ANZ RESEARCH

NEW ZEALAND PROPERTY FOCUS

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INSIDE

Chief Economist Corner: Productivity Puzzle 2
The Property Market in Pictures 6
Property Gauges 10
Economic Overview 12
Mortgage Borrowing Strategy 13
Key Forecasts 14

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HARDER AND SMARTER

SUMMARY

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

CHIEF ECONOMIST CORNER: PRODUCTIVITY PUZZLE

Productivity growth is at the heart of lifting real incomes and boosting living standards i.e. growing outputs faster than inputs. As few would favour a severe house price crunch, the far more attractive way for housing to become more affordable is for incomes to lift. Unfortunately, productivity figures for New Zealand don't make for pleasant reading. The trend has waned, and GDP growth per capita has been weak. We've seen good headline GDP growth but it has been driven by more inputs, particularly more labour. Of course stronger employment is a good thing, but lifting broad living standards requires a bigger return on our efforts. On some levels weak productivity growth doesn't tie in with anecdote. It also must be kept in mind that weaker productivity growth has been a global phenomenon, with New Zealand being 'less bad' than many others. The economic impact (cost) of natural disasters in recent years will have also suppressed productivity, though to what extent is impossible to know. All up, the productivity or GDP per capita story is not as bad as headline figures portray. However, they are still not flash, and lifting productivity performance is essential if living standards are going to rise and the likes of housing affordability agendas met.

PROPERTY GAUGES

Housing market momentum is moderating, notably in Auckland, as the combination of higher mortgage rates, LVR restrictions, stretched affordability and tighter credit criteria impact. A tug-of-war continues between a fundamental mismatch between supply (building consents are falling) and demand (net migration is still strong) which points up for prices, and broader "conditions" including affordability and rising interest rates, which say down. The failure of rents to kick on leaves us biased against the thesis that shortages will rekindle market momentum in a strong fashion. It's a factor, just not the key one at present. We view prospects for higher interest rates as a key factor restraining the market and we're not expecting another surge in house prices for a while.

ECONOMIC OVERVIEW

The economy is still recording decent momentum, supported by what are now reasonably familiar forces. Late-cycle behaviours are apparent, but unlike historical experience, we do not believe the economy has the same degree of imbalances at this point in the cycle that would typically result in boom/bust type cycle. There are tensions across the economy though, with tighter credit and financial conditions a challenge for the likes of housing supply and a headwind for growth. The next move in the OCR will be upwards, but time remains on the RBNZ side.

MORTGAGE BORROWING STRATEGY

Mortgage rates remain virtually unchanged compared with last month. This is thanks largely to the fact that wholesale interest rates have held steady over that period, having edged up in late 2016 before stabilising of late. The mortgage curve remains tick-shaped, as has been the case for some time now, with the 1 year rate the "low point" on the curve. Intensifying competition for deposits does risk another leg up in mortgage rates given the importance of deposits as a source of funds, but this now looks to be factored into the term structure. As such, in our view, 1 year remains the sweet spot for borrowers. However, longer terms do offer more certainty.

CHIEF ECONOMIST CORNER: PRODUCTIVITY PUZZLE

SUMMARY

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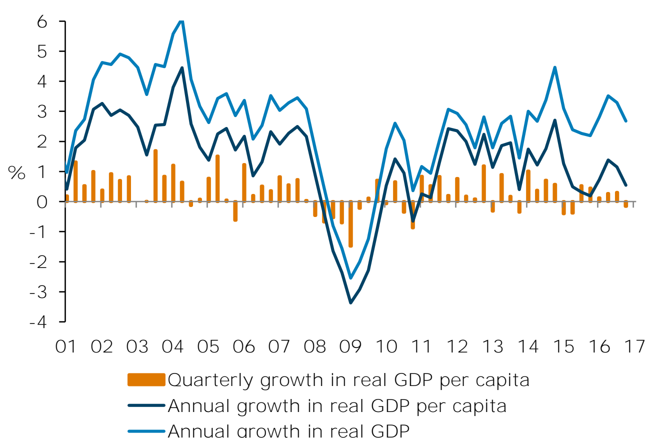
THE PUZZLE

Productivity is the engine of an economy. It sits at the heart of lifting incomes and living standards. This in turn provides more flexibility to invest in the likes of better healthcare, housing, roading, the environment and providing a social safety net. All are intertwined. Highly productive economies are high-wage economies. Most discussion on housing affordability glosses over the income side of the equation. All else equal, we could solve the housing affordability problem over time if income growth were a lot higher. And higher real incomes and productivity go hand in hand.

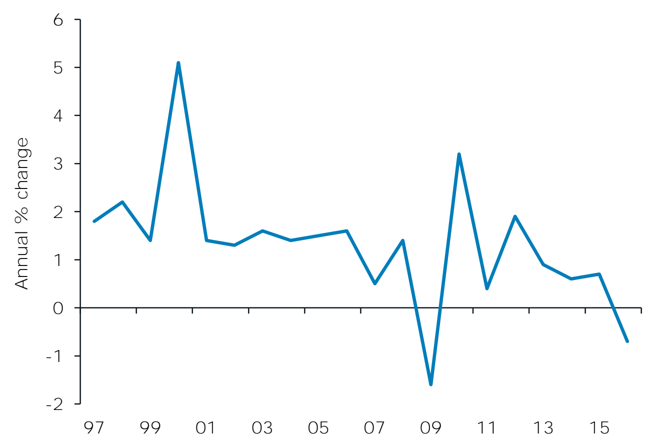
Unfortunately, productivity figures for New Zealand in recent years don't make for pleasant reading. The latest figures showed that in the year to March 2016 labour productivity for the measured sector (which includes all industries except public administration and safety, education and training, health care and social assistance, and ownership of owner-occupied dwellings – thus representing around 80% of GDP) fell 0.7%. This is the weakest result (and the first fall) since 2009. It was driven by a 0.3% fall in the capital-to-labour ratio as well as a 0.4% fall in multifactor productivity.

FIGURE 1: TOTAL AND PER CAPITA REAL GDP GROWTH



Source: ANZ, Statistics NZ

FIGURE 2: MEASURED SECTOR LABOUR PRODUCTIVITY GROWTH



Source: ANZ, Statistics NZ

It was a similar story within the Q4 2016 GDP figures. Although measured on a slightly different basis, they showed GDP divided by hours worked falling for five consecutive quarters to be down 3.8% y/y. Plenty of caution is needed with this measure given that the methodological changes made to the Household Labour Force Survey during the year inflated employment and hours worked figures (diluting inferred productivity). That said, GDP divided by hours paid, or GDP per full-time equivalent employee (taken from the Quarterly Employment Survey) both tell a similar story, with labour productivity on these measures down 0.8% and 0.5% y/y respectively.

