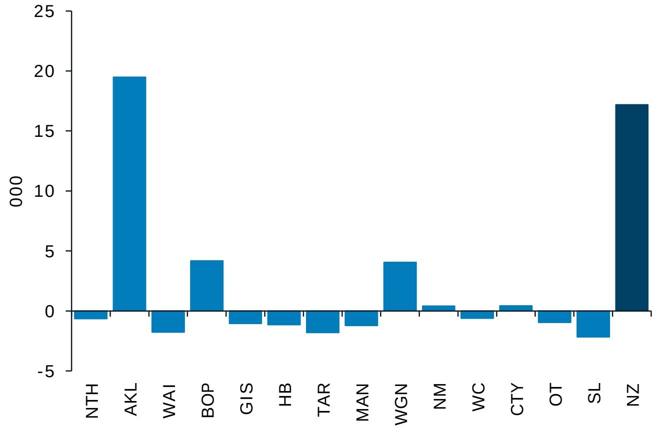
The problem is that rents haven't aligned to the shortage thesis. Auckland rents have risen 25% since 2011 whereas house prices are up 77%. Credit, liquidity, low interest rates, and speculative behaviour have also been key factors driving prices higher.

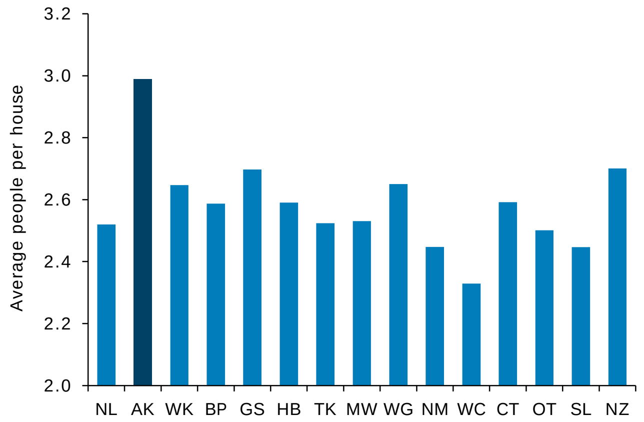
So how does the market become balanced again? Obviously you need to get the supply-side response right. Population trends are relevant; more houses will be needed. Christchurch shows us that the market will respond when supply adjusts. But there is a big list of issues to address, including land costs, development costs, and how necessary infrastructure is going to be funded. Intensification needs to be a reality, but is constrained by NIMBYism. Construction costs are also prohibitive and are bringing into question the 'economics' of some developments. New Zealand needs a lot more 100 square metre houses (typical in the 1970s) and not 200 square metre ones (the current average); the trouble is that land costs do not justify putting a smaller (affordable) house on a section. The Resource Management Act needs to be looked at, as does the process, timing and costs involved in getting consents granted. In addition to this, market forces around the demand side will also play a role. People are leaving Auckland, which is hardly a surprise when Auckland house prices are around 9 times incomes and the rest of New Zealand averages closer to 5. You can also shift supply-demand balance figures considerably depending on assumptions made on the number of people per residence. In Auckland it is already a case of fitting more people in the existing housing stock, with the average number of people per house at 3 (and rising) compared with an average of 2.7 for New Zealand as a whole. Don't expect the kids to leave home in a hurry.

Figure 1: Housing demand-supply balances by region



Source: ANZ

Figure 2: Average number of people per house (2013)



Source: ANZ, Statistics NZ

WHY HAVE YOU BEEN SO FOCUSED ON THE BANKS' FUNDING GAP?

New Zealand has traditionally been a nation of poor savers. This is the reason that the economy has persistently had a current account deficit (in some ways our overdraft with the rest of the world). Banks have therefore accessed foreign capital to fund this domestic savings shortage and it culminated in net external debt as a share of GDP rising to 84% in 2008. That was a noose around the economy's neck and major point of vulnerability when credit markets became extremely difficult during the Global Financial Crisis.

Between 2009 and 2015 the bank funding gap was effectively zero. New Zealanders saved more and borrowed less. The system was in "balance".

But when the housing market took off across the entire country in 2016 and deposit growth slowed as interest rates fell, it was game on again as the funding gap widened. Pre-GFC behaviour was emerging again. That raised the ire of credit-rating agencies and the Reserve Bank, and once again increased New Zealand's vulnerability to the whims of global credit markets.

Now there is nothing wrong with accessing a large pool of international savings to fund a domestic saving shortfall. The problem New Zealand has is that it is already quite indebted, and the channelling of that international pool of savings into housing, which is not a productive investment, risks crowding out other forms of investment.

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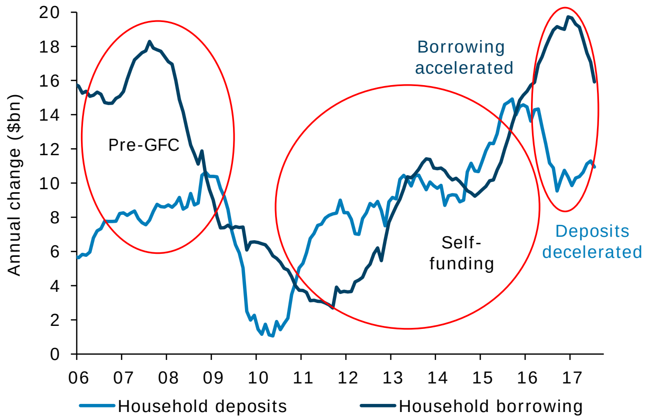
WHAT'S HAPPENED TO THIS 'GAP' OF LATE?

The jaws remain wide when looking at the annual change picture.

