NEW ZEALAND PROPERTY FOCUS

February 2017

INSIDE

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AN ARM AND A LEG

SUMMARY

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

CHIEF ECONOMIST CORNER: AT WHATEVER COST

There are increasing signs that pro-cyclical parts of the economy – house sales and residential building consent issuance – have weakened. LVR restrictions, difficulty finding skilled labour and credit rationing are some of the constraining factors. Such a deceleration is actually healthy if it can take some pricing heat and speculative excesses out of the market, thereby reducing boom/bust risk. However, less housing supply will hardly do that, and one reason supply looks like it is being curtailed is burgeoning costs, with multi-dwelling consent values per square metre exploding in Auckland of late. Some of that may reflect compositional shifts (ie higher-value units) but that's hardly boosting affordable housing. Market forces, in the form of intra-regional migration and changes in household size, will no doubt partially offset growing imbalances. But the market critically needs more supply, and booming costs make it harder for the numbers to stack up for developers.

PROPERTY GAUGES

The market is taking a well overdue breather as the combination of higher interest rates, LVR restrictions and tighter credit criteria impact. Consolidations invariably follow surges. While the pause is welcome and will likely extend for months to come, a fundamental mismatch between supply and demand will keep the market supported and ready to build more momentum down the track.

ECONOMIC OVERVIEW

The economy is expanding briskly but growth is set to moderate over 2017. Key factors driving this softening include capacity bottlenecks (notably finding skilled labour) and a winding down in credit growth. A moderation is required to ensure no build-up in nasty imbalances that would require purging. The next move in the OCR looks to be up. However, with inflation still low, time is on the RBNZ's side.

MORTGAGE BORROWING STRATEGY

Mortgage rates have risen slightly for most terms over the past month, continuing the trend of gradually rising rates that started in the December quarter. The mortgage curve retains its "tick" shape, and as was the case last month, very little separates 4 and 5 year rates. The 1 year remains the cheapest rate, and although we expect the next move in the OCR to be up (rather than down), the Reserve Bank has flagged that any move will be some time away. Despite our view that interest rates are in a rising environment, this is now adequately factored into the term structure of mortgage rates, suggesting the cheaper 1 year is the "sweet spot" for borrowers.

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SUMMARY

There are increasing signs that pro-cyclical parts of the economy – house sales and residential building consent issuance – have weakened. LVR restrictions, difficulty finding skilled labour and credit rationing are some of the constraining factors. Such a deceleration is actually healthy if it can take some pricing heat and speculative excesses out of the market, thereby reducing boom/bust risk. However, less housing supply will hardly do that, and one reason supply looks like it is being curtailed is burgeoning costs, with multi-dwelling consent values per square metre exploding in Auckland of late. Some of that may reflect compositional shifts (ie higher-value units) but that's hardly boosting affordable housing. Market forces, in the form of intra-regional migration and changes in household size, will no doubt partially offset growing imbalances. But the market critically needs more supply, and booming costs make it harder for the numbers to stack up for developers.

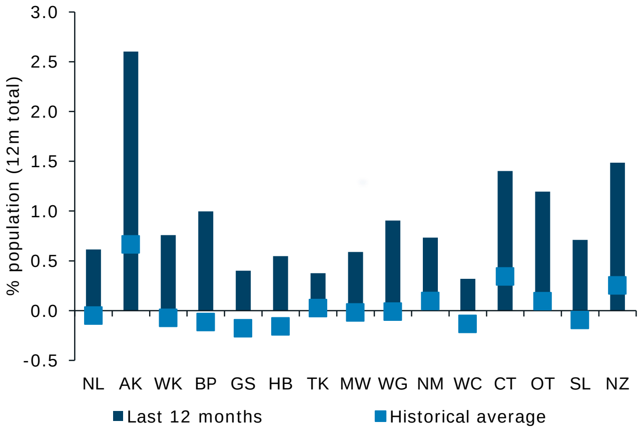
INTRODUCTION

The demand for housing is strong, particularly in Auckland. Current annual net international migrant inflows into Auckland are equivalent to 2½% of the resident population. That compares with 1½% for the country as a whole. Statistics NZ 2015 projections suggested that under its "medium" assumptions for fertility, mortality and net migration, Auckland's population would grow by a further 600k people (37%) by 2043. Right now, the region's population is not only tracking north of that projection, but is actually north of Statistics NZ's "high" scenario (where the population is projected to grow by a further 50% by 2043). That will place huge pressure on both housing and infrastructure.