A host of commentators are also pointing to weak GDP per capita figures, which paint a similar picture. Real GDP grew 2.7% in the year to December, but in per capita terms GDP increased only 0.5%. The wide gap reflects strong population growth, with net migration running at around 1½% of the resident

CHIEF ECONOMIST CORNER: PRODUCTIVITY PUZZLE

population at present. But it would not be correct to say that poor productivity growth is therefore the 'fault' of strong immigration. Migration is an easy scape goat and has played a role, but it isn't that simple. Who's to say that if the population hadn't grown at all, headline GDP growth wouldn't have been exactly correspondingly lower, leaving growth in GDP per capita the same? In all truth, it probably wouldn't have been, given migrants take a while to settle into the labour market, as we discuss more later. But the upshot is that the real issue is that the data says we have been getting our economic growth primarily through increasing factor inputs, primarily of the labour variety (rather than more machines), ostensibly working harder rather than working 'smarter'. Total hours worked were up a hefty 6.7% over 2016, or just short of 1% per employed person, and there are limits to how far that lever can be pulled.

Of course, a high employment rate is a good thing for an economy and for society. But to really lift living standards, the answer is not to increase working hours per person, but to increase the value of the outputs that that labour effort is producing. That's a much trickier and more nebulous concept, that depends on a multitude of factors, including education, available technology and the amount of capital (per worker), the size of firms, and how easily labour resources can move to take advantage of opportunities (and Auckland's high house prices and hence cost of living are unhelpful for the latter).

Weak productivity data needs to be acknowledged, but on a number of levels the productivity picture is still a surprise. Of course we need to be mindful of the *level* versus the *change*, but even the latter doesn't tie in with anecdotes. Cost control is still permeating strongly as a theme some seven years into the economic expansion; waning productivity is normally associated with *less* cost control. Weak productivity is typically seen at the silly stage of the economic cycle, with rising unit labour costs and rising non-tradable inflation (especially from the services sector). We're just not seeing that, at least not across the board. And we're also seeing the economy become more intensive in its energy utilisation, with electricity consumption (on a GWh basis) at its lowest level as a percentage of GDP ever, at 16% at the end of 2016.

It's easy to identify examples where productivity is strong, particularly in the agriculture sector.

- **Ongoing on-farm innovations** include using drones to monitor livestock, robotic milking plants, renewable energy innovations, cloud accounting that combines physical performance and financial information to inform on-farm decision making, livestock traceability technology being used to monitor performance and disease issues, continued investment in higher-yielding new grass and crop cultivars, and animal, artificial insemination of dairy cows with single-sex semen, mechanical fruit-picking machines for kiwifruit, and the list could go on.
- **We're seeing off-farm/orchard innovations too.** Examples include new separation and extraction technologies to create new ingredients for specific packaged food products, or the development of a low lactose whole milk powder, which could be big in the Asian market, increasing value-add. Again there are numerous other examples.

But the official statistics are clearly telling us that such successes are being outweighed by wider forces.

To be fair, the picture is less bad when eyed over a number of years, although it is still soft. Since 2009, labour productivity in the measured sector has experienced annual average growth of 0.7%. It has effectively been flat for the past three years. That compares with an annual average growth rate of 1.3% between 2001 and 2008. Low inflation and weak productivity has suppressed wage growth.

Perhaps part of the issue is that there is still an inherent bias to shove all our eggs in the housing basket. New Zealand is less bad than it was, but housing still dominates the household balance sheet and that chews up critical savings that could be used productively elsewhere, for example to increase the available pool of funds for the expansion of new, high-productivity businesses. The total stock of housing lending in February (at over $200bn) was effectively twice the size of lending to the business sector.

Under-investment in areas such as roading and housing are legacy issues that carry a sting in their tail for productivity – and we're talking about decades of underinvestment here. That's being corrected somewhat now, but that productivity payoff is miles down the track. In Auckland particularly, workers will continue to find it difficult or simply too costly to be where the best employment opportunities are.

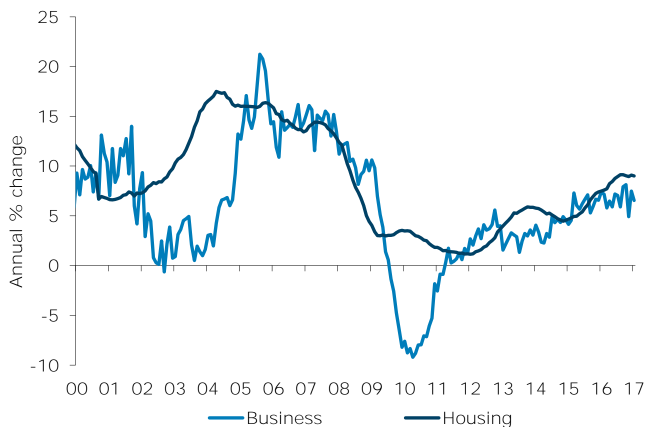
ANZ

CHIEF ECONOMIST CORNER: PRODUCTIVITY PUZZLE

The economy is transitioning and resources don't shift instantaneously, so there is an implicit cost to carry. It's the same when businesses re-orientate. A borrow-and-spend economy is being replaced by a more balanced one (though some behaviours of old have returned of late). That re-orientation is not easy when the NZD is not playing ball and is skewing the playing field away from exporters.

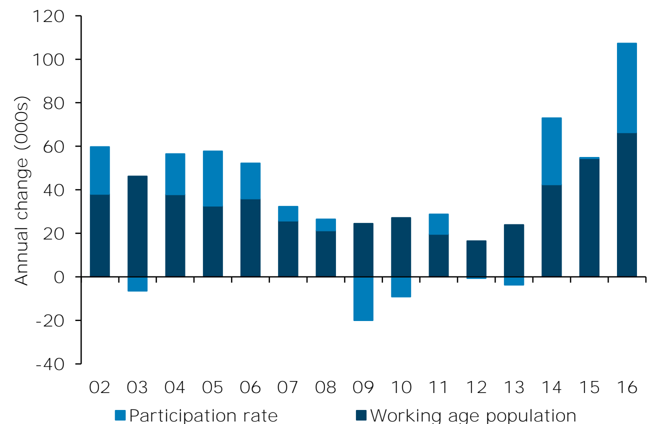
The phenomenal growth in the labour supply in recent years will certainly have played a role suppressing productivity too. As each new worker is drawn into the workforce (be that a new migrant, someone previously unemployed, or a person entering or re-entering the labour force), one would expect that their marginal productivity is lower than a worker who has been employed for some time. The labour force has grown by a strong 13% since the end of 2012 through a combination of working age population growth (net migration) and a rising participation rate (which now sits at all-time highs).

FIGURE 3: HOUSING VS BUSINESS SECTOR CREDIT GROWTH



Source: ANZ, RBNZ

FIGURE 4: BREAKING DOWN THE CHANGE IN THE LABOUR FORCE



Source: ANZ, Statistics NZ

It's hard for an economy to absorb the sheer scale of new migrants arriving at present, particularly with question marks over their mix of skills relative to skills demand.

The economy, as a collective, has chosen to work 'more' over the past few years, with labour input (effectively the total number of hours paid) up close to 11% since March 2011. That reflects not only more people working, but people working more. Average weekly paid hours lifted to 38.7 hours in Q4, which is the highest since 1995. It has meant that the ratio of capital to labour – a key determinant of labour productivity – has effectively been flat since 2011. Getting people into the labour force is fundamentally a good thing, but it's a short-term win if it comes at the expense of productivity.

Firms' decisions partly reflect relative price changes. Whether to invest a marginal dollar in labour or capital will ultimately come down to the relative price between the two. So it is really of no surprise that a flat capital-to-labour ratio since 2011 coincides with effectively no change in the relative price of capital to labour over that same period.