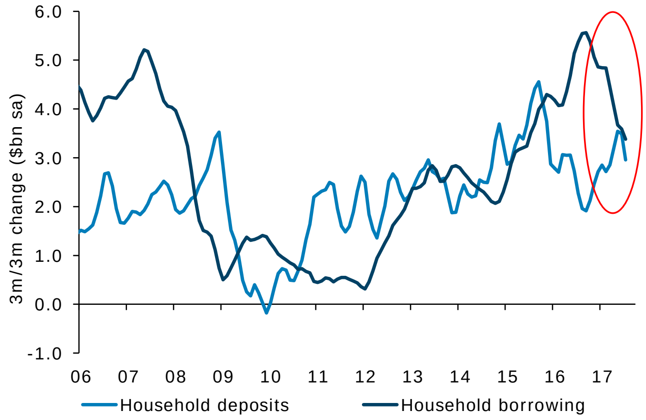
But if we eye more timely measures such as the funding gap over the past three months, it has closed up massively. So a lot of the heavy lifting – getting more deposits in the door (recall deposit rates have lifted in the past year and borrowing rates too, while wholesale interest rates have not) and the rationing of credit – has worked. Annual housing credit growth is now running at 7.1%. But if we look at the annualised pace over the past couple of months, it is closer to 5%.

Figure 3: Bank household funding and claims growth – annual change



Source: ANZ, RBNZ

Figure 4: Bank household funding and claims growth – quarterly change



Source: ANZ, RBNZ

That suggests some of the extreme competitive pressure we've seen in the deposit space can ease up, and the credit wheels can turn a little bit faster as we head into 2018. Both dynamics mean less pressure for retail interest rates to move up, outside of movements in the OCR and wholesale rates.

WHAT ELSE ARE YOU EYING AT THE MOMENT?

Lots! There is obviously the global scene: politically, geopolitically and in terms of the underlying economics. Locally we have some political uncertainty too. The biggest and most powerful central bank (the US Federal Reserve) is set to increase interest rates again before the end of the year and start trimming its QE-bloated balance sheet. How that impacts risk appetites, which have become somewhat addicted to the low interest rates and ample liquidity steroids, is the million dollar question.

There are also two aspects to a weakening Auckland property market that I'm paying particularly close attention to. Auckland house price have fallen 4% since January. On the face of it, that sort of fall is a drop in the bucket given that prices have effectively doubled in the years following the global financial crisis.

But the first is the broader spill-overs from this. Traditionally the economy has tended to be very sensitive to swings in the property market. Where house prices go, the economy tends to follow. Now this traditional link has been less evident over the past couple of years. Household spending didn't respond as positively as it has historically done to rising prices. Perhaps that provides some comfort that weaker prices on the other side may not undermine consumption and the broader economy as much as they would have in the past either.

Indicators such as consumer confidence and motor vehicle sales will take on particular importance over the coming months. If they start to wane, it'll be a signal that a weakening housing market is having a wider impact. But it was encouraging to see consumer confidence lift to a three-year high in September. That's a sign that other factors, such as a strong labour market, are influencing consumers and offsetting the housing drag.

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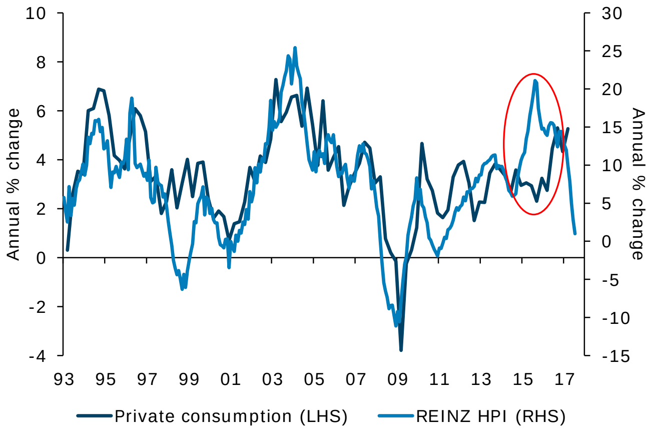
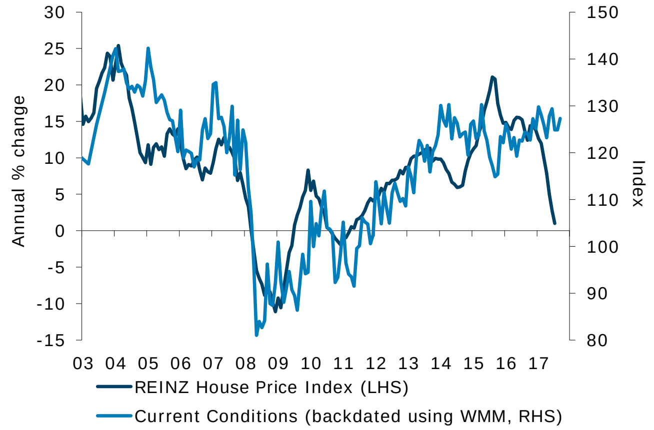
Figure 5: House prices and real private consumption growth



Source: ANZ, Statistics NZ, REINZ

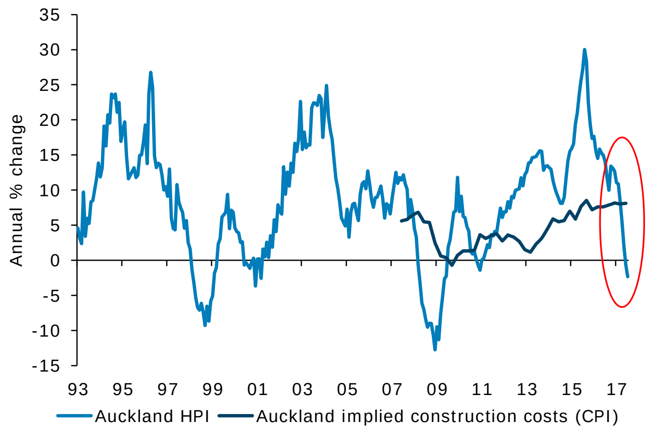
Figure 6: House prices and consumer current conditions



