NEW ZEALAND PROPERTY FOCUS

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CRYSTAL BALL

SUMMARY

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

FEATURE ARTICLE: WHERE TO NOW FOR THE HOUSING MARKET?

The housing market has had a great run in recent years, but times are changing. The market cooled over 2017, but staged a small comeback late in the year. What could be in store for 2018? In November last year we discussed the possible impact of the new Government's policies, concluding that they are likely to keep house prices 'on ice' for the foreseeable future. This month, we focus on some other key drivers – the outlook for migration, mortgage rates, and the Reserve Bank's LVR restrictions – and come to a similar conclusion. We are not anticipating anything untoward; there are certainly still factors that will keep the market supported. However, there are offsetting forces too that make a marked rebound in house price inflation unlikely.

PROPERTY GAUGES

Housing market activity has shown a few more signs of life of late, bouncing off low levels. However, our overall views have not changed. There are clear opposing forces. On the one hand, strong population growth coupled with a challenged supply backdrop argues that a fundamental supply-demand imbalance will continue to drive prices higher. Yet this is going head-to-head with a base in the interest rate cycle, tighter lending standards, LVR restrictions (although these are gradually being eased admittedly), affordability constraints and possibly more restrictive government policy changes. We continue to see prices largely plateauing for now.

ECONOMIC OVERVIEW

Although recent upward revisions to historical GDP growth show the economy performing better than first thought, they haven't meaningfully altered our views on the outlook. We still retain a broadly constructive view of the medium-term growth picture, but do believe there is a chance of a growth wobble in the near-term. The economy is grappling with late-cycle capacity pressures, a softer housing market and is transitioning in terms of its growth drivers. We are still biased towards OCR hikes in time. However, the combination of growth only around trend, a soft housing market, a downward inflation starting point surprise but the likelihood of some cost-push inflation to come is a complicated mix, meaning there are plenty of question marks regarding the timing of hikes.

MORTGAGE BORROWING STRATEGY

With average mortgage rates effectively unchanged in the past month, we continue to believe the decision between fixing for one or two years is a close call. The 1-year rate remains the low point and therefore offers value. But the gap to the 2-year rate is narrow, and may be attractive for those concerned about the possibility of the OCR moving up within the next year. With plenty of questions over the inflation outlook that is no longer our view though. We now don't see the first OCR hike until August next year, which if anything does sway us more to the 1-year rate. But ultimately, borrowers may wish to spread risk by borrowing over a number of fixed terms.

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THE CYCLE SO FAR

New Zealand's housing market experienced exceptionally strong growth between 2012 and 2016, with national house prices surging over 60%. Record median house prices were achieved across many regions of the country as low mortgage interest rates, low housing supply, record net migration, apparent foreign investor interest and the economy growing at or above trend together made for buoyant housing market conditions (see charts on page 9 in our *Property Market in Pictures* section).

The timing and strength of growth rates showed strong regional disparities over this period. Auckland was first out of the blocks with house prices almost doubling in the six years to 2017. Major tourist centres such as Queenstown soon followed. Bay of Plenty house price inflation achieved the highest annual growth rate of all regions (32%) in mid-2016, but all regions except Canterbury managed to tip into double-digit annual growth at some point in the last three years.

However, 2017 marked a dramatic shift in market conditions, with price growth cooling, especially in Auckland, despite still-low mortgage rates. The level of turnover fell sharply, with sales volumes at one stage at the lowest levels since 2011. The third round of LVR restrictions in late 2016 had an immediate impact, particularly on the investor group, which had contributed strongly to the house price boom (see charts on page 10 and 11 for new lending data showing the decline in the investor share). In addition, there was a tightening in bank lending criteria as banks responded to tighter funding conditions and changing perceptions of market conditions. Natural limits would also have started to come into play as housing affordability deteriorated (see chart on page 11).

But interestingly, the last few months of 2017 saw the market stage a modest comeback. From their lows, national sales volumes have bounced 10%, the median number of days to sell has fallen to its shortest period since April (and still well below its historical average), and national house prices have risen for five consecutive months. Auckland has joined in this rally – in fact it modestly outperformed the rest of the country between October and December.

So does it mean that the earlier weakness was all a ruse and the market is in the process of taking off again? One shouldn't dismiss the notion out of hand: a second, third or even fourth wind is something that has become commonplace when discussing the housing market – Auckland's in particular. However, while the election is now out of the way (and we suspect this was an important factor explaining a portion of the short-term dynamics), the longer-term factors that are dampening the market look set to continue.

SO WHAT WILL 2018 BRING?

Regional disparities are likely to persist, which will come down to the idiosyncrasies of various regions. Figure 1 below shows that while the relativities between Auckland house prices and the rest of the country have come back a little, they are still roughly twice the price of the rest of New Zealand. Relative population pressures and housing shortages will see a wedge maintained.

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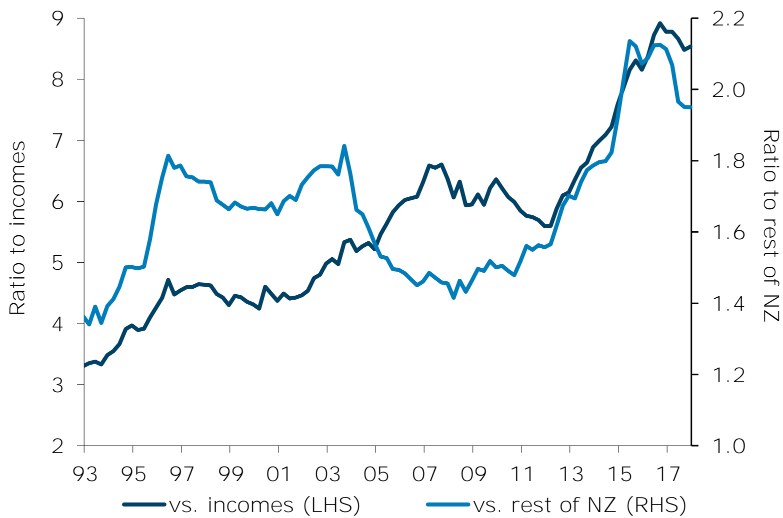
Figure 1. Auckland house prices relative to incomes and to rest of NZ



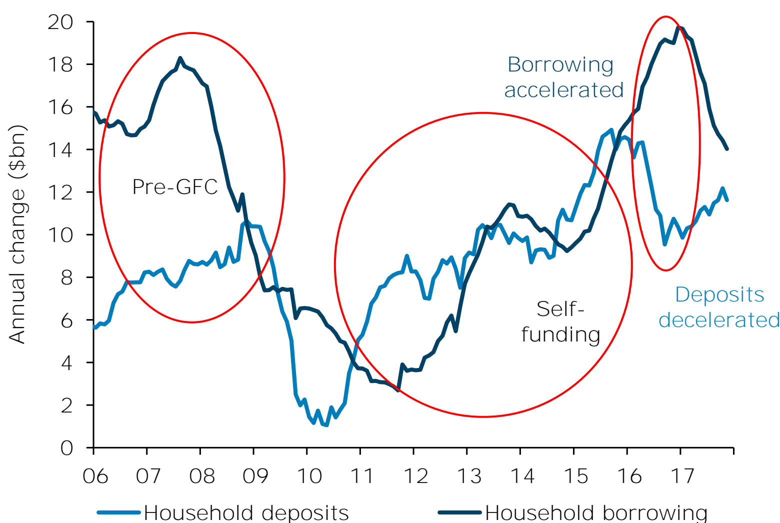
Source: ANZ, REINZ

However, looking at the bigger picture, there are a number of broader forces acting on the national housing market. These are both positive and negative, which leaves one having to gauge the relative importance and strength of each.

