NEW ZEALAND ECONOMICS
ANZ PROPERTY FOCUS

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INSIDE

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SUMMARY

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

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Amongst all the commentary about housing affordability, it is the house price that gets all the attention, with little focus on earnings and income. Prospects for the income side of the equation remain sound: GDP growth is strong, the labour market is tightening, and wage growth is expected to lift. We're not talking "knock the ball out of the park" rises, but steady improvements. There are the usual suspects that could upset the apple cart (the global scene and too much borrowing demanding a shakeout) but New Zealand looks reasonably well placed. We see annual income growth settling around 4-5%. That's highly respectable and a solid backbone, but won't improve housing affordability if we remain in an environment of double-digit house price gains!

THE PROPERTY MARKET IN PICTURES

Nationwide house price growth is starting to cool. Turnover has softened, which we suspect is due more to a lack of new supply than a significant weakening in demand. While still strong, there are also some early signs that new lending growth has begun to cool, and the latest RBNZ LVR restrictions mean we are likely to see that continue.

PROPERTY GAUGES

Our property gauges remain fractured with mixed signals apparent. Valuations are extended amidst rising leverage. Affordability for first home buyers is poor. Yields are low. Credit growth is outpacing incomes – largesse is apparent. Typically that would have us on red alert. However, the combination of demand from migration, a shortage of housing (there is simply not enough builders to keep up) and low interest rates (which has kept serviceability in check) tempers this to amber alert.

ECONOMIC OVERVIEW

Momentum across the economy is strong, and we expect more of the same over the year ahead. As the expansion matures, a lack of skilled staff is becoming more of an issue for businesses to manage. The RBNZ is set to cut the OCR again, despite the broader economy not really needing it. Risks to the outlook largely emanate from offshore. Localised issues (housing excesses and dairy woes) look manageable with the outlook for dairying improving. Continued credit largesse in excess of income growth would be concerning.

MORTGAGE BORROWING STRATEGY

Mortgage rates are virtually unchanged compared with a month ago, with floating rates steady on the Reserve Bank's decision to leave the OCR unchanged in September, and longer tenors standing still despite a mild rise in wholesale interest rates. Although the latter might ordinarily flag a lift in fixed mortgage rates, the Reserve Bank's reiteration that the OCR will likely go lower in November should cap wholesale rates and keep a lid on term mortgage rates. With little on the visible horizon to drive global interest rates markedly higher and the RBNZ flagging rates being low for quite a period, we prefer to target low cost 1-2 year fixed rates.

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FROM P TO E

Amongst all the commentary about housing affordability, it is the house price that gets all the attention, with little focus on earnings and income. Prospects for the income side of the equation remain sound: GDP growth is strong, the labour market is tightening, and wage growth is expected to lift. We're not talking "knock the ball out of the park" rises, but steady improvements. There are the usual suspects that could upset the apple cart (the global scene and too much borrowing demanding a shakeout) but New Zealand looks reasonably well placed. We see annual income growth settling around 4-5%. That's highly respectable and a solid backbone, but won't improve housing affordability if we remain in an environment of double-digit house price gains!

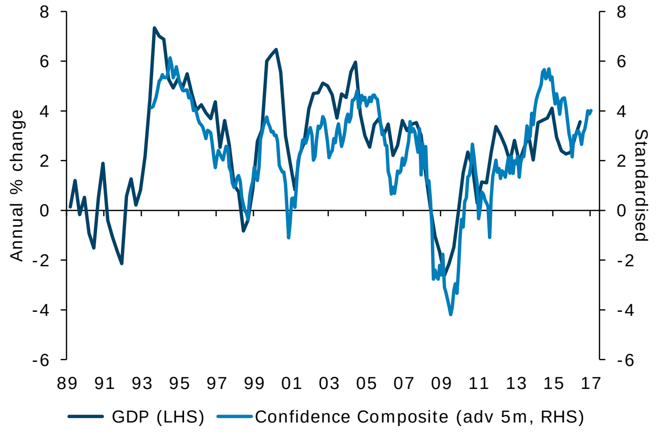
A GLASS HALF FULL

Pick up any housing commentary that discusses affordability and the focus is all about house prices. But that's only half the story; insufficient attention is paid to incomes. People will buy what they can afford. The income side of the ledger – both today, and what is expected in the future – is absolutely critical. Earnings are the backbone of both sustainable economic growth and asset price gains.

So what can we say about the income side of the housing affordability equation?

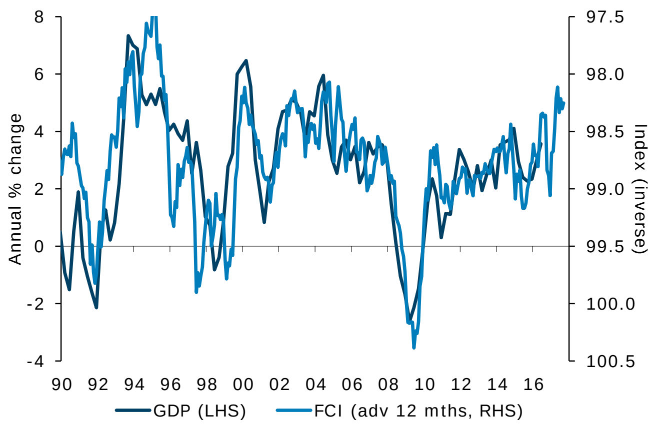
- **Growth prospects across the economy remain sound.** We canvas an array of leading indicators. Financial conditions and our confidence composite index (which combines consumer and business confidence) are elevated and flagging 3½-4% GDP growth despite the high NZD. New Zealand already is one of the best performers in the OECD growth-wise, and the indicators flag more of the same.

FIGURE 1. CONFIDENCE COMPOSITE VERSUS GDP



Source: ANZ, Roy Morgan, Statistics NZ

FIGURE 2. NZ GDP VS FINANCIAL CONDITIONS INDEX



Source: ANZ, Bloomberg

- **Income growth has actually been respectable.** Wage inflation has been subdued amidst low general price inflation but average hourly earnings have grown 2-3% annually over the last four years. With labour hours worked solid and employment growth increasing, gross earnings are moving at a respectable ~5% per year. When other non-labour income/payments are taken into account, the latest household disposable income growth measures are also decent.
- **People are paying tax!** Tax revenue from source deductions are up 6.2% on a year ago (3-month average basis). Who pays tax unless they are making money in the first place? That's a healthy sign.
- **The number of people receiving benefits is falling.** Official numbers of Jobseeker Support benefits have fallen from 140k to 118k over the last 5 years (down 16%). Household Labour Force Survey measures of unemployment, utilisation and participation may bob around a bit and provide mixed signals, but there is no denying the fall in the number of registered persons on a benefit. That said, we acknowledge that eligibility criteria changes can influence the numbers too.
- **Leading indicators of employment are improving.** Both the ANZ Business Outlook Survey and NZIER's Quarterly Survey of Business Opinion (QSBO) have showed improving employment intentions since the start of the year. **ANZ Job Ads are rising sharply, lifting for seven straight months.** And it's the breadth of strength that is telling, with all regions except Canterbury recording double-digit increases over the past year (3-month average).