Source: ANZ, Roy Morgan, REINZ

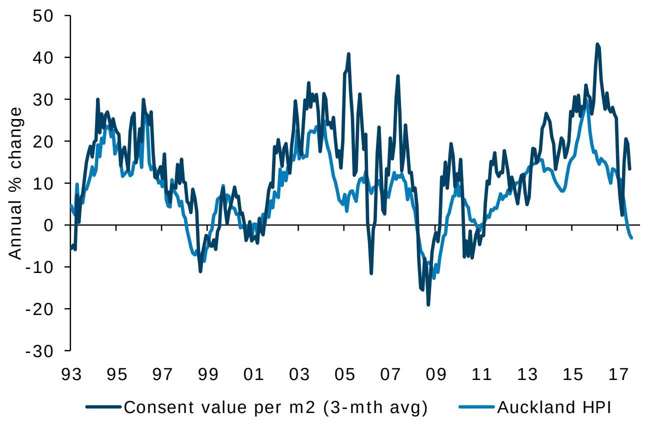
Second, falling house prices and rising construction costs could spell trouble for the development market. We've seen a major listed company take some big hits over a couple of projects. While that's non-residential work, one wonders about the residential area too. REINZ data show Auckland house prices are down 4%. However, some suburbs are anecdotally down 10%. You take price falls of 5-10% and construction costs rising over 8% and whammo, you have no – or even a negative – margin. If we look at different measure of construction costs – the value of consents per square metre – which has bobbled around between 10-15% per year, the story is even more worrying.

Figure 7: Auckland house prices and construction costs



Source: ANZ, REINZ, Statistics NZ

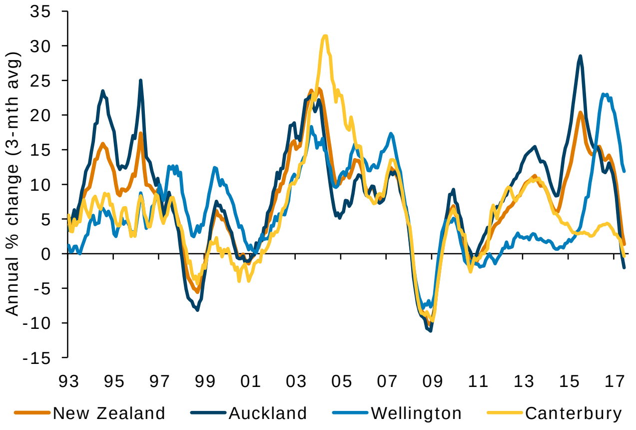
Figure 8: Auckland value of consents per square metre and house prices



Source: ANZ, REINZ, Statistics NZ

THE PROPERTY MARKET IN PICTURES

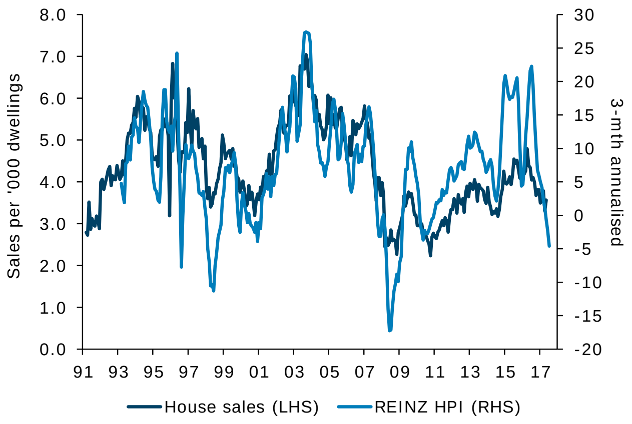
Figure 1. Regional house price inflation



Source: ANZ, REINZ

We estimate the nationwide REINZ House Price Index lifted a meagre 0.2% m/m (seasonally adjusted - sa) in August, following three consecutive falls. This saw annual growth fall to just 0.5% y/y, which is the lowest since mid-2011 (the chart is presented in 3-month average terms). Auckland continues to bear the brunt of the softening, with prices lifting 0.3% m/m (sa) in August, but down 3.6% from their January peak. Across the rest of the country, prices lifted 0.7% in August (sa) and are still up 6.9% y/y. Of the major centres, Wellington is recording the strongest annual price growth of 11% y/y, although this is well off its highs.

Figure 2. REINZ house prices and sales

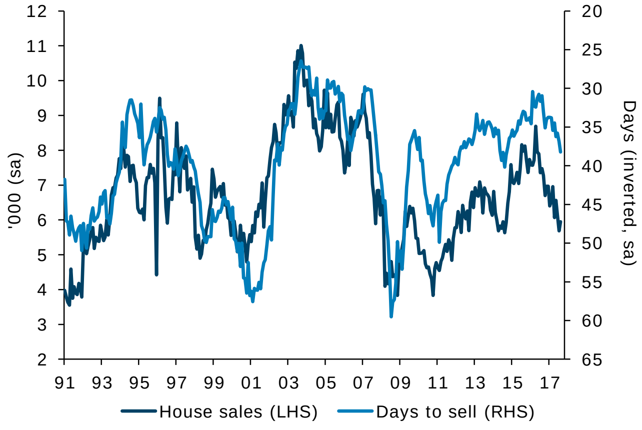


Source: ANZ, REINZ

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

National seasonally adjusted sales volumes bounced 4.7% m/m in August from sharp drops in the previous two months. Sales volumes are down 22% y/y. Again, Auckland is underperforming, with turnover down 28% y/y, although every region is now experiencing turnover lower than a year ago. Excluding Auckland, sales volumes rose 4% m/m (sa) in August 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 rose by 1 day to 38.2 days (sa) in August. While that remains below its historical average (39.6 days), it is well up from less than 31 days 12 months prior.

The median time to sell a property is below historical averages in every region except Auckland and Canterbury.

