

NEW ZEALAND PROPERTY FOCUS

May 2017

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SUMMARY

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

CHIEF ECONOMIST CORNER: SAVE VERSUS SPEND

New Zealand has a considerable pipeline of investment needs, which largely reflects some catch-up and the necessities of catering for a rapidly growing population. Given a domestic saving shortfall, New Zealand's typical modus operandi has been to fund its investment needs through offshore borrowing (running a large current account deficit). While that is still possible to a degree, it is facing far more challenges now given prudential restrictions, credit rating agency attention and financial stability considerations. The onus is falling more on the saving side of the ledger to pull its weight to fund domestic investment needs. While a decent income growth backdrop will assist, there will still be trade-offs. In order for the investment wheels of the economy to continue to turn at the rate necessary, domestic saving will need to lift, and ultimately more saving equals less consumption, with the latter the sacrificial pawn to allow stronger investment.

PROPERTY GAUGES

The battle continues as a fundamental mismatch between supply (flat-lining consents) and demand (net migration is still strong) which points up for prices, goes head-to-head with broader "conditions", including affordability and rising interest rates, which say down. We continue to side more with the latter as being more influential over the coming years. Of course supply matters too, but the interest rate effect looks set to dominate. If a shortage of supply were the major influence on the market, rents would have taken off many years ago; they haven't.

ECONOMIC OVERVIEW

The economy is buoyant and forward growth indicators remain positive. We expect momentum to ease over late 2017 as credit constraints and difficult finding skilled labour bite. History shows New Zealand could be in for a correction in 2018. We think the ten-year boom-bust cycle will be averted; households, regulators and banks are behaving differently. House price inflation is expected to remain subdued over the coming years. The RBNZ will not shift the OCR for quite a while yet.

MORTGAGE BORROWING STRATEGY

Mortgage rates have not changed much over the past month, but the changes that have been seen have been upward, reflecting ongoing intense competition for deposits. This has had a knock-on impact on mortgage rates. The mortgage curve remains tick-shaped, with the 1 year rate both the low point and the "sweet spot" on the curve. With credit growth still outstripping deposit growth, the risk is we see term interest rates go higher (for both deposits and mortgages). However this is well factored into the term structure, and with intense competition for mortgages keeping 1-2 year rates down (and driving breakevens up), these tenors look more favourable from a cost perspective. However, we acknowledge that longer terms do offer more certainty.

CHIEF ECONOMIST CORNER: SAVE VERSUS SPEND

SUMMARY

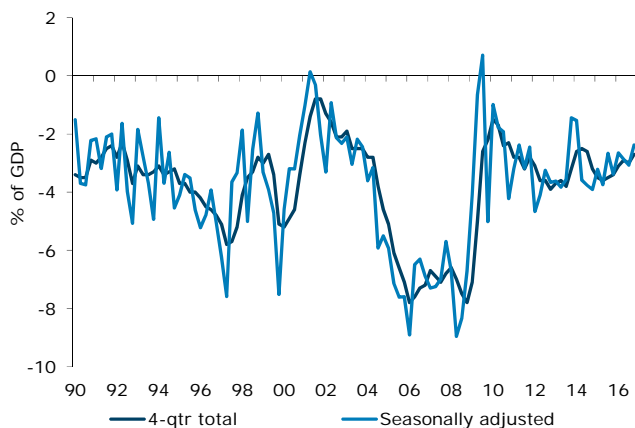
New Zealand has a considerable pipeline of investment needs, which largely reflects some catch-up and the necessities of catering for a rapidly growing population. Given a domestic saving shortfall, New Zealand's typical modus operandi has been to fund its investment needs through offshore borrowing (running a large current account deficit). While that is still possible to a degree, it is facing far more challenges now given prudential restrictions, credit rating agency attention and financial stability considerations. The onus is falling more on the saving side of the ledger to pull its weight to fund domestic investment needs. While a decent income growth backdrop will assist, there will still be trade-offs. In order for the investment wheels of the economy to continue to turn at the rate necessary, domestic saving will need to lift, and ultimately more saving equals less consumption, with the latter the sacrificial pawn to allow stronger investment.

TIME PREFERENCE

New Zealand has a legacy of running large current account deficits. The current account deficit has averaged 3.7% of GDP since 1988. And while there has been the odd quarter when a small surplus was recorded, that is certainly a rare occurrence. Annual deficits have persisted throughout that entire period.

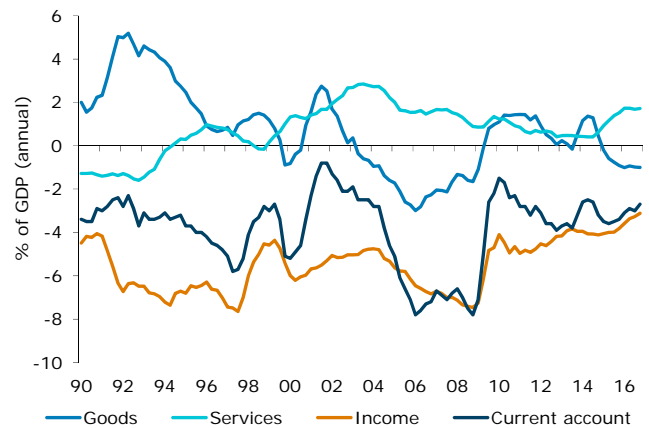
The way the current account is typically considered is through a balance of trade and investment income lens. That is, it represents the balance of our goods and services trade with the rest of the world and the difference in income earned on our international assets and the income earned on foreigners' investment in New Zealand. While we typically pay our way in terms of our international trade in goods and services (in fact the goods and services balance has averaged a surplus of 1.6% of GDP since 1988), we have long had a large investment income deficit, which is effectively a consequence of servicing a large stock of external debt. Net external debt is currently 55% of GDP. This is high relative to peers, albeit well off its peak.

FIGURE 1: CURRENT ACCOUNT BALANCE



Source: ANZ, Statistics NZ

FIGURE 2: COMPOSITION OF CURRENT ACCOUNT



Source: ANZ, Statistics NZ

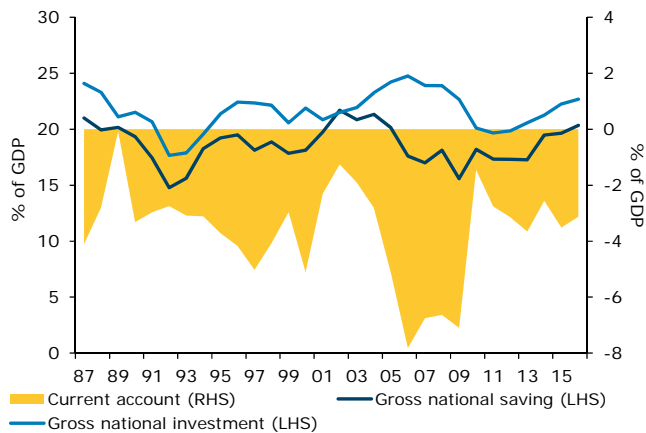
So why do we have this large stock of debt? Well, the current account can also be thought of as a basic accounting identity: the difference between national saving and national investment. The fact the country has persistently run current account deficits effectively means that we haven't been saving enough domestically to fund our investment (by-and-large, housing) needs. We rely on the saving of foreigners. That is, we borrow offshore (or sell assets) to fund our domestic lifestyles. In the year to March 2016, gross national investment totalled \$56.8bn, while national gross saving (the difference between what we earn and what we consume) was just \$50.9bn.

