NEW ZEALAND PROPERTY FOCUS

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THE LOWDOWN ON THE SLOWDOWN

SUMMARY

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

CHIEF ECONOMIST CORNER: THE LOWDOWN

Strong arguments can be made for why the OCR might not increase much, if at all, in the future. Inflation is low and technology is reducing firms' pricing power. The world is struggling to generate growth strong enough to absorb spare capacity and in many places, key pro-cyclical sectors such as housing are now "rolling over". We live in a world beset by low inflation and New Zealand is not immune to these forces. Additionally, prudential policy is increasingly doing the job the OCR used to do. Not only does all this mean that there is little pressure on the OCR to move up at present, it also means that the neutral interest rate (where the OCR will settle across the cycle) has fallen – quite a lot. The OCR is only one factor that shapes borrowing rates and they could change for other reasons, such as bank funding costs. But the OCR is still a material influence and while we can debate whether or not it will lift from current low levels, what is increasingly clear is that it is not going to move by much in any case.

PROPERTY GAUGES

Auckland house prices are falling and momentum across the rest of New Zealand is easing up. There are still strong legs of support from natural population growth and migration. However, the interest rate cycle has turned, credit is harder to come by, affordability constraints have pressured the Auckland market, and LVR restrictions have knocked the investor market. That's a powerful combination that is not set to ease up anytime soon. We expect the market to remain subdued into 2018.

ECONOMIC OVERVIEW

The economy is showing late-cycle behaviour where capacity constraints and a moderation in the housing market are crimping growth. However, the economy has enough impetus from other areas (commodity prices, fiscal policy and household incomes) for the economic expansion to extend. We expect modest GDP growth over the years ahead. While some imbalances have built up (i.e. Auckland house prices and debt accumulation), the trigger to a correction (which has historically been hikes in the OCR) is absent.

MORTGAGE BORROWING STRATEGY

Average mortgage rates remained virtually unchanged again this month, and retain the by-now very familiar tick-shape. The 1 year rate remains the low point; and against our expectation of the next OCR hike being delayed till November 2018, it remains the "sweet spot". It is not quite the proxy for floating that the 6 month could be considered to be, but it's a lot cheaper and fixing annually is still fairly regularly. Longer-term rates remain very low by historic standards and offer certainty, but they are financially less attractive in this low inflation environment.

CHIEF ECONOMIST CORNER: THE LOWDOWN

SUMMARY

Strong arguments can be made for why the OCR might not increase much, if at all, in the future. Inflation is low and technology is reducing **firms' pricing power.** The world is struggling to generate growth strong enough to absorb spare capacity and in many places, key pro-cyclical sectors such as housing are now **"rolling over".** We live in a world beset by low inflation and New Zealand is not immune to these forces. Additionally, prudential policy is increasingly doing the job the OCR used to do. Not only does all this mean that there is little pressure on the OCR to move up at present, it also means that the neutral interest rate (where the OCR will settle across the cycle) has fallen – quite a lot. The OCR is only one factor that shapes borrowing rates and they could change for other reasons, such as bank funding costs. But the OCR is still a material influence and while we can debate whether or not it will lift from current low levels, what is increasingly clear is that it is not going to move by much in any case.

FROM LOW FOR LONGER TO OUTRIGHT UNCHANGED

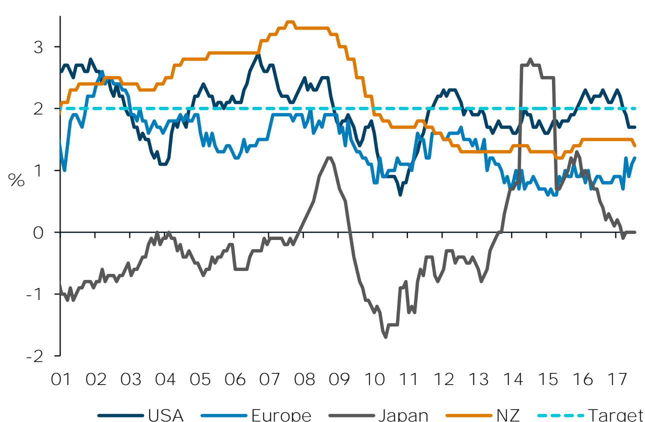
We noted last month that domestic inflation signals were mixed and that made the outlook for the OCR and interest rates much more uncertain. Ultimately, it looked like the OCR would be low for longer.

This month we're going a step further and point out why the OCR might not be moving up at all. We also introduce the concept of the neutral interest rate to think about how far the OCR, if it does have to rise, might go. Now the OCR is not the only influence on the interest rates borrowers face, but it's a material one and still matters a lot.

Consider the following:

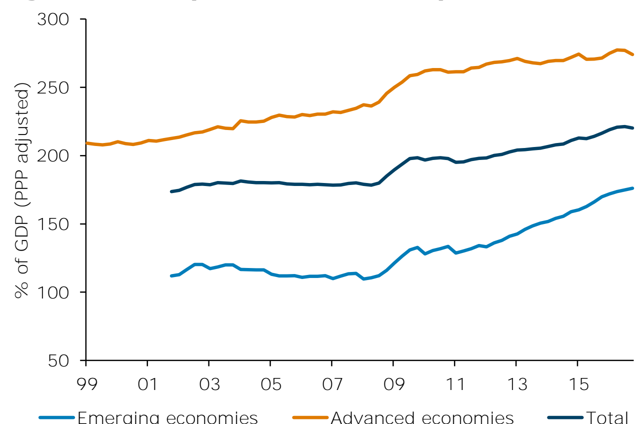
- **The global inflation pulse is not accelerating;** witness continued subdued CPI reads (and wage inflation) across a US economy that has an unemployment rate of 4.3% (and falling).
- **It is a similar story here in New Zealand.** Month after month our Monthly Inflation Gauge is telling us that there is a lack of inflation outside of housing. And the housing market has now turned!
- **Disruptive technology and technological advancement continue to suppress (and in some instances completely remove) pricing power.** That's not going away; it's intensifying.
- **The world still needs to deleverage, which is deflationary.** Locally, the ratio of household debt to income has never been higher. But New Zealand households are not unique in this regard. In fact, the world has never had as much debt as it does today, with a ratio of 220% of GDP at the end of 2016. By putting the global economy on a borrowing bender, central banks have now created a financial stability risk. Low rates have created so much debt, that it'll be hard to move them up!