This strong demand outlook is before you even consider whether or not there is a shortage of dwellings to begin with in Auckland. We believe there is, perhaps around 20-25k, but the exact figure is open to plenty of conjecture and critically dependent on some key assumptions.

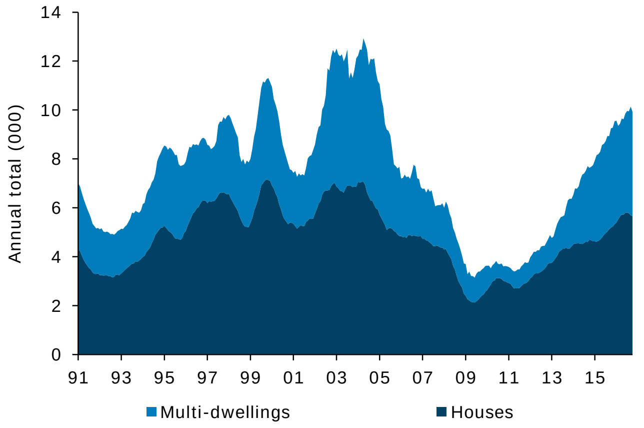
The supply side is responding. Over 2016, Auckland dwelling consents totalled close to 10k, which is the highest since 2004. Consents for multi-dwelling units made up 43% of that (the highest share since 2005), so there is increased evidence of intensification, which is what the region needs to see. But of course, part of this growth just reflects catch-up after a material period of underinvestment since around the middle of last decade. Eyeballing the chart below shows that while consents have been trending up, it's still a way off prior peaks and that's before we make an allowance for population growth over the period.

FIGURE 1: REGIONAL NET INTERNATIONAL MIGRATION



Source: ANZ, Statistics NZ

FIGURE 2: AUCKLAND DWELLING CONSENTS ISSUED



Source: ANZ, Statistics NZ

Given the growth picture, chinks in the supply response is the last thing needed right now, but that's precisely what is happening.

There are increasing reports of residential development projects being delayed or canned. Although the annual total charted above is holding up, our estimates of seasonally adjusted Auckland consent issuance show it actually falling in four of the past six months, to be down around 20% since June 2016 (see figure 3 over). That's a material drop. The Auckland housing market has cooled too, with the volume of turnover falling for its ninth consecutive month in January (in seasonally adjusted terms), and the Auckland market being one of only two regions where houses are now taking longer to sell than their historical average (the other is Canterbury).

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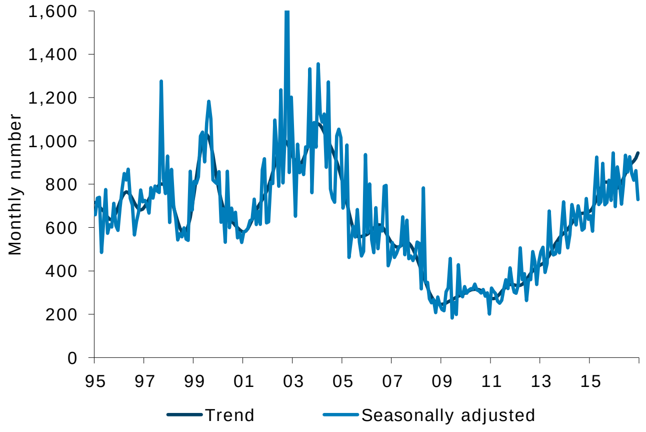
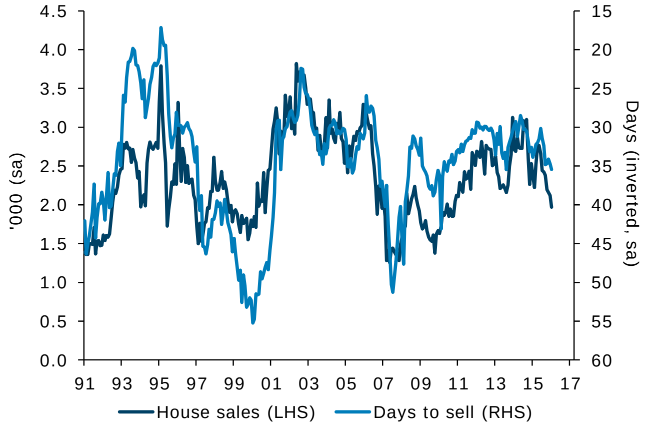
FIGURE 3: AUCKLAND DWELLING CONSENT ISSUANCE