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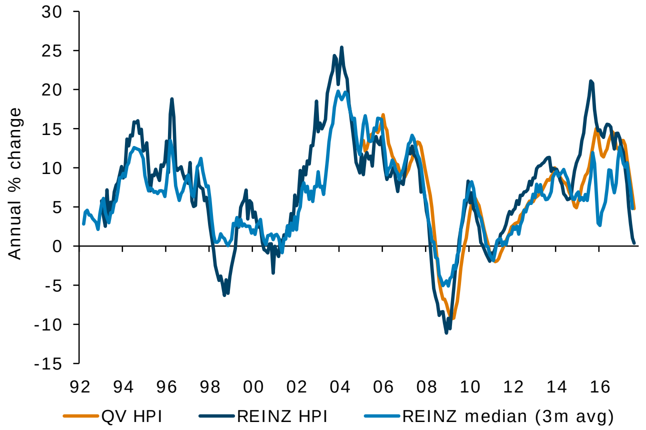
Figure 4. REINZ and QV house prices

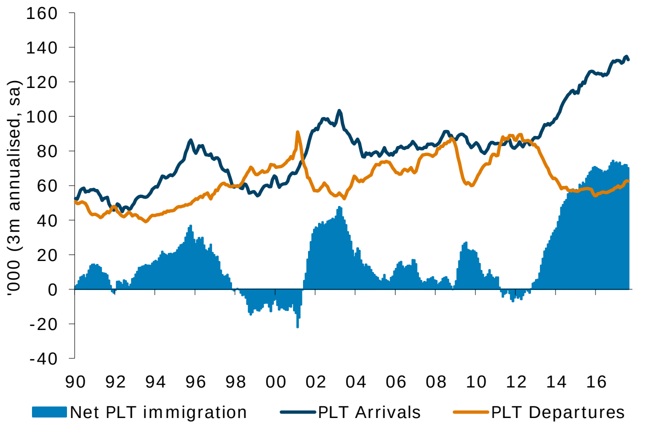


Source: ANZ, REINZ, QVNZ

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 lifted 1.8% m/m (sa) in August, and annual growth rebounded to 8% y/y. This is stronger than the REINZ House Price Index (0.4% y/y) and the QVNZ measure of price growth (4.8% y/y). The latter two measures adjust for changes in the quality of houses sold, while the median sale price will be biased up if the lower end of the market slows more. But the trend in annual inflation in all three is pointing firmly down.

Figure 5. Net permanent/long-term immigration



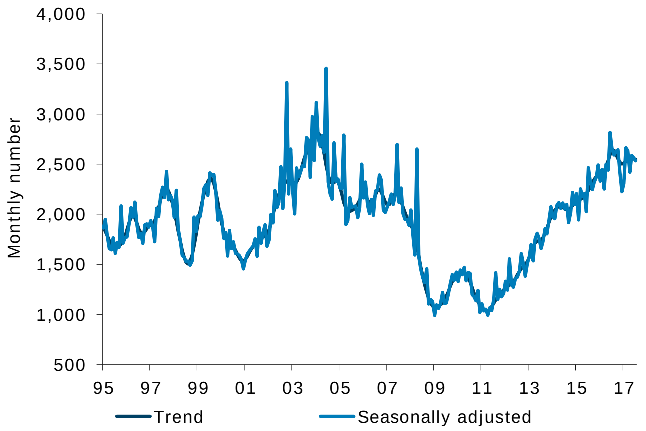
Source: ANZ, Statistics NZ

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 dipped to 70.4k in August. It appears to be topping out at high levels. Although arrivals continue to rise, departures have started trending higher (off lows).

While we are perhaps reaching a "peak", net inflows are expected to remain strong. New Zealand's labour market continues to perform well, and 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 fell 0.7% m/m in July, on top of a 1.3% m/m fall in June. Issuance has certainly been volatile over recent months, but stepping back from this, the level has effectively been hovering around the same level for 12 months now. July issuance was broadly 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. And falling house prices amidst rising costs undermine the viability of development.

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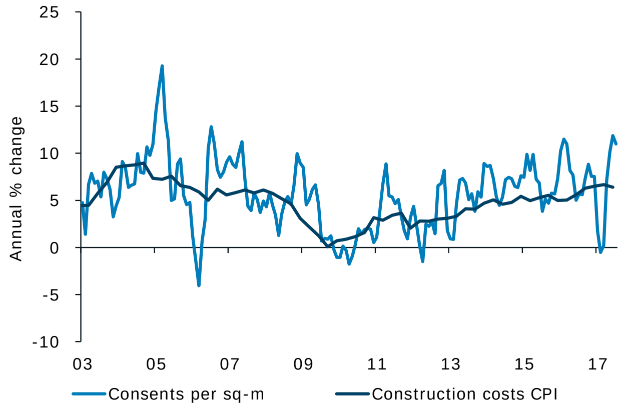
Figure 7. Construction cost inflation



Source: ANZ, Statistics NZ

On a three-month average basis, **the value of residential consents per square metre rose 11% y/y in July.** 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 bounce-back corroborates this view.

Costs per square metre in Auckland (especially in the multi-dwelling space) have lifted especially strongly over the past year or so, 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

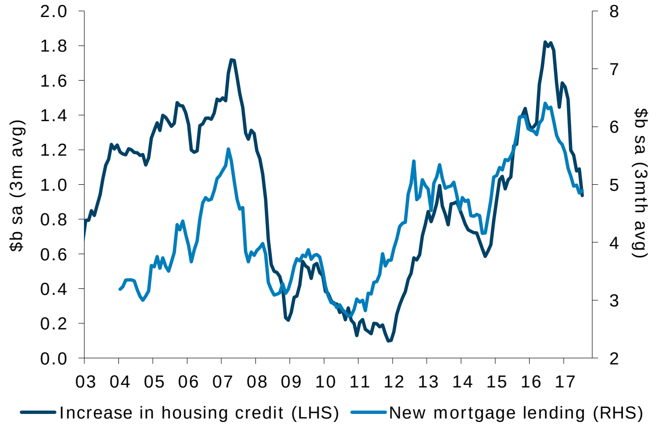
Source: ANZ, RBNZ

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 bounced in August (the chart is presented in 3-month average terms). We estimate that in seasonally adjusted terms, new lending rose 6.0% m/m to $5.05bn, following falls in both June and July. In fact, this is only the fourth increase in the past 12 months, with lending still down 16% y/y.

New investor lending continues to be weak. In August, lending to investors was down 36% y/y, making up only 22% of total lending. That is the lowest share since these figures started being released in August 2014.

Figure 9. New mortgage lending and & housing credit



Source: ANZ, REINZ, RBNZ

July saw the smallest monthly growth in total mortgage lending since mid-2015 (+0.3% m/m, seasonally adjusted). In three-month annualised terms, lending growth continued to ease to 5.3%, well down from the 10% pace recorded in August 2016.