Figure 1: G3 and New Zealand core inflation



Source: ANZ, Bloomberg

Figure 2: Total (non-financial sector) debt to GDP



Source: ANZ, BIS

- **Statistically the world is "due" for another accident;** it's been close to ten years since the Global Financial Crisis, and there is no shortage of candidates for the catalyst.

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- **There is a political mood for changing the Policy Targets Agreement and monetary policy operating framework –** and it won't be a lean towards the strict inflation targeting side; rather towards more flexibility.
- **Tighter prudential policy is overlapping with monetary policy.** LVR restrictions have clearly had the desired impact of cooling the Auckland housing market. Even so, the RBNZ wants its toolkit expanded to include debt-to-income restrictions (though we think the Government has effectively ruled that out). That comes on top of a review of bank capital (not just the level, but also what qualifies as "capital") and it seems highly unlikely the RBNZ will say that less is needed. Structural changes in the way banks fund themselves have seen increased competition for domestic deposits and opened up what is likely to prove a permanently wider wedge between retail and wholesale interest rates. It is all reducing the need for traditional monetary policy tools (the OCR) to be employed.
- **Globally, the credit accelerator model is broken; that's eliminated the traditionally "easy" way to drive above-trend growth and an inflationary pulse.** Central banks have credit facilitation and creation in their sights and the world has too much debt already.
- **Getting consistently strong above-trend growth – a prerequisite for sustained inflation – faces challenges.** Monetary policy works by encouraging people to shift activity from the future to today, and vice versa. Stimulatory policy brings forward consumption and encourages borrowing. However, the world already has a lot of debt; indeed prudential policy is targeting it as a financial stability risk. And are people really going to pull forward their consumption if technological change might eliminate their job? **So we're not seeing asset price booms translate into spending equivalents. It's when the two go hand-in-hand that you get a broad inflation pulse.**
- **The NZD remains persistently high.**

Good luck getting inflation to settle around 2% in that environment. A 2% inflation target is arbitrary anyway. What is so magical about it? If inflation averages 1½% or 2½%, we can't think of why that would materially alter economic outcomes. And is deflation for "goods" – which is what we are seeing – that bad anyway?

Conceivably, these forces could mean the OCR is on hold indefinitely. Some may even argue that these forces mean that the days of inflation targeting (at least in the current form) are numbered. Central banks have been struggling for years to generate higher levels of inflation despite unprecedented amounts of stimulus. Secular deflationary forces mean that those challenges will persist, if not intensify. Yet financial stability risks have risen. **A strategy of pushing economies to run hot to attempt to get inflation higher is not without risks.**

NEUTRAL COLOURS

For now, we are more inclined to see these forces manifesting in a lower neutral policy rate, rather than negating the need for a future tightening cycle altogether.

The neutral rate is the level the OCR is expected to oscillate around across the business cycle.

The RBNZ Assistant Governor announced a month ago that the Bank now sees the neutral OCR at 3.5%. That's a midpoint estimate across a range so let's call it indicative. That is down from a previously announced estimate of over 4%, although it does appear as though the RBNZ has been downgrading its views behind the scenes for a while now. It follows hot on the heels of a similar estimate from the RBA.

It is quite possible the neutral rate is even lower and has a '2-handle' in front of it right now. That's massively lower than estimates prior to the GFC when the neutral rate was thought to be around 6% (and a reason borrowing rates ended up around 9%). That estimate broadly reflected nominal GDP of 4.5-5%, some New Zealand-specific risk premium, and a bit extra to reflect New Zealand households' historical preference to spend today as opposed to save for tomorrow (households' time preference). Interest rates needed to be high to cool things down. **So what has changed?**

- **In many ways if reflects the forces described above. Neutral interest rates are lower all around the globe.** There is little inflation, inflation expectations are lower, leverage is higher, the credit wheels are turning more slowly, prudential policy is being used more and more, and growth in GDP and productivity is lower. So the traditional text-book that says that the neutral interest rate should be around nominal GDP growth is being rewritten.

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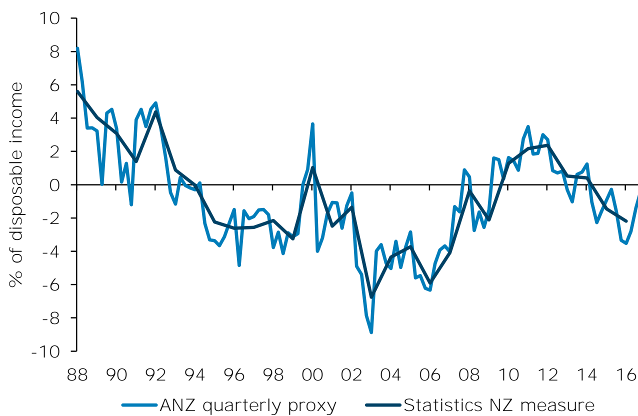
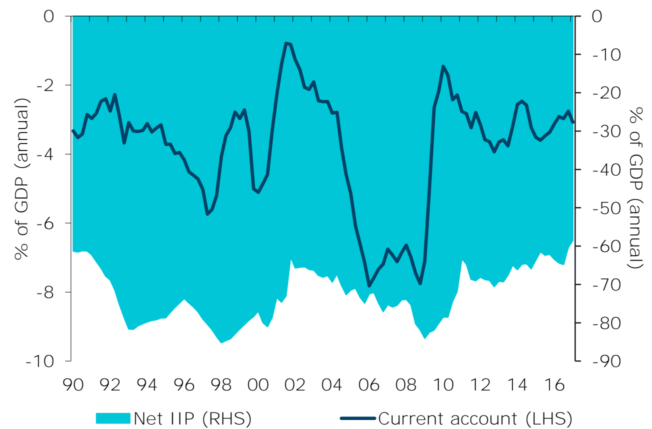
- **Households' time preference of money has clearly shifted in New Zealand.** Households are still not great savers, but they are not as bad as they were prior to the GFC: the household saving rate averaged -5% between 2003 and 2007, and the current account deficit hit close to 8% of GDP. The latter is 3.1% currently, and our estimates of the saving rate sit a little below zero. Not great, admittedly, but better. Additionally, we're not seeing the traditional consumption surge that has historically tended to coincide with a boom in the housing market. The RBNZ has noted this too. See "Changing dynamics in household behaviour: What do they mean for inflationary pressures?". Less borrow-and-spend behaviour implies households' time preference has fallen (more patience; less emphasis on today) and interest rates accordingly do not need to be as high.
- **New Zealand's risk premium is lower.** Net external debt is now 55% of GDP, less than Australia's, and the maturity profile of that debt is now far longer than it has been in the past. New Zealand doesn't have a shadow banking sector. The political situation is far more stable than that evident in many other countries – though the upcoming election looks set to be a cracker.