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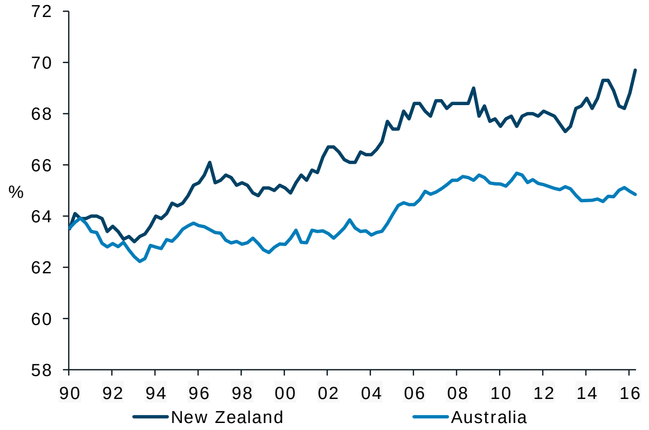
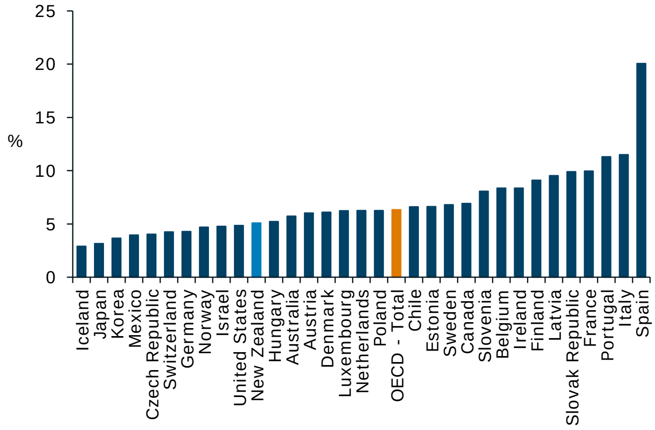
- **Labour force participation has been rising.** We've seen a significant structural shift over many years that means more people are either working or actively looking for work. Employment growth is putting money in pockets and there are few substitutes for on-the-ground experience. For a bit of perspective, labour force participation rates are considerably higher than in Australia, with demographic and policy differences at play (e.g. a stronger emphasis on getting beneficiaries into the labour force in New Zealand). Despite high participation, New Zealand's unemployment rate is at the better end of the OECD spectrum. The participation rate can have a big impact on recorded unemployment rates. All else equal, if Australia had New Zealand's participation rate, its unemployment rate would be over 12% (compared with the current 5.7% rate).

FIGURE 3. PARTICIPATION RATES



Source: ANZ, Statistics NZ, Australian Bureau of Statistics

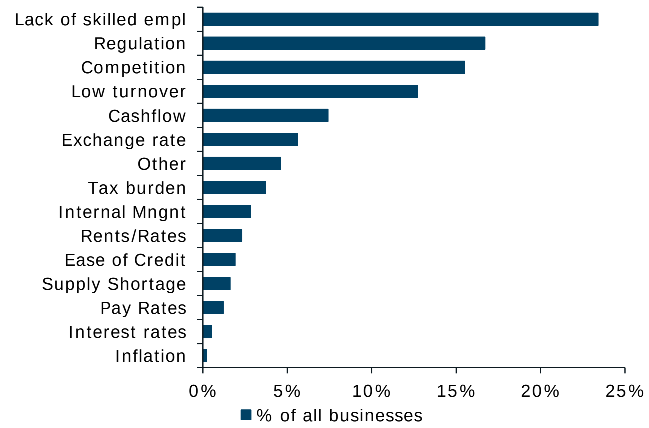
FIGURE 4. OECD HARMONISED UNEMPLOYMENT RATES



Source: ANZ, OECD

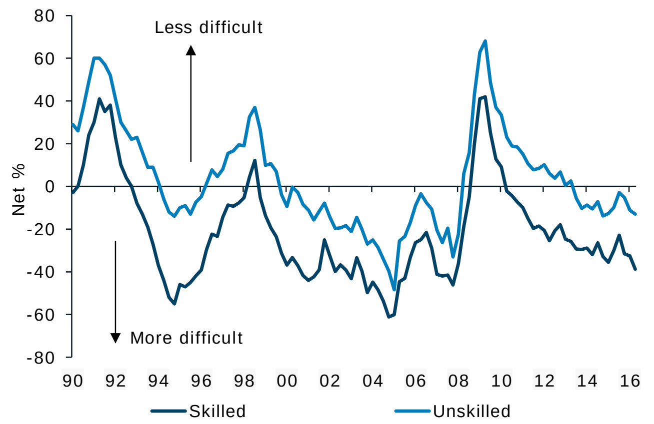
- **The labour market is tightening.** Skill shortages are becoming more apparent. In fact, our ANZ Small Business Microscope shows firms are now reporting a lack of skilled staff as their biggest constraint. Other surveys like the QSBO and MYOB Small Business Monitor have echoed similar messages. As the labour market tightens, wages should start to lift.

FIGURE 5. BIGGEST PROBLEM FACING BUSINESSES



Source: ANZ

FIGURE 6. QSBO DIFFICULTY FINDING LABOUR



Source: ANZ, NZIER

- **Demographic pressure is going to accentuate the shortage of skills and labour.** People are working longer but there is a cold hard reality – there are not enough people, or at least people with the right skills, entering the workforce. This will be exacerbated if migration starts to subside (and the topic is becoming a political issue). Almost a quarter (23.4%) of Household Labour Force Survey (HLFS) employed persons are aged 55+. Ten years ago it was 17%; 20 years ago it was just 11%. That's a huge bow-wave of people that will eventually leave the labour force. The agricultural sector in particular faces skill challenges across the supply chain and can't afford to have the talent pool dry up. There is a swathe of industries facing real pressures that will have to turn to imported labour and/or paying more for local labour.

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- **Inflation is expected to slowly rise.** That matters because wages (at least the pure wage inflation component) do directionally tend to follow inflation as employees push for cost of living adjustments. Put simply, employers ascertain what the inflation rate is and tend to adjust wage levels accordingly.
- **We have a policy framework that is working better – that's good for outcomes on average across the cycle.** Historically, New Zealand has tended to be whacked around by policy swings (and global events) more heavily than most countries. We've seen massive lurches in market conditions, which are never good for businesses, who like certainty. We've had the RBNZ's misguided use of the Monetary Conditions Index framework prior to (and during) the Asian crisis, which transmitted FX volatility straight into interest rates. The RBNZ was too late lifting rates during 2005-2007 and then had to play catch-up; the OCR went to 8.25% and a domestic recession followed (even before the GFC hit). Now the central bank is taking a far more proactive stance, looking at vulnerabilities associated with housing via prudential policy. That forsakes the short game for the long one. Fiscal policy is also being set more within a medium-term context. The economy's microeconomic foundations are getting stronger via a decent policy platform, which is good for growth in the medium-term.
- **In politics one can sense a swing towards populism globally.** Whether that drives some sort of a rebalancing in incomes (more accruing to employees and less to capital) remains to be seen. When we eye the employee compensation share of income in the US, which has been trending lower for some time, we see some real pressure for some rebalancing to take hold.

A GLASS HALF EMPTY

Ok, so that's the potential good news for incomes. What about the other side of the ledger?