The high-LVR lending restrictions, increased credit rationing by banks, and evolving expectations regarding capital gains – are having a marked impact on both house sales and credit availability. Add in election uncertainty and we would not be surprised to see mortgage lending growth remain at this more moderate pace over the coming months.

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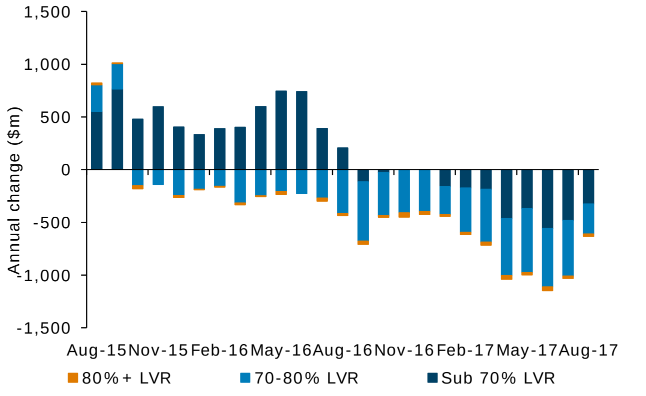
Figure 10. Annual change in investor lending by LVR

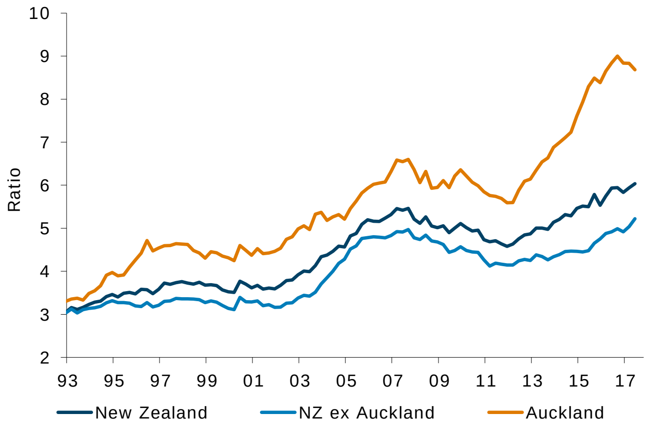


Source: ANZ, RBNZ

New lending to investors is well off its mid-2016 peak. It was down 36% y/y in August. Investors' share of overall new lending, at 22%, 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 could also reflect uncertainty around the upcoming election and the housing market outlook in general.

Related to the LVR restrictions, a larger share of new lending is on less-risky terms. In August, the share of total investor lending done at LVRs of less than 70% was 89%. That is a far greater share than in late-2014 when it was less than half.

Figure 11. Regional house prices to income

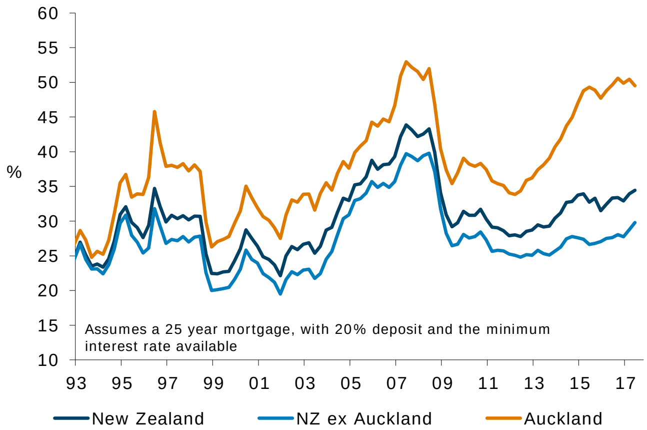


Source: ANZ, REINZ, Statistics NZ

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 6 times income for the past 12 months. Auckland, however, has seen its ratio ease from a high of 9 times in September last year to an estimated 8.7 times in the June quarter. While still extremely high, the easing reflects recent house price falls. Outside of Auckland, the ratio has continued to rise, and at 5.2 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 34.5% at the moment.

However, once again 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 broadly 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

Long-term fundamentals (population growth, migration) are going head to head with cyclical drivers (mortgage rates bottoming out, affordability, credit availability and LVR restrictions). While you can't ignore the fundamentals, cyclical drivers – such as the ability to borrow and at what interest rate – are hugely relevant, particularly when they push the market up a long way in a short space of time. Auckland is the case in point, and we expect the cyclical drivers to work in a reciprocal manner and keep activity constrained, despite an obvious shortage. If rents were rising sharply, we'd have more sympathy for the fundamentals dominating over the coming year.

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	↔/↓	Biting in Auckland. Less so in the regions.
Serviceability/ indebtedness	High debt and low rates ok. High rates not	↔/↓	Looks okay so long as interest rates stay low and the unemployment rate keeps trending lower.
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	Peaking	↔/↑	We appear to be at "peak" migrants. But the easing to be gradual.
Supply-demand balance	Demand > Supply	↔/↑	We need to be building 35-40k plus dwellings, not ~30k.
Consents and house sales	Shortage	↔/↑	Good luck finding a builder.
Liquidity	Tight	↓	Credit rationing still apparent.
Globalisation	Mixed bag	↔	Non-resident buyers no longer that influential. Other big global housing markets cooling a little too.
Housing supply	Too few	↔/↑	Fewer builders + higher construction costs + less credit + pressure on margins = supply struggles to keep up.
House prices to rents	Too high	↔/↓	Rents are not moving up much. That suggests the argument that housing shortages are the key market driver is fiction.
On balance	**Flat-lining**	↔	**Positives negating the negatives leaving the market in limbo. Auckland weaker as affordability bites more.**

