ANZ RESEARCH SEPTEMBER 2018

NEW ZEALAND PROPERTY FOCUS

BUILD ME UP BUTTERCUP

ANZ

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SUMMARY

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

FEATURE ARTICLE: BUILD ME UP BUTTERCUP

Since late 2017 households have been building their housing equity. In part this reflects reduced turnover as the housing market has cooled; high turnover tends to be associated with increased debt because buyers typically have less equity than sellers. Recent lower turnover partly reflects government policy changes, uncertainty and affordability constraints. But credit conditions have played an important role in reducing turnover and building housing equity too. In addition, households are perhaps more constrained or more cautious towards debt in the post-crisis period. Nonetheless, debt levels remain high, meaning that households will be vulnerable should house prices fall or interest rates rise. The fact that those entering the market now have bigger buffers does help mitigate the risk and the potential fallout of a disorderly housing market downturn, with macro-prudential policy having played an important role here. But in light of financial stability risks, we expect that the RBNZ will take a cautious (and gradual) approach to easing loan-to-value ratio restrictions. An easing in November is possible, but settings are expected to remain "tight" for some time.

PROPERTY GAUGES

House prices have ticked up a little in the past couple of months, but that's on the back of recent softness. House prices in Auckland continue to fall and houses are taking longer to sell, meaning further weakness in prices is possible. Outside Auckland and Canterbury, housing markets remain tight and it's reasonable to expect that pressures in these markets will continue. A number of headwinds are weighing on the housing market, including policy changes, bank prudence, and investor uncertainty. This is particularly true in Auckland, where affordability constraints are biting. Meanwhile, markets outside Auckland continue to play catch up – a dynamic that looks set to continue. Overall price pressures are expected to continue to gradually moderate from here. But given the large, offsetting forces at play, there may be some bumps in the road ahead.

ECONOMIC OVERVIEW

The economic outlook is looking less assured and there are questions around the strength of domestic demand going into the second-half of the year. Data has been mixed but is generally a bit more downbeat: businesses are pessimistic and consents have dipped, but households have been resilient. We do not expect that the cycle is about to roll over, with a number of factors supportive of growth, but we do think it will be difficult to grow at trend. In that environment, it will be a struggle for core inflation to return sustainably to the RBNZ's 2% target. As such, we expect the OCR will remain on hold for some time yet – and a cut is possible should economic data disappoint.

MORTGAGE BORROWING STRATEGY

Average fixed mortgage rates have fallen over the past month, especially for longer terms. However, our favoured borrowing strategy is unchanged in that we think the 1-year fixed rate is the sweet-spot. It remains the lowest point on the curve, but also provides a short enough duration to quickly benefit if the RBNZ were to cut the OCR again, which we see as a non-trivial possibility. It also is a far cheaper option for borrowers than floating rate exposure, which maintains a large cost pick-up to shorter fixed rate terms.

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SUMMARY

Since late 2017 households have been building their housing equity. In part this reflects reduced turnover as the housing market has cooled; high turnover tends to be associated with increased debt because buyers typically have less equity than sellers. Recent lower turnover partly reflects government policy changes, uncertainty and affordability constraints. But credit conditions have played an important role in reducing turnover and building housing equity too. In addition, households are perhaps more constrained or more cautious towards debt in the post-crisis period. Nonetheless, debt levels remain high, meaning that households will be vulnerable should house prices fall or interest rates rise. The fact that those entering the market now have bigger buffers does help mitigate the risk and the potential fallout of a disorderly housing market downturn, with macro-prudential policy having played an important role here. But in light of financial stability risks, we expect that the RBNZ will take a cautious (and gradual) approach to easing loan-to-value ratio restrictions. An easing in November is possible, but settings are expected to remain "tight" for some time.

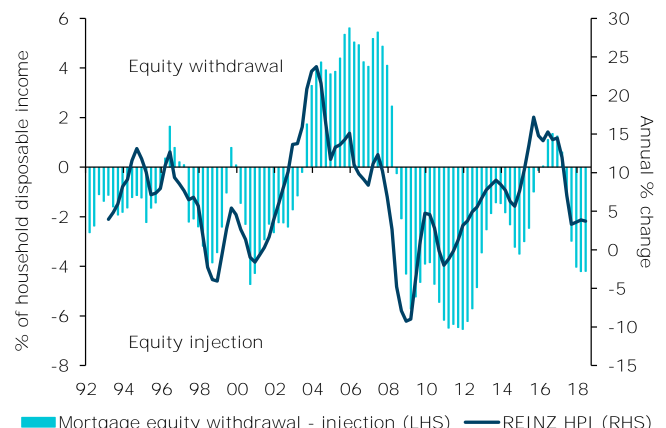
BUILDING BUFFERS

Over 2018 to date, the housing market has been fairly stable (figure 1); sales have taken a step down in recent months and house prices inflation has been consistently running at around 4% y/y. This stabilisation in the market follows the cooling seen over 2017, when house price inflation moderated from the elevated rates of 14-15% y/y that prevailed over 2016. As the housing market has slowed, households have been building their equity buffers. We estimate that equity has been "injected" into the housing stock since late 2017, after a period of withdrawal in late 2016 and early 2017 (figure 2).[1] That is, investment in the housing stock has outpaced the build-up of mortgage debt in recent times – meaning households in aggregate have been building the stock of housing that they own outright.

Figure 1. House sales and house price inflation

Source: REINZ, ANZ Research

Figure 2. Mortgage equity withdrawal (injection) and house price inflation



Source: IRD, RBNZ, REINZ, Statistics NZ, ANZ Research

WHAT HAS HAPPENED?

Mortgage equity injection can be the result of active choices on the part of households to build up their wealth in housing. Equity withdrawal, on the other hand, can be associated with households actively drawing down their equity and taking on more debt – for example, by putting a new car on the mortgage. In the 2000s, this sort of equity withdrawal was an important feature of housing market dynamics in New Zealand. As house prices rose, households used their newfound wealth to spend, adding to the significant run-up in household debt over that period (figure 3). Consumption grew very strongly (figure 4).

Since 2008, household debt has remained elevated, but households have generally been building their equity buffers, with consumption growth more moderate on the whole. There has been less new debt associated with housing turnover (figure 5). And the value of housing assets has risen by more than liabilities, boosting household net worth. Households appear to have been behaving a bit differently this cycle, perhaps because they are constrained or feel more cautious towards debt. But household behaviour is only one part of story; there has also been a post-crisis tightening in credit conditions, with banks subject to tighter regulation and reluctant to go offshore to the same degree to fund mortgage lending (figure 6).

[1] For more information see Smith (2006) and Wong (2017).