- **There are still layers of vulnerability across the economy.** Top of the list is housing and the associated exuberances. Housing and construction are hugely pro-cyclical parts of the economy.
  - Any model where credit growth is growing at 8-9% and income growth at less than half of that is on borrowed time. You can't have house price gains continue to outpace income growth indefinitely. The bigger the boom (binge), the bigger the potential bust (hangover).
  - By some metrics New Zealand looks a lot better than it has historically. The current account is not blowing out in association with rapid credit growth and house price gains, as has been the historical experience. Household saving has dipped, but the piggy bank is not being completely raided. Consumption growth per capita is respectable, as opposed to flagging boom times. Restraint can let the party run longer.
  - That said, the obvious is blatantly obvious. Auckland house prices are trading at a multiple of 9 times incomes. The national figure is 6 times (and the ex-Auckland figure is less than 5). Household debt has gone from 159% of income to 165% since the financial crisis.
  - The upshot: we're on notice.
- **Jobs are under threat as the fourth industrial revolution takes hold.** Technology continues to change business models and the skills needed for production. It includes the impact of profound technological advancement: artificial intelligence, robotics, 3D printing, genetics, nano-technology et al. One survey suggests a **net** loss of 5 million jobs in 15 major and emerging economies over the next five years.[1] Boston Consulting Group has predicted that by 2025 as much as 25% of jobs currently available could be replaced by technology, including robotics. Artificial intelligence and robotics are set to do more and more of what people used to do. There are around 3.5 million drivers in the US and self-driving trucks are being touted / trialled. That's not an environment conducive to putting your hand out for a pay rise. Wage growth will flatten and income inequality will grow. **More questions need to be asked about the education sector** if New Zealand is going to be competitive in a digital age and rapidly changing environment. **There will be a lift in technological unemployment (the loss of jobs brought about by technological change**). We've seen it before. The loom replaced the weaver. The ditch-digger the shovel. **The only curb for the undesirable side effects is to drive a society that is more adaptable, innovative and receptive to change.**
- **We must be wary of sugar-coating the labour market too much; a host of labour market indicators portray a less flattering picture and flag structural challenges.** Underemployment (part timers who want to and are available to work more as a share of the employed population) sits at 4.3% – it has been around the same level since the GFC. Underutilisation (those who are unemployed, underemployed and potentially could

[1] World Economic Forum - Future of Jobs Survey

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and want to work) is 13% – again, no material shift lower in recent years. Unemployment rates for Maori and Pacific Island people are near or above 10%; that's high. Northland has an unemployment rate of 10.6% while Southland and Otago's are 4.5% and 5% respectively. It's difficult to shift / mobilise people. Such figures flag structural rigidities across the market that job creation alone will not necessarily overcome.

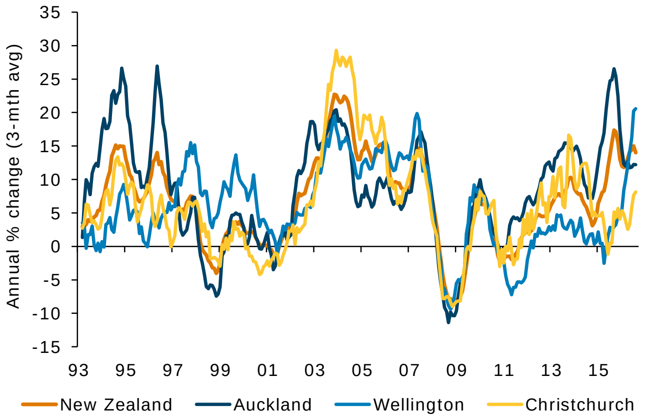
- **New Zealand's productivity performance has not been conducive to higher wages.** GDP per capita stands at around 80% of Australia's and 92% of the OECD average (2015). It's hard to get sufficient scale to drive major lifts in efficiency across a small economy. Policy settings and the macro framework say performance should be better, and it's been somewhat of a challenge to explain why productivity performance hasn't improved. There are some encouraging nuances when we look at energy intensity, agriculture productivity, and our general discussions with firms on the ground. The current skill shortages in the labour market will also naturally see firms look to alternatives; increased capital investment (capital deepening) should eventually pay productivity dividends. But productivity needs to lift if wages are going to grow faster than inflation.
- **The global scene remains precarious.** Time and time again in New Zealand's economic history it's been global events (typically in combination with domestic excesses such as a high current account deficit and extended housing market) that have been the coup-de-grace for local economic expansions.
  - **It has now been 8 years since the start of the GFC.** Statistically, we tend to run in roughly 10 year cycles (eg. 1987, 1997 Asian crisis, and the global financial rout in 2008).
  - **There is no shortage of debt (still) around the globe.** In fact it's significantly higher than it was prior to the GFC. The developed world has shifted debt from the private sector to the public sector while emerging markets have been on a borrowing bender, with China at the epicentre.
  - **Low interest rates and extraordinary policy settings have acted as important economic stabilisers but are now counterproductive.**
    - We haven't had the necessary cleanout post the GFC; zombie firms have been protected by cheap borrowing costs and in some cases public support.
    - It's an odd world where savers have to pay to depart with their money. But that's negative interest rates at work.
    - Low interest rates are an unmitigated disaster for pension funds globally – a ticking time bomb given population ageing.
    - Asset values do not reflect their risk. That's abundant liquidity at work, which implicitly forces investors to put their money to work in more risky propositions and move up the credit curve.
    - Low interest rates mean high asset values. Liquidity trumps economic fundamentals. Investment misallocation takes hold. But pipers invariably get paid in the end.
  - **There is no shortage of geopolitical candidates that could set off a chain of unpleasant events. It only takes a small fuse to light a big bomb.**
  - **Politically, we're seeing a global push towards populism at the expense of economic leadership** – driven to no small extent by the worsened income inequality that has resulted from successful monetary policy efforts to puff up asset prices. Weaker economic foundations and growth will result as populist decision-making comes to the fore. It's easy to envisage the world becoming more inward and protectionist. That'll be bad for trade and incomes.
  - **Interest rates around most of the development world sit south of 1% (many close to zero) and the total level of gross debt across governments in the OECD is around 110% of GDP;** the unweighted average is 86% (2014). That doesn't leave much ammunition to fight a crisis.

CONCLUSION

The New Zealand economy is on a roll. Associated solid income gains will provide some spine to the household sector over the coming years. While welcome, there are risks, and we shouldn't sugar-coat the challenges the likes of the fourth industrial revolution will entail. Moreover, **it'll be cold comfort if double-digit house price gains cannot be lowered into low single-digit territory.** It's also fair to say that global risks are increasing, and policymakers have far less ammunition than they did in the last cycle to fight a downturn. A little wariness in boom times can be a wise approach in the long run.

THE PROPERTY MARKET IN PICTURES

FIGURE 1. REGIONAL HOUSE PRICES

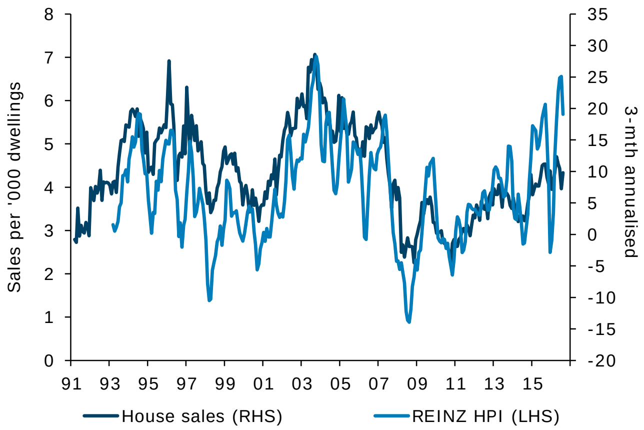


Source: ANZ, REINZ

Nationwide house prices eased slightly in August. Our preferred measure of prices (the REINZ stratified measure) showed nationwide prices falling 2.2% sa (2.0% q/q), with annual growth easing to 11.7% y/y. To put it in context, this was the first monthly house price fall since October last year, and follows a phenomenal run. In July, three-month average prices were annualising at 25%! At 19% in August, momentum remains strong.