Source: ANZ, Statistics NZ

FIGURE 4: AUCKLAND HOUSE SALES AND DAYS TO SELL



Source: ANZ, REINZ

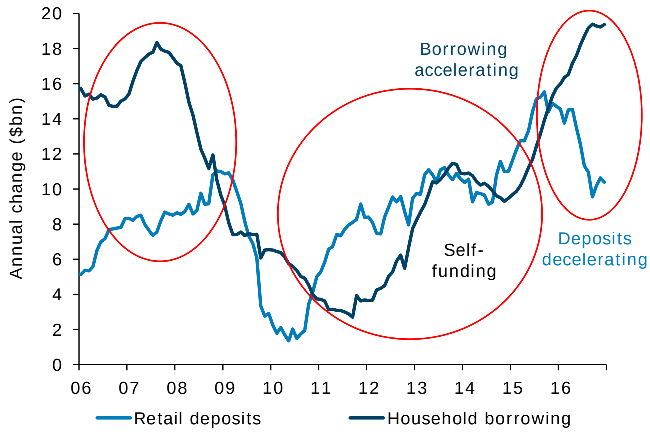
Some will be noise versus signal. Regional consents data is incredibly volatile on a monthly basis, so plenty of caution about making strong conclusions is necessary. Moreover, the reasons for project cancelations can be numerous and in many cases unrelated. **But we do believe the overall message of a weakening in the supply picture is consistent with some key challenges that the construction and housing sector is being forced to grapple with right now.**

The finger can be partly pointed at skilled labour shortages; demand across the construction sector is booming all over. But that would see activity level out, as opposed to driving a drop. We believe there are some other factors at play.

Credit is being rationed. That's prudent at the top of the cycle and also necessary to rein in a wide bank 'funding gap', with deposit growth still trailing credit growth. In household parlance, that's more money going out the door than is coming in. Banks can fill such a gap temporarily by borrowing offshore, but it would not be in New Zealand's long-term interest to let such a gap persist. The current account (external debt levels) would blow out, New Zealand's credit rating would likely get reviewed, and inflation would turn up if a spending boom were to join the housing equivalent, necessitating higher interest rates. Credit-driven booms invariably end in a bust as the piper gets paid.

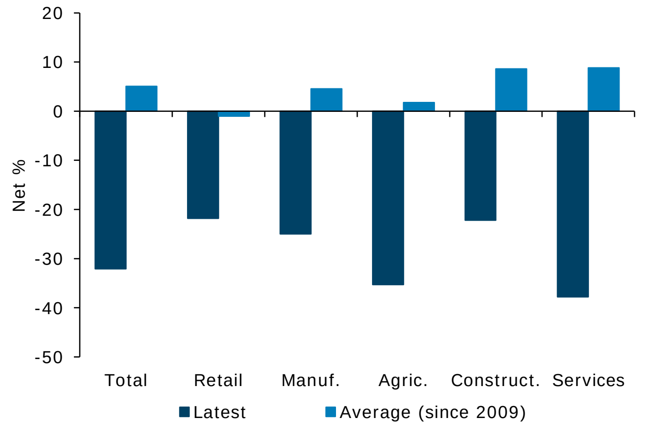
In playing the long game though, less credit makes it more difficult for pro-cyclical components of the economy, such as housing and construction. A net 32% of respondents to our Business Outlook survey reported finding it more difficult obtaining credit in December, the highest since we began asking this question in 2009. **So it's having an impact, though we note the construction sector is not the most bearish on obtaining credit;** a net 22% of construction firms reported it as more difficult getting credit. The sector finding it most difficult is actually services.