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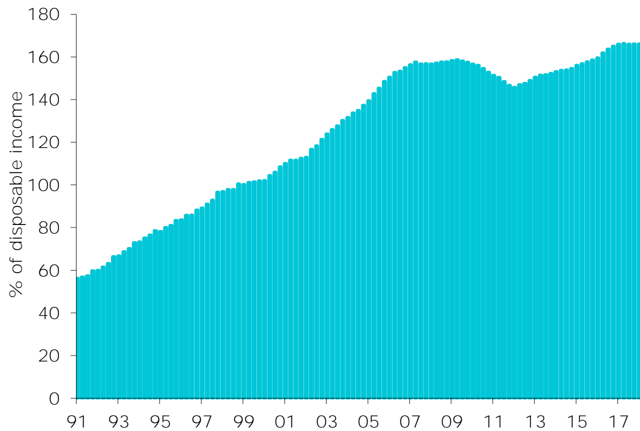
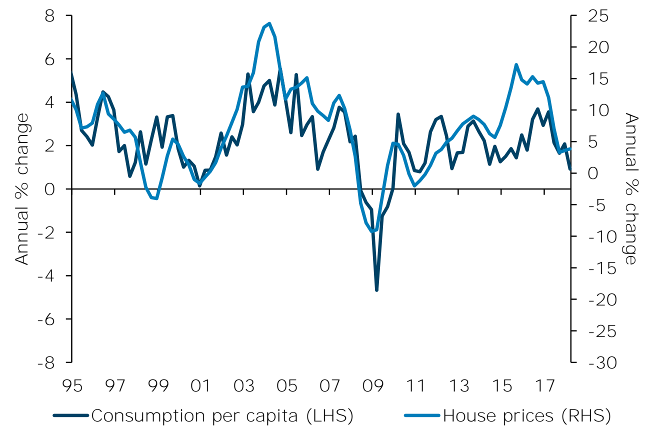
Figure 3. Household debt relative to incomes



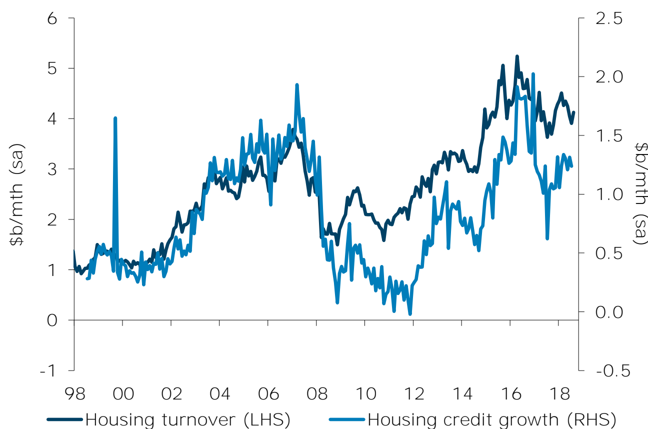
Source: REINZ, ANZ Research

Figure 4. House price inflation and consumption



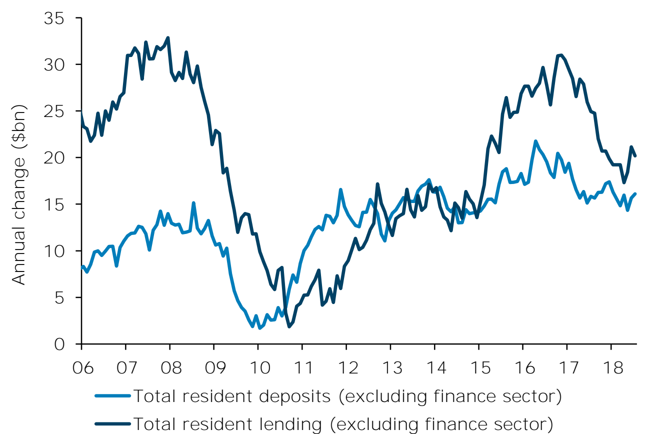
Source: REINZ, Statistics NZ, ANZ Research

Figure 5. Housing turnover and housing credit growth



Source: RBNZ, REINZ, ANZ Research

Figure 6. Bank deposit funding and claims growth ("funding gap")



Source: RBNZ, ANZ Research

During 2016, households in aggregate started withdrawing housing equity for a brief time. This stemmed from an increase in housing turnover, rather than a change in behaviour ***per se***. More housing transactions are associated with more equity withdrawal (or less injection), because buyers generally have less equity than sellers. But the amount of debt associated with a given amount of turnover did not increase during this time and has been stable since late 2014, after increasing after 2008.

As housing turnover has moderated in recent times, there has been a reduction in the flow of mortgage lending. Housing credit growth has cooled from 10% y/y (3-month moving average) in mid-2016 to 6.2% in July 2018, reflecting policy changes (particularly the RBNZ's loan-to-value restrictions on investors), prudence on the part of banks as they have pared back their funding gaps, and a bit more wariness on the part of house buyers, related to uncertainty, policy changes and affordability constraints. In addition, non-rebuild-related investment in the housing stock has been very elevated, despite more moderate credit growth. Households have been building their housing equity once more.

AN IMPORTANT VULNERABILITY

The fact that households have been improving their equity stakes is a good thing, in that it shores up household balance sheets. Household equity in housing has risen, although aggregate net worth is not much higher than it was in the mid-2000s as a proportion of incomes (figure 7). But despite this improvement in equity, it is important not to be complacent about New Zealand's structural vulnerability associated with high levels of household debt. Households are highly indebted and house prices are "overvalued" – they are very elevated relative to incomes and rents (figure 8), particularly in Auckland and Tauranga.[2] House prices and debt levels are high in an international comparison too.

[2] Demographia (2018).

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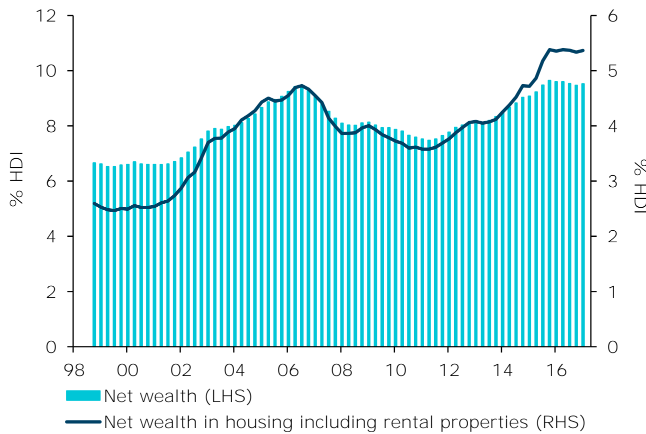
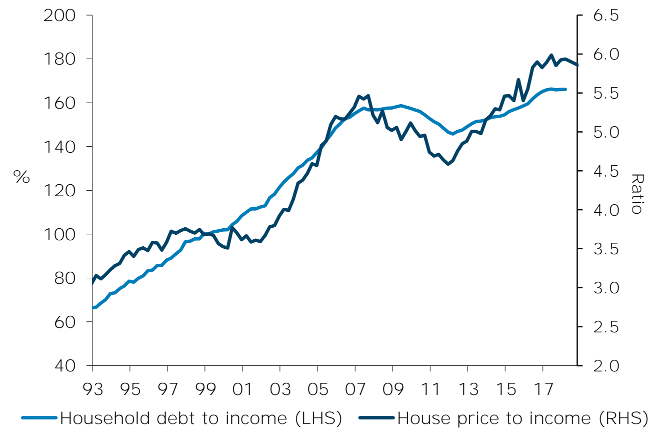
Households typically judge their financial position on a premise that housing values will at least remain where they are – if not increase. But it is entirely possible to imagine a scenario in which house prices could fall meaningfully. If a hit to the economy (eg a global shock) were to see the labour market deteriorate markedly, then this could put some highly leveraged households in financial distress, and create forced sales, which are the fastest way to see house prices adjust downwards. If the situation were particularly bad, it could create a vicious cycle: as collateral values fall, it could become more difficult to get credit, and house prices could fall further, putting more pressure on household balance sheets. The higher debt levels are in this scenario, the worse the fallout, because heavily indebted households have fewer options as regards refinancing and reducing their repayments.