Auckland price growth on an annualised 3-month basis is around average, while Wellington is the strongest of the regions, with annualised 3-month price growth of 27%. The North Island remains stronger than the South (Christchurch 16%, other South Island 13%).

FIGURE 2. REINZ HOUSE PRICES AND SALES



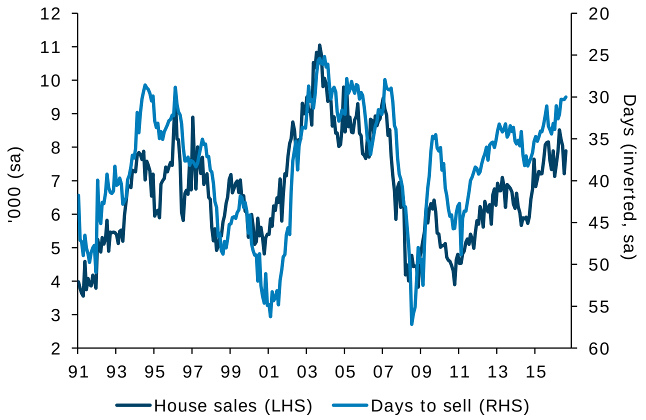
Source: ANZ, REINZ

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

Seasonally adjusted sales rebounded 9.4% m/m in August after a sharp fall in July – with Auckland the notable exception. On a 3m/3m basis, volumes are now down 5.7% and are 2.8% below levels 12 months prior. Auckland sales volumes are down 19% y/y – the only region with sales lower than a year ago.

The weaker trend in sales activity does hint at more modest price growth going forward. However, at this stage we see it as more indicative of a lack of available property listings than a signal of weaker demand.

FIGURE 3. SALES AND MEDIAN DAYS TO SELL



Source: ANZ, REINZ

The length of time it takes to sell a house is also an indicator of the strength of the real estate market. It encompasses both demand and supply-side considerations.

Nationally, the median time to sell a house held steady at just 30.2 days (sa) in August, which is the equal lowest since June 2007 and well below the historical average of 38 days. It supports the argument of weaker sales numbers being driven by a lack of supply rather than softer demand.

Over the past 12 months, the median time to sell a house has fallen most dramatically in Northland and Manawatu/Whanganui. In Auckland, it has sat around 30-31 days for the past year. It is lowest in Nelson/Marlborough (20.2 days).

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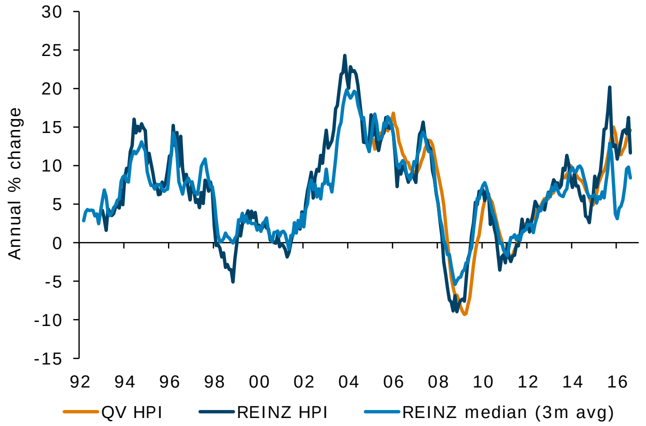
FIGURE 4. REINZ AND QV HOUSE PRICES

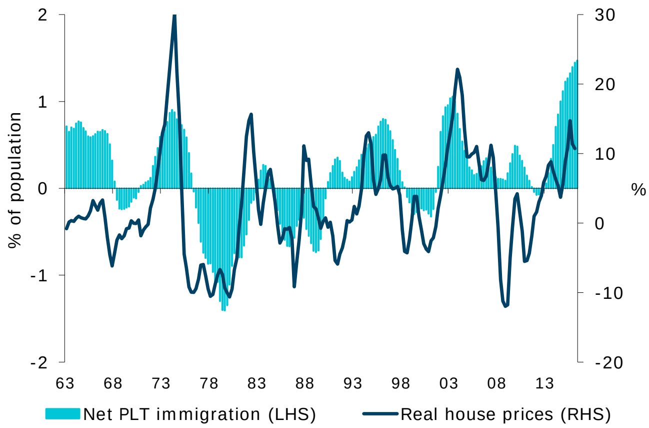


Source: ANZ, REINZ, QVNZ CoreLogic

There are three key measures of house prices in New Zealand: the median and stratified house price measures produced by REINZ, and the monthly QVNZ house price index published by Property IQ. The latter tends to lag the other measures as it records sales later in the transaction process. Moreover, movements do not line up exactly given differing methodologies, with the REINZ median typically more volatile as it is sensitive to the composition of sales taking place.

The REINZ median sale price, which is holding above $500K (after breaching this level for the first time ever in May), **was up 5.8% y/y in August.** This remains well below both the REINZ stratified and the QVNZ measure of price growth (11.5% and 14.6% y/y respectively), which adjust for difference in the quality of houses sold.

FIGURE 5. NET PLT IMMIGRATION AND HOUSE PRICES



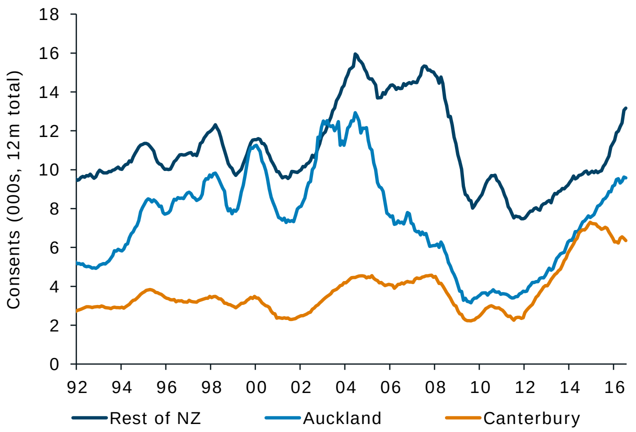
Source: ANZ, Statistics NZ, QVNZ

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

On a three-month annualised basis, net permanent and long-term migration held relative steady at 67.7K in August, which is around 1½% of the resident population. More arrivals and fewer departures have both contributed to this large net inflow.

While net inflows have eased from the record high of close to 72K annualised late in 2015, we are not expecting them to ease back to the long-run average of around 15K any time soon. Due to its economic outperformance, perceived safety and political ructions elsewhere, New Zealand will remain an attractive destination for migrants.