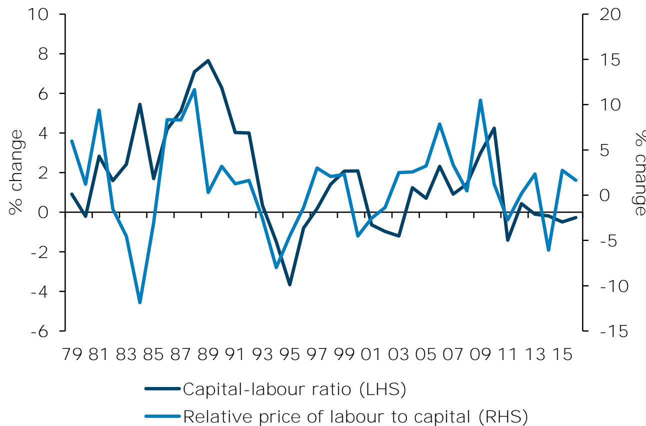
That's still cold comfort because with the NZD high, capital investment has been relatively cheap. It's just that the cost of labour has been relatively cheap too.

The challenges of supply-side shocks also need to be acknowledged. The natural disasters the country has been dealing with, from the 2010/11 Canterbury earthquakes right up to the latest earthquake in Kaikoura, while temporary, do impact on the efficient allocation of resources. They wiped out or displaced capital stock. People's lives and businesses have been disrupted. We've rebuilt and worked our way around them, but there has been an efficiency loss / cost.

It's somewhat puzzling why such natural disasters have not been acknowledged as major factors suppressing productivity. The Christchurch earthquake was a $50 billion hit to the national balance sheet and capital stock. Whilst impossible to quantify, common sense says the impact will have been non-trivial. Then the Kaikoura quake occurred. The drive from Christchurch to Picton is now two hours longer. Some major infrastructure (i.e. a couple of ports) is not fully operational. Logistical functions continue to be disrupted.

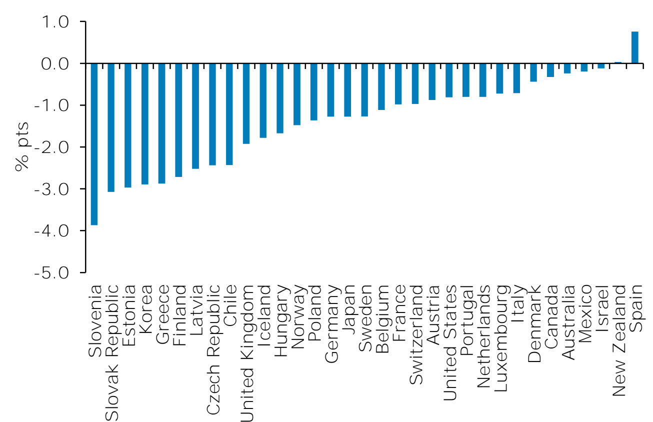
CHIEF ECONOMIST CORNER: PRODUCTIVITY PUZZLE

FIGURE 5: CHANGE IN CAPITAL-LABOUR RATIO AND RELATIVE FACTOR PRICES



Source: ANZ, Statistics NZ

FIGURE 6: CHANGE IN LABOUR PRODUCTIVITY GROWTH (2009-2015 AVG LESS 1990-2008 AVG)



Source: ANZ, OECD

But weak labour productivity growth is an issue far from unique to New Zealand. It has been a global phenomenon, with the average annual labour productivity growth across the G7 of just 0.8% between 2009 and 2015, which is less than half the average seen between 1990 and 2008. This soft trend is one of the more perplexing and debated issues right now considering it comes at a time when technology is apparently advancing at an exponential pace.

In fact, the softer trend has actually been far less pronounced in New Zealand than elsewhere. On a GDP versus hours worked basis (using OECD data), average labour productivity growth between 2009 and 2015 in New Zealand is actually broadly similar to the average between 1990 and 2008. That is a vastly different story to the rest of the OECD – productivity growth has weakened in every country with the exception of Spain and Ireland (although for the latter, changes in the measurement of GDP make this misleading).

So it effectively means that New Zealand is a case of being 'less bad'. Of course the overall level of productivity matters as well (in fact it matters a lot), and New Zealand hasn't – and still doesn't – stack up so well on that front. It is one of the reasons our GDP per capita sits in the bottom half of the OECD. And being less bad in a relative comparison to a prior period doesn't hide the fact New Zealand has still underperformed in an absolute sense.

The direction of productivity growth from here takes on critical importance. A continuation of weakness would be a harbinger of an end to the economic expansion; complacency ends good times. Weak productivity raises unit labour costs and puts pressure on inflation. For real wage rises to be sustainable, productivity needs to lift.

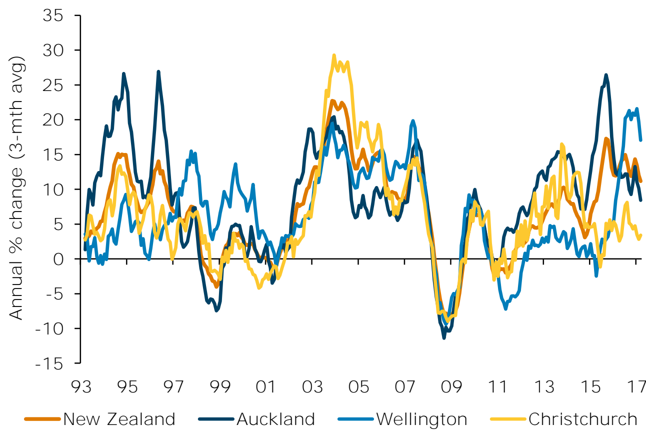
Improving productivity growth is easier said than done. The levers are not always so obvious. One of the greatest productivity elixirs was the invention of spectacles; that shows just how subtle big drivers of change can be. And it isn't as simple as saying that everything that increases measured productivity is desirable. For example, we would get a great boost by going back to five-day-a-week shopping. We'd reschedule our busy lives and still purchase what we needed to, and it'd save the retail sector a bundle in wage costs. Sometimes the choices we make as a society (such as demanding convenience) come with an implicit cost.

When it comes to increasing productivity New Zealand seems to be pushing the right buttons (infrastructure, education, better public services) and we rank well across numerous surveys in regard to ease of doing business etc. **But there are issues of scale** (we are small), **the tyranny of distance**, **economic structure** (still primarily a commodity exporter and not a value-added one), and **legacy issues** to deal with such as **a poor savings and investment culture**.

You don't overcome these challenges and play catch-up by thinking inside the square; you need to be outside it. The status quo just doesn't cut it. Fostering a big shift in ideas, methods and being a lot more creative is the real challenge for New Zealand. For housing to be more affordable, productivity enhancement needs to be part of the debate, and lift, so incomes can too in a sustainable fashion.