Figure 7. Household net wealth and net wealth in housing (% of annual household disposable income)



Source: RBNZ, ANZ Research

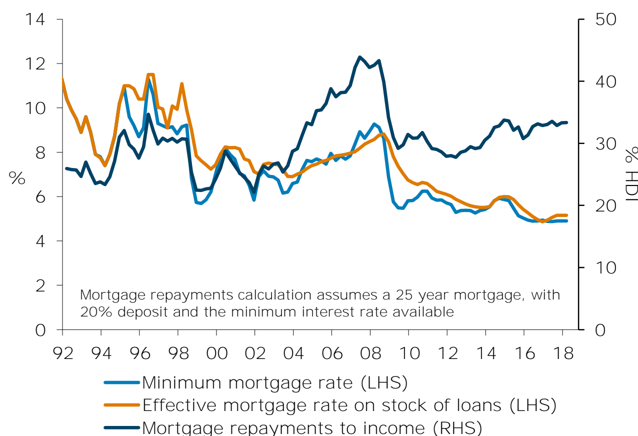
Figure 8. House prices and household debt relative to incomes



Source: RBNZ, REINZ, Statistics NZ, ANZ Research

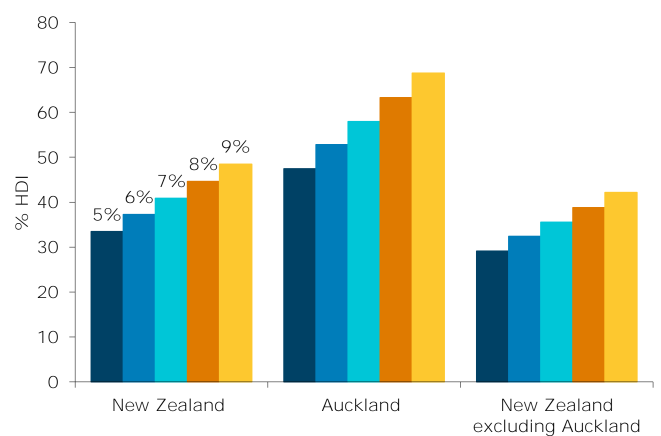
High debt levels also make households more vulnerable to changes in interest rates. The global secular decline in interest rates has contributed to the increase in debt levels and house prices. Lower interest rates have meant that households can service a larger loan with a given income (figure 9). But those same high levels of debt may now be contributing to the "new normal" of low interest rates.[3] If mortgage rates were to head back to 9%, then 48% of incomes would be required for new purchases (all else equal) for New Zealand as a whole, compared with 33% currently (figure 10). For Auckland, servicing would increase from 47% to 69% of incomes. The impact on a given homeowner would depend on their debt loading and mortgage structure (fixed rates provide protection for a time), but the impact on both housing demand and consumption would be hefty. Of course the RBNZ is unlikely to be hiking rates in a scenario where the economy is going backwards, but as we learned in 2008, bank funding costs matter for retail interest rates too, and they can be countercyclical.

Figure 9. Household debt servicing and interest rates



Source: RBNZ, REINZ, Statistics NZ, ANZ Research

Figure 10. Mortgage repayments as share of income at different interest rate levels



Source: RBNZ, REINZ, Statistics NZ, ANZ Research

[3] High debt increases the need to save in the future, which can dampen the neutral interest rate (all else equal).

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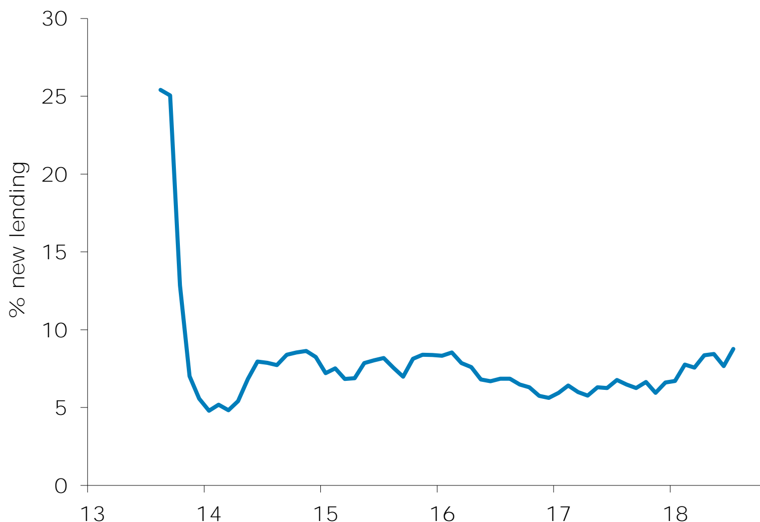
THE ROLE OF MACRO-PRU

The fact that those entering the market now have bigger buffers helps mitigate the risk and potential fallout of a disorderly housing market downturn. Macro-prudential policy has played a key role in reducing these risks. The RBNZ's loan-to-value restrictions have contributed to housing market headwinds by limiting the debt that households can take on when buying a house, and by directly requiring purchasers, especially investors, to hold more equity, they have also made households more resilient. This reduces systemic risk in the financial system as a whole. Macro-prudential policy also gives the RBNZ scope to support the financial system in the event of a housing market correction. If it threatened to turn disorderly, we expect the RBNZ would loosen loan-to-value ratios (along with monetary policy) very quickly in order to encourage lending and support housing values – though in that scenario giving banks permission to engage in riskier mortgage lending could be pushing on a string, depending on banks' own perceptions of where the housing market is headed and the risks that such lending might entail at that juncture.

But that's an extreme scenario; what about where we are now?

Macro-prudential policy settings are currently "tight"; the proportion of loans with deposits of less than 20% is still well below levels seen before the restrictions were introduced in 2013 (figure 11). It's unclear exactly what a "neutral" loan-to-value setting is – the setting that would neither stoke nor constrain the housing market from current levels of activity – but it could be consistent with lower-deposit loans being somewhere in the realm of 15-20% of lending, as opposed to under 10% now.

Figure 11. High-LVR lending as a share of new loan commitments



Source: REINZ, ANZ Research

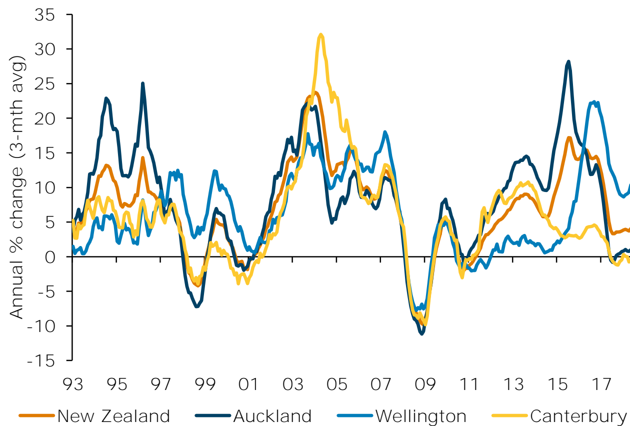
With the housing market cooler, credit growth subdued and households less vulnerable than they were, the RBNZ is likely to be thinking about when and under what circumstances loan-to-value restrictions might be adjusted to more "neutral" settings. At this stage credit conditions appear supportive of continued growth in the economy, but a significant resurgence in the housing market and credit growth looks unlikely. It is therefore possible that the RBNZ eases loan-to-value ratio restrictions when it releases its Financial Stability Report in November if the housing market continues to moderate from here, as we expect. But in light of the financial stability risks associated with high levels of debt, we expect that the RBNZ will remains cautious. Any easing will be gradual, with overall settings expected to remain "tight".