FIGURE 6. RESIDENTIAL CONSENTS



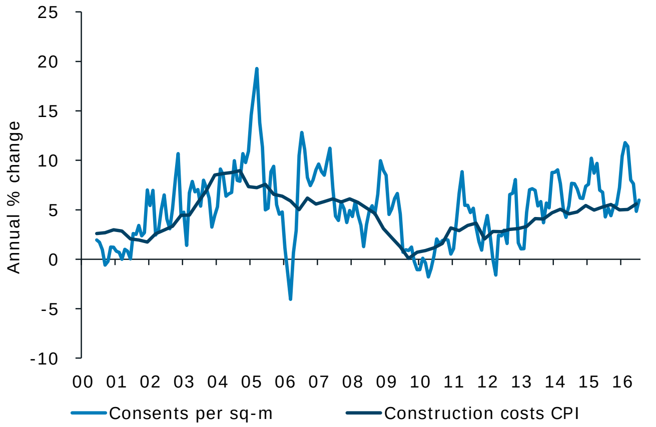
Source: ANZ, Statistics NZ

Nationwide residential consent issuance has been strengthening. On a three-month annualised basis, total issuance remained above 30K in July, which is effectively the highest since mid-2004.

A large part of the increase has been due to the Auckland region (annual issuance of 9.6K), although there are some signs that this is starting to be capped by increasing capacity constraints in the construction sector. Canterbury issuance is off its highs, but only modestly so. Nevertheless, this is consistent with other evidence suggesting that the residential component of the earthquake is past its peak. Positive trends have been clearly evident in likes of Wellington and other regional North Island areas. In fact, issuance in these regions is now accelerating strongly.

THE PROPERTY MARKET IN PICTURES

FIGURE 7. CONSTRUCTION COST INFLATION

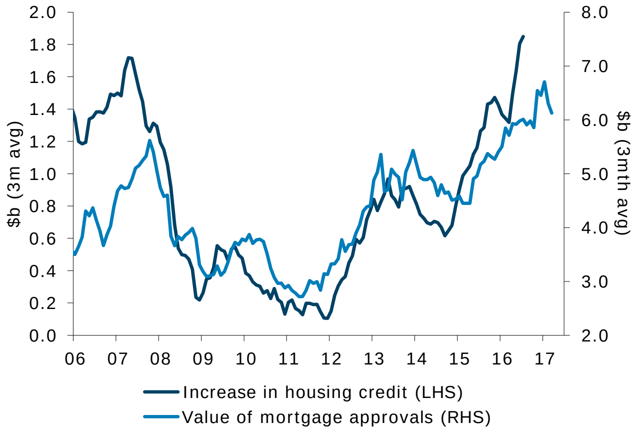


Source: ANZ, Statistics NZ

On a three-month average basis, **the value of residential consents per square metre was up 'only' 6.0% y/y in July, which is below the strong rates of growth experienced earlier in the year.** However, because it is a volatile measure, we are not reading much into it at this stage. In fact, it has ticked a little higher again of late. Looking through the volatility, an upward trend is apparent, which is consistent with the upward trend seen in the construction cost component of the CPI, which sat at 5.6% y/y in Q2 (7.6% y/y for Auckland).

Our internal anecdotes continue to highlight that capacity pressures in the construction sector are reasonably intense, and not limited to any one region. Forward books are generally full, and in some cases work is reportedly being turned away. Difficulty finding the appropriate staff (or any staff) was a common theme in the sector.

FIGURE 8. MORTGAGE APPROVALS & HOUSING CREDIT



Source: ANZ, RBNZ

Weekly housing loan approval figures are published by the RBNZ. These tend to provide leading information on the state of household credit and housing market activity.

The mid-2015 surge in approvals preceded the strengthening in mortgage borrowing and housing market lift as investors rushed to get into the market prior to the looming Government and RBNZ changes.

Approvals values, while at a strong level, have eased modestly off their highs of late and signal that a peak in housing credit growth may be close at hand.

FIGURE 9. HOUSE TURNOVER AND MORTGAGE GROWTH

Source: ANZ, REINZ, RBNZ

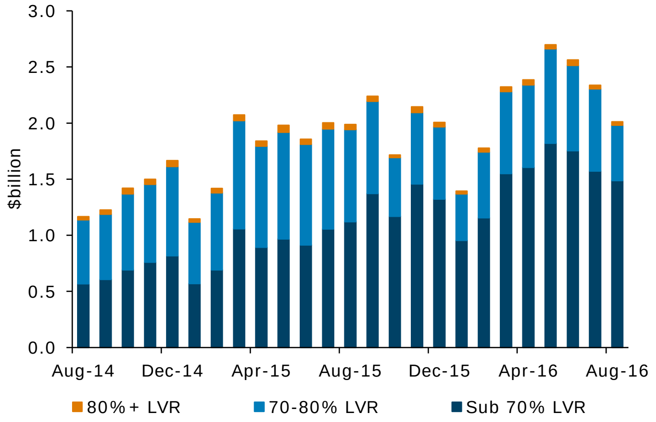
Despite house sales values being at all-time highs, mortgage borrowing levels are only just approaching pre-GFC peaks (although the rate of growth is strong).

The high-LVR lending restrictions that have been in place since October 2013 have also played a role in slowing the pick-up in mortgage borrowing. They were tightened in November 2015 for Auckland investors (deposit requirement of 30%) but relaxed in other areas (up to 15% of new lending could be for borrowers with less than a 20% deposit).

A further tightening in national LVR limits recently announced by the RBNZ is likely to see mortgage growth slow. But figures are not yet available on their impact.

THE PROPERTY MARKET IN PICTURES

FIGURE 10. INVESTOR LENDING BY LVR

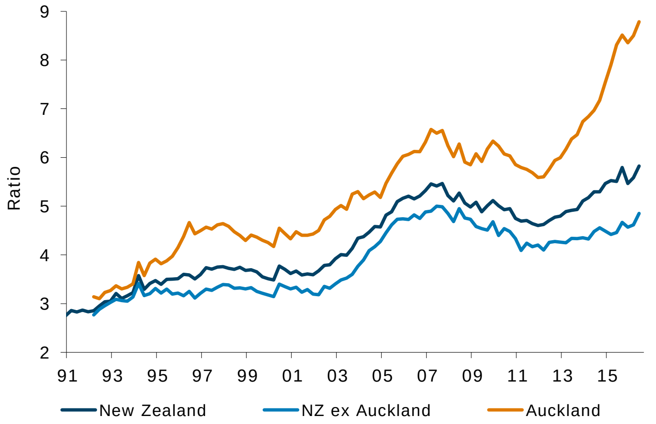


Source: ANZ, RBNZ

There are now some signs that the growth in new investor lending has begun to cool, which is no doubt at least in part a result of banks largely implementing the RBNZ's new LVR restrictions already (the policy becomes official in October). In August, new investor lending was up just 1.2% y/y, making up 32.9% of total new lending – the lowest share since figures started being released in August 2014.

As a share of total investor lending, lending done with LVRs in excess of 70% made up 26% of the total in August. This is down from 33% in July and over 50% in mid-2015. Moreover, 52% of new investor lending was on interest-only terms, which is the lowest share since February.

FIGURE 11. REGIONAL HOUSE PRICES TO INCOME

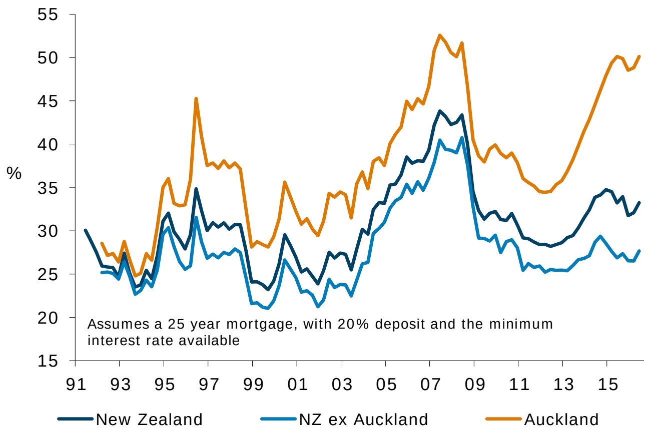


Source: ANZ, REINZ, Statistics NZ

One standard measure of housing affordability is the ratio of average house prices to income. It is a common measure used internationally to compare housing affordability across countries. That said, it does not take into account things like average housing size and quality, interest rates and financial liberalisation. Therefore, it is really only a partial gauge as some of these factors mean that it is logical for this ratio to have risen over time.