Figure 3: Household saving rate



Source: ANZ, Statistics NZ

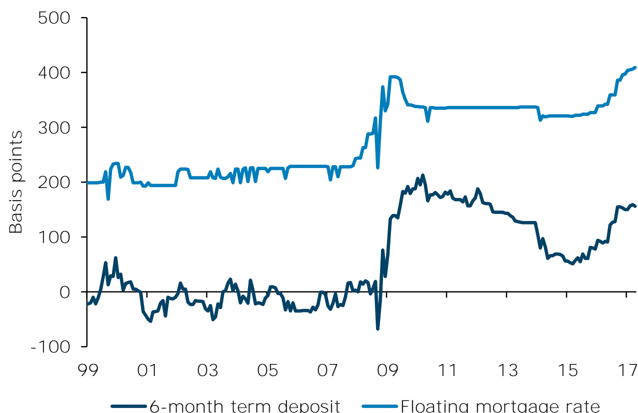
Figure 4: Net international investment position and current account



Source: ANZ, Statistics NZ

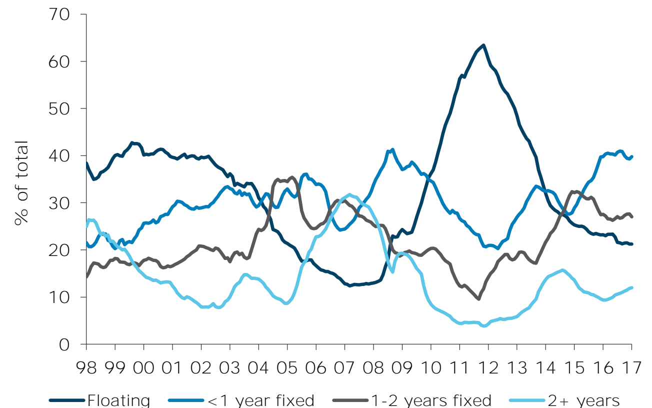
- **Deposit rates are trading well above the OCR.** Six month deposit rates used to trade around the OCR; they are now trading around 160bps higher. One and two year term deposit rates are on average around 175bps above the OCR. **It means that a 3.5% OCR is effectively 5.25%.**
- **The borrowing "curve" is now upwards sloping.** The difference between the 5-year and 1-year mortgage rate is currently 120bps, whereas prior to the GFC it was negative. This has seen the duration of mortgage borrowing remain far shorter, with 66% of mortgages currently on floating or fixed terms less than 12 months, compared with less than 40% in 2007. It means that monetary policy will have more punch at the front end when it does come time to lift rates.

Figure 5: OCR and deposit and mortgage rate spreads



Source: ANZ, RBNZ

Figure 6: Proportion of mortgage debt by maturity



Source: ANZ, RBNZ

CHIEF ECONOMIST CORNER: THE LOWDOWN

So let's do some basic maths. We'll start with the old 6% estimate for neutral. Knock off 1.25%pts for a conservative deposit margin effect; 0.5%pts for lower inflation expectations (inflation has averaged 1% over the past five years; it averaged 2.2% for the decade prior to the GFC, so our 0.5%pt estimate is conservative); say 0.5%pts for prudential and bank policy (we'd say that's very conservative too, considering the impact on the property market); another 0.25%pts for the leverage and curve effect; and say 0.5%pts for changes in households' time preference. Suddenly you have a new neutral that's 3%! **Now these are ballpark figures of course. There is likely to be some overlap in terms of the effects, but the point is simply that a lot of small changes add up.** We are inclined to think the neutral OCR is perhaps a little below 3% at present.

The bottom line is that it's hard to see the OCR moving up a long way, if much at all. Prudential policy and other forces are doing the heavy lifting. A wedge is effectively opening up between actual borrowing rates and the traditional OCR tool.

However, while it is tempting to flat-line our OCR projections completely, we're resisting that temptation, preferring instead to project the OCR to lift, though not for a while yet. There are a few reasons for this:

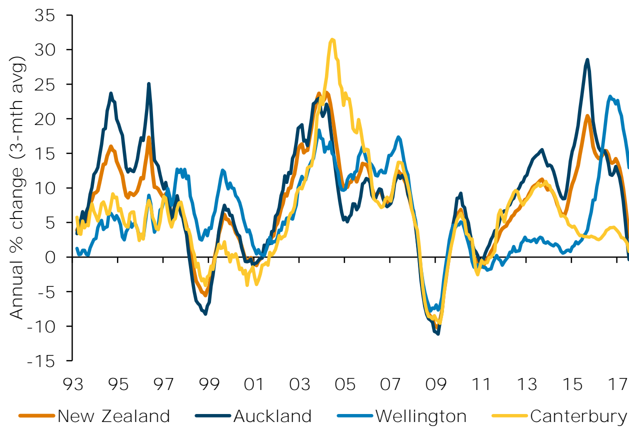
- **The global economy is expected to hold together well enough;** not necessarily sufficiently to drive inflation strictly to target, **but enough that policy needs to be wound back, given central banks' increasing focus on financial stability risks.** The Fed is close to the balance sheet unwind exit door and the ECB is expected to inch towards it in 2018. It's untenable to think New Zealand's interest rates end up below those in the US, but that is precisely what the Fed's dot plot and RBNZ's OCR profile portray; the NZD/USD won't be anywhere near current levels in that situation.
- **The NZD looks set to correct lower** as central bank policy settings shift globally and the liquidity cycle turns. Now we are not expecting it to fall by much, but still enough to alter the tradable inflation pulse.
- **We are forecasting the local labour market to tighten sufficiently to lift wage inflation; that will flow into broader inflation trends.**
- **Fiscal policy is set to be loosened.** The fiscal accounts are back in the black. Surpluses are projected and net debt is declining – that's a recipe for spending more. The politicians won't be able to keep their hands off the loot in what's looking like a tight race. Tighter fiscal policy (effectively taking more money out of people's pockets than what is given back) is set to be replaced by expansionary fiscal policy and more money in people's pockets. More money via fiscal policy means less stimulus is needed from monetary policy.