Some factors supporting house prices include:

- Still-low mortgage interest rates.
- The recent easing of LVR restrictions, and the signal from the RBNZ of a desire to continue tapering these restrictions.
- Housing supply that is set to grow only slowly due to capacity, funding and cost constraints in the construction sector.
- Solid household income growth, due to both the strong labour market and record-high terms of trade.
- A closing of a bank funding 'gap' (figure 2 below), which could, at the margin, result in more lending competition within the mortgage market. We have recently seen small decreases in carded mortgage rates by some players.

Figure 2. Bank household funding and claims growth



Source: ANZ, RBNZ

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On the other side of the ledger, a number of factors are keeping, or will keep, a lid on prices:

- Net migration has started to tentatively ease and the Government has signalled it would like to stem inflows further. The Australian labour market has been strengthening, which traditionally leads to westward flows of people.
- Affordability remains very stretched – nationally, house prices are around six times income, whereas in Auckland they are nine times. Outside of Auckland the ratio is 5.2 and rising.
- The Government is proposing tax changes (extending the bright-line test and ring-fencing losses on investor housing) that aim to reduce speculative demand for housing.
- The Government intends to ban foreigners from buying existing homes.
- Measures to improve the lot of renters equate to higher costs for landlords.
- The KiwiBuild programme aims to build 100k affordable homes over the next 10 years. While this looks optimistic given capacity constraints in the construction sector, it is likely to succeed in tipping the balance of new houses built towards the more affordable end.

We discussed the likely impact of the new government policies in our November *Property Focus*, so will not repeat ourselves here. Rather, we will focus on the traditional cyclical drivers of the housing cycle: migration and mortgage interest rates, as well as the Reserve Bank's LVR restrictions, now that the Bank has announced the start of an easing of those policies.

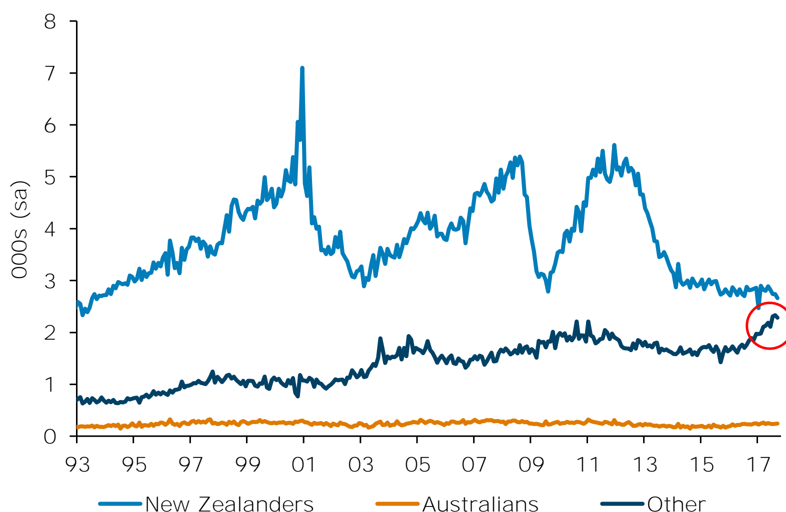
MIGRATION

Net migrant inflows appear to have turned (see chart on page 9). In November, a seasonally adjusted net inflow of 5,610 migrants was experienced, which was similar to the previous month. While the 12-month running total remains strong at just over 70,000, the 3-month annualised net inflow (sa) has fallen from a peak of over 74k last November to now sit at 66k.

This easing in net inflows has been driven by both a lift in departures and a slight moderation in the number arrivals. Long-term arrivals, while still at a historically strong level, are down from the all-time highs seen in June. In fact, on a trend basis Statistics NZ now estimate that arrivals are falling at a 0.6% monthly pace. Monthly long-term departures on the other hand, are up around 11% from their recent low, and are sitting near the highest levels since late 2013.

Interestingly, the lift in departures is currently being driven by non-New Zealand and non-Australian citizens (figure 3 below). This reflects the natural cycling effect of strong arrivals in recent years. However, with the Australian labour market strengthening recently, an important theme to watch over the coming year will be trans-Tasman migration, given that this has historically been a crucial driver of overall net migration (figure 4).

Figure 3. Total departures



Source: ANZ, Statistics NZ

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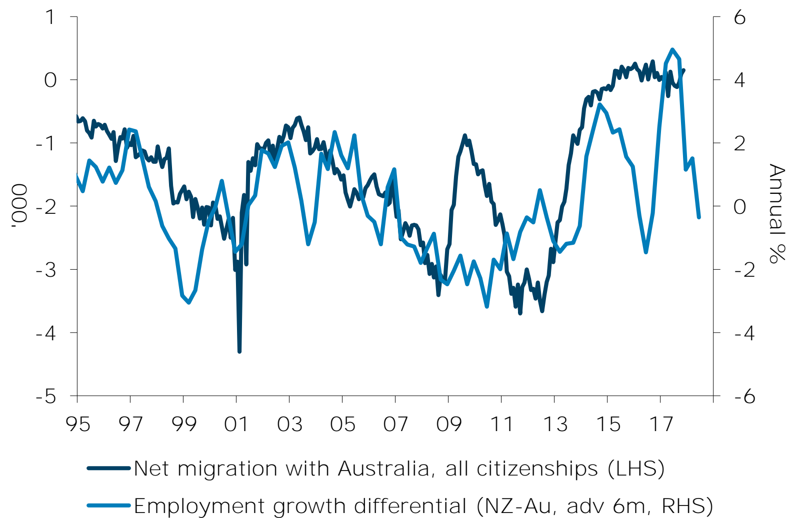
Figure 4. Relative employment growth and trans-Tasman net migration



(Chart includes ANZ Q4 forecast for NZ; Australia Q4 is average of October/November only)

Source: ABS, Statistics NZ, ANZ

The other theme to watch for migration is of course any changes in government policy. The new Government has signalled a desire to reduce net migration by 20-30k per year, and also pledged to channel immigration away from Auckland and into regions with 'genuine skills shortages'. However, at this stage there are still few concrete details on how it intends to do this. The one challenge it will certainly face is how any policy changes are weighed up against the potential to further exacerbate skill shortages in the economy. Firms are already stating that finding skilled staff is the hardest it has been since 2005.

The bottom line: Given possible tweaks in government policy, a New Zealand economic backdrop that is perhaps not outperforming to the degree it was, especially relative to Australia, due to natural cycling effects, we believe net migrant inflows have peaked. While any migration forecast contains a great deal of uncertainty, we assume annual net inflows will ease to 45k by the end of 2019. While not necessarily a headwind for the housing market, it will be less of a positive influence.

MORTGAGE RATES

In simple terms, mortgage rates can be thought of as being made up of two components: wholesale interest rates and bank funding costs.