Nationally, the ratio sits just below a ratio of 6, which is slightly above the previous highs recorded prior to the GFC. However, there is a stark regional divide. We estimate the average house price to income in Auckland has now risen to close to 9 times, suggesting a severely unaffordable market. Elsewhere, the ratio is around 5 times, which is back where it peaked prior to the financial crisis.

FIGURE 12. REGIONAL MORTGAGE PAYMENTS TO INCOME



Source: ANZ, REINZ, RBNZ, Statistics NZ

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

We estimate that the average mortgage payment to income nationally is around 33% at the moment. It has even fallen below its highs due to recent mortgage rate falls.

However, once again there are stark regional differences, with the average mortgage payment to income in Auckland around 50%. That is near the highs reached in 2007 despite mortgage rates being at historic lows currently. It highlights how sensitive some Auckland borrowers would be to even a small lift in interest rates.

PROPERTY GAUGES

Our property gauges remain fractured with mixed signals apparent. Valuations are extended amidst rising leverage. Affordability for first home buyers is poor. Yields are low. Credit growth is outpacing incomes – largesse is apparent. Typically that would have us on red alert. However, the combination of demand from migration, a shortage of housing (there is simply not enough builders to keep up) and low interest rates (which has kept serviceability in check) tempers this to amber alert.

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 existing mortgage payments.

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 across the regions.

Indicator	Level	Direction for prices	Comment
Affordability	Extended	↔/↓	House prices (and debt) growing at double the rate of incomes.
Serviceability/ indebtedness	Mixed bag	↔/↓	Debt high but saved by low interest rates.
Interest rates / RBNZ	Down	↔	RBNZ is still cutting but homeowners unlikely to get the full benefit with increased bank competition for deposits apparent.
Migration	Still booming	↔/↑	NZ looks better than most = a strong inflow and low outflow. Turning more political as an issue.
Supply-demand balance	Shortage is more acute	↔/↑	Strong population demand and not enough builders to erect enough houses.
Consents and house sales	More builders please	↔/↑	Consents chasing a moving target and not keeping up.
Liquidity	Take that	↓	RBNZ says credit growth needs to slow. LVR restrictions implemented and debt to income limits next.
Globalisation	Global market	↔	We think our houses are expensive. Offshore buyers think they are cheap.
Housing supply	Not enough	↔/↑	Rising but still can't keep pace with demand.
House prices to rents	How low can you go?	↔/↓	Yields keep falling. Investors need the capital gains.
On balance	**A slow rate of appreciation**	↔	**Still tension between a housing shortage and valuations.**

PROPERTY GAUGES

FIGURE 1: HOUSING AFFORDABILITY

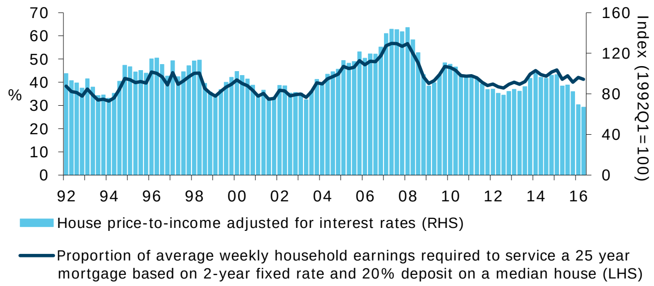


FIGURE 2: SERVICEABILITY AND INDEBTEDNESS

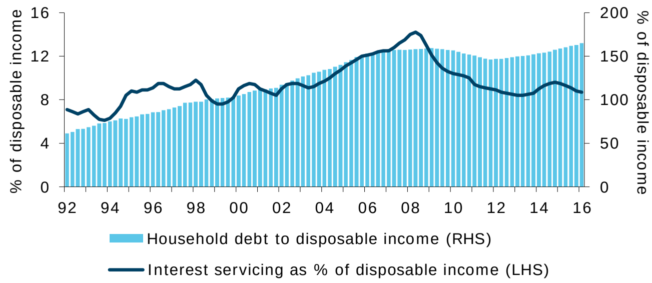


FIGURE 3: NEW CUSTOMER AVERAGE RESIDENTIAL MORTGAGE RATE (<80% LVR)