THE PROPERTY MARKET IN PICTURES

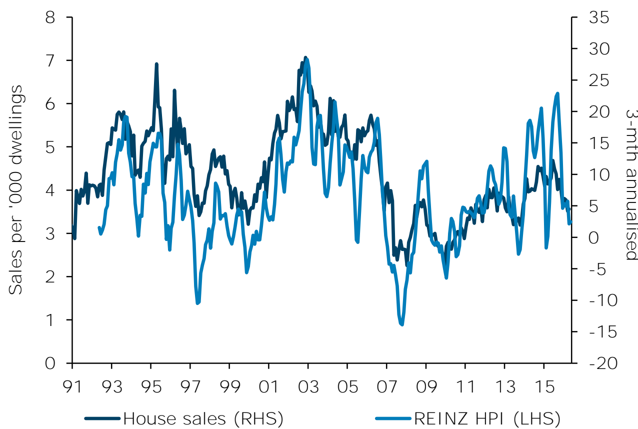
FIGURE 1. REGIONAL HOUSE PRICES



Source: ANZ, REINZ

According to the REINZ stratified measure, nationwide house prices bounced back 2.2% in March on top of a 0.8% lift in February (sa). Wellington prices fell 1.3% but all other regions rose. While the numbers can be volatile, especially around the turn of the year, it seems clear that momentum in price growth has broadly slowed, though it is now stabilising. On a 3-month annualised basis, nationwide prices are running at 2.5%, which is up from 2.1% in February but down from over 23% over mid-2016. Auckland prices are running at -9% on the same measure. The North Island outside of Auckland and Wellington is outperforming, with annualised 3-month growth of 11.4%.

FIGURE 2. REINZ HOUSE PRICES AND SALES



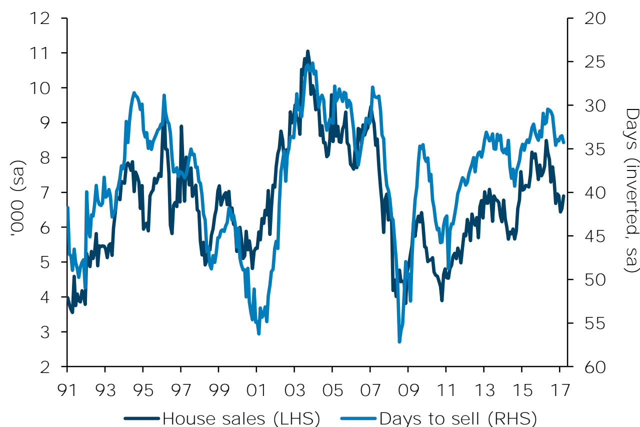
Source: ANZ, REINZ

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

Seasonally adjusted sales lifted 6.0% m/m in March, completing its bounce-back from a 6.7% fall in January. House sales have fallen in seven of the past 12 months. This weakness is broad-based. Auckland sales volumes are down around quarter versus their April-2016 peak, while ex-Auckland volumes are down 16% over the same period.

The softer trend in sales activity suggests that the recent moderation in house price growth will continue. That said, sales did increase over the past two months (seasonally adjusted) in both Auckland and the rest of the country.

FIGURE 3. SALES AND MEDIAN DAYS TO SELL



Source: ANZ, REINZ

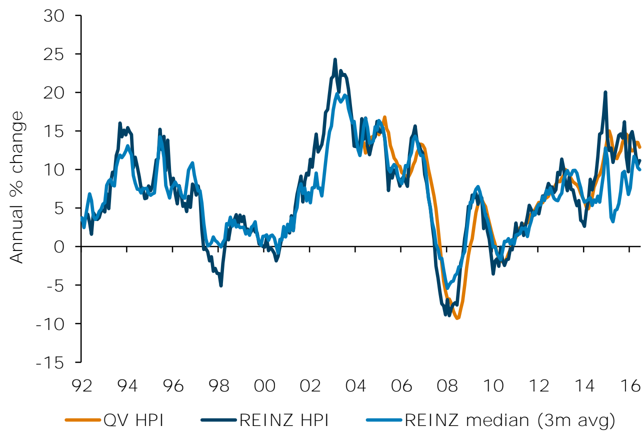
How long it takes to sell a house is also an indicator of the strength of the market, encompassing both demand and supply-side considerations. Larger cities tend to see houses sell more quickly, but deviations in a region from its average provide an indicator of the heat in a market at any given time.

Nationally, the median time to sell a house increased from 33.5 to 34.3 days (sa) in March. This is well up from its mid-2016 lows of close to 30 days.

The median time to sell a property is below historical averages in every region except Auckland (36.5 days, versus a long-run average of 34.5) and Canterbury (36 days, versus a long-run average of 35.5 days).

THE PROPERTY MARKET IN PICTURES

FIGURE 4. REINZ AND QV HOUSE PRICES

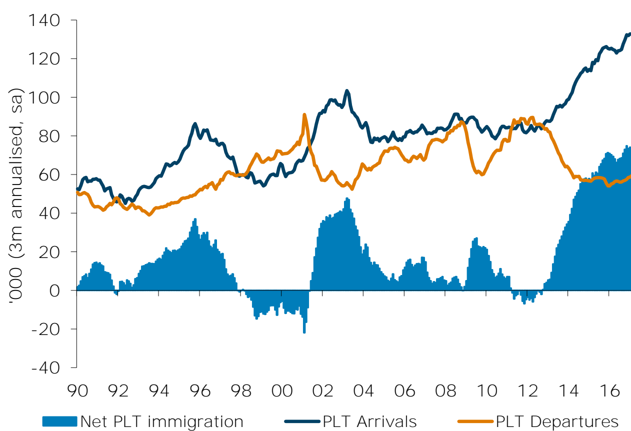


Source: ANZ, REINZ, QVNZ

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

The REINZ median sale price lifted 1.8% in March and is up 10.2% y/y. This is a little lower than the REINZ stratified measure (11.2% y/y) and the QVNZ measure of price growth (12.9% y/y), with the latter two measures adjusting for changes in the quality of houses sold.

FIGURE 5. NET PLT IMMIGRATION



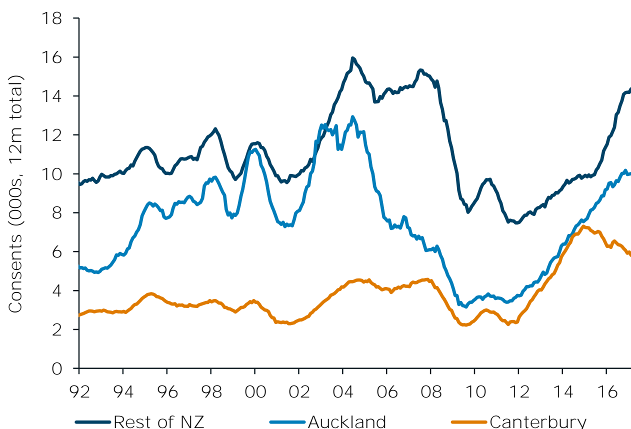
Source: ANZ, Statistics NZ

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

On a three-month annualised basis, net permanent and long-term migration was close to 74k in March, which is near all-time highs and over 1½% of the resident population. More arrivals and fewer departures have both contributed to this large net inflow, although over the past 12 months or so, the former has been the dominant factor.

Migration inflows are expected to remain strong. New Zealand's current strong labour market (particularly relative to Australia, by far the most relevant comparator) will allure people home. In a world of fractured international politics (Brexit, US political uncertainty), there'll be no shortage of people with a desire to move to New Zealand.