There is nothing fundamentally wrong with borrowing. It's cheaper than equity! And it is society expressing its preference to spend today (or buy a bigger, flashier house) as opposed to invest for tomorrow. Offshore capital (saving) is typically readily available, at a price. Now you can't borrow indefinitely of course, but for a country with an open capital account and developed financial system like New Zealand, it does mean that you can make choices about the timing of spending, saving or investing.

Unfortunately in New Zealand's case, the borrowing has been housing-centric. It might well have been a logical response to expectations of capital gain, and housing is a critical "need", but it's hardly done much to add to the economy's productive base.

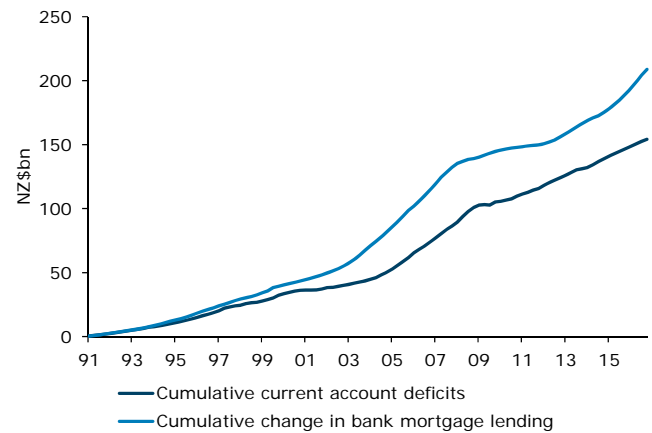
CHIEF ECONOMIST CORNER: SAVE VERSUS SPEND

FIGURE 3: NATIONAL SAVING AND INVESTMENT



Source: ANZ, Statistics NZ

FIGURE 4: CURRENT ACCOUNT AND BANK LENDING



Source: ANZ, Statistics NZ

New Zealand is a small, open, volatile and in particular, indebted country. Many commentators point to these features as the key reasons why we have higher interest rates than many other countries. That's part of the story.

But if you favour consuming today over consuming tomorrow (as New Zealanders appear to do), you need higher interest rates today to induce people to save rather than spend. The rate that induces an individual to be indifferent between consuming today or consuming tomorrow is termed the rate of time preference, and it is a key determinant of real interest rates. So one of the key reasons New Zealand has had higher interest rates relative to others is simply that more nudging has been required to encourage people to spend less and save more. Or put another way, it's historically taken major lifts in interest rates to slow the housing and consumption sides of the economy down.

Right now, New Zealand has a very long investment wish (need) list that reflects the necessities of catering for a strongly growing population. Items on the list range from critical housing requirements to transport infrastructure, schools, hospitals and hotels (tourism). In other words, the economy is currently experiencing a construction and investment boom that shows no signs of letting up, with the biggest constraint being the ability to find the skilled labour necessary to design, build and manage these projects. This investment pipeline will be around for years.

So the critical question is, how will it all be paid for? The wheels of the economy do not turn efficiently if people, businesses and government are not investing, or cannot.

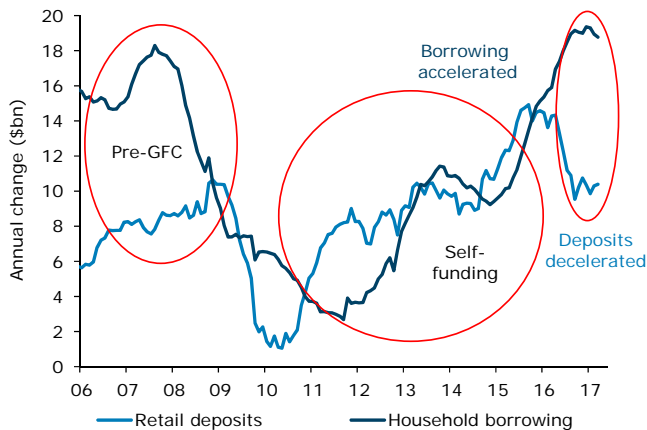
Typically we finance our investment needs through a mixture of domestic saving and borrowing overseas. In fact, since the GFC (and up until recently) we have been leaning more and more on the former. We have documented this extensively of late, but with deposit growth largely matching accelerating credit growth within the banking system for the majority of the post-GFC years, in many ways the system was self-financing. Banks didn't have to tap international markets to the same extent as we have seen in the past, which is a key reason the economy's net external debt position fell from 84% of GDP in 2008 to 55% of GDP now. However, that changed around 12 months ago when deposit growth started to slow sharply while the demand for credit remained strong. To keep the economy's investment wheels turning, banks were forced to turn more to offshore sources for funding. In September 2016, offshore bank funding had increased by over \$11bn compared with 12 months prior.

However, this strong reliance on offshore borrowing is now facing some challenges.

- **It irks the rating agencies;** we have a strong (low) public net debt position (25% of GDP and forecast to fall below 20%) but a large stock of private sector (overseas) debt. It's a weakness, and the private sector debt burden (intermediated through the banking system) is inconsistent with other nations that have similar strong credit ratings. This weakness is mitigated by the strength of the fiscal position, and strong bank capital and funding buffers. But it's a vulnerability nonetheless.

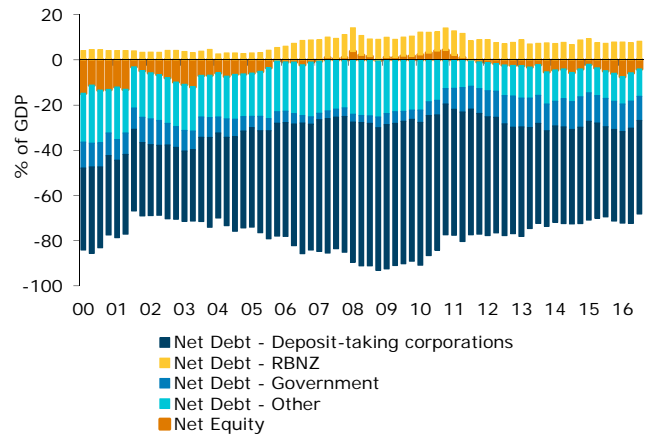
CHIEF ECONOMIST CORNER: SAVE VERSUS SPEND

FIGURE 5: BANK HOUSEHOLD LENDING AND DEPOSIT GROWTH



Source: ANZ, RBNZ

FIGURE 6: NET INTERNATIONAL INVESTMENT POSITION



Source: ANZ, Statistics NZ

- **There are limits to how much overall external borrowing is prudent.** While New Zealand's net external debt burden has fallen from 84% to 55% of GDP, that still represents \$146bn in absolute terms. The country's overall net liability position stands at \$157bn, which is \$33,000 for every man, woman and child. These are hardly insignificant sums. The servicing of this large stock of external debt is effectively the reason why New Zealand's investment income balance of the current account balance has averaged a deficit of 5.2% of GDP since 2008.
- **Regulators view a large dependence on offshore funding as a risk and are getting twitchier about it.** In response to earlier concerns over the stability of bank funding, the RBNZ introduced the Core Funding Ratio (CFR), requiring 70% of banks' non-equity funding to be raised through non-market funding (mostly deposits). Banks are well within required limits, but as the reliance on offshore funding lifts (even with it being done at longer terms), that increases the funding that banks will eventually be required to roll over once it no longer qualifies under the CFR as its maturity nears. That rollover risk increases the financial system's susceptibility to market volatility and international markets.
- **The point above is complicated by changes made by the Australian Prudential Regulation Authority that now require New Zealand banks to reduce their reliance on funding via their Australian parent;** all else equal this needs to be substituted with either a) alternate offshore funding; or b) more domestic funding.
- **Offshore borrowing (or the selling of assets to foreigners) is a politically sensitive topic.**