FIGURE 5: BANK FUNDING AND CLAIMS GROWTH



Source: ANZ, Statistics NZ

FIGURE 6: ANZBO NET DIFFICULTY IN OBTAINING CREDIT



Source: ANZ

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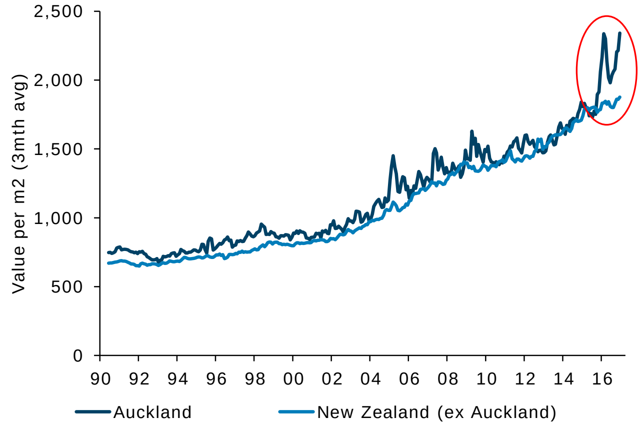
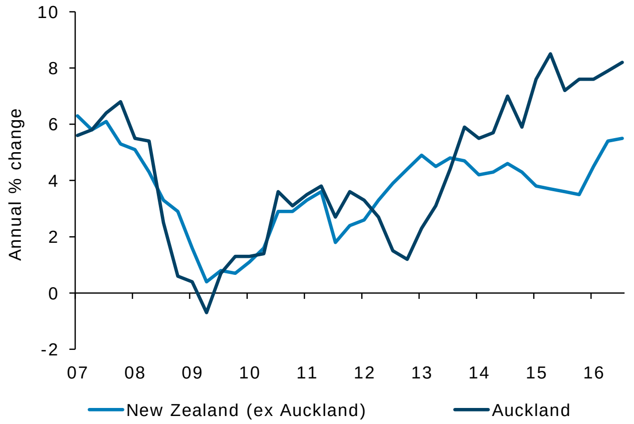
An emerging canary in the coalmine is construction costs, which have exploded, making the viability of projects (and also obtaining credit) more challenging. You can see this in the difference in consent value per square metre in Auckland versus the rest of the country. It has always been a little more expensive to build in Auckland, but the gap is now historically wide, with Auckland around $2,400/m^2 and the rest of the country less than $1,900/m^2 (note these are consented figures and not actual costs; it is not the final word, but a useful gauge). It certainly fits with the Q4 CPI figures that showed implied construction costs rising 8.2% y/y in Auckland versus 5.5% y/y growth in the rest of the country.

FIGURE 7: CONSENT VALUE PER SQUARE METRE



Source: ANZ, Statistics NZ

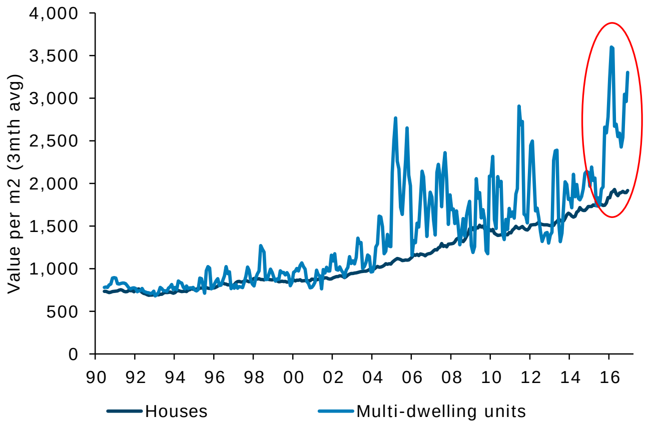
FIGURE 8: REGIONAL CONSTRUCTION COST INFLATION (CPI)