At shorter maturities, wholesale interest rates tend to reflect actual and expected moves in the Official Cash Rate, which is the primary tool used by the Reserve Bank to steer the economy and (hopefully) eventually inflation. So expectations for future growth, the state of the labour market, how much slack the economy has, government policies, global conditions, commodity prices and inflation expectations all can influence market perceptions of where monetary policy is heading. The housing market itself, being one of the most cyclical elements of the economy and the largest asset class in the country, can also have a large say in future monetary policy direction, given its historical influence on inflation through the consumer wealth channel and through its direct influence on the likes of construction costs and rents.

Right now, despite the economy performing reasonably well over recent times and showing signs of capacity strain, a lack of sustained inflation pressures looks set to keep the RBNZ side-lined. In Q4, the CPI surprised on the downside by only rising 0.1% q/q (1.6% y/y). And courtesy of base effects, the lower starting point, recent NZD strength and the likes of the new Government's tertiary education subsidies, we see headline inflation falling back towards 1% in Q1, and staying below 2% until the middle of 2019.

Our central scenario is still that domestic inflation pressures will rise and broaden in time. That is predicated on the belief that some cost-push pressures will emerge from the labour market. However, it is highly unclear whether that is going to be enough to offset ongoing deflationary forces from elsewhere (increased labour mobility, retail sector margin compression, well-anchored inflation expectations, a world with excessive leverage, etc). It is fair to say that our conviction in a broadening in inflation pressures occurring even gradually over the next couple of years is reducing.

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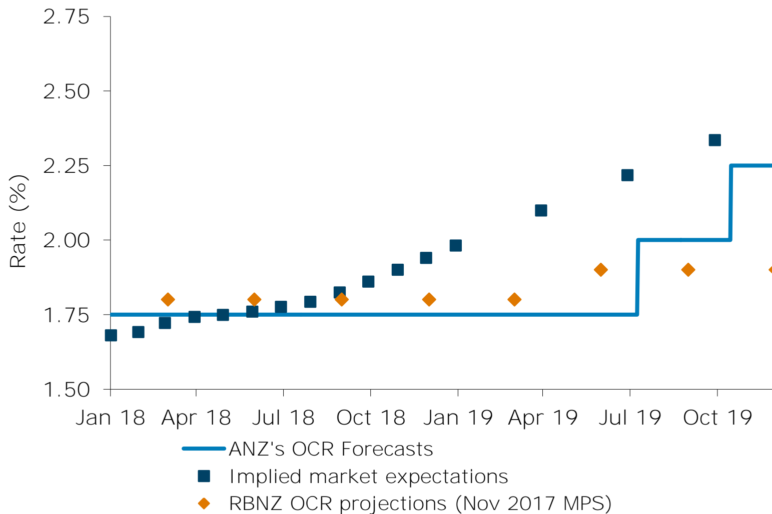
As such, we recently pushed out our expectation for when the first OCR hike would occur. Whereas we had previously pencilled in the RBNZ to begin tightening late this year, we now see the first hike in mid-2019. A lot can – and no doubt will – happen between now and then, and there is still plenty of conjecture over the exact timing and catalysts for a move.

But that will keep short-term interest rates well anchored. In fact, given that the market is still pricing in OCR hikes from late this year, there is room for short-term wholesale interest rates to fall modestly (figure 6).

Figure 6. RBNZ OCR expectations: RBNZ, ANZ, market-implied



Source: ANZ, Bloomberg, RBNZ

Longer-term wholesale interest rates are dictated more by global forces, and in particular movements in global interest rates, like the bellwether US 10-year bond yield.[1] Theoretically, longer-term global interest rates are determined by market perceptions of where growth will settle on average over time, and likewise long-term perceptions of inflation. However, over recent years there has also been the distortionary impact of unprecedented central bank policy action as some key global central banks have been actively buying long-term government securities (quantitative easing) in an attempt to loosen financial conditions, given they had slashed their cash rates to effectively zero (or even below in some cases).

Right now, markets are nervously toying with a global reflationary theme. On the back of a synchronised upswing in global growth, a shift in rhetoric from a number of central banks (as they see deflationary risks as having subsided, but financial stability considerations as still highly relevant), a recovery in commodity prices, and a stabilisation in inflation expectations, global bond yields have started to lift off historic lows. In fact, the US 10-year bond yield, at over 2.7%, is the highest it has been in three years. We don't see this rate of assent being sustained (it was only 2.4% at the start of the year), and there is certainly a limit to how high global interest rates can get before they'd start to have a detrimental impact on global asset valuations and growth expectations (and therefore inflation again). However, a gradual lift in global interest rates as central banks begin to step away from their ultra-stimulatory policies is a key element of our forecasts. By the end of 2019, we forecast the US 10-year bond yield at 3.0%, which, all else being equal, will put upward pressure on our longer-term mortgage rates here.

We'll turn now to the second element of domestic mortgage rates – banks' costs of funds. New Zealand banks obtain a large part of the funding from domestic depositors, but also some of their funding offshore. Right now, global funding conditions are highly favourable, with CDS spreads (a proxy for bank offshore funding costs) near their tightest levels since the financial crisis. However, given recent prudential regulations and prudence borne of experience, it is neither desirable nor possible for banks to fully fund themselves through just offshore channels, even if this happens to be the cheapest form of funding, like it is now.

[1] There is of course also a spread between New Zealand and global interest rates, which we won't discuss here, but that spread has narrowed considerably over recent times.

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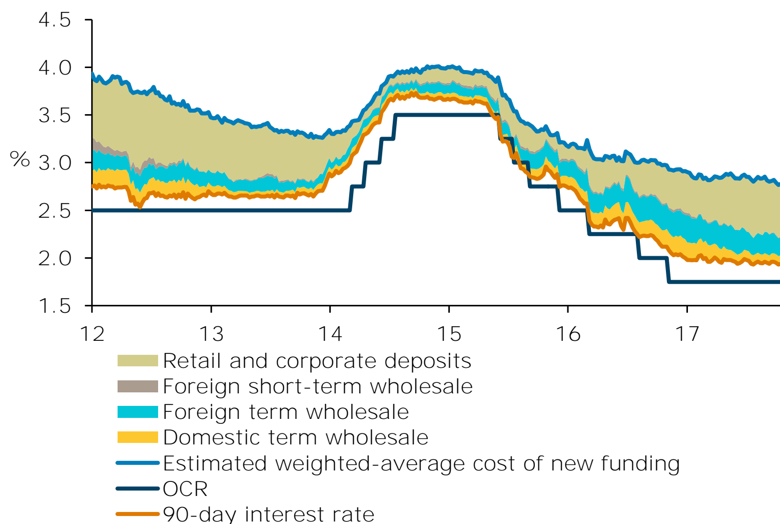
Over recent times, what has actually had the biggest influence on bank funding costs has been the ease (or not) with which banks could raise local term deposits (figure 7). Up until around 18 months ago, that was a relatively simple exercise, as domestic deposit growth was rising at a similar pace to loan growth. But as figure 2 shows, deposit growth (in this case household deposit growth) began to decelerate sharply – perhaps as the RBNZ cut the OCR and term deposit rates fell. At a time of still-strong demand for credit and increased scrutiny of banks' offshore borrowing by the regulator and credit rating agencies, that forced banks to compete more aggressively for domestic deposits, forcing term deposit rates higher (despite wholesale interest rates and the OCR not moving).