Banks are attempting to mitigate this challenge (funding gap) through competing more aggressively for domestic funding and restricting credit. As such, deposit rates are rising (and with them, lending rates), and credit is increasingly being rationed. That is a logical response. However, credit rationing is hardly a factor that is going to assist with the likes of boosting housing supply or infrastructure more generally. Credit is the grease in the economy's investment wheels.

In many ways, the funding pressures that banks are currently facing can also be thought of as a current account constraint. If it is becoming harder, or we should be more wary about funding a saving shortfall through overseas borrowing, then simple maths would say that either national saving needs to lift or investment has to fall. Now admittedly, that's probably a little too black and white; there is of course scope to fill the gap with a little more offshore capital. Our current account deficit is *only* 2.7% of GDP. We've run far larger deficits before. Perhaps something up to 4% of GDP would be manageable given the economy's investment needs. But anything larger than that and the net external debt position relative to the size of the economy would start to rise again and that will get [negative] attention.

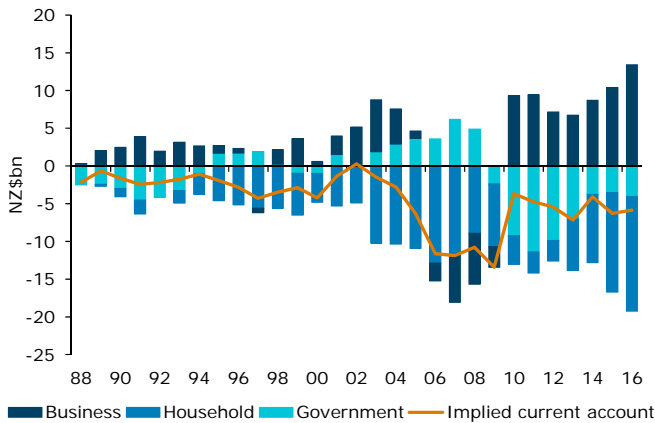
The downstream implications of this tension between national saving and investment are meaningful:

- **You can see stronger saving across the business and government sectors already.** We estimate that in the year to March 2016, the business sector's net saving totalled over \$13bn (which is close to twice the size of the current account deficit itself). However, household net saving has been a clear laggard. In fact, households were dissaving to the tune of over \$15bn over the same period.

CHIEF ECONOMIST CORNER: SAVE VERSUS SPEND

- **Strong business sector saving is thus unlikely to be enough. Households will need to pick up the baton as well.** Higher deposit rates will of course help in this regard. But ultimately more saving equals less consumption, and consumption is a big part of the economy (around 60% in fact – for private consumption at least). Within our forecasts, one of the key overriding themes is that investment's share of GDP continues to rise, while consumption's share continues to fall off highs.

FIGURE 7: SECTORAL NET SAVING



Source: ANZ, Statistics NZ

FIGURE 8: INVESTMENT AND CONSUMPTION SHARES

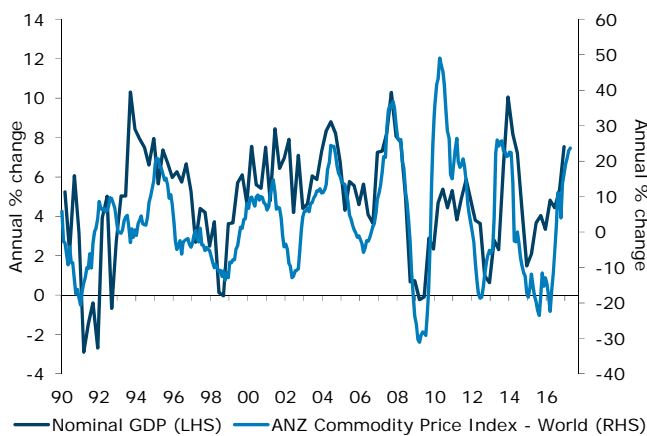


Source: ANZ, Statistics NZ

- **So in order for investment to continue to grow strongly (which it needs to do), life for retailers is not going to get any easier** despite prospects for income growth being good (consumption has indeed been contained, notwithstanding the reasonable retail sales figures of late – it's the housing spend-up that's been the problem).
- **Admittedly, in practice some investment will be sacrificed too as wants and needs are prioritised.** You can already see this occurring in some of the speculative parts of the property market, which are struggling to get credit.

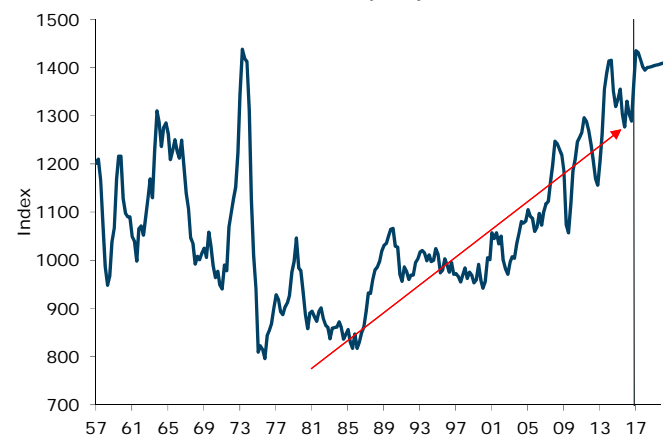
Now one thing that does look like it will assist in lifting national saving is that New Zealand has a reasonable income tailwind at its back. Saving more is obviously far easier when income growth is strong. Commodity prices and the terms of trade have lifted, boosting national income growth. In fact, it is possible that the terms of trade could surge to new all-time high over the next quarter or two, and our current expectations are that those gains will generally be maintained over the coming years.