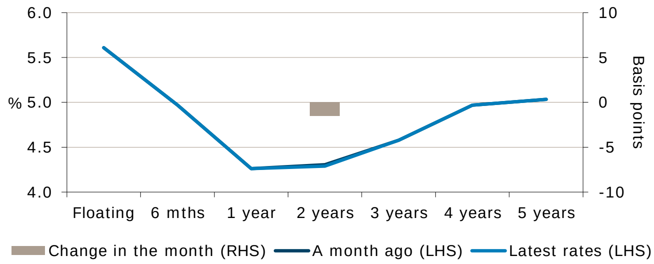


FIGURE 4: NET MIGRATION

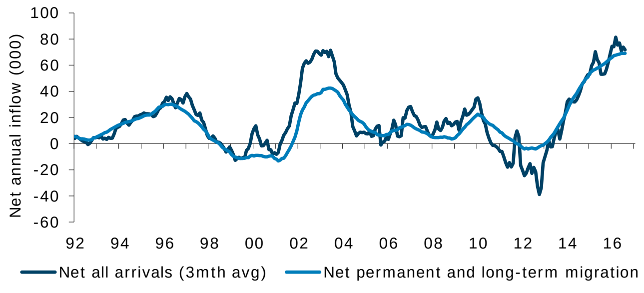


FIGURE 5: HOUSING SUPPLY-DEMAND BALANCE

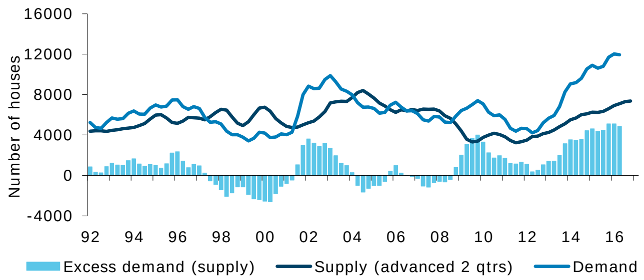


FIGURE 6: BUILDING CONSENTS AND HOUSE SALES

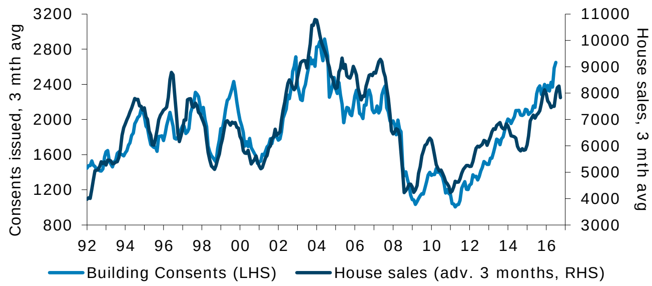


FIGURE 7: LIQUIDITY AND HOUSE PRICES

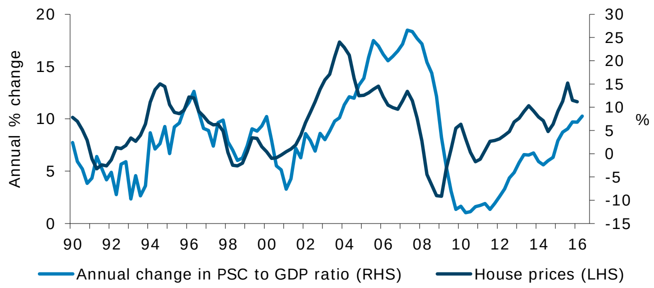


FIGURE 8: HOUSE PRICE INFLATION COMPARISON

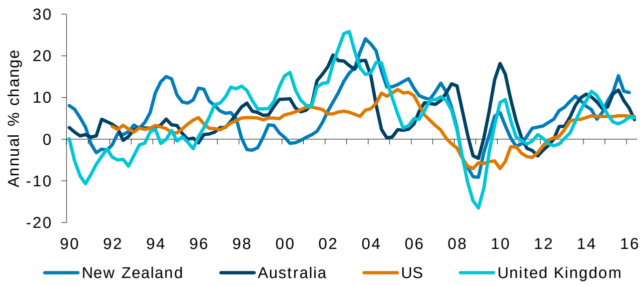
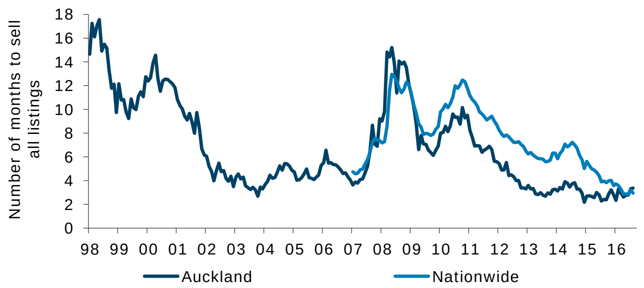
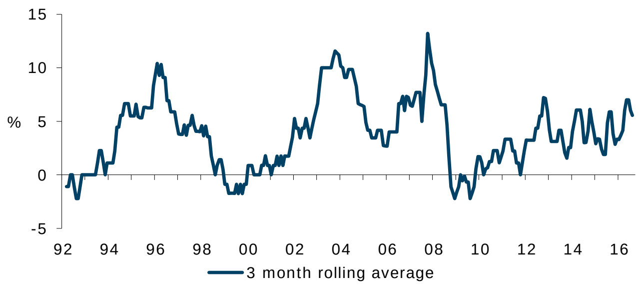


FIGURE 9: HOUSING SUPPLY



IGURE 10: MEDIAN RENTAL, ANNUAL GROWTH



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

ECONOMIC OVERVIEW

SUMMARY

Momentum across the economy is strong, and we expect more of the same over the year ahead. As the expansion matures, a lack of skilled staff is becoming more of an issue for businesses to manage. The RBNZ is set to cut the OCR again, despite the broader economy not really needing it. Risks to the outlook largely emanate from offshore. Localised issues (housing excesses and dairy woes) look manageable with the outlook for dairying improving. Continued credit largesse in excess of income growth would be concerning.

OUR VIEW

The economy is expanding briskly. The economy has maintained strong momentum, with three quarters of growth of +0.9% q/q. Migration inflows remain strong. Construction is booming. Housing prices have surged. Tourism has flourished. That combination remains in vogue. Each month of consistent expansion is encouraging firms to invest further and take on more staff. Success is breeding more enthusiasm for success.

We forecast GDP growth just above 3% over the year ahead. Key signals from our proprietary leading indicators remain positive. Our confidence composite gauge and financial conditions index are pointing to strong momentum being maintained. Job ads have now risen for seven consecutive months. The unemployment rate is trending lower and real household income growth is running at an above-average pace.

Strong growth is bringing capacity bottlenecks. Firms are finding it more difficult to find skilled staff (NZIER Quarterly Survey of Business Opinion, ANZ Small Business Microscope and MYOB). That's a handbrake on momentum, albeit a better problem to have than a lack of demand!

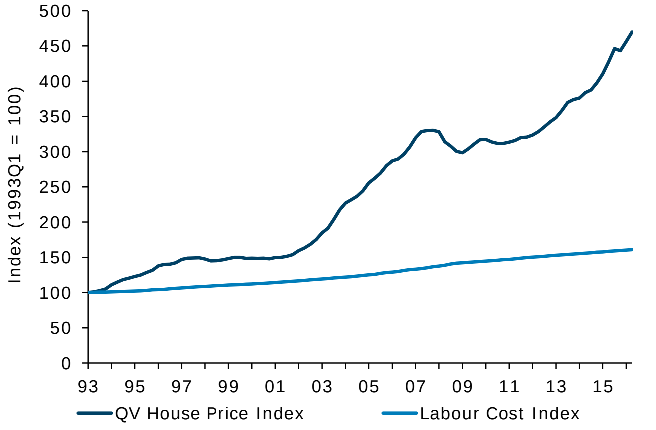
The RBNZ is set to cut the OCR again. The economy – and particularly the housing market – doesn't need it, but the RBNZ has an inflation target and the high NZD is suppressing tradable and headline inflation.

Two localised challenges / risks to the outlook look more manageable:

- **The dairy sector is still under considerable cashflow strain, but the outlook for prices is less bleak.** Cost structures are being pruned. Balance is being restored to the market; low international dairy prices are curtailing supply, thereby helping to stabilise prices. The industry is still going through an adjustment but it's not as bad as it was shaping up to be just a few months ago.
- **Housing excesses.** Borrowing excesses (household debt is 165% of disposable income) in combination with valuation excesses ups the ante on a house price correction. However, that's hard to envisage given support from migration and a curtailed supply-side response. The RBNZ is tempering market activity via tighter LVR restrictions, with early (anecdotal) signs of success. But another year of strong credit growth and booming house prices would put us on notice. We have lot of asset (house) price inflation but little wage inflation. That's creating income equality issues and will bring intergenerational debates to the fore.

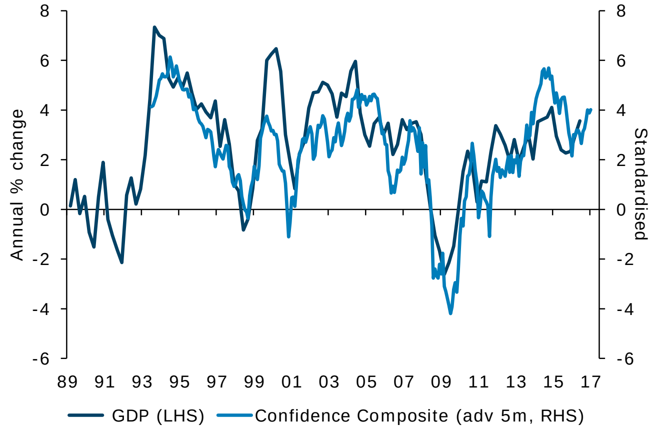
The greatest risk is still the global scene. Globalisation and economic integration are being replaced by the antithesis. Emerging market Asia has high leverage. Europe faces structural challenges. Market distortions are aplenty. Low interest rates are potentially fostering bigger problems down the track.