Admittedly, there is still plenty of debate about whether these forces will be sufficiently strong to outweigh the impact of secular inflation suppressants like technology, and see the OCR move up. But what is increasingly clear is that even if the OCR does lift, it won't be moving far. Now other forces such as bank borrowing costs could impact borrowing rates in time. The OCR is not the only influence. But it is an important anchor point, and so if it is not moving up much (if at all), then the same can ultimately be said for borrowing rates.

ANZ

THE PROPERTY MARKET IN PICTURES

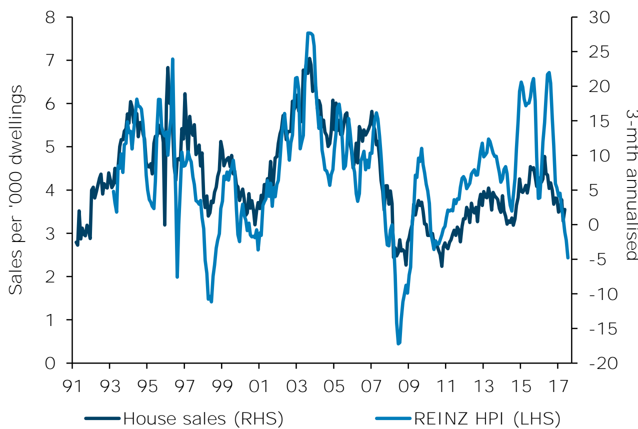
Figure 1. Regional house prices



Source: ANZ, REINZ

We estimate the nationwide REINZ House Price Index fell a further 0.4% m/m (seasonally adjusted - sa) in July, which was the third consecutive fall and the fourth fall in the past five months. It saw annual growth fall to just 1.1% 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 falling 0.4% m/m (sa) in June, to be down 4% since January. Across the rest of the country, prices dipped 0.1% in July (sa) and are still up 7.5% y/y. Of the major centres, Wellington is recording the strongest annual price growth of 10% y/y, although this is well off its highs.

Figure 2. REINZ house prices and sales

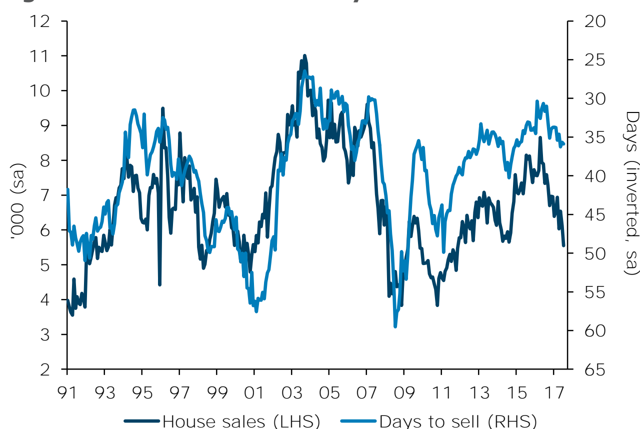


Source: ANZ, REINZ

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

Seasonally adjusted sales volumes tumbled 9.3% m/m in July, which followed a 6.5% m/m drop in June. In fact, sales volumes are down 24% y/y, and are at their lowest monthly level since November 2011. Again, Auckland is underperforming, with turnover down over 31% y/y, although every region is now experiencing negative annual turnover growth. Excluding Auckland, sales volumes fell 10% m/m (sa) in July and are down 21% y/y.

Figure 3. Sales and median days to sell



Source: ANZ, REINZ

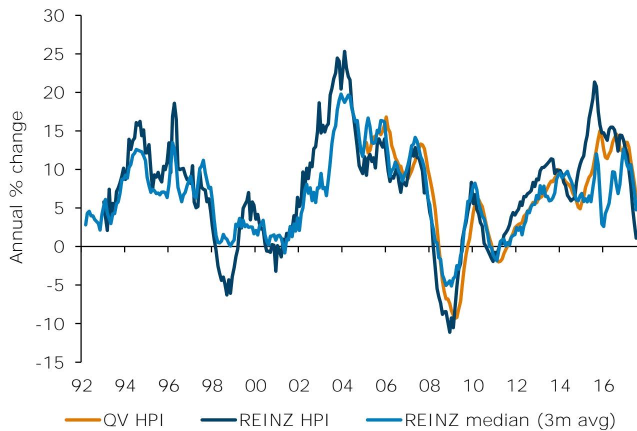
How long it takes to sell a house is also an indicator of the strength of the market, encompassing both demand and supply-side considerations. Larger cities tend to see houses sell more quickly, but deviations in a region from its average provide an indicator of the heat in a market at any given time.

Nationally, the median time to sell a house rose by 0.2 days to 35.9 days (sa) in July. 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 except Auckland and the West Coast.

THE PROPERTY MARKET IN PICTURES

Figure 4. REINZ and QV house prices

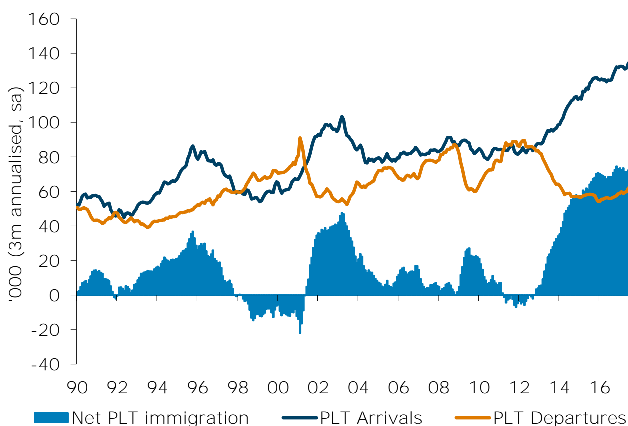


Source: ANZ, REINZ, QVNZ

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 fell 1.1% m/m (sa) in July, seeing annual growth drop to 3.2% y/y. This is now a little stronger than the REINZ House Price Index (1.1% y/y) and below the QVNZ measure of price growth (6.4% y/y). The latter two measures adjust for changes in the quality of houses sold. But annual inflation in all three is pointing firmly down.