FIGURE 9: NOMINAL GDP AND COMMODITY PRICES



Source: ANZ, Statistics NZ

FIGURE 10: TERMS OF TRADE (OTI)

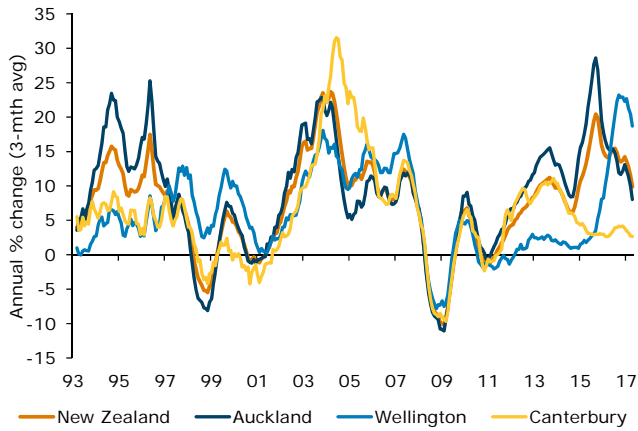


Source: ANZ, Statistics NZ

But while it'll help, stronger income growth won't completely avert tensions and trade-offs. Greater attention still needs to be focused on the saving side of the ledger. The game looks to be up on the old "fill-ya-boots with borrowing offshore" modus operandi. While it is a lever that can be pulled, it can't be yanked as enthusiastically as in the past. **Sustaining New Zealand's investment needs is going to require more domestic saving to finance it. The numbers don't stack up otherwise.**

THE PROPERTY MARKET IN PICTURES

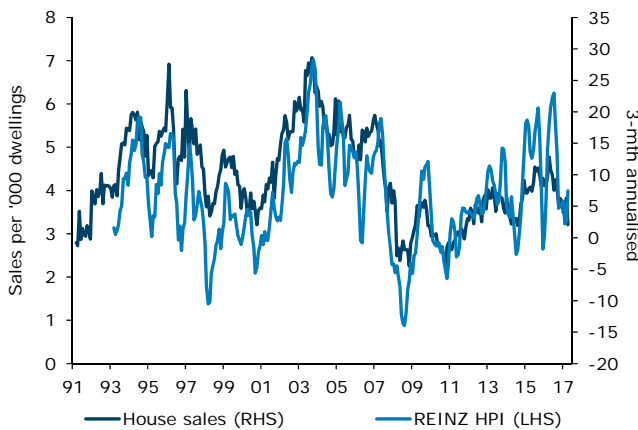
FIGURE 1. REGIONAL HOUSE PRICES



Source: ANZ, REINZ

According to the REINZ House Price Index, nationwide house prices rose 0.4% m/m (sa) in April, which saw annual growth ease to 7.8% (this data is presented in 3-month average terms). Of the main urban centres, price growth remains the strongest in Wellington (+19% y/y). In Auckland and Canterbury, the equivalent rates of growth are 8.1% and 2.7% y/y respectively. Of the smaller regions, Gisborne and the Hawke's Bay are experiencing the strongest price growth, both at 21% y/y.

FIGURE 2. REINZ HOUSE PRICES AND SALES



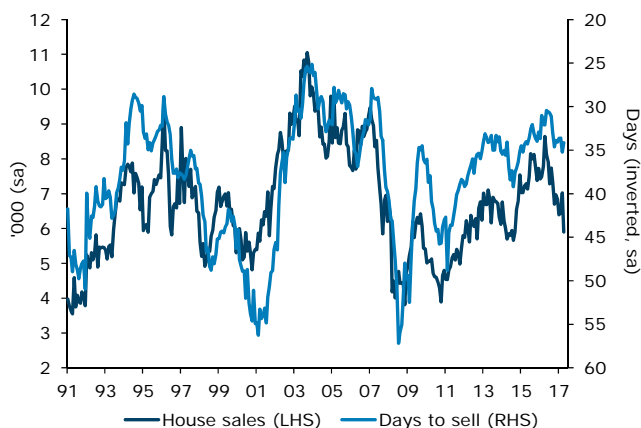
Source: ANZ, REINZ

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

Seasonally adjusted sales volumes plunged 16% m/m in April, to the lowest level since August 2014. Admittedly, the timing of Easter and poor weather over the month are likely to have had a dampening influence, so the figures should be treated with plenty of caution. That said, sales have fallen in eight of the past 12 months, so a weaker trend has certainly been evident.

The softer trend in sales activity suggests that the recent moderation in annual house price growth will continue.

FIGURE 3. SALES AND MEDIAN DAYS TO SELL



Source: ANZ, REINZ

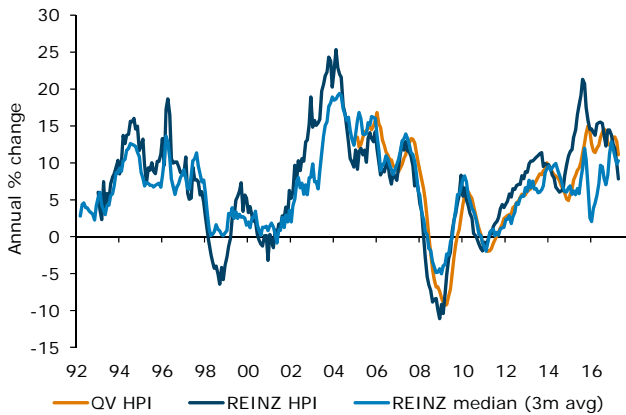
How long it takes to sell a house is also an indicator of the strength of the market, encompassing both demand and supply-side considerations. Larger cities tend to see houses sell more quickly, but deviations in a region from its average provide an indicator of the heat in a market at any given time.

Nationally, the median time to sell a house fell from 35.4 to 34.4 (sa) days in April, highlighting that the fall in sales volumes discussed above likely overstates the degree housing market weakness. That said, the time to sell a house is up from its mid-2016 lows of close to 30 days.

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

THE PROPERTY MARKET IN PICTURES

FIGURE 4. REINZ AND QV HOUSE PRICES

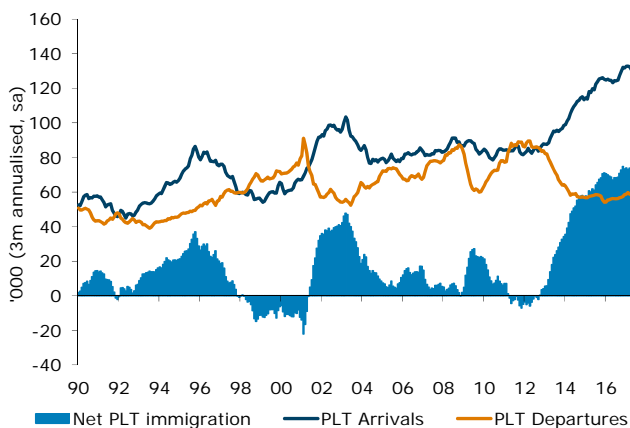


Source: ANZ, REINZ, QVNZ

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 2.4% m/m (sa) in April and is up 10.4% y/y. This is now a little stronger than the REINZ House Price Index (7.8% y/y) and a little lower than the QVNZ measure of price growth (11.1% y/y), with the latter two measures adjusting for changes in the quality of houses sold.

FIGURE 5. NET PLT IMMIGRATION



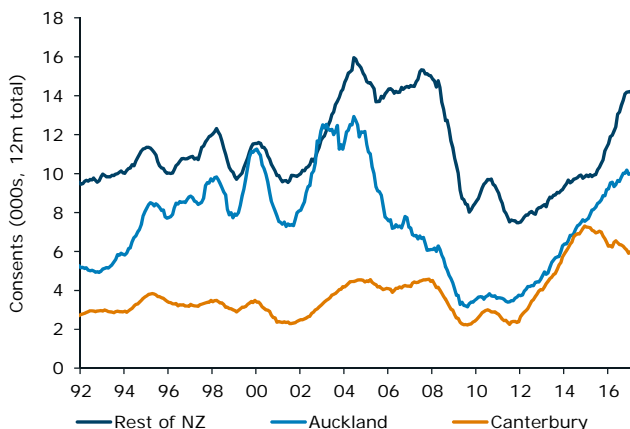
Source: ANZ, Statistics NZ

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

On a three-month annualised basis, net permanent and long-term migration was 71.4k in April. This is still near record levels and over 1½% of the resident population. More arrivals and fewer departures have both contributed to this large net inflow, although over the past 12 months or so, the former has been the dominant factor.