Figure 7: Private banks' marginal funding costs



Source: RBNZ, ANZ

But as credit growth has cooled and deposit growth has lifted, those funding pressures are no longer as intense. As such, we have already seen some term deposit rates (and hence fixed mortgage rates) begin to ease modestly. As long as that 'funding gap' – the gap between overall deposit and loan growth – remains steady, a return of bank competition in the mortgage space could actually see mortgage rates begin to ease off modestly again.

The bottom line: Given subdued domestic inflation pressures, we continue to see the OCR on hold for the foreseeable future. That will help anchor short-term mortgage rates at historically low levels. In fact, with bank funding pressures subsiding a little, as the 'gap' between deposit and loan growth has closed, there is even potential for competitive pressures in the market to step up a degree triggering modest mortgage rate falls. However, longer-term mortgage rates are at the whims of global forces and on the back of these, look to be biased higher.

LVR RESTRICTIONS

The RBNZ last year announced a modest easing of LVR restrictions for the first time since their introduction in 2013. Effective from 1 January this year, the 'speed limit' for high (+80%) LVR lending to owner-occupiers was raised from 10% to 15% while residential property investors saw their LVR threshold lifted from 60% to 65%.

The LVR restrictions have had a clear impact on the composition of new lending. Since their introduction in 2013, the share of high-LVR loans has fallen from over 25% of total new lending to around 6% currently. This has included various tweaks to the initial policy, including the specific targeting of Auckland residential investors, to then subsequently encompassing investor lending across the entire country. As a share of total new lending, lending to investors has fallen from close to 35% in mid-2016, to less than 22% currently.

Will these latest changes have much of an impact? The answer is "possibly, but probably only at the margin". We would classify the changes as 'tweaks' more than anything. And while the RBNZ has signalled its intention to continue to taper these policies, it certainly will only do so incrementally and changes will be cautiously engineered to prevent a deterioration in lending standards or the debt serviceability of households.

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So it will be a case of perhaps only easing them further as other measures to cool housing demand are implemented. The RBNZ stated in its November Financial Stability Report that "LVR restrictions will be adjusted gradually over time, provided that financial stability risks remain contained. Gradual adjustment to policy will reduce the risk of resurgence in the housing market and a deterioration in lending standards."

The following criteria will need to be satisfied:

- Evidence that house price and credit growth have fallen to around the rate of household income growth.
- A low risk of housing market resurgence once LVR restrictions are eased.
- Confidence that an easing in policy will not undermine the resilience of the financial system.

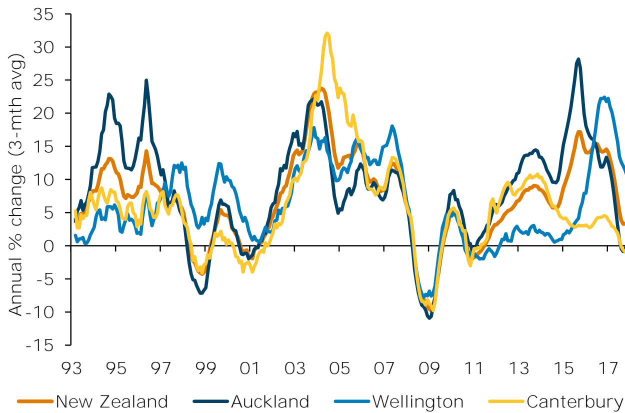
The bottom line: LVR restrictions are likely to be eased further, but only if the market shows signs of ongoing independent cooling (which may or may not be due to the policies of the new Government). In that regard, we don't see any changes having a large influence over market activity and prices over the next couple of years.

CONCLUSION

Net migration is cooling, but should stay historically strong. LVR restrictions are being eased, but only gradually. Short-term mortgage rates are likely stable, although there is potential for some modest falls, but longer-term mortgage rates look set to rise in line with global reflationary forces. As is often the case with housing market drivers, there are plenty of moving parts. But even though house prices continue to look well out of whack with incomes, especially in Auckland, and the new Government intends to introduce policies targeting speculative housing demand, we still do not see a sharp downward correction as likely. That would require a sharp deterioration in debt serviceability and a lift in forced sales, which is not on our horizon. Certainly if the economy was sideswiped by some particularly nasty shock from offshore, that could change the picture, but at this stage we are still of the view that with a number of opposing forces will simply see house prices remaining 'on ice' for the foreseeable future.

THE PROPERTY MARKET IN PICTURES

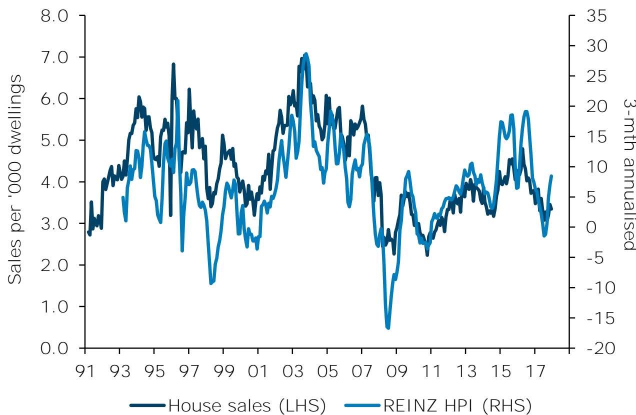
Figure 1. Regional house price inflation



Source: ANZ, REINZ

The REINZ House Price Index rose for a fifth straight month in seasonally adjusted terms in December, lifting 0.7% m/m. That is about the average pace of monthly increase seen over that time. It saw annual growth tick up to 3.9% y/y (the chart is presented in 3-month average terms). Although Auckland prices (2.3%) have actually risen a little more than the rest of the country (1.8%) over the past three months, they are up only 0.8% y/y. Across the rest of the country, prices rose 0.7% m/m in December, and are up 6.9% y/y. Of the major centres, Wellington is recording the strongest annual price growth of 9.8% y/y, although this is off its highs.

Figure 2. REINZ house prices and sales



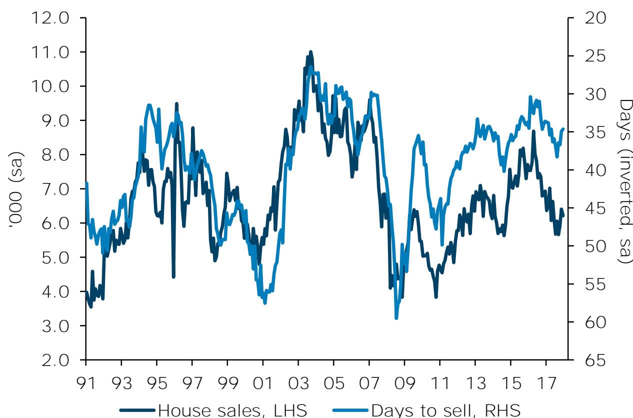
Source: ANZ, REINZ

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

National seasonally adjusted sales volumes dipped by 3.1% m/m in December. That follows increases of 4.7% and 8.1% in the prior two months. But as some context, December sales, while certainly up from the recent lows, are still 11% below the 2017 high, and 17% below the average experienced over 2016.

From a regional perspective, Auckland had a strong end to the year, with volumes up 8.3% m/m (sa), to the highest levels since March. That compares with a 9.6% m/m (sa) fall across the rest of the country. Interestingly, not a single region across the country is experiencing higher sales volumes compared with a year ago.