FIGURE 6. RESIDENTIAL CONSENTS



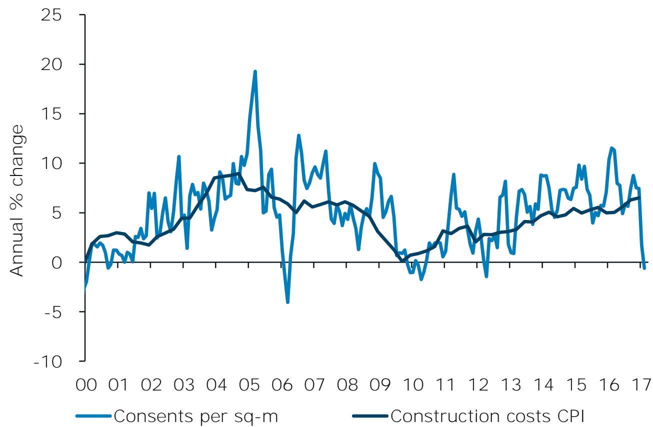
Source: ANZ, Statistics NZ

Seasonally adjusted dwelling consent issuance lifted 14.0% m/m in February on top of a 2.1% lift in January as the data continues to recover from large falls in both November and December. The volatility has been driven by apartments, which have bounced back 36% in the past two months, largely reversing December's fall. Consents for 'houses' jumped 14% in February, but have fallen in four of the past six months.

But despite the bounce in today's data, issuance is still off its highs. In seasonally adjusted terms, the number of consents is down 8% nationally from its mid-2016 peak. Canterbury is recording trend growth of -5.1% m/m at present (unsurprising, given the gradual winding down of the earthquake rebuild), while Auckland, Waikato and Wellington are recording monthly trend growth of -2.6%, -2.5% and -3.7% respectively.

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 actually fell 0.6% y/y in February.** This continues a surprisingly sharp fall in growth from the close to 9% rates seen over the latter part of 2016. This may indicate that construction cost inflation is finally starting to wane, but we suspect it is primarily compositional. Given the extreme volatility in this cost measure we will await further data before drawing any conclusions. Costs per square metre in Auckland (especially in the multi-dwelling space) have lifted especially strongly of late, and our internal anecdotes continue to highlight that capacity pressures in the construction sector are intense, with a severe shortage of labour.

FIGURE 8. NEW MORTGAGE LENDING AND HOUSING CREDIT

Source: ANZ, RBNZ

New residential mortgage lending figures are published by the RBNZ. They can provide leading information on household credit growth and housing market activity.

New mortgage lending softened further in February. We estimate that in seasonally adjusted terms, new lending fell 2.1% m/m to $5.0bn, which follows a 9.7% m/m fall in January, and is the lowest amount since November 2014. The data mirrors the fall in the value of housing turnover.

Softer new lending was reasonably broad-based. Whereas previously the slowing was largely an investor story (and new investor lending is currently down 35% y/y), the growth in lending to first home buyers and other owner occupiers has also cooled of late too, with the former flat y/y, and the latter down 4.5% y/y.

FIGURE 9. HOUSE TURNOVER AND MORTGAGE GROWTH

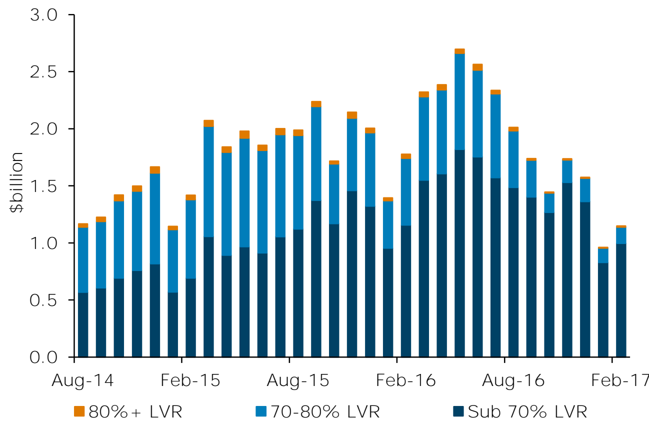
Source: ANZ, REINZ, RBNZ

Growth in the overall stock of mortgages has continued to cool, after a period of strong growth. For the second consecutive month, total housing credit rose 0.5% m/m in February, with a 3-month annualised pace of growth easing to 7.5%, the softest since mid-2015 and well down from the 10% pace recorded in August 2016.

The latest tightening of the high-LVR lending restrictions – together with increased credit rationing by banks – appear to be having a marked impact on both house sales and credit availability. Add in recent modest increases in mortgage rates (and widespread expectations of more to come), and we expect to see mortgage lending growth remain at this more moderate pace over the coming months.

THE PROPERTY MARKET IN PICTURES

FIGURE 10. INVESTOR LENDING BY LVR

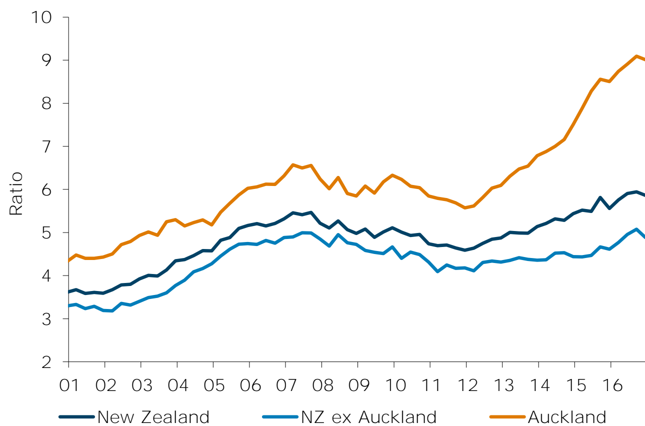


Source: ANZ, RBNZ

New lending to investors is well off its mid-2016 peak, down 35% y/y in February. Its share of overall new lending, at 26%, is well down from a peak of 38% in June 2016. This is no doubt related to the latest round of RBNZ LVR restrictions, which officially came into force on 1 October 2016 but influenced lending decisions in the months prior.

Related to this, a larger share of new lending is on less-risky terms. As a share of total investor lending, lending done with LVRs in excess of 70% made up just 13% of the total in February, down from 33% in July and over 50% in mid-2015.

FIGURE 11. REGIONAL HOUSE PRICES TO INCOME

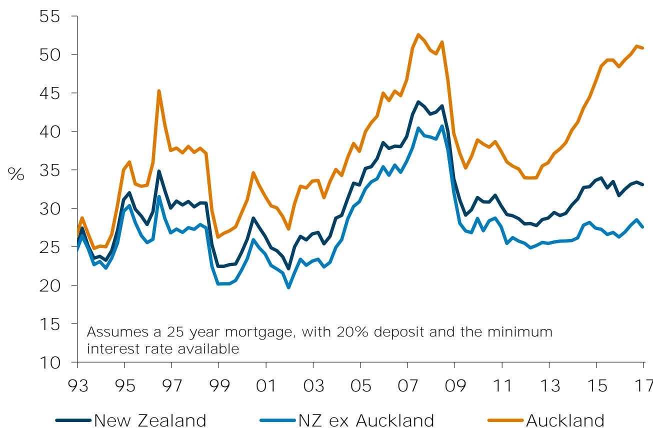


Source: ANZ, REINZ, Statistics NZ

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

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

FIGURE 12. REGIONAL MORTGAGE PAYMENTS TO INCOME



Source: ANZ, REINZ, RBNZ, Statistics NZ

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

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

However, once again there are stark regional differences, with the average mortgage payment to income in Auckland around 51% for new purchasers. That is on par with the highs reached in 2007 despite mortgage rates being near historic lows currently. It highlights how sensitive some recent home-buyers in Auckland would be to even a small lift in interest rates.