Figure 5. Net permanent/long-term immigration



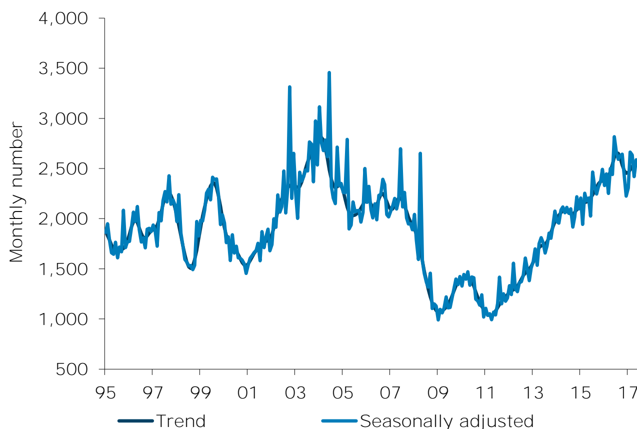
Source: ANZ, Statistics NZ

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 held at around 72k in July. This is near record levels and over 1½% of the resident population. Although departures have started trending higher off low levels, arrivals continue to lift strongly.

While we are perhaps reaching a "peak", net inflows are expected to remain strong. New Zealand's labour market continues to perform well (even relative to an improving Australian market), 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



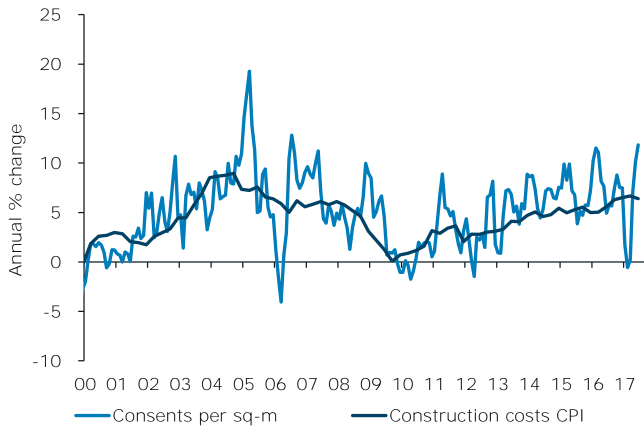
Source: ANZ, Statistics NZ

Seasonally adjusted dwelling consent issuance fell 1.0% m/m in June, following a 6.9% m/m lift in May. 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. June 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.

THE PROPERTY MARKET IN PICTURES

Figure 7. Construction cost inflation

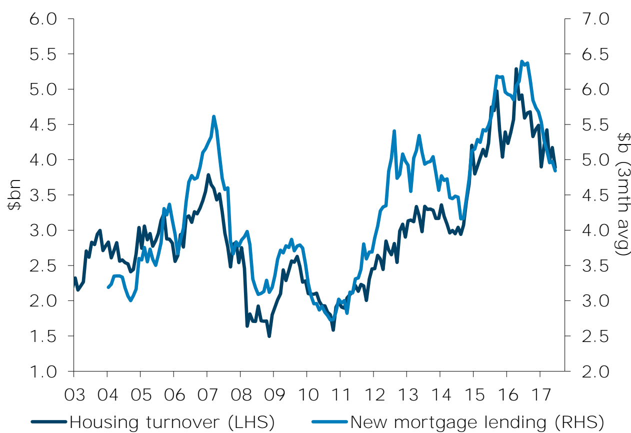


Source: ANZ, Statistics NZ

On a three-month average basis, **the value of residential consents per square metre rose 12% y/y in June.** 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 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 fell in June (the chart is presented in 3-month average terms). We estimate that in seasonally adjusted terms, new lending fell 3.8% m/m to $4.87bn, which followed a 10% m/m lift in May. Overall, new lending is down 25% y/y, with the fall mirroring the decline in the value of housing turnover.

New investor lending continues to be weak. In June, lending to investors was down 49% y/y, making up less than 24% of total lending. Conversely, new lending to first home buyers was down a more modest 3.4% y/y, making up 14% of the total.

Figure 9. New mortgage lending and & housing credit

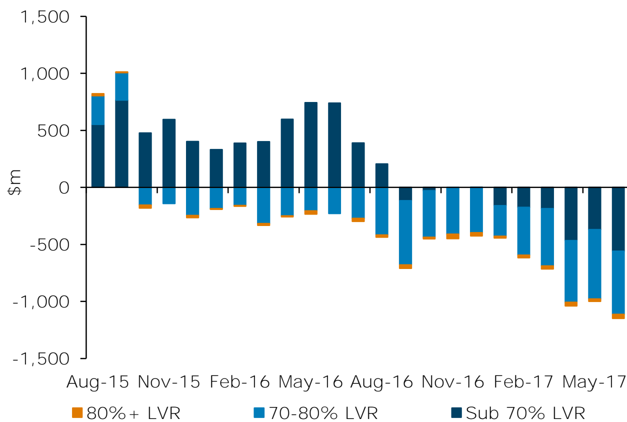
Source: ANZ, REINZ, RBNZ

After May saw the smallest monthly growth in total mortgage lending since mid-2015 (+0.4% m/m), **June saw a mild acceleration, with lending rising 0.6% m/m in seasonally adjusted terms.** That said, in three-month annualised terms, lending growth was broadly stable at 6.3%, 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 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

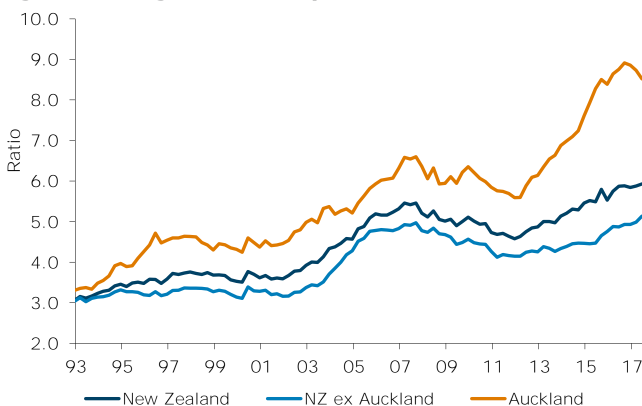


Source: ANZ, RBNZ

New lending to investors is well off its mid-2016 peak. In fact, it has effectively halved, dropping 49% y/y in June. Investors' share of overall new lending, at less than 24%, 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 June, the share of total investor lending done at LVRs of less than 70% was 90%. That is a far greater share than in late-2014 when it was less than half.