Figure 3. Sales and median days to sell



Source: ANZ, REINZ

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

Nationally, the median time to sell a house fell by 0.3 days to 34.6 days (sa) in December. That is the shortest period since April and is down from over 38 days only four months ago. It is well below the historical average of 39.6 days, but is still higher than the low of 30.8 days seen in mid-2016.

The median time to sell a property is below historical averages in every region except the West Coast.

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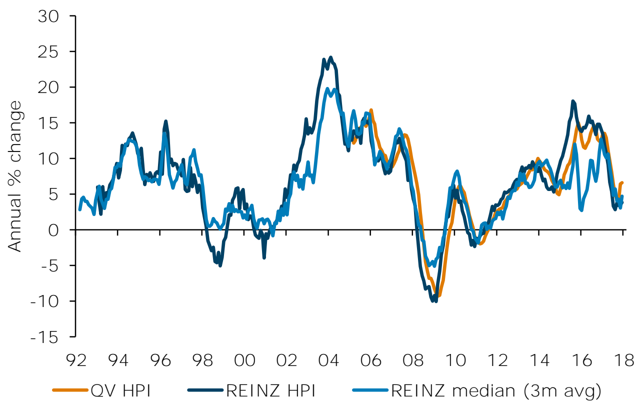
Figure 4. REINZ and QV house prices

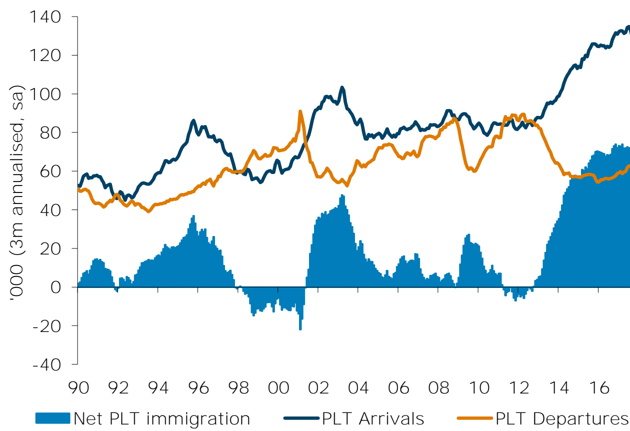


Source: ANZ, REINZ, QVNZ

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

The REINZ median sale price rose 2.6% m/m (sa) in December, with annual growth lifting to 6.0% y/y. This is a little stronger than the REINZ HPI (3.9% y/y) but below the QVNZ measure of price growth (6.6% y/y).

Figure 5. Net permanent/long-term immigration



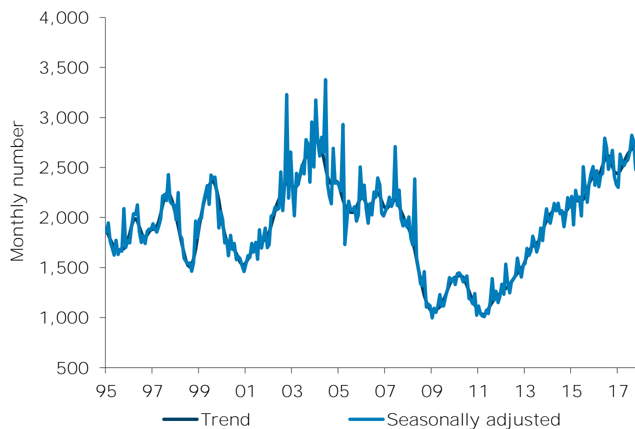
Source: ANZ, Statistics NZ

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.

Recently, net migrant inflows have begun to slow. On a three-month annualised basis, net inflows remained below 66k in November, which is effectively the lowest since mid-2015. The combination of falling arrivals and rising departures is driving this slower pace of net inflows.

Ahead of any possible policy changes, the increase in departures of non-New Zealand and Australian citizens (due to a natural cycling effect as previously large numbers of arrivals leave) already speaks to a likely 'peak' in net migration.

Figure 6. Residential building consents



Source: ANZ, Statistics NZ

Dwelling consent issuance bounced 10.8% m/m (sa) in November. This effectively reverses October's 10.4% m/m fall. Both moves were led by the volatile multi-dwelling component, which we estimate rose 38% m/m in November. Issuance for 'houses' fell 1.3% m/m, its fourth consecutive fall. From a floor-area perspective – most relevant for gauging future construction – we estimate issuance fell 1.6% m/m (sa).

When we step back from monthly volatility, we still believe we are in an environment where annual issuance will struggle to push much higher. While the demand picture remains solid, and strong population growth requires ongoing lifts in housing supply, that supply response is being challenged by the '3 Cs' (capacity, costs and credit). We don't see these pressures easing any time soon.

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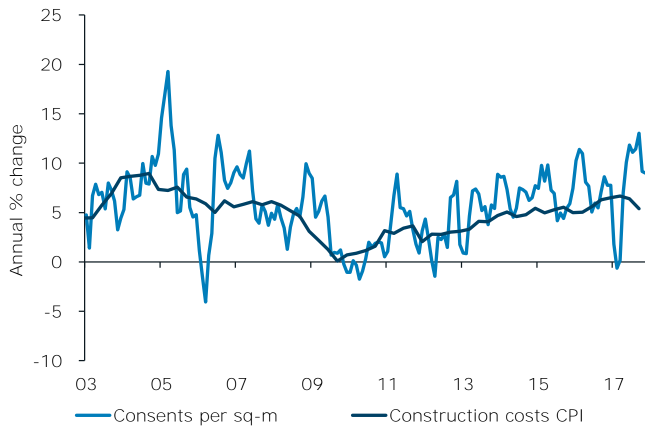
Figure 7. Construction cost inflation



Source: ANZ, Statistics NZ

On a three-month average basis, **the value of residential consents per square metre** – a proxy for construction cost inflation – **was relatively steady at 9.0% y/y in November.** This is down from over 13% in September, but remains elevated.

Notably, the implied measure of construction costs from the CPI has started to ease, falling to 5.4% y/y in Q3, from 6.4% y/y in Q2. It is going to be interesting to see whether, with house price growth cooling, construction cost inflation can continue to run at its earlier strong pace.

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.

We estimate that new mortgage lending was unchanged in December in seasonally adjusted terms (the chart is presented in 3-month average terms). That follows increases of 3.3% m/m and 1.8% m/m in October and November respectively. However, new lending remains down 13% y/y.

New investor lending continues to be soft. In December, lending to investors was down 23% y/y, making up less than 21% of total lending. That is well below the 35% share seen in mid-2016.

Figure 9. New mortgage lending and housing credit

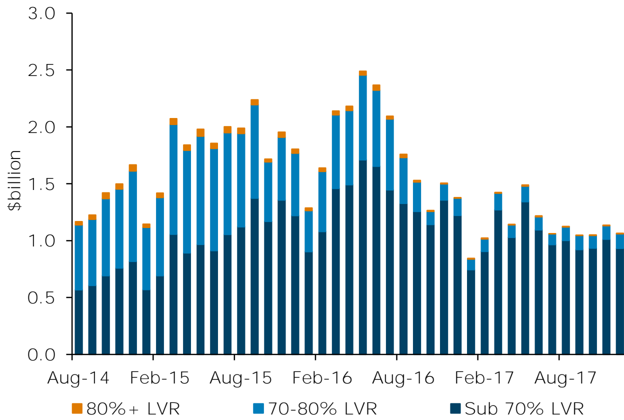
Source: ANZ, REINZ, RBNZ

Total household lending growth was steady in November, at 0.4% m/m (sa). This is effectively the same as the average monthly growth rate over the past six months. As such, growth in three-month annualised terms has also been relatively steady of late, sitting at 5.3% in November.