PROPERTY GAUGES

Figure 1: Housing affordability

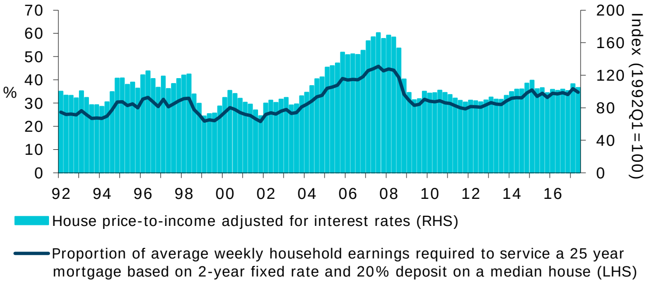


Figure 2: Household debt to disposable income

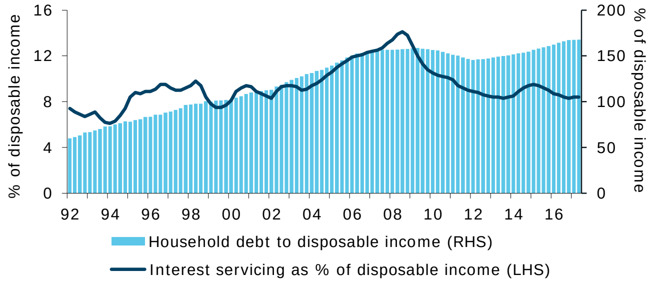


Figure 3: New customer average residential mortgage rate (<80% LVR)

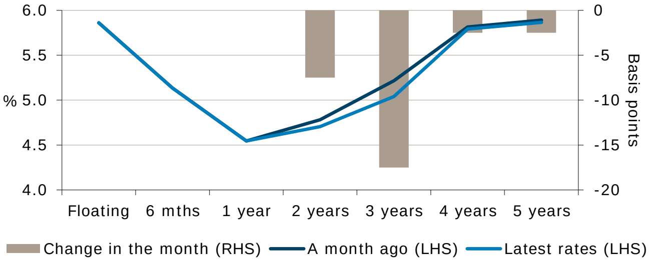


Figure 4: Net migration

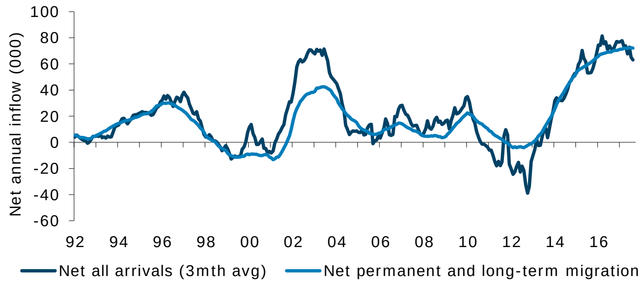


Figure 5: Housing supply-demand balance

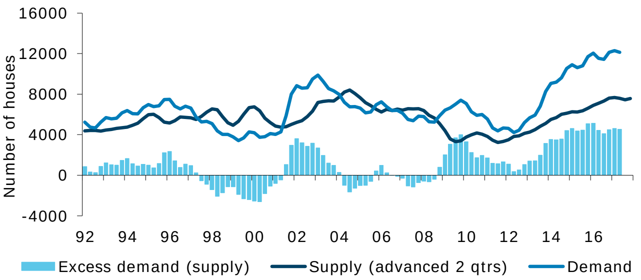


Figure 6: Building consents and house sales

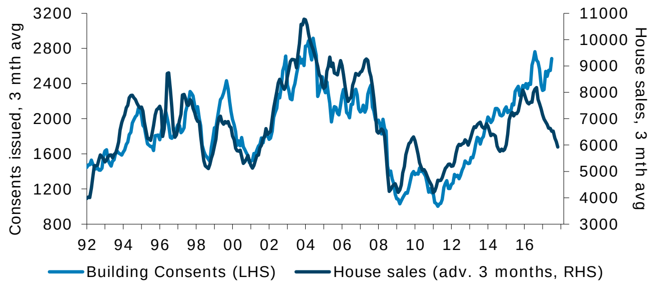


Figure 7: Liquidity and house prices

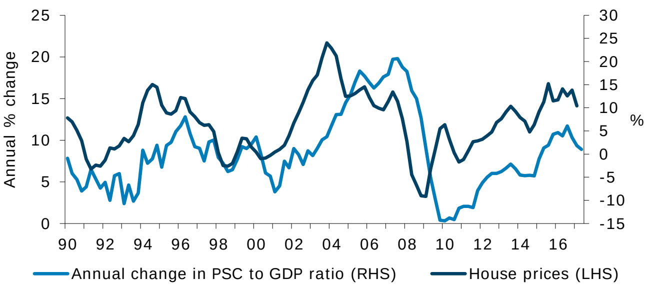


Figure 8: House price inflation comparison

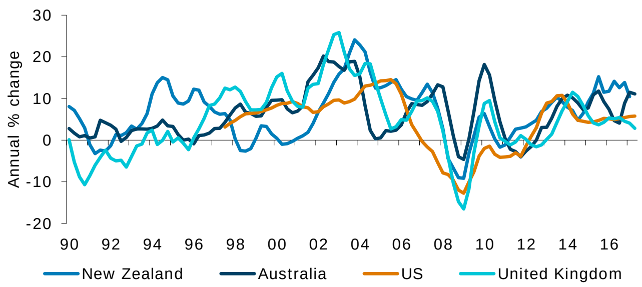


Figure 9: Housing supply

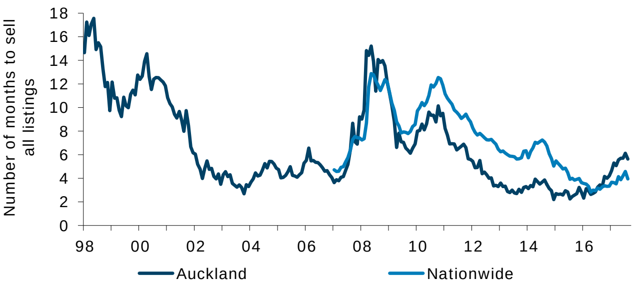
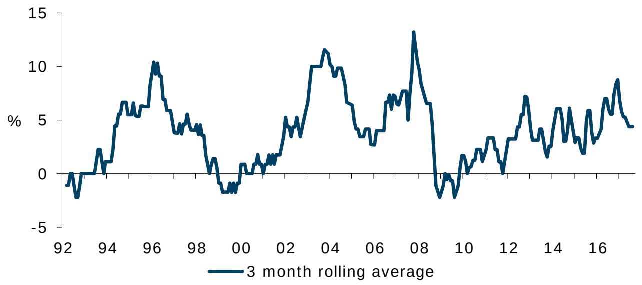


Figure 10: Median rental, annual growth



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

ECONOMIC OVERVIEW

SUMMARY

Some key economic drivers have either peaked or are set to peak, and the housing cycle has turned. New drivers will come to fore in the form of commodity prices, fiscal policy and rising household incomes. We expect the economic expansion to extend further, with modest GDP growth over the years ahead. Inflation is expected to remain low and the same applies to the OCR. An extended period of election-related uncertainty would be unwelcome and would have the ability to derail the economy's transition from the "old" drivers to the "new".