Figure 11. Regional house prices to income

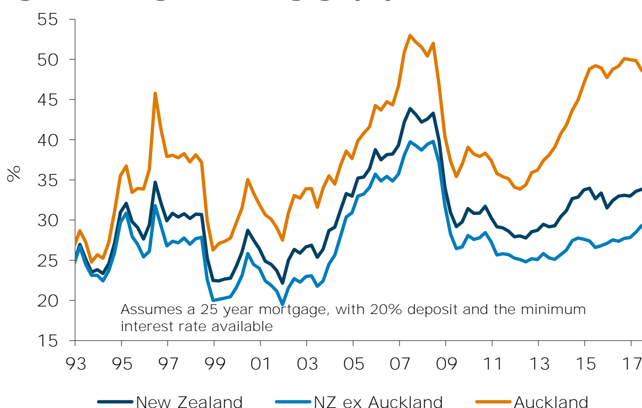


Source: ANZ, REINZ, Statistics NZ

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 has been broadly stable at just below 6 times income for the past 12 months. Auckland, however, has seen its ratio fall from a high of just under 9 times to an estimated 8.5 times in the June quarter. That is the lowest level in 18 months (although still extremely high) and reflects recent house price falls. Elsewhere, the ratio has continued to rise, and at 5.1 times, is now a little over where it peaked in 2007.

Figure 12. Regional mortgage payments to income



Source: ANZ, REINZ, RBNZ, Statistics NZ

Another, arguably more comprehensive, measure of housing affordability is to look at it through the lens of debt serviceability, as this also takes into account interest rates, which are an important driver of housing market cycles.

We estimate that for a purchaser of a median-priced home (20% deposit), the average mortgage payment to income nationally is around 34% at the moment.

However, once again there are stark regional differences, with the average mortgage payment to income in Auckland around 49% for new purchasers. While 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

Auckland house prices are falling and momentum across the rest of New Zealand is easing up. There are still strong legs of support from natural population growth and migration. However, the interest rate cycle has turned, credit is harder to come by, affordability constraints have pressured the Auckland market, and LVR restrictions have knocked the investor market. That's a powerful combination that is not set to ease up anytime soon. We expect the market to remain subdued into 2018.

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	Prices too high	↔/↓	You need a lot of debt or huge equity / deposit to buy.
Serviceability/ indebtedness	Will rise as interest rates do	↔/↓	Leveraged households vulnerable to turn in the interest rate cycle.
Interest rates / RBNZ	Slow ascent	↔/↓	The OCR is likely on hold for some time yet, but the bias for mortgage rates is still a little higher
Migration	Booming	↔/↑	We are at "peak" migration. 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	↔/↑	Capacity constraints (builder availability) constraining consents.
Liquidity	Tight	↓	Money no longer easy to get.
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 = 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**	↔	**Less credit + LVRs + no more rate cuts + demand/supply imbalance = a market plateau**

ANZ

PROPERTY GAUGES

Figure 1: Housing affordability

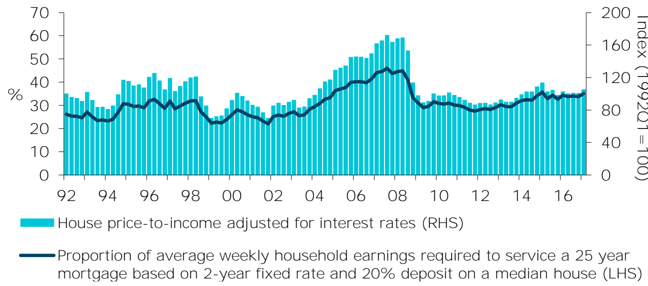


Figure 2: Household debt to disposable income

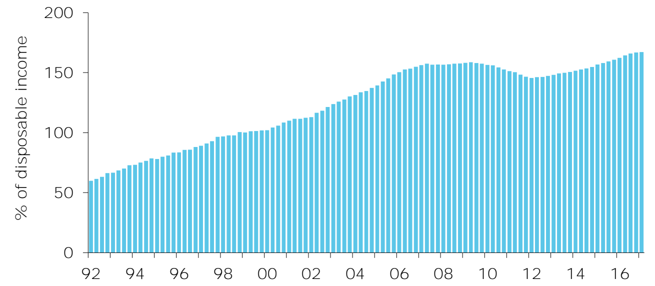


Figure 3: New customer average residential mortgage rate (<80% LVR)