FIGURE 1. NZ HOUSE PRICE AND WAGE INFLATION



Source: ANZ, Statistics NZ, QVNZ

FIGURE 2. CONFIDENCE COMPOSITE VERSUS GDP



Source: ANZ, Roy Morgan, Statistics NZ

MORTGAGE BORROWING STRATEGY

SUMMARY

Mortgage rates are virtually unchanged compared with a month ago, with floating rates steady on the Reserve Bank's decision to leave the OCR unchanged in September, and longer tenors standing still despite a mild rise in wholesale interest rates. Although the latter might ordinarily flag a lift in fixed mortgage rates, the Reserve Bank's reiteration that the OCR will likely go lower in November should cap wholesale rates and keep a lid on term mortgage rates. With little on the visible horizon to drive global interest rates markedly higher and the RBNZ flagging rates being low for quite a period, we prefer to target low cost 1-2 year fixed rates.

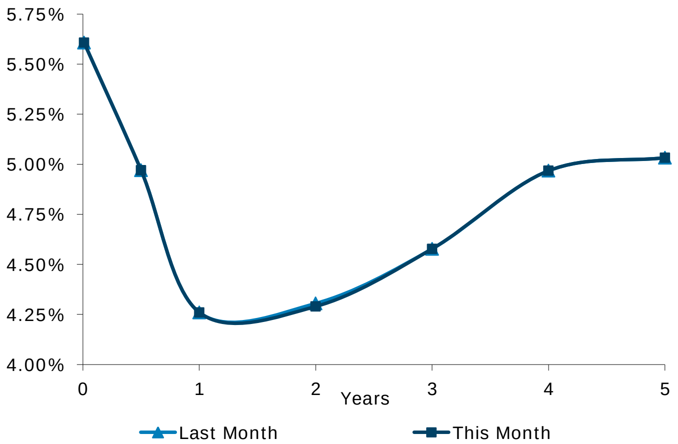
OUR VIEW

Mortgage rates are essentially unchanged compared to last month. While for the floating rate that's a logical result of the Reserve Bank (RBNZ) leaving the OCR on hold this month, term rates have actually held steady (other than some very minor tweaks) despite a slight rise in wholesale rates. Rises generally reflect lifts in global rates (which were in turn pushed higher by fears that central bank easing had reached exhaustion point) and concerns that the RBNZ wasn't eager to continue easing. However, the RBNZ's September reiteration that "further policy easing will be required" has helped soothe markets, and should equally cheer borrowers.

Global interest rates have continued to oscillate, and while most commentators expect the US Federal Reserve to deliver a second rate hike in December, markets are unlikely to fully price this in until after the US presidential elections are out of the way, such is the degree of political uncertainty in the US. With the ECB in easing mode still, and the Bank of Japan looking to anchor Japanese 10-year bond yields at zero percent, the prospects of a sustained rise in global interest rates is low, reducing the threat of a rise in (highly correlated) New Zealand term interest rates.

Given the tame outlook for interest rates, and outright low rates on offer up front, we favour the cheaper 1-2 year rates. If we're to split hairs, we have a mild preference for the 1 year, simply because our forecast of a lower OCR (we expect two more cuts) suggests the 1-year rate will be lower in 1 year's time, making it likely that a 1 year + 1 year strategy will prove to be cheaper than a 2-year fixed rate (albeit only by a small amount).

CARDED SPECIAL MORTGAGE RATES^



Special Mortgage Rates		Breakevens for 20%+ equity borrowers			
Term	Current	in 6mths	in 1yr	in 18mths	in 2 yrs
Floating	5.61%				
6 months	4.97%	3.55%	4.31%	4.34%	5.01%
1 year	4.26%	3.93%	4.32%	4.67%	5.15%
2 years	4.29%	4.30%	4.74%	5.15%	5.65%
3 years	4.58%	4.74%	5.20%	5.36%	5.53%
4 years	4.97%	5.00%	5.23%		
5 years	5.03%	#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	5.61%				
6 months	5.06%	4.49%	4.92%	4.82%	5.18%
1 year	4.77%	4.70%	4.87%	5.00%	5.26%
2 years	4.82%	4.85%	5.06%	5.19%	5.37%
3 years	4.97%	5.02%	5.20%	5.33%	5.51%
4 years	5.09%	5.18%	5.35%		
5 years	5.23%	*may be subject to a low equity fee			

By contrast, breakevens (beyond 6 months) generally have interest rates rising, suggesting that it is worth selecting a longer term only if you think interest rates will rise. Broadly speaking then, as with last month, we think the most sensible strategy is to select the cheapest rate (the 1-2 year), but to keep up interest payments so as to get your principal down as soon as possible. We would also note that although the 5-year rate is higher, it is historically low (at around 5%), and despite the additional cost, may suit more risk-averse borrowers.

^ *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 2016 (based on REINZ data)

	House prices (ann % chg)	3mth % chg	No of sales (sa)	Mthly % chg	Avg days to sell (sa)
Northland	12.3	9.3	286	+10%	36
Auckland	13.8	5.7	2,450	-1%	32
Waikato/BOP/Gisborne	23.3	8.1	1,409	+8%	30
Hawke's Bay	12.1	4.0	263	+19%	30
Manawatu-Whanganui	14.7	7.3	413	+15%	29
Taranaki	9.2	-4.5	192	+4%	35
Wellington	14.6	4.0	875	+13%	23
Nelson-Marlborough	11.4	1.9	289	+27%	20
Canterbury/Westland	2.4	-0.8	973	+7%	32
Central Otago Lakes	41.2	6.5	159	+4%	36
Otago	4.5	3.5	316	+4%	23
Southland	11.7	2.1	241	+28%	38
NEW ZEALAND	**5.8**	**3.0**	**7,890**	**+9%**	**30**

Key forecasts

	Actual			Forecasts						
Economic indicators	**Dec-15**	**Mar-16**	**Jun-16**	**Sep-16**	**Dec-16**	**Mar-17**	**Jun-17**	**Sep-17**	**Dec-17**	**Mar-18**
GDP (Ann Avg % Chg)	2.5	2.5	2.8	3.1	3.4	3.5	3.5	3.5	3.2	3.0
CPI Inflation (Annual % Chg)	0.1	0.4	0.4	0.2	0.7	1.1	1.0	1.6	1.7	1.8
Unemployment Rate (%)	5.0	5.2	5.1	5.1	5.0	5.0	5.0	4.9	4.9	4.8
Interest rates (carded)	**Mar-16**	**Jun-16**	**Latest**	**Dec-16**	**Mar-17**	**Jun-17**	**Sep-17**	**Dec-17**	**Mar-18**	**Jun-18**
Official Cash Rate	2.25	2.25	2.00	1.75	1.50	1.50	1.50	1.50	1.50	1.50
90-Day Bank Bill Rate	2.3	2.4	2.2	2.0	1.8	1.8	1.8	1.8	1.8	1.8
Floating Mortgage Rate	5.7	5.7	5.7	5.6	5.5	5.5	5.5	5.5	5.5	5.5
1-Yr Fixed Mortgage Rate	4.9	4.9	4.9	4.9	4.8	5.0	5.1	5.2	5.3	5.3
2-Yr Fixed Mortgage Rate	5.1	5.1	5.1	4.9	5.0	5.0	5.2	5.3	5.4	5.5
5-Yr Fixed Mortgage Rate	5.7	5.6	5.6	5.4	5.6	5.5	5.7	5.7	6.0	6.1

Source: ANZ, Statistics NZ, RBNZ

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