OUR VIEW

A number of key economic drivers have peaked or are set to peak:

- The construction sector is at peak-build, constrained now by a lack of skilled labour, pressure on margins and the 'economics' of projects. Finding skilled labour remains a key issue across the construction sector. The level of activity will remain high though.
- Migration trends have started to ease back with departures showing signs of picking up, and there is political pressure to restrain it further.
- We appear to be close to peak tourists, with accommodation becoming an issue over busy periods.

The housing market has also turned, as the combination of LVR restrictions, election uncertainty, less foreigner activity, tighter lending criteria and turn in the interest rate cycle have weighed. Auckland prices have fared the weakest as capital chases cheaper valuations elsewhere and as stretched affordability bites.

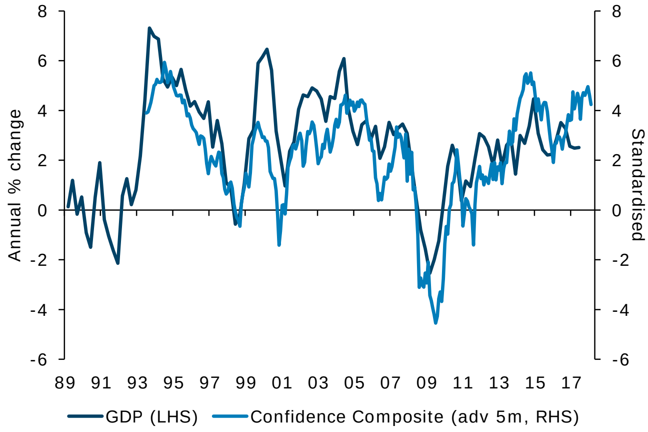
Softer housing is not expected to undermine the broader economy, though we are watchful. The wealth effect from rising house prices has traditionally been a key influence on household consumption, which is a sizeable part of GDP. Key indicators to watch are consumer confidence and motor vehicle sales; both are holding up for now. Consumer confidence in particular is being supported by a strong labour market. That said, falling house prices (in Auckland) and rising construction costs are not a good combination for the development market.

New economic drivers are emerging. Fiscal policy is moving to an expansionary stance and political pressure will likely mean even more stimulus beyond the latest family assistance package. The terms of trade (ratio of export prices to import prices) are the highest we've seen since 1973; the lift will add a lot to growth as the rural cheque-book starts to open. Household income growth is buoyant courtesy of strong employment gains.

Uncertainty from the election has the ability to result in an economic soft spot in late 2017 and early 2018. The time value option for businesses is to wait and defer when uncertainty is rising. That said, we are not expecting any major lurch in economic direction and it worth remembering that amongst a lot of political turmoil, the US economy has still performed well.

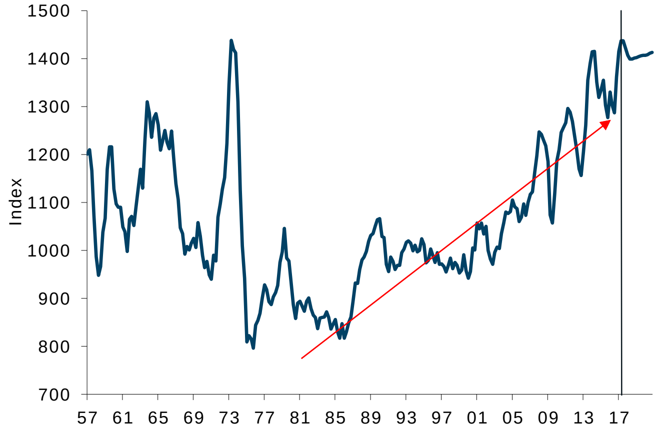
The RBNZ is expected to keep the OCR on hold for an extended period. Outside of housing, inflation is benign. With prudential policy tightening financial conditions and doing the work of the OCR, and inflation outside of housing low, the OCR might not be moving at all. Rates will remain stable and any volatility will come through the NZD. We do expect to see some pressure on wage growth to lift as the labour market tightens.

Figure 1. GDP vs Confidence Composite



Source: ANZ, Roy Morgan, Statistics NZ

Figure 2. Terms of trade (OTI basis)



Source: ANZ, Statistics NZ

MORTGAGE BORROWING STRATEGY

SUMMARY

Average mortgage rates nudged a little lower in what we call the belly (2-3 year) of the curve but retained the familiar tick-shape. From a pure "lowest is best" assessment, the 1 year rate stands out. Slight movements lower in the 2 and 3 year rates have improved their break-evens but not sufficiently for us to move from favouring the 1 year rate as the sweet spot. Longer-term rates remain very low by historic standards and offer certainty. The downside is that we struggle to see where inflation is going to come from to necessitate major lifts in the OCR.