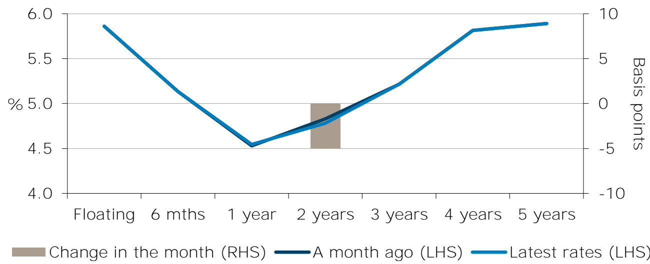


Figure 4: Net migration

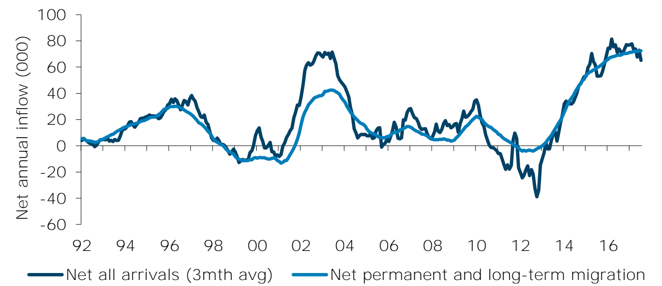


Figure 5: Housing supply-demand balance

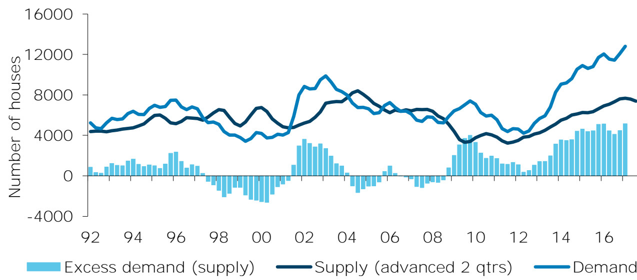


Figure 6: Building consents and house sales

Figure 7: Liquidity and house prices

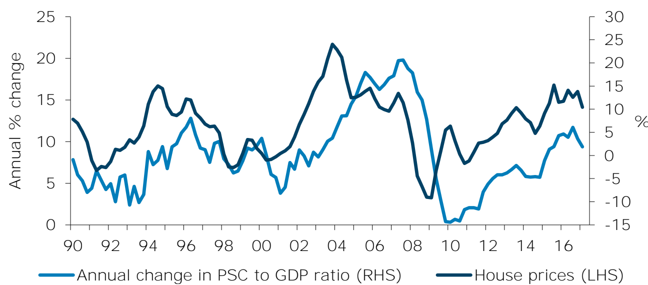


Figure 8: House price inflation comparison

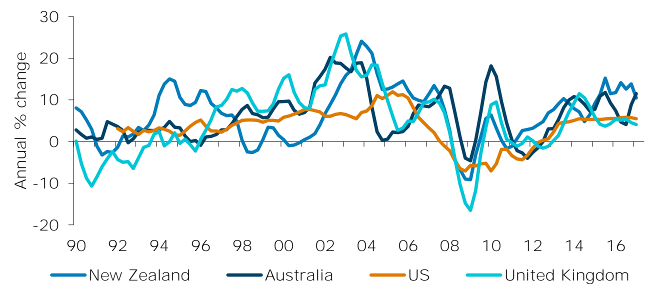


Figure 9: Housing supply

Figure 10: Median rental, annual growth

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

ECONOMIC OVERVIEW

SUMMARY

The economy is showing late-cycle behaviour where capacity constraints and a moderation in the housing market are crimping growth. However, the economy has enough impetus from other areas (commodity prices, fiscal policy and household incomes) for the economic expansion to extend. We expect modest GDP growth over the years ahead. While some imbalances have built up (i.e. Auckland house prices and debt accumulation), the trigger to a correction (which has historically been hikes in the OCR) is absent.

OUR VIEW

The economy continues to exhibit late-cycle behaviours. Growth is respectable but skilled labour is becoming harder to find. Spare capacity is being absorbed. Demand is not the problem; meeting the demand is. Typically that leads to inflation, higher interest rates and a turn in the business cycle.

But this cycle is different on numerous levels:

- Growth has been less exuberant at the top of the cycle; excesses have built up, but not to extreme levels.
- The current account deficit is contained.
- We are not seeing a consumption boom in combination with a housing one.
- The combination of this plus a high NZD and technology is suppressing inflation; the RBNZ is firmly on hold.
- Policymakers have been far more proactive reining in excesses (and the banking sector too); credit growth has eased.
- We can't build enough houses; late in the cycle we typically build too many.

This combination leaves us comfortable that the business cycle will extend and we won't see an aggressive turn for the worse, as has been the historical tendency.

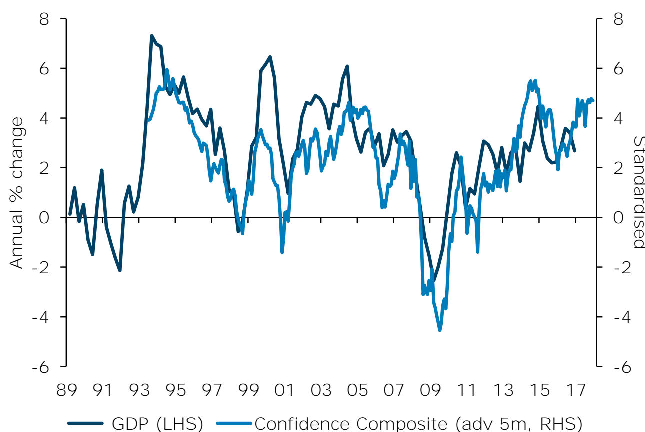
So far, a turn in key pro-cyclical sectors – such as housing – is not impacting the wider economy. Auckland house prices have eased 4% in six months. House price momentum across the wider country is still solid, but less stellar. Credit is harder to obtain. Despite this, business and consumer confidence remain at elevated levels and our composite measure points to good growth prospects. That's a sign of a broad-based economic expansion in operation.

The economy will pivot over the coming two years as the drivers of growth shift. There are the obvious focal points such as migration and tourism. Construction is facing capacity constraints so will take less of a lead role. Fiscal policy is moving to an expansionary stance, putting money in peoples' pockets. The terms of trade (ratio of export prices to import prices) are set to hit all-time highs; the lift will add a lot to GDP growth.

The RBNZ is expected to keep the OCR on hold for an extended period. Outside of housing, inflation is benign. With prudential policy doing the work of the OCR in slowing the housing market, and inflation outside of housing low, the OCR might not be moving at all.

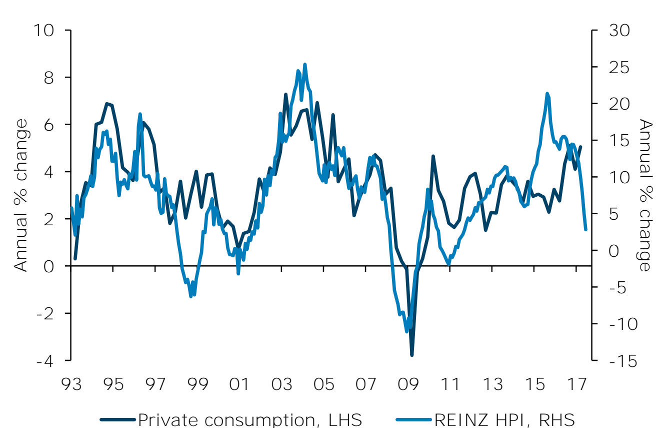
The election is looking to be a close-run thing. This has the potential to cause unease in the business sector but we don't believe it will amount to much. Policy platforms are reasonably centralist and sensible.