High-LVR lending restrictions, increased credit rationing by banks, and evolving expectations regarding capital gains – are all having an impact on both house sales and credit availability. While we do not envisage the rate of housing lending growth slowing significantly further from here (in fact LVR restrictions have been eased a touch), we expect the more moderate pace of lending growth that is now occurring to persist for the foreseeable future.

THE PROPERTY MARKET IN PICTURES

Figure 10. Investor lending by LVR

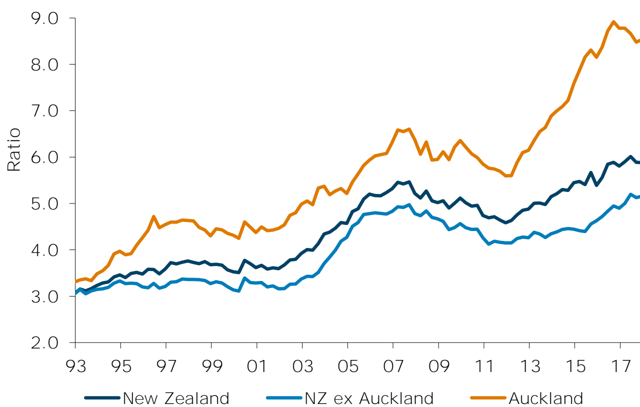


Source: ANZ, RBNZ

New lending to investors is well off its mid-2016 peak, and was down 23% y/y in December, but is showing signs of basing. Investors' share of overall new lending at 20.9% is well down from a peak of 35% in June 2016. This lower share no doubt relates, at least in part, to the impact of the RBNZ's latest round of LVR restrictions (which came into force in October 2016). While the RBNZ has recently announced that these restrictions will be eased modestly (from 1 January 2018), the easing is best defined as a tweak at this stage.

Related to the LVR restrictions, a larger share of new lending is on less-risky terms. In December, the share of total investor lending done at LVRs of less than 70% was 88%. That is a far greater share than in late-2014, when it was less than half.

Figure 11. Regional house prices to income

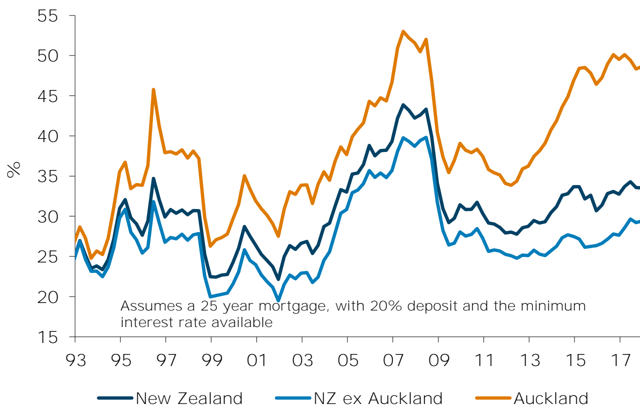


Source: ANZ, REINZ, Statistics NZ

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 six times income for the past 12 months. Auckland, however, has seen its ratio ease from a high of nine times in Q3 last year to an estimated 8.5 times in the Q4. While still extremely high, the easing reflects the recent moderation in house price growth. Outside of Auckland, the ratio has continued to rise, and at 5.2 times, is now a little over where it peaked in 2007.

Figure 12. Regional mortgage payments to income



Source: ANZ, REINZ, RBNZ, Statistics NZ

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

We estimate that for a purchaser of a median-priced home (20% deposit), the average mortgage payment to income nationally is around 33.5% at the moment.

However, once again there are stark regional differences, with the average mortgage payment to income in Auckland just short of 50% for new purchasers. While (just) off its highs, it is still broadly on par with the highs reached in 2007, despite mortgage rates being near historic lows currently. It highlights how sensitive some recent home-buyers in Auckland would be to even a small lift in interest rates.

PROPERTY GAUGES

Housing market activity has shown a few more signs of life of late, bouncing off low levels. However, our overall views have not changed. There are clear opposing forces. On the one hand, strong population growth coupled with a challenged supply backdrop argues that a fundamental supply-demand imbalance will continue to drive prices higher. Yet this is going head-to-head with a base in the interest rate cycle, tighter lending standards, LVR restrictions (although these are gradually being eased admittedly), affordability constraints and possibly more restrictive government policy changes. We continue to see prices largely plateauing for now.

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 still clearly relevant. It is the main reason we see the Auckland market underperforming over the next few years.
Serviceability/ indebtedness	High debt and low rates okay. High rates not.	↔/↓	Looks okay as long as interest rates stay low and the unemployment rate keeps trending lower.
Interest rates / RBNZ	Slow ascent	↔/↓	The case can be argued that the OCR is not moving for a long time. We're still favouring a couple of OCR hikes eventually.
Migration	Peaking	↔	Appears to have peaked even ahead of potential policy changes. But not set to fall sharply.
Supply-demand balance	Demand > Supply	↔/↑	We need to be building 35-40k plus dwellings, not ~30k.
Consents and house sales	Shortage	↔/↑	Dwelling consent issuance ultimately flat-lining around 30k annualised.
Liquidity	Tight	↔/↓	Credit rationing still apparent, although closure of bank funding gap suggests a little more wriggle room.
Globalisation	Mixed bag	↔	Non-resident buyers no longer that influential. Other big global housing markets cooling a little too.
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 not moving up much. That suggests the argument that housing shortages are the key market driver is fiction.
On balance	**Flat-lining**	↔	**Positives offsetting the negatives, leaving the market in limbo. Auckland weaker as affordability bites harder.**

ANZ

PROPERTY GAUGES

Figure 1: Housing affordability

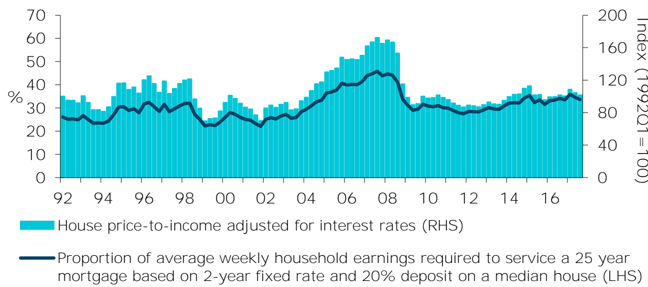


Figure 2: Household debt to disposable income

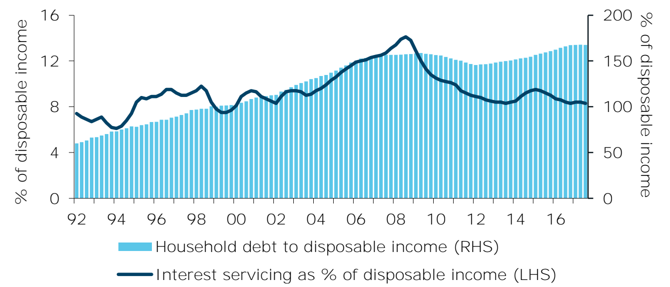


Figure 3: New customer average residential mortgage rate (<80% LVR)