While it is not our central expectation, an increase in credit growth remains a risk. The market for existing housing is expected to remain contained, but significant new home building is expected to take place over coming years, which may require a faster pace of mortgage growth than has been seen recently. And with discretionary incomes squeezed, it is unclear how sustainable the current rate of equity injection is. If over coming months the housing market were to show any signs of resurgence, credit growth were to accelerate, or there was a move to less conservative lending, then we expect an easing in loan-to-value restrictions in November would be off the table.

The pace of macro-prudential easing will depend on how housing market and credit conditions evolve over coming months. But one thing seems clear: the RBNZ will want to be sure that there's no more fuel in the tank before taking its foot completely off the brake.

PROPERTY MARKET IN PICTURES

Figure 1. Regional house price inflation

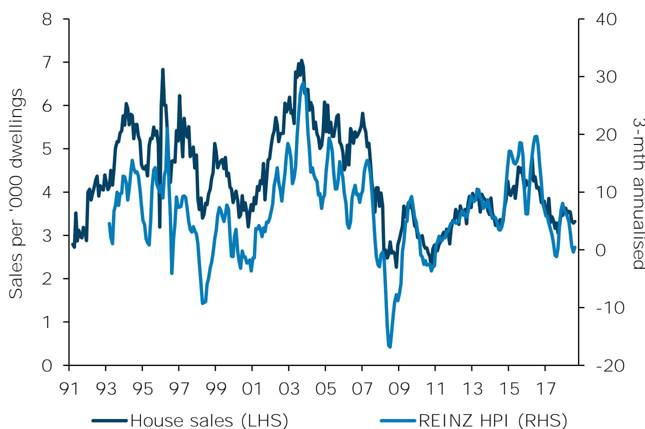


Source: ANZ, REINZ

House prices have seen little growth this year. The REINZ house price index increased 0.4% m/m in August, after rising 0.3% in July, on the back of a soft June quarter. Annual house price inflation ticked up to 4.3% y/y (3mma) from 4.1%. But much of the strength over the past year was seen in the second half of 2017. Over 2018 to date, house prices have risen only 1.6% nationwide.

House prices in Auckland continue to fall, but other markets remain tight. Auckland house prices fell 0.4% m/m in August, to be down 2.5% since early in the year, although this is a modest decline relative to the rapid increases prior. Outside of Auckland, markets are tight except in Canterbury. House prices outside Auckland rose 0.8% m/m in August, with annual inflation ticking up to 7.5% y/y (3mma).

Figure 2. REINZ house prices and sales



Source: ANZ, REINZ

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

House sales have taken a step down in recent months. We estimate that seasonally adjusted sales rose 1.3% in August after falling 1.3% in July and 5.7% in June. Sales are 2.6% higher than a year ago (3mma). The recent decline in sales is consistent with price pressures remaining contained or even moderating in coming months. In Auckland house sales fell a further 1.7% m/m in August, and are down 14% since early in the year. Outside of Auckland sales were up 2.3% m/m in August, more than reversing last month's decline.

Figure 3. Sales and median days to sell

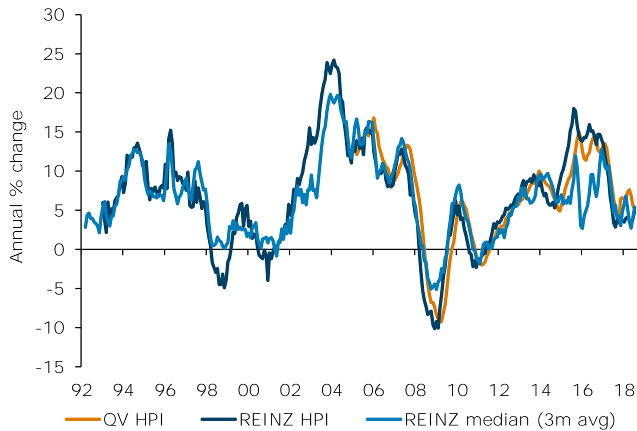
Source: ANZ, REINZ

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.

Housing markets outside Auckland and Canterbury remain tight. Nationwide the median time to sell a house ticked up to 39 days in August (sa). It's taking longer to sell properties in Auckland, with days to sell lengthening further to 44 days on average in August (compared to a historical average of 36 days). Time to sell has lengthened a little further in Canterbury as well at 41 days, compared to a historical average of 36. Days to sell remain below average in all other regions, with markets tight.

PROPERTY MARKET IN PICTURES

Figure 4. REINZ and QV house prices

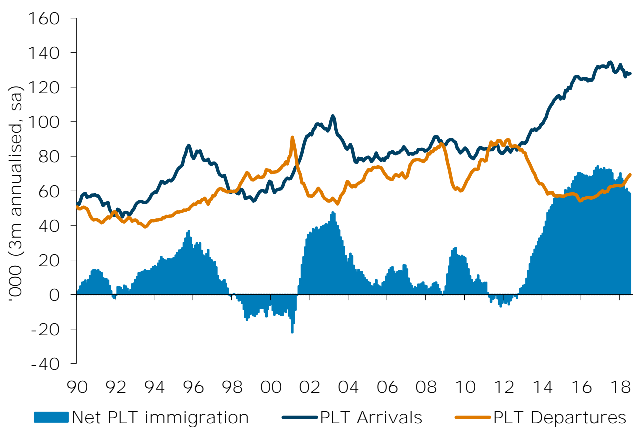


Source: ANZ, REINZ, QVNZ

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

The REINZ median sale price fell 0.3% m/m (sa) in August. Annual growth is running at 5.1% y/y (3mma). The QVNZ measure of price growth has moderated to 4.8% y/y, converging to the more timely REINZ data. The REINZ HPI – our preferred measure – is sitting a touch below the other two series (4.3% y/y 3mma).

Figure 5. Net permanent/long-term immigration



Source: ANZ, Statistics NZ

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

The migration cycle is easing gradually from high levels, but it remains a slow grind. Permanent and long-term net migration monthly inflows fell by 120 to 4,720 in July (seasonally adjusted), with arrivals flat and departures lifting. At 63,800, annual net inflows have moderated almost 12% over the past year, but they nonetheless remain high. How rapidly the migration cycle will ease is a key source of uncertainty for the property market and economic activity more generally.

Figure 6. Residential building consents

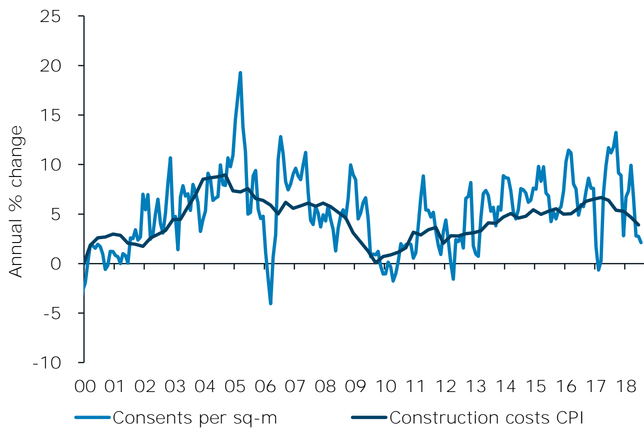
Source: ANZ, Statistics NZ

Consent issuance has been volatile of late. But in trend terms, growth has been softening. Dwelling consent issuance fell 10.4% m/m in July, following a 8.2% drop in Jun. The dip was seen across apartments and houses. In trend terms growth in residential consents has been waning (from increasing 3.3% m/m in February to falling 2.1% per month currently).