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 allure 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 CONSENTS



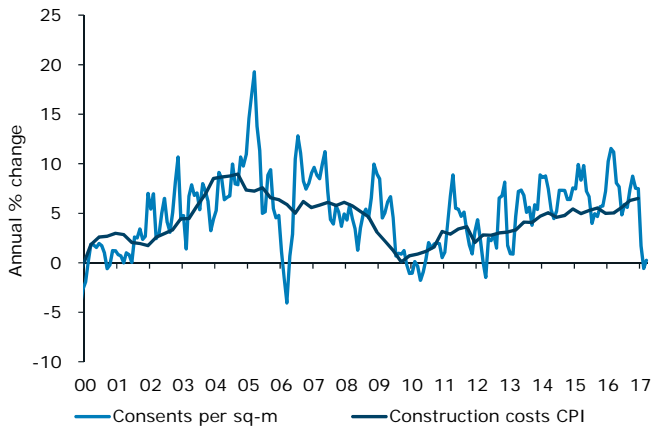
Source: ANZ, Statistics NZ

Seasonally adjusted dwelling consent issuance dipped 1.8% m/m in March. However, that followed an upwardly revised gain of 17% m/m in February (previously reported as 14%), so it was a respectable outcome. In seasonally adjusted terms, issuance for houses fell 5.2% m/m, while multi-dwelling consents rose 5.7% m/m.

After some sharp weakness over the latter part of 2016, consent issuance looks to be stabilising and that's encouraging. While issuance is off its highs, it has now bounced nearly 20% since December, and is actually a little above the average recorded over the past 12 months. On a trend basis, issuance is now running at a +1.5% m/m pace, although interestingly that is being led by regional New Zealand, with trend issuance continuing to fall in the likes of Auckland, Waikato, Wellington and Canterbury.

THE PROPERTY MARKET IN PICTURES

FIGURE 7. CONSTRUCTION COST INFLATION



Source: ANZ, Statistics NZ

On a three-month average basis, **the value of residential consents per square metre was up just 0.3% y/y in March**. This proxy for construction costs has shown a surprisingly sharp fall in growth from the near-9% rates seen over the latter part of 2016. This may indicate that construction cost inflation is finally starting to wane, but we suspect it is primarily compositional. Given the extreme volatility in this cost measure we will await further data before drawing any conclusions. 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 CREDIT



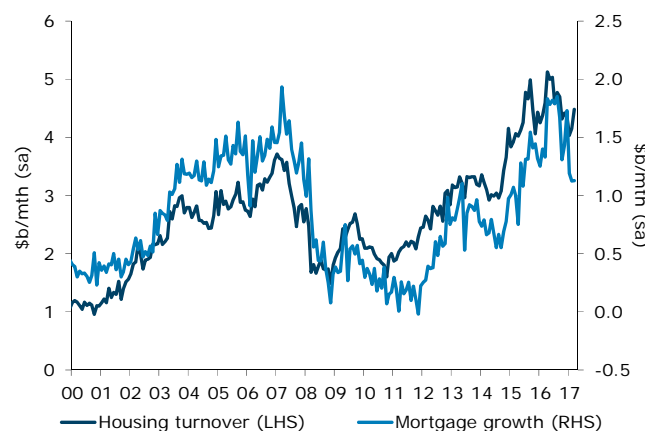
Source: ANZ, RBNZ

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 March (the chart is presented in 3-month average terms). We estimate that in seasonally adjusted terms, new lending rose 5.0% m/m to \$5.3bn, which is only the second monthly increase in the past eight months. Overall, new lending is down 8.9% y/y, with the fall mirroring the fall in the value of housing turnover.

New investor lending continues to be a weak spot. In March, lending to investors was down 32% y/y, making up 26% of total lending. Conversely, new lending to first home buyers and other owner occupiers was up 8.6% and 2.7% y/y respectively.

FIGURE 9. HOUSE TURNOVER AND MORTGAGE GROWTH



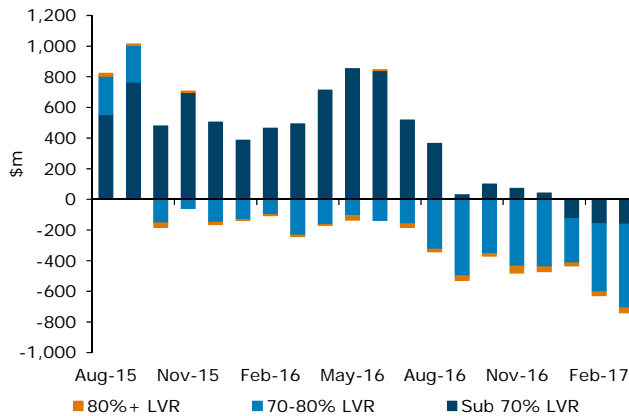
Source: ANZ, REINZ, RBNZ

Growth in the overall stock of mortgages has continued to cool, after a period of strong growth. For the third consecutive month, total housing credit rose 0.5% m/m in March, with a 3-month annualised pace of growth easing to 6.9%, the softest since mid-2015 and 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 recent modest increases in mortgage rates (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

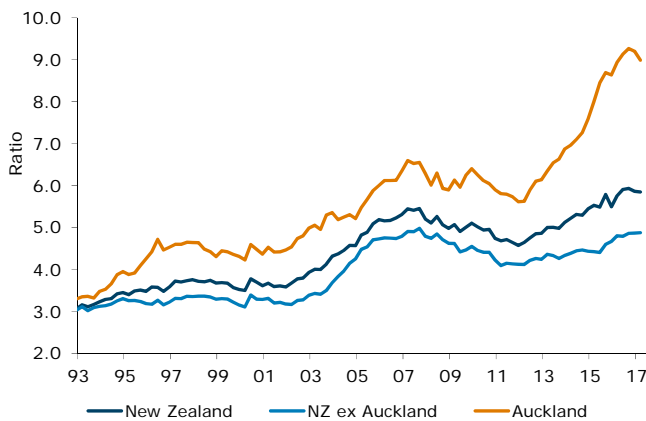


Source: ANZ, RBNZ

New lending to investors is well off its mid-2016 peak, to be down 32% y/y in March. Investors' share of overall new lending, at 26%, 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. As a share of total investor lending, lending done with LVRs in excess of 70% made up just 12% of the total in February, down from 33% in July 2016 and over 50% in mid-2015.