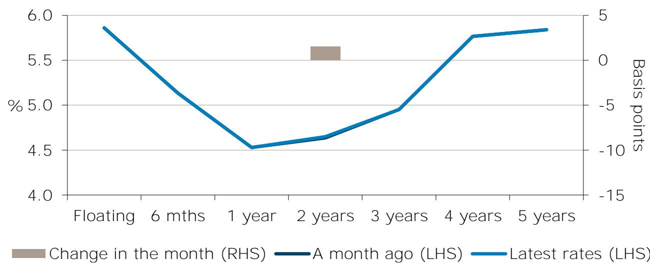


Figure 4: Net migration

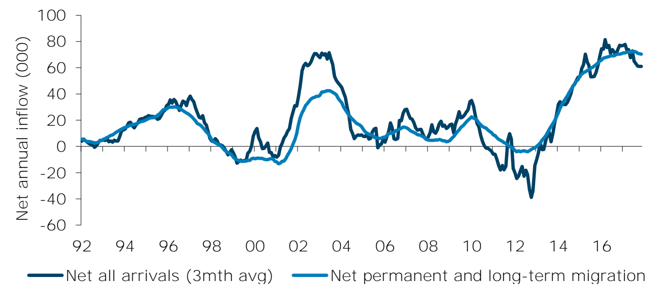


Figure 5: Housing supply-demand balance

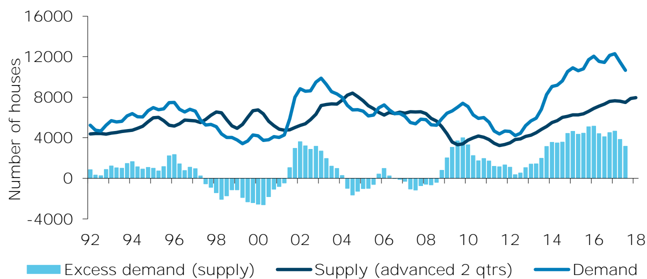


Figure 6: Building consents and house sales

Figure 7: Liquidity and house prices

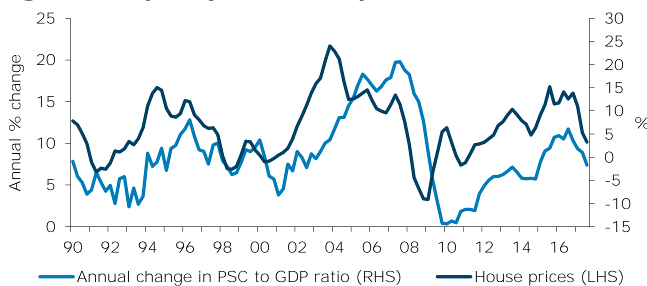


Figure 8: House price inflation comparison

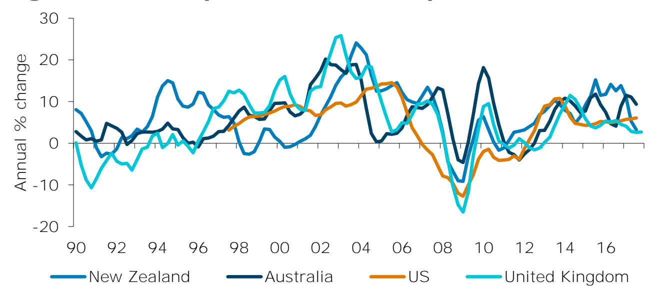


Figure 9: Housing supply

Figure 10: Median rental, annual growth

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

ECONOMIC OVERVIEW

SUMMARY

Although recent upward revisions to historical GDP growth show the economy performing better than first thought, they haven't meaningfully altered our views on the outlook. We still retain a broadly constructive view of the medium-term growth picture, but do believe there is a chance of a growth wobble in the near-term. The economy is grappling with late-cycle capacity pressures, a softer housing market and is transitioning in terms of its growth drivers. We are still biased towards OCR hikes in time. However, the combination of growth only around trend, a soft housing market, a downward inflation starting point surprise but the likelihood of some cost-push inflation to come is a complicated mix, meaning there are plenty of question marks regarding the timing of hikes.

OUR VIEW

Recent data revisions imply the economy has been growing better than initially estimated. That said, we still anticipate something of a growth wobble in the near term but for activity to rebound after that – but not to growth rates previously seen, with population growth set to slow and a productivity miracle unlikely.

We are seeing some typical late-cycle challenges (capacity pressures, housing excesses, stretched household balance sheets and margin pressure). However, cautious banks and a proactive central bank mean it hasn't been 2007 all over again – the current account is contained; credit growth is relatively subdued. But household debt is high and even in the best-case scenario this will dampen consumption growth and hence overall activity growth in the future.

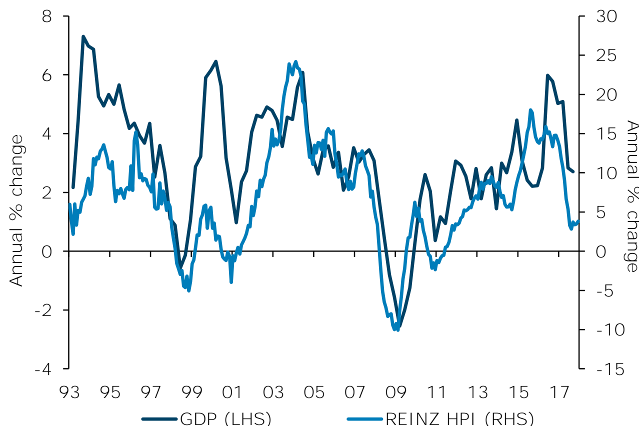
What we are watching:

- **The housing market.** This time is different? It is, in that the slow-down seen over the past 12 months has not been caused by higher interest rates. But the impact on consumption growth could nonetheless be marked as people reassess their strained balance sheets without the prospect of easy capital gains.
- **The impact of heightened policy uncertainty.** We are reasonably agnostic on the new Government's proposed policy platform overall, but change can be unsettling, leading to restrained spending and hiring decisions. We are assuming the decline in business confidence contains a protest element and that firms will eventually get on with it.

The labour market is maturing, and it is probably 'as good as it gets' for the terms of trade and tourism. Migration appears to have topped out. The construction sector is maxed out. But a strong fiscal impulse is looming and the prospects for household income growth are solid, given our expectation that wage growth is set to finally increase (albeit modestly). **All up, we see downside risks to growth near-term, but remain reasonably constructive on the medium-term picture.**

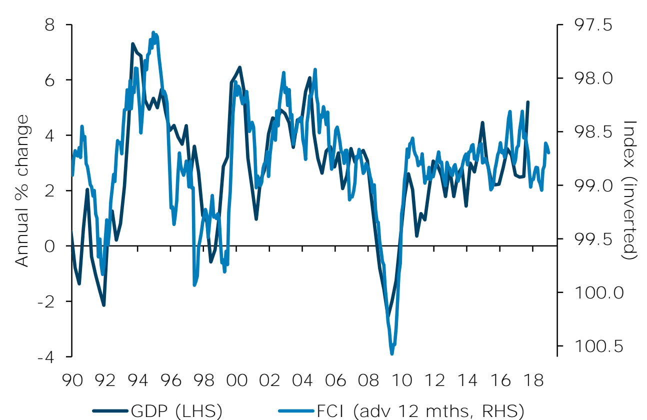
While we see downside risks to the RBNZ's growth forecasts, we still expect domestic inflation pressures to build gradually. Due to pressure on wages (particularly at the low end and partly policy-induced) we see the heftiest pressures on costs seen for many years, at a time when capacity is stretched. But inflation keeps failing to arrive. **We are still biased towards OCR hikes in time.** However, there remain plenty of questions over the timing. We've pencilled in August 2019 as the timing of the first hike.