PROPERTY GAUGES

Housing market momentum is moderating, notably in Auckland, as the combination of higher mortgage rates, LVR restrictions, stretched affordability and tighter credit criteria impact. A tug-of-war continues between a fundamental mismatch between supply (building consents are falling) and demand (net migration is still strong) which points up for prices, and **broader "conditions" including affordability and rising interest rates**, which say down. The failure of rents to kick on leaves us biased against the thesis that shortages will rekindle market momentum in a strong **fashion. It's a factor, just not the** key one at present. We view prospects for higher interest rates as a key factor restraining the market and **we're not expecting another surge in house prices for a while**.

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	Stretched	↔/↓	Low interest rates meant house prices lifted faster than incomes but interest rates are now gradually rising.
Serviceability/ indebtedness	Deteriorating	↔/↓	More debt and higher interest rates is not a great combination.
Interest rates / RBNZ	Rising	↓	We are in a rising interest rate environment. The pace is glacial but the turning point is past.
Migration	Extreme	↔/↑	Pressure on Government to reduce it but levers are not easy to pull when a lot of the net inflow is New Zealanders returning or staying.
Supply-demand balance	Demand > Supply	↔/↑	Demand is outstripping supply and the latter looks to be slowing.
Consents and house sales	Shortage	↔/↑	Not enough builders to lift supply materially.
Liquidity	Fewer loans	↓	LVR restrictions are biting and banks are curtailing supply of credit, particularly at the riskier end.
Globalisation	Mixed bag	↔	Auckland (9 times income) no longer looks cheap in a global comparison but the rest of NZ still does (5 times). So the regions are now outperforming Auckland.
Housing supply	Behind the 8-ball	↔/↑	Less credit + higher construction costs + no labour = less supply.
House prices to rents	Mismatch	↔/↓	Rents not keeping pace with house prices.
On balance	**Flat-lining**	↔	**Higher interest rates and less easily available credit have taken the wind out of the market.**

PROPERTY GAUGES

FIGURE 1: HOUSING AFFORDABILITY

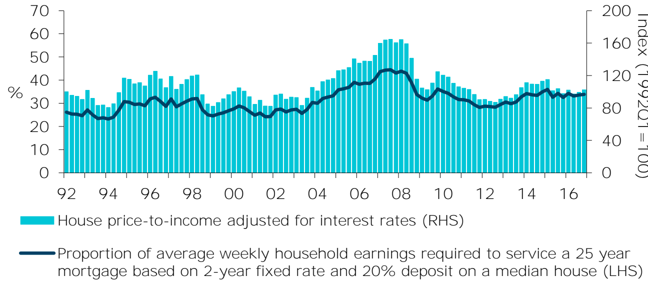


FIGURE 2: SERVICEABILITY AND INDEBTEDNESS

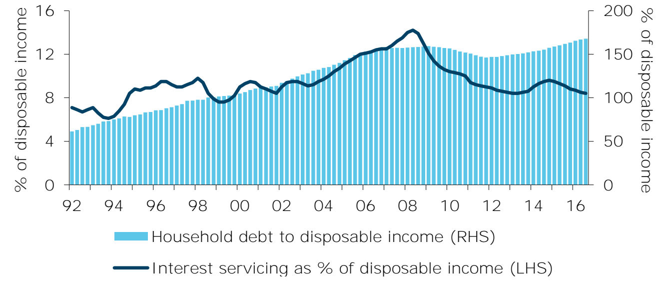


FIGURE 3: NEW CUSTOMER AVERAGE RESIDENTIAL MORTGAGE RATE (<80% LVR)