FIGURE 11. REGIONAL HOUSE PRICES TO INCOME

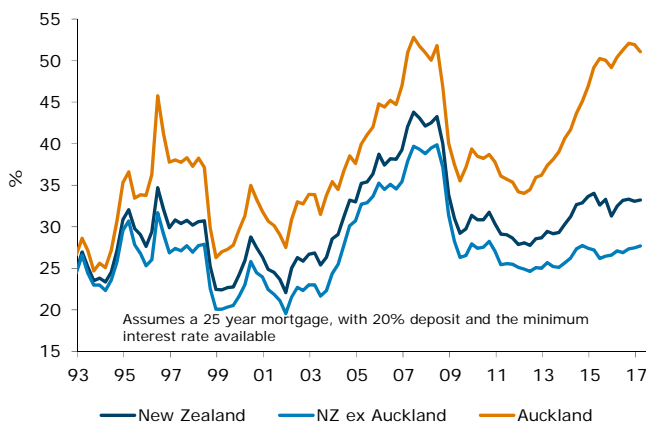


Source: ANZ, REINZ, Statistics NZ

One standard measure of housing affordability is the ratio of average house prices to incomes. It is a common 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 has risen to around 9 times, suggesting a severely unaffordable market. 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 51% 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 battle continues as a fundamental mismatch between supply (flat-lining consents) and demand (net migration is still strong) which points up for prices, goes head-to-head with broader “conditions”, including affordability and rising interest rates, which say down. We continue to side with the latter as being more influential over the coming years. Of course supply matters too, but the interest rate effect looks set to dominate. If a shortage of supply were the major influence on the market, rents would have taken off many years ago; they haven't.

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	Favours sellers	↔/↓	Takes a long time to save for a deposit and house prices to incomes are high.
Serviceability/ indebtedness	To deteriorate	↔/↓	More debt and higher interest rates is not a great combination.
Interest rates / RBNZ	On the up	↓	Interest rates still low, but off their lows. That changes the buyer psychology.
Migration	Extreme	↔/↑	A political hot potato. We need to import labour but more people places pressure on infrastructure and housing
Supply-demand balance	Demand > Supply	↔/↑	Demand is outstripping supply and the latter looks to be slowing.
Consents and house sales	Shortage	↔/↑	Not enough builders to lift supply materially.
Liquidity	Less credit	↓	It's a tighter regulatory environment and set to get tighter.
Globalisation	Mixed bag	↔	Auckland (9 times income) no longer looks cheap in a global comparison but the rest of NZ still does (5 times). So the regions are now outperforming Auckland.
Housing supply	Behind the 8-ball	↔/↑	Less credit + higher construction costs + no labour = less supply.
House prices to rents	Too high	↔/↓	Still a large gap between house prices and rents.
On balance	Flat-lining	↔	Interest rates will dominate over the coming year.

PROPERTY GAUGES

FIGURE 1: HOUSING AFFORDABILITY

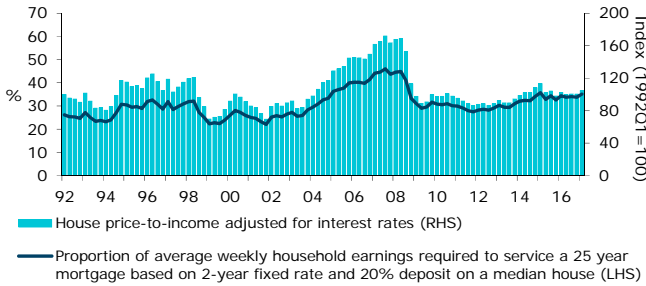


FIGURE 2: SERVICEABILITY AND INDEBTEDNESS

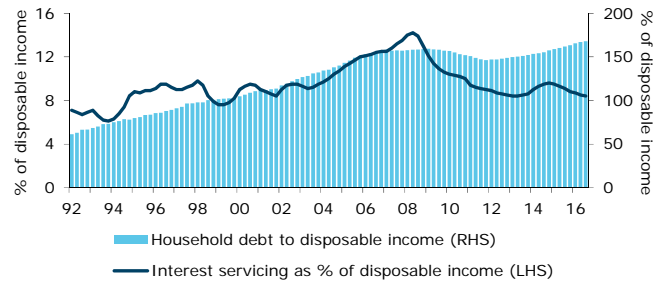


FIGURE 3: NEW CUSTOMER AVERAGE RESIDENTIAL MORTGAGE RATE (<80% LVR)