Figure 1. House prices vs real GDP growth



Source: ANZ, Statistics NZ, REINZ

Figure 2. Financial conditions and GDP



Source: ANZ, Statistics NZ

MORTGAGE BORROWING STRATEGY

SUMMARY

With average mortgage rates effectively unchanged in the past month, we continue to believe the decision between fixing for one or two years is a close call. The 1-year rate remains the low point and therefore offers value. But the gap to the 2-year rate is narrow, and may be attractive for those concerned about the possibility of the OCR moving up within the next year. With plenty of questions over the inflation outlook that is no longer our view though. We now don't see the first OCR hike until August next year, which if anything does sway us more to the 1-year rate. But ultimately, borrowers may wish to spread risk by borrowing over a number of fixed terms.

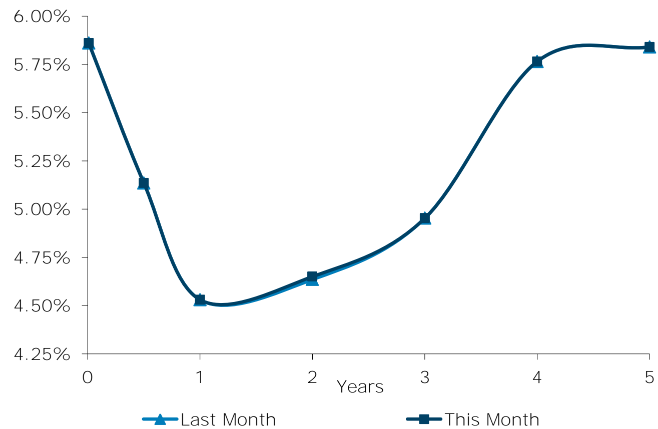
OUR VIEW

Once again, average mortgage rates have hardly changed in the past month, continuing a theme of mortgage rates being remarkably stable for some time now. The level and term structure of the "tick-shaped" mortgage curve is pretty much as it has been since January last year.

The 1-year rate remains the low point on the curve, and continues to offer value. However, the gap to the 2-year rate is narrow, which makes the decision between fixing for either one or two years a close call. That said, our revised forecasts for the monetary policy outlook, wherein we now don't see the first OCR hike until August next year, sway us a little more towards the 1-year rate. There remain plenty of questions over the inflation outlook in a world of structural deflationary forces. While we do still believe the likelihood of an OCR hike is greater than a cut, the timing is highly uncertain, and the spirit of our forecasts is of the OCR being on hold for some time yet. What's more, when hikes do get underway, what is clear is that the OCR will only be lifted gradually. That keeps the "value" in rolling short-dated hedges.

Breakeven analysis supports this close call between the 1 and 2-year rates at present. For instance, the average 2-year special rate is only 12bps above the 1-year rate. The 1-year rate would need to rise by only 21bps (from 4.53% to 4.77%) over the next year in order for it to be cheaper fixing for 2 years at 4.65% than rolling two 1-year terms. **That's not a huge rise in the 1-year rate. So certainty looks "cheap".** There is a more notable step-up between the 2 year and 3 year (30bps); the breakeven on a 2-year at 4.64% versus a 3-year at 4.95% is 5.16%. While not out of the question, that extent of lift in the 2-year rate would require either more confidence that the OCR is moving up or the global inflation pulse is shifting. It is hard to have much conviction in that prospect right now.

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%	3.93%	4.71%	4.83%	5.41%
1 year	4.53%	4.32%	4.77%	5.12%	5.56%
2 years	4.65%	4.72%	5.16%	5.94%	6.88%
3 years	4.95%	5.40%	6.18%	6.41%	6.63%
4 years	5.77%	5.89%	6.17%		
5 years	5.84%	#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%	4.65%	5.65%	5.17%	5.88%
1 year	4.93%	5.15%	5.41%	5.52%	6.02%
2 years	5.17%	5.34%	5.71%	6.03%	6.56%
3 years	5.45%	5.73%	6.18%	6.36%	6.66%
4 years	5.87%	6.06%	6.35%		
5 years	6.07%	*may be subject to a low equity fee			

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

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

KEY FORECASTS

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

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

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

	House prices (ann % chg)	3mth % chg	No of sales (sa)	Mthly % chg	Avg days to sell (sa)
Northland	7.9	-5.3	196	-1%	48
Auckland	1.9	1.7	1,918	+8%	35
Waikato	11.8	1.2	653	+3%	40
Bay of Plenty	20.2	6.0	440	+6%	39
Gisborne	6.9	7.9	49	-15%	34
Hawke's Bay	18.0	0.4	199	-16%	30
Manawatu-Whanganui	14.1	2.2	388	+2%	34
Taranaki	3.1	3.5	182	-7%	45
Wellington	4.4	0.8	673	-9%	32
Tasman, Nelson and Marlborough	12.2	1.1	48	-41%	30
Canterbury	-0.6	4.3	736	-23%	33
Otago	12.3	2.2	379	-2%	32
West Coast	-1.2	6.5	27	-8%	150
Southland	4.3	0.5	149	-6%	31
NEW ZEALAND	6.0	2.2	6,213	-3%	35

Key forecasts

	Actual			Forecasts						
Economic indicators	**Mar-17**	**Jun-17**	**Sep-17**	**Dec-17**	**Mar-18**	**Jun-18**	**Sep-18**	**Dec-18**	**Mar-19**	**Jun-19**
GDP (Ann Avg % Chg)	3.7	3.3	3.0	2.9	2.8	2.7	2.8	2.9	3.0	3.1
CPI Inflation (Annual % Chg)	2.2	1.7	1.9	1.6(a)	1.1	1.4	1.5	1.6	1.7	2.1
Unemployment Rate (%)	4.9	4.8	4.6	4.7	4.6	4.5	4.5	4.4	4.4	4.4
Interest rates (RBNZ)	**Mar-17**	**Jun-17**	**Sep-17**	**Dec-17**	**Mar-18**	**Jun-18**	**Sep-18**	**Dec-18**	**Mar-19**	**Jun-19**
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	2.0	2.0	2.0	1.9	1.9	2.0	2.0	2.0	2.0	2.1
Floating Mortgage Rate	5.8	5.9	5.9	5.9	5.9	5.9	5.9	5.9	5.9	5.9
1-Yr Fixed Mortgage Rate	5.1	5.1	5.0	5.0	5.1	5.1	5.2	5.2	5.2	5.3
2-Yr Fixed Mortgage Rate	5.3	5.3	5.2	5.2	5.3	5.4	5.5	5.5	5.5	5.6
5-Yr Fixed Mortgage Rate	6.3	6.3	6.3	6.2	6.3	6.5	6.7	6.8	6.8	6.9

Source: ANZ, Statistics NZ, RBNZ

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