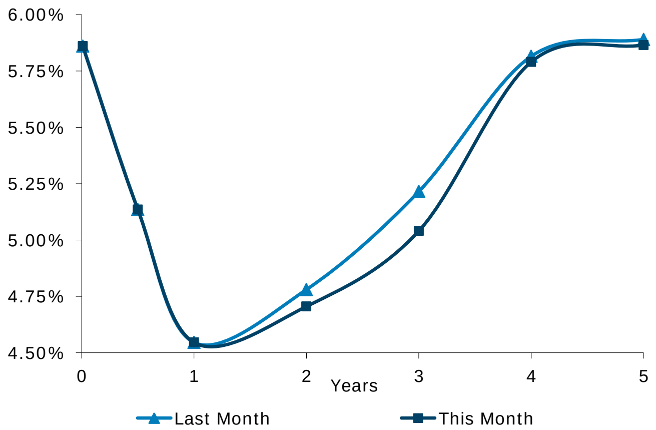
OUR VIEW

Mortgage rates eased a tad over the month in the 2-3 year part of the curve. The level and term structure of the "tick-shaped" mortgage curve is pretty much as it has been since January. A host of reasons can be identified why rates have fallen a tad, including movements in wholesale rates, competitive pressure and less intense competition for deposits.

The 1 year rate remains favoured from a pure "lowest is best" perspective. That's been the case for some time and regular readers will be aware that we've favoured that spot for some time. That continues to be reinforced by our view towards the OCR, which is for no change for an extended period. With key pro-cyclical and inflationary parts of the economy such as housing turning lower, one wonders where inflation is going to come from. Three inflationary candidates are a lower NZD, an uptick in wages and looser fiscal policy. But they are going head-to-head with some major deflation suppressants, so any inflation, if and when it turns up, is hardly going to mean the OCR is headed a lot higher. It'll nudge up as opposed to trend up. That keeps the "value" in rolling short-dated.

Breakeven analysis shows that certainty can be provided for a modest cost, at least in the front part of the curve. For instance, the average two year rate is only 16 bps above the 1 year rate. The 1 year rate would need to rise by 32 bps (from 4.55% to 4.87%) over the next year in order for it to be cheaper fixing for 2 years at 4.71% than rolling two 1-year terms. **That's not a huge rise in the 1 year rate. So certainty looks "cheap".** There is a more notable step-up between the 2 year and 3 year (33bps); the breakeven on a 2 year at 4.71% versus a 3 year at 5.04% is 5.29%. The "challenge" to this is simple. Where is the inflation going to come from that requires the OCR to be moving up a long way or even by a modest amount?

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%	4.79%	4.95%	5.54%
1 year	4.55%	4.37%	4.87%	5.24%	5.71%
2 years	4.71%	4.81%	5.29%	6.01%	6.88%
3 years	5.04%	5.46%	6.21%	6.43%	6.64%
4 years	5.79%	5.91%	6.20%		
5 years	5.87%	#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%	4.53%	5.75%	5.17%	5.98%
1 year	4.87%	5.14%	5.46%	5.57%	6.14%
2 years	5.17%	5.36%	5.80%	6.06%	6.57%
3 years	5.49%	5.76%	6.20%	6.37%	6.67%
4 years	5.87%	6.06%	6.36%		
5 years	6.07%	*may be subject to a low equity fee			

Some borrowers may wish to spread their borrowing over a number of fixed terms. That makes sense from a risk-management perspective, and having a number of tranches rolling over more regularly does smooth interest expenses. We're also mindful that we do still expect rates to ultimately rise rather than fall – even if we think the rise will occur later rather than sooner. That may leave some borrowers feeling a bit nervous, and make them more inclined to select a longer term. **These are all valid considerations**, even if, as noted, a pure cost emphasis would shift the focus towards the 1 year and possibly some in the 2 year part of the curve.

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

KEY FORECASTS

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

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

Housing market indicators for August 2017 (based on REINZ data)

	House prices (ann % chg)	3mth % chg	No of sales (sa)	Mthly % chg	Avg days to sell (sa)
Northland	20.2	3.1	184	-2%	46
Auckland	-1.3	-1.1	1,741	+6%	42
Waikato	12.4	1.7	585	+8%	41
Bay of Plenty	9.9	0.8	460	+14%	43
Gisborne	-10.5	-4.9	48	-15%	39
Hawke's Bay	19.0	4.7	217	+3%	30
Manawatu-Whanganui	18.8	5.4	344	-9%	30
Taranaki	10.7	-1.8	150	-12%	46
Wellington	8.7	-0.1	688	+1%	28
Tasman, Nelson and Marlborough	10.4	-0.5	215	-7%	29
Canterbury	1.1	-2.5	831	+16%	38
Otago	11.1	2.8	361	+6%	35
West Coast	-8.0	11.1	37	+8%	77
Southland	22.1	7.8	154	+5%	35
NEW ZEALAND	**8.0**	**-0.7**	**5,951**	**+5%**	**38**

Key forecasts

	Actual			Forecasts						
Economic indicators	**Dec-16**	**Mar-17**	**Jun-17**	**Sep-17**	**Dec-17**	**Mar-18**	**Jun-18**	**Sep-18**	**Dec-18**	**Mar-19**
GDP (Ann Avg % Chg)	3.0	3.0	2.7	2.5	2.6	2.7	2.8	2.9	2.9	3.0
CPI Inflation (Annual % Chg)	1.3	2.2	1.7	1.7	1.3	1.0	1.4	1.9	2.1	2.2
Unemployment Rate (%)	5.2	4.9	4.8	4.8	4.7	4.6	4.5	4.4	4.4	4.3
Interest rates (RBNZ)	**Dec-16**	**Mar-17**	**Jun-17**	**Sep-17**	**Dec-17**	**Mar-18**	**Jun-18**	**Sep-18**	**Dec-18**	**Mar-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	2.0	2.0	2.0	2.0	2.0	2.0	2.1	2.3	2.5
Floating Mortgage Rate	5.7	5.8	5.9	5.9	5.9	5.9	5.9	5.9	6.1	6.4
1-Yr Fixed Mortgage Rate	4.9	5.1	5.1	5.0	5.1	5.1	5.1	5.2	5.4	5.5
2-Yr Fixed Mortgage Rate	5.1	5.3	5.3	5.2	5.3	5.3	5.4	5.5	5.6	5.7
5-Yr Fixed Mortgage Rate	5.9	6.3	6.3	6.1	6.1	6.1	6.2	6.4	6.5	6.6

Source: ANZ, Statistics NZ, RBNZ

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