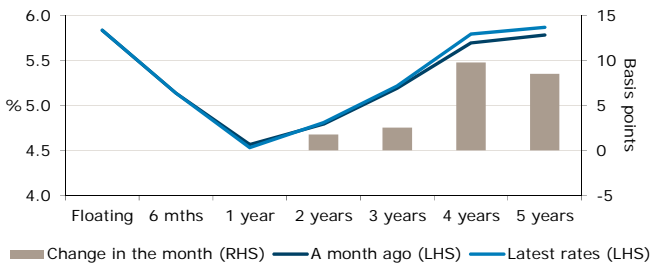


FIGURE 4: NET MIGRATION

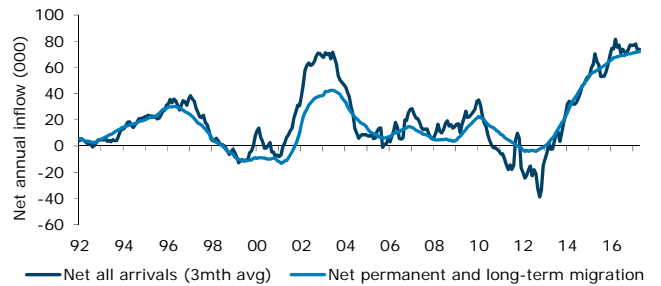


FIGURE 5: HOUSING SUPPLY-DEMAND BALANCE

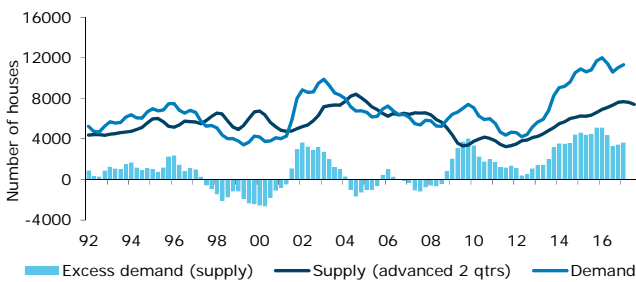


FIGURE 6: BUILDING CONSENTS AND HOUSE SALES

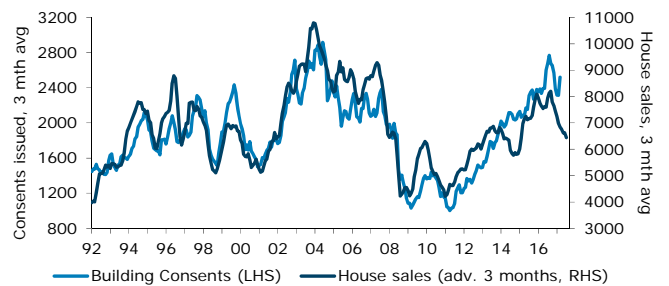


FIGURE 7: LIQUIDITY AND HOUSE PRICES

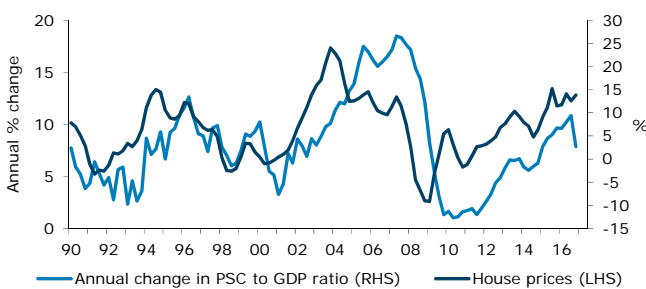


FIGURE 8: HOUSE PRICE INFLATION COMPARISON

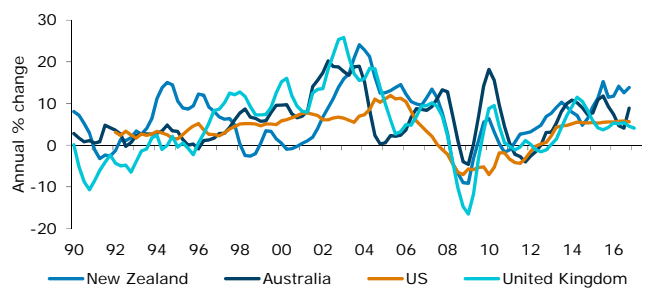


FIGURE 9: HOUSING SUPPLY

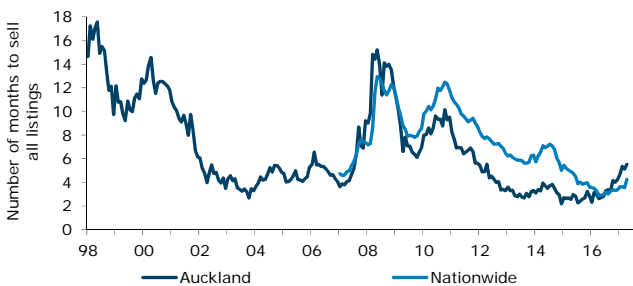
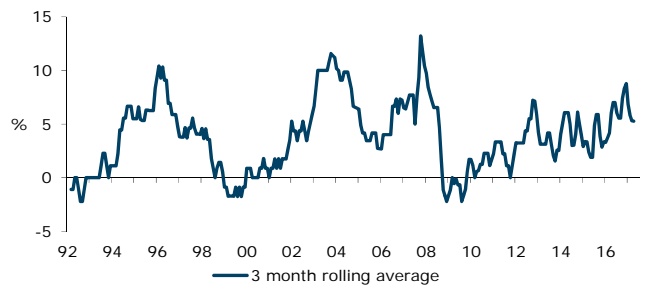


FIGURE 10: MEDIAN RENTAL, ANNUAL GROWTH



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



ECONOMIC OVERVIEW

SUMMARY

The economy is buoyant and forward growth indicators remain positive. We expect momentum to ease over late 2017 as credit constraints and difficult finding skilled labour bite. History shows New Zealand could be in for a correction in 2018. We think the ten-year boom-bust cycle will be averted; households, regulators and banks are behaving differently. House price inflation is expected to remain subdued over the coming years. The RBNZ will not shift the OCR for quite a while yet.

OUR VIEW

The economy accelerated in 2017 relative to the end of 2016, despite housing activity easing. The unemployment rate has fallen below 5%. Momentum across the broader economy is strong.

Forward indicators are positive. Business and consumer confidence are elevated. Our Truckometer is showing forward momentum. Commodity prices have picked up. Migration numbers remain strong. Tourism is booming.

We expect growth to moderate over the back half of 2017, though remain respectable. Financial conditions have tightened and a sizeable funding gap (too few deposits relative to credit growth) flags continued pressure for credit growth to slow and relative prices to shift more towards savers at the expense of borrowers. This funding gap is implicitly forcing a savings-deficit nation to fund its investment needs more locally. This caps investment growth and means the economy needs to save more, which implies spending less. That trades off growth today for growth in the future.

Labour (skill shortages) bottlenecks are coming more to the fore. We still expect the unemployment rate to fall further over 2017 and wage growth to lift. There is the potential for some bow-wave demands for wage increases, given rising inflation and spill-over from industry settlements.

History shows that New Zealand could be due for a correction in 2018. The economy runs in a 10-year cycle and we can certainly identify some similarities to previous cycles, including housing excesses, rapid credit growth, high leverage and rampant inflation in some pockets (construction).

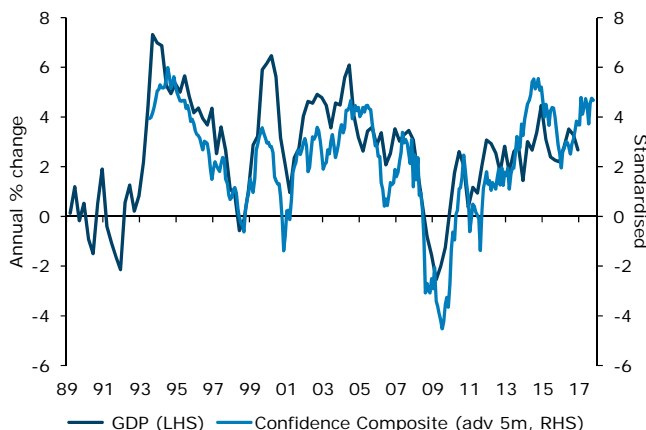
However, we think this pattern will be averted through the combination of housing shortages (we normally have an excess supply late in the cycle), tamed inflation (RBNZ at bay), regulatory action (loan-to-value restrictions), and banks reining in credit growth at the top of the cycle. Such forces are tempering demand at the top of the cycle.

Housing market activity has slowed, notably in Auckland. We expect this consolidation to last a while with the impact of rising interest rates to lean against key drivers such as population growth. While we are expecting house price inflation to ease as interest rates bite, we expect residential construction activity to remain strong.

The RBNZ is expected to keep the OCR on hold until mid-2018. Outside of housing, inflation is benign. With banks lifting retail interest rates already, the RBNZ will sit on the side-lines for a while yet.

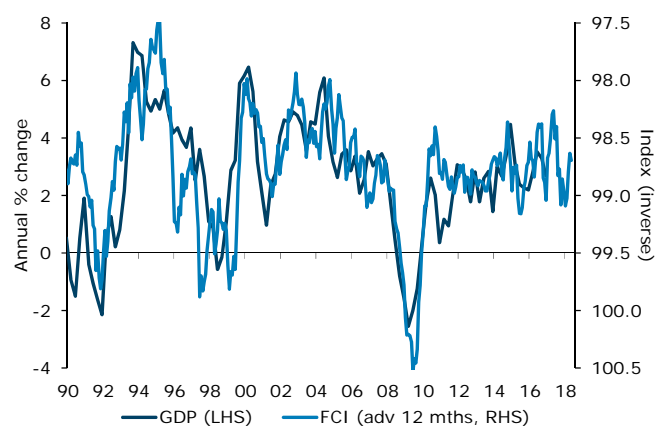
We continue to have concerns over the global scene, which presents the biggest economic risk. The US Fed is hiking. Central banks appear more alert to the side-effects of keeping rates low for too long. Regulatory headwinds continue to emerge. The resentment vote is leading to questionable policy decisions. China has considerable leverage.