July's fall in dwelling consents represents a meaningful drop, consistent with reports that the construction pipeline is waning. The outlook is looking less assured, which is made more challenging by the fact that the construction industry is grappling with capacity constraints, low productivity, and financing strains from profit squeeze and reduced credit availability.

PROPERTY MARKET IN PICTURES

Figure 7. Construction cost inflation

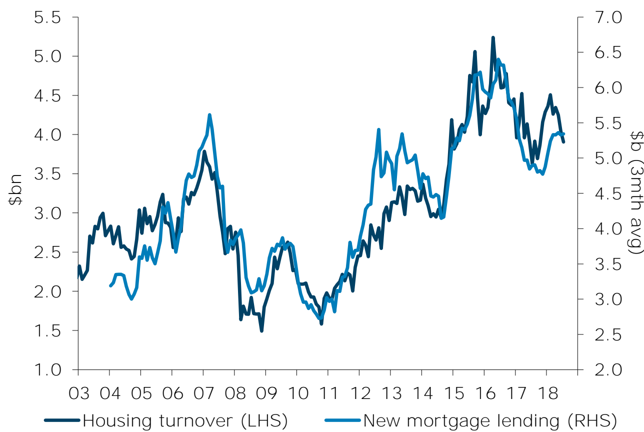


Source: ANZ, Statistics NZ

Construction cost inflation has been moderating. Growth in the cost of consented work per square metre – a proxy for construction cost inflation – continues to moderate. It rose 2.1% y/y (3mma) in July, down from 10% in March. The CPI inflation measure of construction costs was up 3.9% y/y in June 2018, down from the recent peak of 6.7% in March 2017.

Anecdotes confirm that momentum in building cost inflation appears to be waning, although measured inflation is still running at a moderate pace. Firm pessimism may be leading to wariness in passing through cost increases, despite an evident profit squeeze, perhaps because sentiment is generally downbeat.

Figure 8. New mortgage lending and housing turnover



Source: ANZ, RBNZ

New residential mortgage lending figures are published by the RBNZ. These are gross (rather than net) flows and can provide leading information on household credit growth and housing market activity.

Growth in new mortgage lending has moderated in recent months, consistent with cooling in housing turnover. New mortgage lending increased 0.2% m/m in July in seasonally adjusted terms (3mma), down from 4% m/m growth in January. This moderation in lending flows may result in a softening in net household credit growth in coming months. Since mid-2016, the share going to investors has fallen (from 35%). But more recently, the composition of lending has been stable, with approximately 25% going to investors, 15% to first home buyers, and 60% to other owner occupiers.

Figure 9. New mortgage lending and housing credit

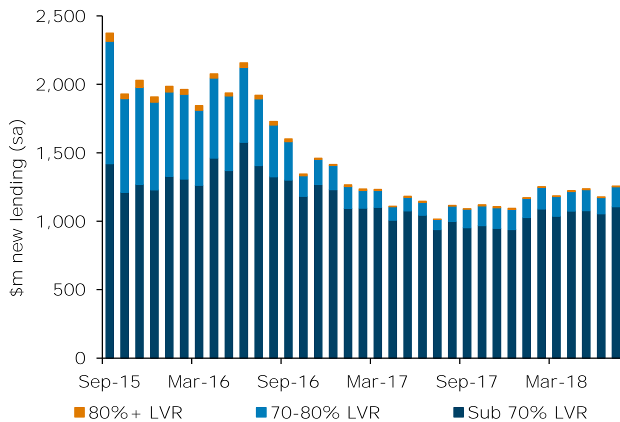
Source: ANZ, REINZ, RBNZ

Household credit growth has been growing at a consistent monthly pace since early 2017. Household lending increased 0.5% m/m in July. In annual terms, credit growth is running at 6.0% y/y.

Given recent moderation in house sales and new mortgage lending, it is possible that housing credit growth eases a little in coming months. We don't expect to see a significant slowing in credit growth, but we do think it is likely that it will be contained. Banks are prudent, loan-to-value ratio restrictions are in effect and there are a number of headwinds acting on the housing market, with activity having taken a step down of late.

PROPERTY MARKET IN PICTURES

Figure 10. Investor lending by LVR

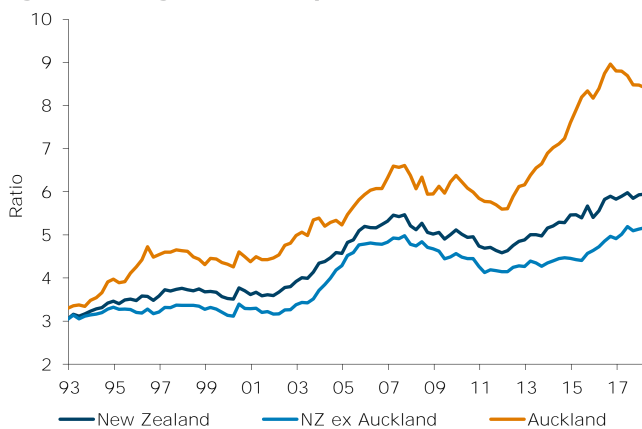


Source: ANZ, RBNZ

On a seasonally adjusted basis, new lending to investors increased 2.4% m/m in July. But looking through monthly volatility, **new lending to investors has been broadly flat since late 2016** – increasing about $1.2bn per month. This is 40% below the $2bn of new lending per month seen through H1 2016. This lower pace of lending relates, at least in part, to the impact of loan-to-value ratio restrictions (which came into force in October 2016 and were loosened marginally at the start of the year).

Investor lending is on less-risky terms. In July, the share of total investor lending at loan-to-value ratios of less than 70% was 86% (seasonally adjusted). That is a far greater share than in late-2014, when it was less than half.

Figure 11. Regional house prices to income

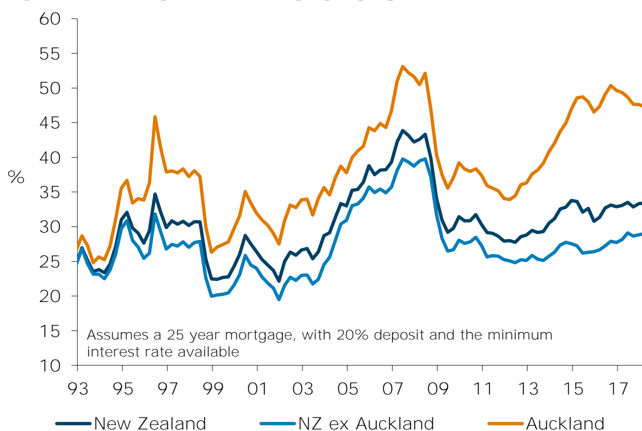


Source: ANZ, REINZ, Statistics NZ

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 has seen its ratio ease from a high of 9 times in Q3 last year to an estimated 8.5 times in Q1 2018. While still extremely high, the easing reflects the recent moderation in house price growth. Outside of Auckland, the ratio has continued to rise; at 5.2 times incomes this is at record highs.