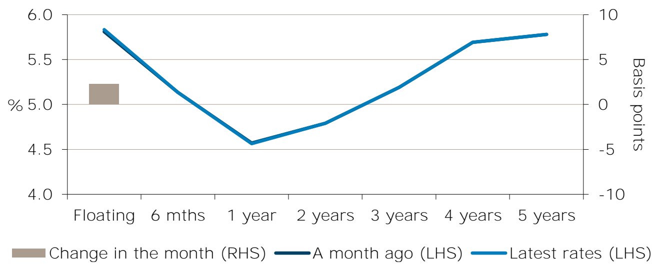


FIGURE 4: NET MIGRATION

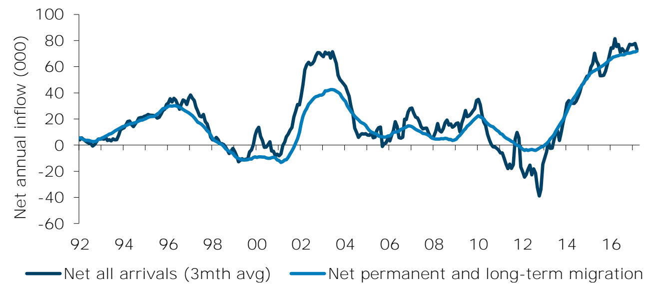


FIGURE 5: HOUSING SUPPLY-DEMAND BALANCE

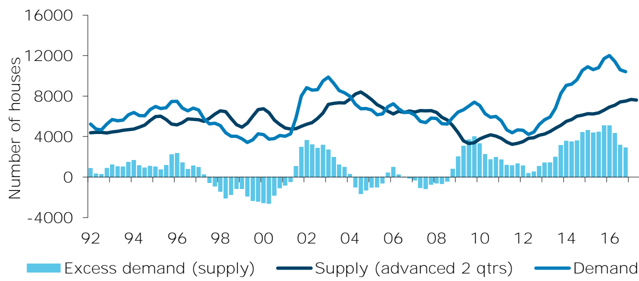


FIGURE 6: BUILDING CONSENTS AND HOUSE SALES

FIGURE 7: LIQUIDITY AND HOUSE PRICES

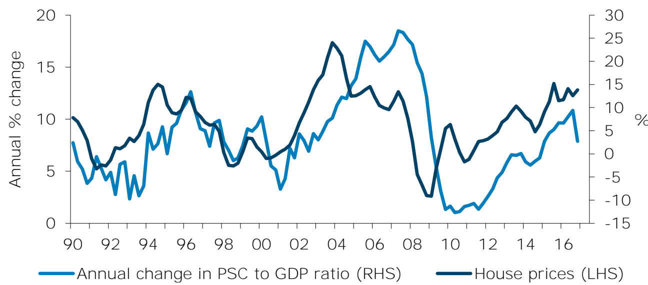


FIGURE 8: HOUSE PRICE INFLATION COMPARISON

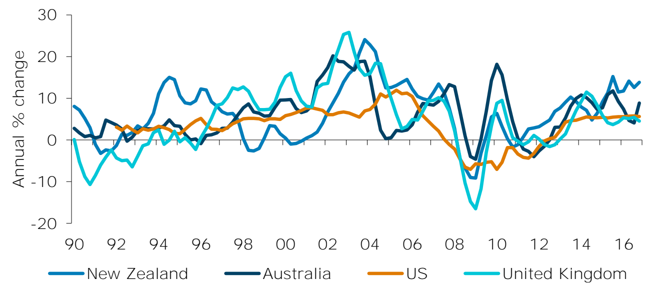


FIGURE 9: HOUSING SUPPLY

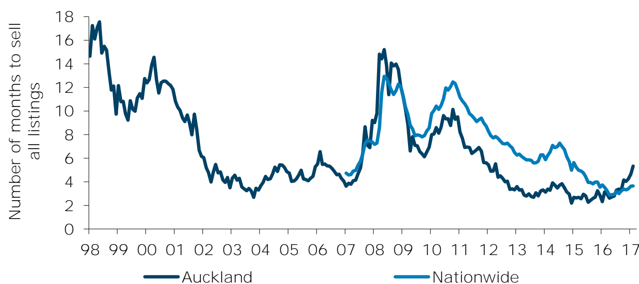
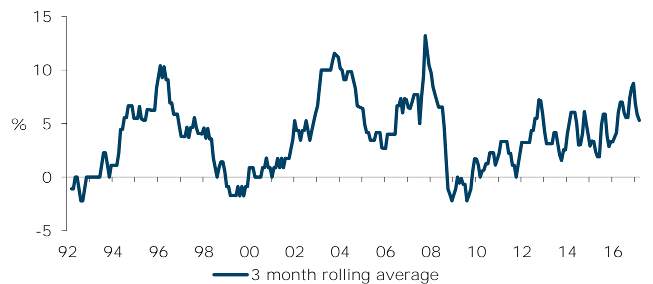


FIGURE 10: MEDIAN RENTAL, ANNUAL GROWTH



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

ECONOMIC OVERVIEW

SUMMARY

The economy is still recording decent momentum, supported by what are now reasonably familiar forces. Late-cycle behaviours are apparent, but unlike historical experience, we do not believe the economy has the same degree of imbalances at this point in the cycle that would typically result in boom/bust type cycle. There are tensions across the economy though, with tighter credit and financial conditions a challenge for the likes of housing supply and a headwind for growth. The next move in the OCR will be upwards, but time remains on the RBNZ side.

OUR VIEW

The economy is recording solid growth. While momentum did slow over late 2016, it is recovering in 2017. We estimate growth has eased from a 3.5-4% mid-2016 pace to 3-3.5% now (a bounce from Q4's 2.7%). The economy continues to be supported by strong migration, construction activity, tourism, broad-based commodity price support and favourable policy settings. Headwinds from low dairy prices are lingering but fading.

With the economy into its eighth year of economic expansion, a key challenge is managing late-cycle behaviours. New Zealand has tended to run in a 10-year business cycle and head into self-inflicted downturns prior to major global events. Finding skilled staff is difficult. Capacity pressures are building. Construction costs have ballooned. Productivity has deteriorated and housing-related excesses have grown, with leverage rising. Historically, in such circumstances the current account deficit has blown out and a housing boom, in conjunction with a consumption boom, has tended to contribute to rising inflation, leading to rapid lifts in interest rates. So far, this hasn't happened, but we can't be complacent.

This business cycle is looking different from the historical experience on six levels:

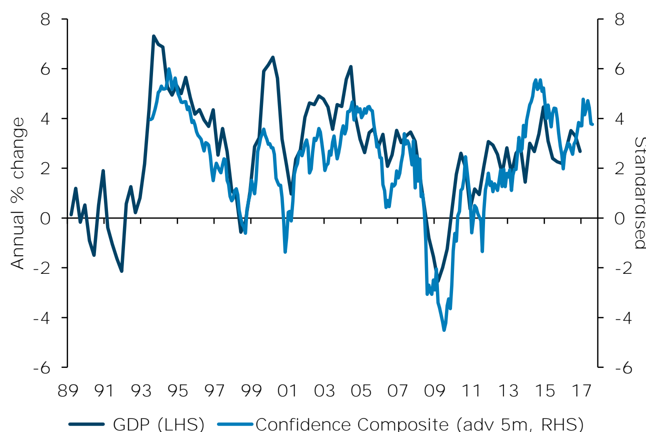
- We have a housing / investment boom but have not seen a consumption equivalent; that's helping to keep inflation at bay (along with other factors).
- We have a shortage of housing as opposed to an excess supply; we still can't build enough.
- We don't have a sizeable shadow banking sector in operation.
- The RBNZ has brought macro-prudential tools to the table, helping curtail housing excesses.
- Banks are actively re-pricing risk and rationing credit late in the cycle.
- Productivity growth is not that weak if natural disasters (i.e. Christchurch) are taken into account.

Such forces naturally lead to tension across the economy. The housing market has slowed – quite suddenly. Less credit will accentuate housing imbalances and will put pressure on the economy to generate more domestic savings to fund its investment needs. Saving for tomorrow means less growth today. However, less growth today means firmer prospects tomorrow with prospects for a less-volatile business cycle, which adds to business certainty and confidence.

The next move in the OCR will be a hike, though time is still on the RBNZ's side.

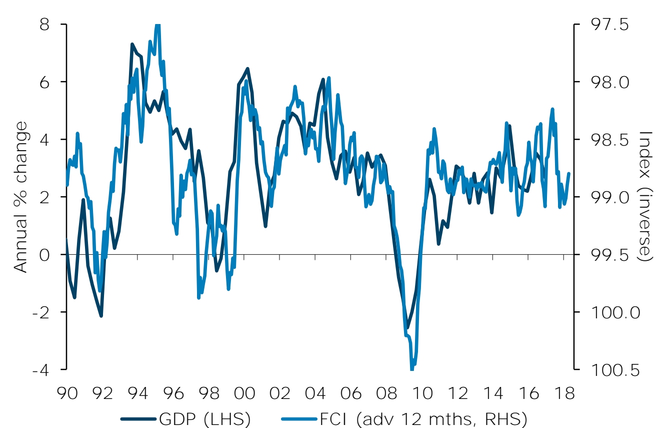
We continue to have concerns over the global economy, which we view as the major economic risk. Productivity is weak. Interest rates need to move up. Demographics are now a headwind. Leverage is high. Policy platforms are poor. The geopolitical situation is fragile. It all adds up to a slow growth rut with lots of volatility.

FIGURE 1. GDP VS CONFIDENCE COMPOSITE



Source: ANZ, Roy Morgan, Statistics NZ

FIGURE 2. GDP VS FINANCIAL CONDITIONS INDEX



Source: ANZ, Statistics NZ, Bloomberg

MORTGAGE BORROWING STRATEGY

SUMMARY

Mortgage rates remain virtually unchanged compared with last month. This is thanks largely to the fact that wholesale interest rates have held steady over that period, having edged up in late 2016 before stabilising of late. The mortgage curve remains tick-shaped, as has been the case for some time now, with the 1 year rate the "low point" on the curve. Intensifying competition for deposits does risk another leg up in mortgage rates given the importance of deposits as a source of funds, but this now looks to be factored into the term structure. As such, in our view, 1 year remains the sweet spot for borrowers. However, longer terms do offer more certainty.