FIGURE 1. GDP VS CONFIDENCE COMPOSITE



Source: ANZ, Roy Morgan, Statistics NZ

FIGURE 2. GDP VS FINANCIAL CONDITIONS INDEX



Source: ANZ, Statistics NZ, Bloomberg

MORTGAGE BORROWING STRATEGY

SUMMARY

Mortgage rates have not changed much over the past month, but the changes that have been seen have been upward, reflecting ongoing intense competition for deposits. This has had a knock-on impact on mortgage rates. The mortgage curve remains tick-shaped, with the 1 year rate both the low point and the “sweet spot” on the curve. With credit growth still outstripping deposit growth, the risk is we see term interest rates go higher (for both deposits and mortgages). However this is well factored into the term structure, and with intense competition for mortgages keeping 1-2 year rates down (and driving breakevens up), these tenors look more favourable from a cost perspective. However, we acknowledge that longer terms do offer more certainty.

OUR VIEW

Mortgage interest rates have not changed much over the past month, but the changes that have been seen have been **moves up for longer tenors. This is entirely consistent with what we have seen across deposit rates**, which have, in turn, been driven by the need to close the gap between deposit and lending growth.

The bottom line is that as a country, **New Zealand does not generate sufficient domestic savings to fund our investment (borrowing) requirements.** So we tap offshore savings. However, if the investment-savings gap is large, the current account deficit becomes unsustainable. In turn, **this becomes a cue for shifts in relative prices to encourage a better balance, and that’s what we are seeing now: the pendulum swinging more in favour of savers, rather than borrowers.**

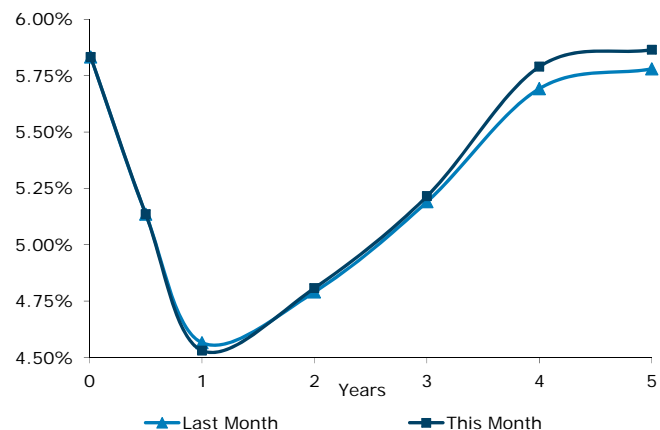
Given the small changes seen over the past month, **the mortgage curve remains tick-shaped, with the 1 year rate marking the low point.** Moreover, we believe this remains the “sweet spot”. **But it’s not just because it is the cheapest outright rate; it is vastly cheaper than the alternatives.** This has the effect of biasing breakevens upward, which in turn means that borrowers would need to expect large rises in mortgage rates in coming years for it to be worthwhile fixing for a longer term.

As our breakeven table shows, **the whole term structure of mortgage rates** (from 6 months to 3 years) **need to rise by an average of 1.48% over the next 2 years for it to be worthwhile fixing for longer now.** That could happen, but it’s a big assumption, given our view that the OCR will be on hold for another year, and that global interest rates (which tend to be the bigger driver of long-term rates) will rise only gradually.

At face value, this makes the 1 year rate look very favourable, at least from a cost perspective. Having said that, **it’s not always about cost. Certainty matters, as does “rollover risk”** (i.e. the risk that you have to make another difficult and calculated decision when your existing fixed rate rolls off). One obvious way to mitigate this is to split your mortgage into two or three separate tranches, and to roll each tranche separately. **It is also worth keeping an eye out for specials at particular points on the curve, like 18 months.** At the moment, rates offered by most banks are about halfway between the 1 and 2 year rate, so they are not that “special”. But by spreading a loan over a mixture of 1 year, 18 months and 2 years, you can at least spread your rollover risk.

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

CARDED SPECIAL MORTGAGE RATES ^



Special Mortgage Rates		Breakevens for 20%+ equity borrowers			
Term	Current	in 6mths	in 1yr	in 18mths	in 2 yrs
Floating	5.83%				
6 months	5.14%	3.93%	4.95%	5.22%	5.83%
1 year	4.53%	4.44%	5.09%	5.53%	6.03%
2 years	4.81%	4.98%	5.56%	6.13%	6.77%
3 years	5.22%	5.56%	6.21%	6.41%	6.57%
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	5.83%				
6 months	5.24%	4.63%	5.11%	4.99%	6.36%
1 year	4.93%	4.87%	5.05%	5.68%	6.64%
2 years	4.99%	5.27%	5.84%	6.26%	6.79%
3 years	5.54%	5.80%	6.21%	6.49%	6.82%
4 years	5.89%	6.08%	6.38%		
5 years	6.09%	*may be subject to a low equity fee			

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 April 2017 (based on REINZ data)

	House prices (ann % chg)	3mth % chg	No of sales (sa)	Mthly % chg	Avg days to sell (sa)
Northland	15.2	2.9	207	-13%	37
Auckland	2.9	-1.0	1,766	-11%	35
Waikato	22.0	3.5	614	-13%	36
Bay of Plenty	16.5	5.1	452	-13%	43
Gisborne	22.5	14.1	57	-2%	31
Hawke's Bay	13.7	5.0	228	-16%	32
Manawatu-Wanganui	10.6	-0.7	323	-29%	27
Taranaki	3.4	-0.4	157	-6%	43
Wellington	18.8	2.7	671	-20%	28
Tasman, Nelson and Marlborough	0.8	3.0	186	-28%	27
Canterbury	3.8	1.3	726	-18%	35
Otago	12.8	2.5	345	-21%	26
West Coast	-21.4	-0.6	22	-20%	92
Southland	5.8	-4.5	110	-34%	30
NEW ZEALAND	10.4	3.1	5,863	-16%	34

Key forecasts

Economic indicators	Actual			Forecasts						
	Jun-16	Sep-16	Dec-16	Mar-17	Jun-17	Sep-17	Dec-17	Mar-18	Jun-18	Sep-18
GDP (Ann Avg % Chg)	2.7	3.0	3.1	3.1	3.0	3.0	3.1	3.0	2.9	2.6
CPI Inflation (Annual % Chg)	0.4	0.4	1.3	2.2(a)	2.0	2.2	2.0	1.7	2.0	2.1
Unemployment Rate (%)	5.0	4.9	5.2	4.9(a)	4.8	4.7	4.7	4.6	4.5	4.4
Interest rates (RBNZ)	Jun-16	Sep-16	Dec-16	Mar-17	Jun-17	Sep-17	Dec-17	Mar-18	Jun-18	Sep-18
Official Cash Rate	2.25	2.00	1.75	1.75	1.75	1.75	1.75	1.75	2.00	2.25
90-Day Bank Bill Rate	2.4	2.2	2.0	2.0	2.0	2.0	2.0	2.1	2.3	2.5
Floating Mortgage Rate	5.7	5.6	5.7	5.8	5.8	5.8	5.8	5.8	6.1	6.3
1-Yr Fixed Mortgage Rate	4.9	4.9	4.9	5.1	5.1	5.1	5.1	5.2	5.4	5.5
2-Yr Fixed Mortgage Rate	5.1	5.1	5.1	5.3	5.4	5.4	5.5	5.5	5.7	5.8
5-Yr Fixed Mortgage Rate	5.6	5.6	5.9	6.3	6.5	6.5	6.6	6.7	6.8	6.9

Source: ANZ, Statistics NZ, RBNZ

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