Figure 12. Regional mortgage payments to income



Source: ANZ, REINZ, RBNZ, Statistics NZ

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

We estimate that for a purchaser of a median-priced home (20% deposit), the average mortgage payment to income nationally is around 33.3%. However, there are stark regional differences, with the average mortgage payment to income in Auckland just short of 50% for new purchasers. While (just) off its highs, this is still on par with the highs reached in 2007, despite mortgage rates being near historic lows currently. It highlights how sensitive some recent home-buyers in Auckland would be to even a small lift in interest rates.

PROPERTY GAUGES

House prices have ticked up a little in the past couple of months, but that's on the back of recent softness. House prices in Auckland continue to fall and houses are taking longer to sell, meaning further weakness in prices is possible. Outside Auckland and Canterbury, housing markets remain tight and it's reasonable to expect that pressures in these markets will continue. A number of headwinds are weighing on the housing market, including policy changes, bank prudence, and investor uncertainty. This is particularly true in Auckland, where affordability constraints are biting. Meanwhile, markets outside Auckland continue to play catch up – a dynamic that looks set to continue. Overall price pressures are expected to continue to gradually moderate from here. But given the large, offsetting forces at play, there may be some bumps in the road ahead.

We use ten gauges to assess the state of the property market and look for signs that changes are in the wind.

AFFORDABILITY. For new entrants into the housing market, we measure affordability using the ratio of house prices to income (adjusted for interest rates) and mortgage payments as a proportion of income.

SERVICEABILITY / INDEBTEDNESS. For existing homeowners, serviceability relates interest payments to income, while indebtedness is measured as the level of debt relative to income.

INTEREST RATES. Interest rates affect both the affordability of new houses and the serviceability of debt.

MIGRATION. A key source of demand for housing.

SUPPLY-DEMAND BALANCE. We use dwelling consents issuance to proxy growth in supply. Demand is derived via the natural growth rate in the population, net migration, and the average household size.

CONSENTS AND HOUSE SALES. These are key gauges of activity in the property market.

LIQUIDITY. We look at growth in private sector credit relative to GDP to assess the availability of credit in supporting the property market.

GLOBALISATION. We look at relative property price movements between New Zealand, the US, the UK, and Australia, in recognition of the important role that global factors play in New Zealand's property cycle.

HOUSING SUPPLY. We look at the supply of housing listed on the market, recorded as the number of months needed to clear the housing stock. A high figure indicates that buyers have the upper hand.

HOUSE PRICES TO RENTS. We look at median prices to rents as an indicator of relative affordability.

Indicator	Level	Direction for prices	Comment
Affordability	Unaffordable	↔/↓	Affordability constraints are very relevant. It is the main reason we see the Auckland market underperforming over the next few years.
Serviceability/ indebtedness	High debt, low rates OK – high rates not	↔/↓	Serviceability looks okay provided interest rates stay low and income growth is solid. Debt levels are high.
Interest rates / RBNZ	Slow ascent	↔/↓	We see the OCR on hold for the foreseeable future, but the next move in the OCR may well be down.
Migration	Peaked	↔/↑	The cycle is easing gradually. But population growth is still solid and inflows are not set to fall sharply.
Supply-demand balance	Demand > Supply	↔/↑	MBIE estimates New Zealand is short 71k houses, with a shortage of 45k in Auckland. Pent-up demand is supporting price increases.
Consents and house sales	Shortage	↔/↑	We expect consents issuance will struggle to push higher, with the construction sector reaching its limits.
Liquidity	Tight	↔/↓	Credit availability is very relevant. Closure of the bank funding gap means there is wriggle room, but prudence will be maintained.
Globalisation	Mixed bag	↔	Non-resident buyers aren't very influential, but policy changes may dampen demand. The housing market is weak in Australia.
Housing supply	Too few	↔/↑	The Government is going to take a more active role, but there are still questions about crowding out other work and labour shortages.
House prices to rents	Too high	↔/↓	Rents are moving up, with pressures on the existing stock apparent, although these are not the only game in town.
On balance	**In recent ranges**	↔	**There could be some bumps in the road ahead, but conditions are supportive of continued price increases.**

PROPERTY GAUGES

Figure 1: Housing affordability

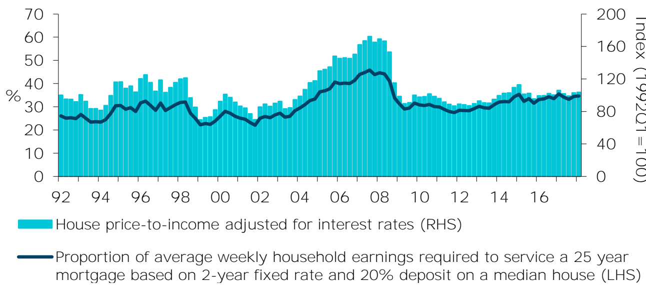


Figure 2: Household debt to disposable income

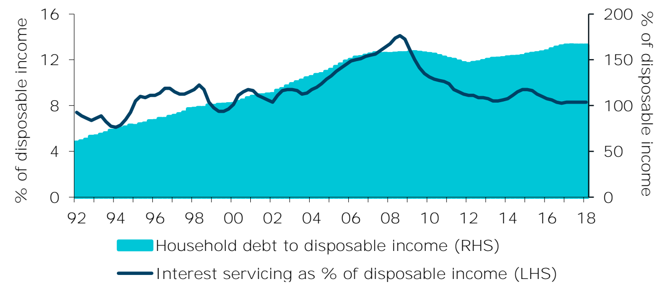


Figure 3: New customer average residential mortgage rate (<80% LVR)