OUR VIEW

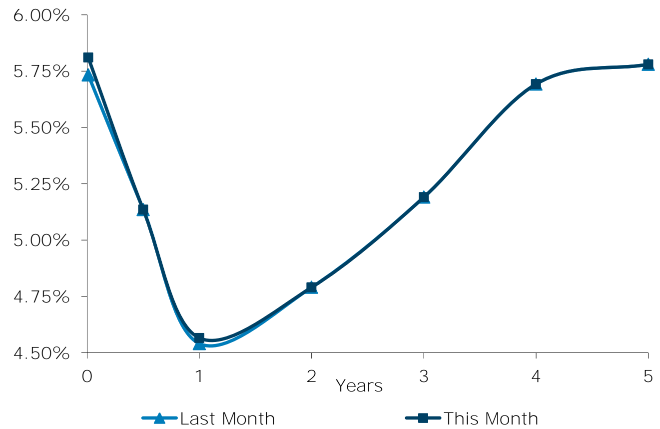
Mortgage interest rates have barely changed over the past month, reflecting a period of stability for wholesale rates and early signs of a cooling off in credit growth. The mortgage curve remains tick-shaped, with **the 1 year rate marking the low point.**

We believe the 1 year remains the sweet spot on the curve. While partly a reflection of the fact that it's the cheapest rate, it's also a reflection of our judgement on the future given what's built into the term structure of interest rates, and where they are headed. That is, after all, more important over the long term. Simply **choosing the cheapest option all the time is the easiest on cashflow initially, but it may not be the best option over the long run.** However, on this occasion it looks to be.

At the moment we see limited benefit in paying a premium to fix for longer. This is because the term structure is building in a more rapid rise in mortgage rates than we expect, implying that it is likely to be cheaper to go for back-to-back 1 year fixes than a single 2 year fix. As an example, if one chose to fix for 2 years at 4.79%, by forgoing the option of fixing for 1 year at 4.57%, mathematically that implies that you expect the 1 year rate to be above 5.02% in one year's time. That could happen, but we believe it's a line call.

Rising wholesale rates are a perennial risk to mortgage rates, but they have tended to fall of late, having followed US bond yields lower during the most recent period of heightened geopolitical risks and softening US economic data. **Conversely, if we were to see a rise in retail term deposit rates, we would likely see a rise in mortgage rates**– such is the importance of term deposits as a source of bank funding. **However, we believe these risks are adequately built into the term structure.** Having said that, **it's not always about cost. Certainty matters, as does "rollover risk"** (i.e. the risk that you have to make another difficult and calculated decision when your existing fixed rate rolls off). One obvious way to avoid this is to split your mortgage into two or three separate tranches, and to roll each tranche separately. **With some banks offering 18 month specials, it may be worthwhile considering splitting your mortgage into three loans; fix a third for 6 months, a third for a year and a third for 18 months, and roll each for a year upon maturity.** That way, **at any point in time you'll always have at least a year of certainty up your sleeve**, and if the curve remains tick-shaped (as it has been for a long time), **you're likely to always be paying a competitive rate.**

CARDED SPECIAL MORTGAGE RATES^



Special Mortgage Rates		Breakevens for 20%+ equity borrowers			
Term	Current	in 6mths	in 1yr	in 18mths	in 2 yrs
Floating	5.83%				
6 months	5.14%	4.00%	4.90%	5.13%	5.79%
1 year	4.57%	4.45%	5.02%	5.46%	5.99%
2 years	4.79%	4.95%	5.50%	6.01%	6.60%
3 years	5.19%	5.49%	6.07%	6.27%	6.44%
4 years	5.69%	5.81%	6.08%		
5 years	5.78%	#Average of "big four" banks			

Standard Mortgage Rates		Breakevens for standard mortgage rates*			
Term	Current	in 6mths	in 1yr	in 18mths	in 2 yrs
Floating	5.83%				
6 months	5.24%	4.75%	5.67%	5.22%	5.90%
1 year	4.99%	5.21%	5.44%	5.56%	6.04%
2 years	5.22%	5.38%	5.74%	5.96%	6.37%
3 years	5.49%	5.71%	6.06%	6.22%	6.49%
4 years	5.79%	5.97%	6.23%		
5 years	5.98%	*may be subject to a low equity fee			

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

KEY FORECASTS

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

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

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

	House prices (ann % chg)	3mth % chg	No of sales (sa)	Mthly % chg	Avg days to sell (sa)
Northland	26.9	4.7	267	-1%	35
Auckland	8.4	-0.7	2,372	+5%	37
Waikato/BOP/Gisborne	17.4	2.5	1,236	+9%	39
Hawke's Bay	24.5	6.8	255	+21%	31
Manawatu-Whanganui	16.4	3.4	383	+18%	33
Taranaki	17.1	0.0	189	-13%	41
Wellington	14.1	2.6	860	+12%	29
Nelson-Marlborough	12.6	3.3	260	+7%	32
Canterbury/Westland	3.5	0.2	1,008	+6%	36
Central Otago Lakes	-2.1	4.0	161	+13%	40
Otago	14.4	4.4	276	+9%	22
Southland	7.0	-4.6	205	+8%	33
NEW ZEALAND	**10.2**	**1.4**	**7,319**	**+6%**	**34**

Key forecasts

	Actual			Forecasts						
Economic indicators	**Jun-16**	**Sep-16**	**Dec-16**	**Mar-17**	**Jun-17**	**Sep-17**	**Dec-17**	**Mar-18**	**Jun-18**	**Sep-18**
GDP (Ann Avg % Chg)	2.7	3.0	3.1	3.1	3.0	3.0	3.1	3.0	2.9	2.6
CPI Inflation (Annual % Chg)	0.4	0.4	1.3	2.2(a)	2.0	2.2	2.0	1.7	2.0	2.1
Unemployment Rate (%)	5.0	4.9	5.2	5.0	4.8	4.7	4.7	4.6	4.5	4.5
Interest rates (RBNZ)	**Jun-16**	**Sep-16**	**Dec-16**	**Mar-17**	**Jun-17**	**Sep-17**	**Dec-17**	**Mar-18**	**Jun-18**	**Sep-18**
Official Cash Rate	2.25	2.00	1.75	1.75	1.75	1.75	1.75	1.75	2.00	2.25
90-Day Bank Bill Rate	2.4	2.2	2.0	2.0	2.0	2.0	2.0	2.1	2.3	2.5
Floating Mortgage Rate	5.7	5.6	5.7	5.8	5.8	5.8	5.8	5.8	6.0	6.3
1-Yr Fixed Mortgage Rate	4.9	4.9	4.9	5.0	5.0	5.1	5.1	5.2	5.3	5.4
2-Yr Fixed Mortgage Rate	5.1	5.1	5.1	5.2	5.4	5.4	5.5	5.6	5.7	5.8
5-Yr Fixed Mortgage Rate	5.6	5.6	5.9	6.1	6.4	6.5	6.6	6.6	6.7	6.8

Source: ANZ, Statistics NZ, RBNZ

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