Figure 1. GDP vs Confidence Composite



Source: ANZ, Roy Morgan, Statistics NZ

Figure 2. House prices and real private consumption



Source: ANZ, Statistics NZ, REINZ

MORTGAGE BORROWING STRATEGY

SUMMARY

Average mortgage rates remained virtually unchanged again this month, and retain the by-now very familiar tick-shape. The 1 year rate remains the low point; and against our expectation of the next OCR hike being delayed till November 2018, it remains the "sweet spot". It is not quite the proxy for floating that the 6 month could be considered to be, but it's a lot cheaper and fixing annually is still fairly regularly. Longer-term rates remain very low by historic standards and offer certainty, but they are financially less attractive in this low inflation environment.

OUR VIEW

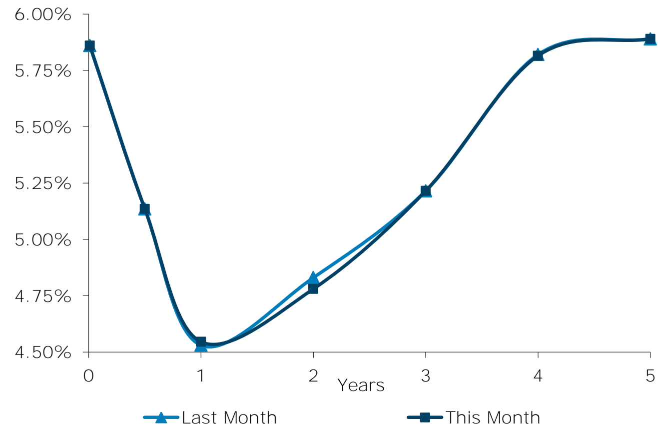
Mortgage rates remain steady, with the overall level and term structure of the by-now familiar "tick-shaped" mortgage curve pretty much as it has been since January, when average term rates^ rose between 0.3-0.4%pts. Changes this month were minor, with the 0.05%pt fall in the average 2 year rate the biggest move.

The 1 year rate remains the lowest point on the curve. We have maintained for some time now that it is also the "sweet spot" on the curve given the likelihood of the OCR being on hold for at least the rest of the year. That view has been further reinforced in recent weeks – we have now pushed out the timing of the first OCR hike in our forecasts from May to November 2018. **Such an outlook biases the focus towards the cheaper, shorter fixed terms like the 1 year**, with a view to making a fresh decision when that fixed term expires next year.

Within that broad "short-term" strategy it is worth asking if similar terms like the 6 month or 2 year (or 18 month rates offered by some banks) are worthwhile. Financially, we don't feel that they are at the moment. Indeed, the average 1 year rate is more than half a percentage point below average 6 and 18 month rates, yet we expect rates to hold broadly steady for at least another year. The average 2 year is "only" 0.23%pts higher than the average 1 year, but **if we think in breakeven terms, you'd have to expect the 1 year rate to rise by at least 0.47%pts (from 4.55% to 5.02%) over the next year in order for it to be cheaper fixing for 2 years at 4.78% than rolling two 1-year terms. That could happen, but it is unlikely** if the OCR is still at 1.75% this time next year, as we expect.

From a pure cost perspective, the 1 year rate looks attractive. **However, we do need to acknowledge that some people value certainty. Accordingly, with just 0.23%pts separating 1 and 2 years rates (for borrowers with 20%+ equity), and all fixed rates below 6%, some borrowers may wish to spread their borrowing over a number of longer 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.

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%	4.90%	5.13%	5.87%
1 year	4.55%	4.43%	5.02%	5.50%	6.09%
2 years	4.78%	4.96%	5.55%	6.15%	6.85%
3 years	5.22%	5.58%	6.24%	6.45%	6.63%
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%	5.75%	5.23%	6.07%
1 year	4.97%	5.23%	5.49%	5.65%	6.24%
2 years	5.23%	5.44%	5.86%	6.12%	6.60%
3 years	5.57%	5.82%	6.23%	6.41%	6.71%
4 years	5.92%	6.11%	6.40%		
5 years	6.12%	*may be subject to a low equity fee			

^ *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 July 2017 (based on REINZ data)

	House prices (ann % chg)	3mth % chg	No of sales (sa)	Mthly % chg	Avg days to sell (sa)
Northland	22.9	8.2	186	+7%	47
Auckland	-1.3	-0.8	1,610	-8%	39
Waikato	8.9	4.0	538	-18%	39
Bay of Plenty	-1.6	0.6	393	-4%	44
Gisborne	14.5	-3.1	56	-2%	39
Hawke's Bay	25.5	3.5	212	-14%	31
Manawatu-Wanganui	6.5	6.9	376	+6%	28
Taranaki	3.8	-0.9	171	0%	39
Wellington	9.1	1.0	637	-16%	26
Tasman, Nelson and Marlborough	9.0	3.1	223	+6%	31
Canterbury	-2.4	-3.0	703	-16%	36
Otago	15.1	6.0	330	-12%	27
West Coast	-22.9	11.6	29	-18%	89
Southland	4.7	9.4	144	-13%	27
NEW ZEALAND	**3.2**	**-0.2**	**5,546**	**-9%**	**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(a)	4.8	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	1.75	1.75	2.00
90-Day Bank Bill Rate	2.2	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.1	2.3
Floating Mortgage Rate	5.6	5.7	5.8	5.9	5.9	5.9	5.9	5.9	5.9	6.1
1-Yr Fixed Mortgage Rate	4.9	4.9	5.1	5.1	5.1	5.1	5.1	5.2	5.2	5.4
2-Yr Fixed Mortgage Rate	5.1	5.1	5.3	5.3	5.2	5.3	5.3	5.4	5.5	5.6
5-Yr Fixed Mortgage Rate	5.6	5.9	6.3	6.3	6.1	6.1	6.2	6.3	6.4	6.6

Source: ANZ, Statistics NZ, RBNZ

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