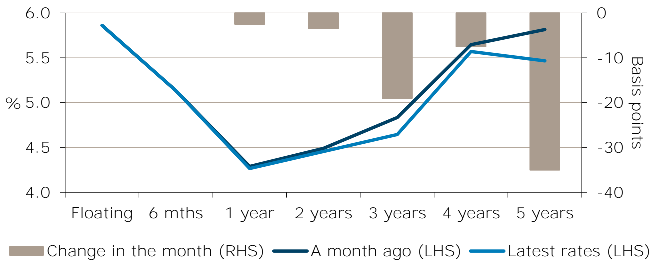


Figure 4: Net immigration

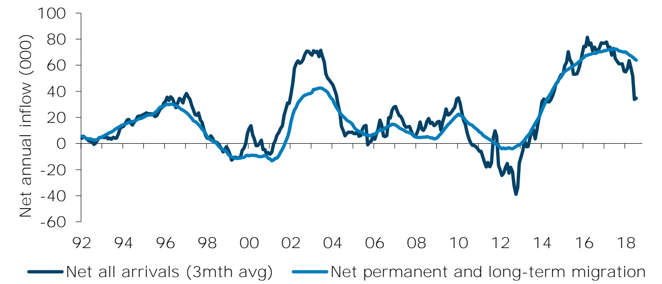


Figure 5: Housing supply-demand balance

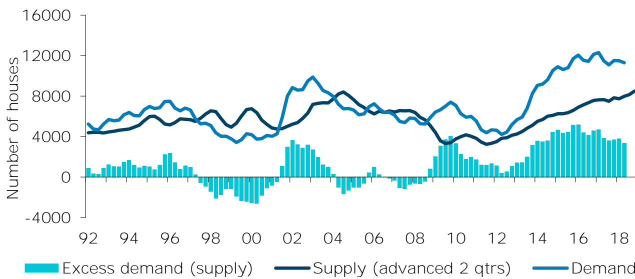


Figure 6: Building consents and house sales

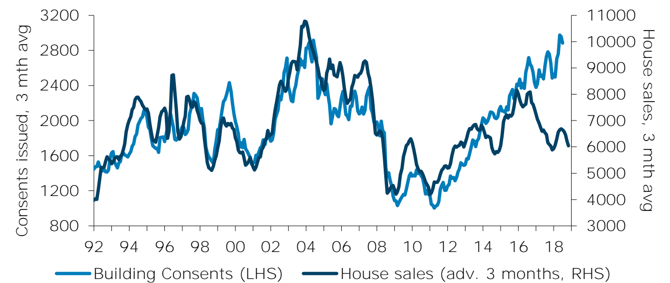


Figure 7: Liquidity and house prices

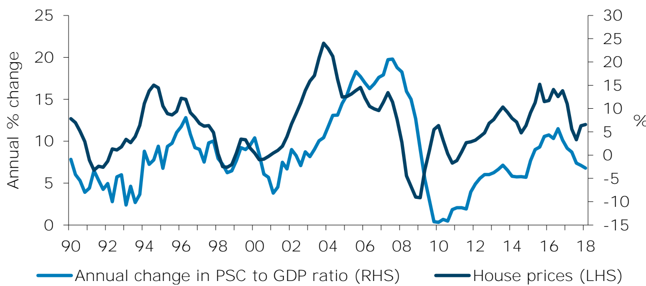


Figure 8: House price inflation comparison

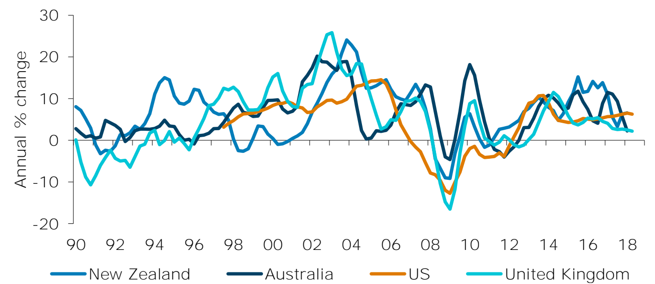


Figure 9: Housing supply

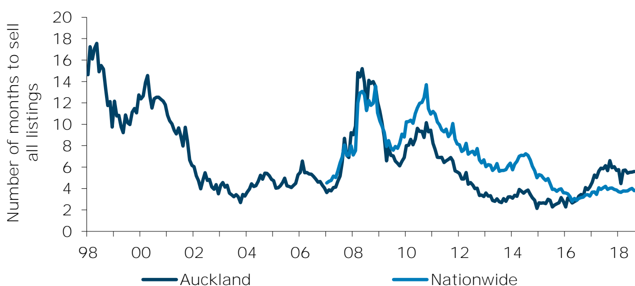
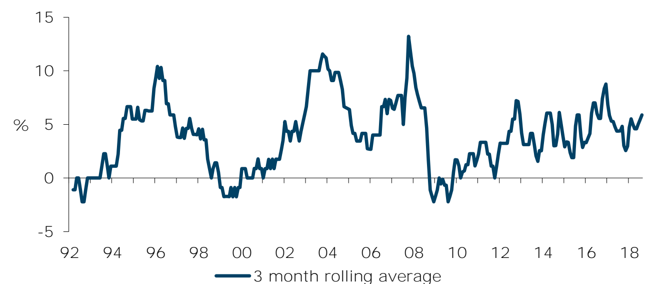


Figure 10: Median rental, annual growth



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

ECONOMIC OVERVIEW

SUMMARY

The economic outlook is looking less assured and there are questions about the strength of domestic demand going into the second-half of the year. Data has been mixed but generally a bit more downbeat: businesses are pessimistic and consents have dipped, but households have been resilient. We do not expect that the cycle is about to roll over, with a number of factors supportive of growth, but we do think it will be difficult to grow at trend. In that environment, it will be a struggle for core inflation to return sustainably to the RBNZ's 2% target. As such, we expect the OCR will remain on hold for some time yet – and a cut is possible should economic data disappoint.

OUR VIEW

Economic momentum has softened and a key question for the economic outlook is the strength of domestic demand into the second half of next year. This risk comes on the back of downbeat expectations and intentions from business surveys, with the RBNZ having indicated that it is concerned about the possibility of weaker activity and that it is willing to do what is required to support the economy. Although it's early days in terms of the data flow, economic data so far is painting a mixed picture of domestic demand into the second half of the year:

- Business expectations point to a moderation in activity and pessimism appears to be impacting decisions, with employment and investment intentions having turned negative. Policy uncertainty continues to cast a shadow, profitability is squeezed, and credit is difficult to come by for firms.
- The ANZ Truckometer has been fairly resilient, although it has been sending some mixed signals of late. ANZ job ads growth points to stability in the labour market.
- The housing market has been broadly stable, affected by a number of offsetting factors. Continued moderation in price pressures seems likely, given the headwinds that are at play. And it's fair to say that the housing market does not look set to provide a significant impetus to residential investment or consumption at present.
- Dwelling consents have been weaker in recent months, consistent with anecdotes that the pipeline of work is looking less assured, adding to a number of challenges already being experienced by the construction industry.
- Households appear resilient, with sentiment holding up near average levels. Electronic card spending data appears to have stabilised in trend terms, after moderating earlier this year.

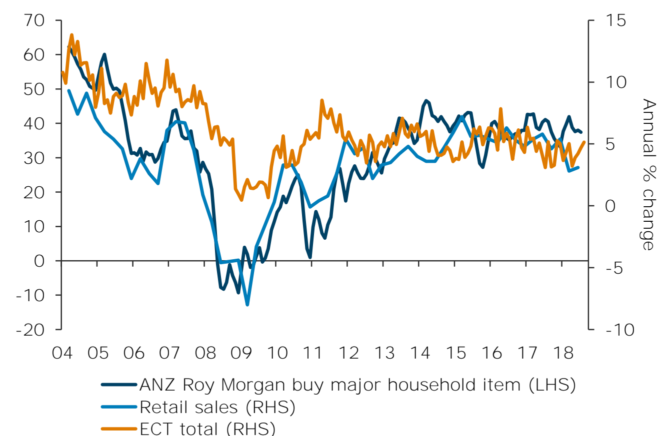
Many activity indicators are still to come and we will be watching the full range of data as it comes available. It's fair to say that the economic outlook is looking less assured. But there are also a number of factors that are supportive of growth. The terms of trade remains elevated, fiscal policy looks set to provide a boost, and net exports are becoming less of a drag thanks to recent exchange rate depreciation. At the same time, the labour market is tight and household spending appears supportive. As such, even if activity data comes in weaker than expected, we do not expect that the cycle is about to roll over. But we do think it will be difficult for the economy to grow at trend – and we do not expect that resource pressures will intensify from here.

In this environment, it will be a struggle for core inflation to return sustainably to the RBNZ's 2% target. Even though CPI inflation is expected to be boosted by temporary factors, we expect that the underlying inflation pulse will only improve gradually. In our view, an OCR hike will not be required to offset inflationary pressure, with the OCR on hold for some time yet. In fact, given uncertainty about the outlook for activity, our view is that a cut in the OCR is more likely than a hike. Should the domestic picture disappoint, the housing market soften considerably, or external conditions deteriorate, then an OCR cut could eventuate quite quickly.

Figure 1: ANZ Business Outlook investment intentions and GDP growth

Source: ANZ, Statistics NZ

Figure 2: ECT spending, retail sales, ANZ Consumer Confidence



Source: ANZ, Roy Morgan, Statistics NZ

MORTGAGE BORROWING STRATEGY

SUMMARY

Average fixed mortgage rates have fallen over the past month, especially for longer terms. However, our favoured borrowing strategy is unchanged in that we think the 1-year fixed rate is the sweet-spot. It remains the lowest point on the curve, but also provides a short enough duration to quickly benefit if the RBNZ was forced to cut the OCR again, which we see as a non-trivial possibility. It also is a far cheaper option for borrowers than floating rate exposure, which maintains a large cost pick-up to shorter fixed rate terms.

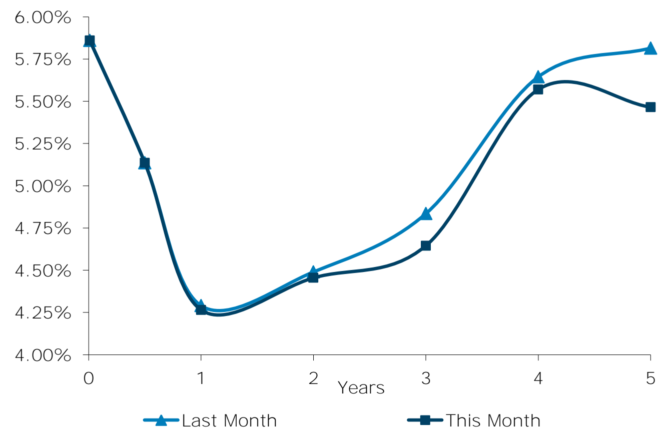
OUR VIEW

There have been some meaningful changes in average mortgage rates across the 'big four' banks over the past month. In particular, average special rates across terms longer than 2 years have all fallen, with the 3-, 4-, and 5-year rates 19, 8 and 35bps lower respectively since our last edition.

While at the margin this makes fixing for longer terms more attractive, we still don't believe the value stacks up. In fact, our favoured borrowing strategy is unchanged in that we believe the 1-year fixed rate is still the sweet spot. It provides the balance between being the lowest point on the curve as well as providing short enough duration to benefit if the RBNZ happened to cut the OCR again in the future. And while ANZ's official view is that the next move from the RBNZ won't be a cut (although we aren't forecasting hikes in the foreseeable future either to be fair), we certainly believe the chance of cuts within the next 12 months is far greater than hikes. That makes fixing for shorter durations far more attractive (as opposed to floating rate borrowing, which represents quite a step-up in costs at current rates).

Breakeven analysis supports our view. For instance, to be indifferent between fixing for two years at 4.46% or rolling two consecutive 1-year fixed rates, the average 1-year fixed mortgage rate would need to lift from 4.27% currently to 4.65% in one year's time. That is not a large move by historical standards, but it is certainly inconsistent with our new expectation for the OCR – that is, on hold for a considerable period. There is also an added benefit from keeping borrowing shorter in duration: you maintain the flexibility to take advantage of the possibility of lower rates in the future were they to eventuate.

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%	3.40%	4.55%	4.74%	4.93%
1 year	4.27%	3.97%	4.65%	4.84%	5.03%
2 years	4.46%	4.40%	4.84%	5.67%	6.69%
3 years	4.65%	5.10%	6.01%	6.10%	6.14%
4 years	5.57%	5.57%	5.77%		
5 years	5.47%	#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%	4.42%	5.25%	4.96%	5.50%
1 year	4.82%	4.84%	5.11%	5.23%	5.61%
2 years	4.96%	5.03%	5.36%	5.77%	6.38%
3 years	5.18%	5.46%	5.96%	6.04%	6.18%
4 years	5.67%	5.74%	5.91%		
5 years	5.69%	*may be subject to a low equity fee			

We believe the decision of where to fix on the mortgage curve is becoming easier for borrowers at present, with the odds of rate hikes over the next few years diminishing. As always, though, each individual borrower should consider their own circumstances. Spreading borrowing over a number of fixed terms is always a strategy that makes sense from a risk-management perspective. That said, we favour keeping those 'tranches' relatively short in duration right now.

^ 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 2018 (based on REINZ data)

	House prices (ann % chg)	3mth % chg	No of sales (sa)	Mthly % chg	Avg days to sell (sa)
Northland	7.6	3.3	188	-5%	50
Auckland	1.3	0.3	1,734	-2%	44
Waikato	9.3	4.1	664	+5%	42
Bay of Plenty	5.3	1.1	447	-1%	46
Gisborne	42.2	3.5	57	+12%	40
Hawke's Bay	9.6	2.3	223	-7%	29
Manawatu-Whanganui	10.3	-0.1	387	+3%	26
Taranaki	3.8	5.8	186	+13%	36
Wellington	16.6	5.5	689	+1%	29
Tasman, Nelson and Marlborough	8.6	4.0	210	-2%	37
Canterbury	-0.4	-1.6	875	+8%	41
Otago	13.6	-1.5	391	+6%	29
West Coast	20.7	12.3	35	-18%	46
Southland	-4.2	3.2	190	-3%	25
NEW ZEALAND	**3.6**	**1.7**	**6,236**	**+1%**	**39**

Key forecasts

	Actual				Forecasts					
Economic indicators	Sep-17	Dec-17	Mar-18	Jun-18	Sep-18	Dec-18	Mar-19	Jun-19	Sep-19	Dec-19
GDP (Ann % Chg)	2.6	2.9	2.7	2.5	2.5	2.4	2.5	2.5	2.5	2.6
CPI Inflation (Annual % Chg)	1.9	1.6	1.1	1.5(a)	1.5	1.8	2.0	2.1	2.0	1.9
Unemployment Rate (%)	4.6	4.5	4.4	4.5(a)	4.4	4.4	4.4	4.4	4.3	4.3
House Prices (Annual % Chg)	3.3	3.6	3.9	3.7(a)	4.2	2.6	1.7	2.0	2.0	2.0
Interest rates (RBNZ)	Dec-17	Mar-18	Jun-18	Sep-18	Dec-18	Mar-19	Jun-19	Sep-19	Dec-19	Mar-20
Official Cash Rate	1.75	1.75	1.75	1.75	1.75	1.75	1.75	1.75	1.75	1.75
90-Day Bank Bill Rate	1.9	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0
Floating Mortgage Rate	5.8	5.8	5.8	5.8	5.8	5.8	5.8	5.8	5.8	5.8
1-Yr Fixed Mortgage Rate	4.9	4.9	4.9	4.8	4.9	4.9	4.9	5.0	5.0	5.0
2-Yr Fixed Mortgage Rate	5.1	5.1	5.0	4.9	5.0	5.0	5.1	5.1	5.2	5.2
5-Yr Fixed Mortgage Rate	5.9	5.9	5.9	5.7	5.8	5.8	5.9	5.9	6.0	6.0

Source: ANZ, Statistics NZ, RBNZ, REINZ

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