Source: ANZ, Statistics NZ

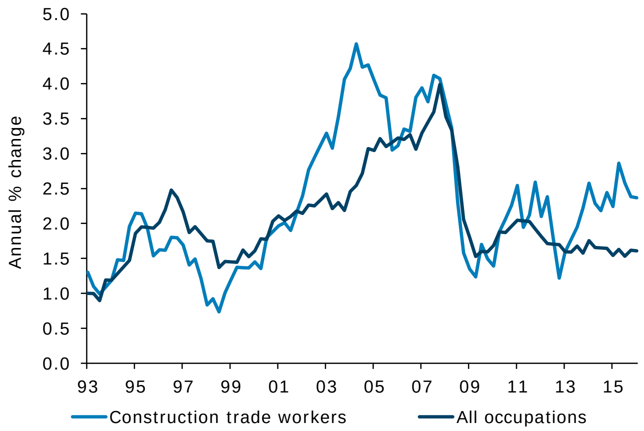
The majority of this cost escalation is in the multi-dwelling space. Compared with 'houses', which have seen costs rise steadily over time in Auckland (to about $1,900/m^2), the value of consents per square metre for multi-dwelling units has surged to over $3,500/m^2. Now to be fair, with many developments (apartment developments especially) occurring in the CBD or city fringe, elevated land values means it just doesn't make sense to build low-value dwellings. You need to earn a return somehow. So part of the increase is likely compositional. Yet that's a huge surge and costs appear to have got to the point where these projects are becoming increasingly difficult to make "work" from a risk-return perspective.

FIGURE 9: AUCKLAND CONSENT VALUE PER SQUARE METRE



Source: ANZ, Statistics NZ

FIGURE 10: SECTORAL LCI WAGE INFLATION



Source: ANZ, Statistics NZ

It all points to intensifying dwelling supply growth headwinds. In fact, there is a risk that the above pressures actually result in a slower rate of dwelling construction over the coming months. And we haven't gone too far into things like the difficulties the construction sector is having in finding skilled staff (seeing construction sector wage inflation outperform nationwide rates – figure 10), which is also constraining its ability to respond to demand. At a time when net migration inflows are showing few signs of turning, a weaker supply story certainly

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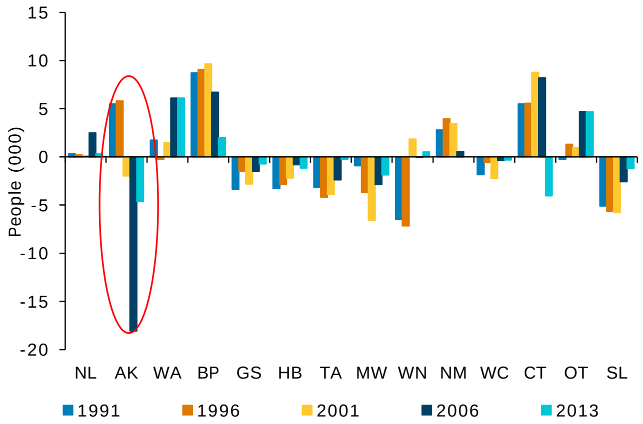
doesn't paint a picture of Auckland housing imbalances and affordability challenges improving – let alone being solved – any time soon.

Now there are ways for 'the market' to at least partially offset this imbalance. These include:

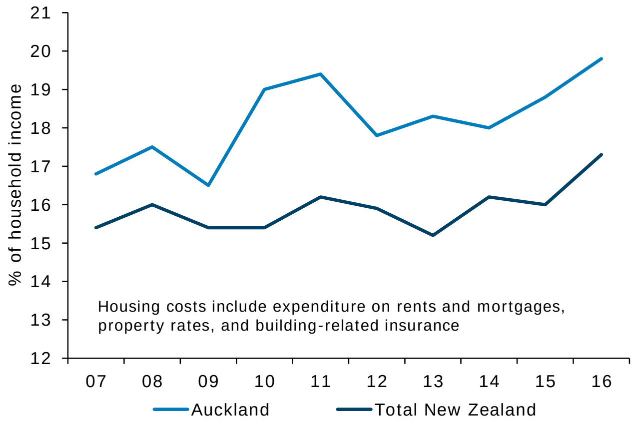
- **Increased inter-regional migration.** Unfortunately data is limited on this front. But the last three censuses showed that relative to the prior five-year period, the Auckland region experienced a net outflow of residents to other regions. Admittedly, the numbers are small (-18k in 2006; -5k in 2013) and major beneficiaries have been the outer Auckland ring (Waikato, Bay of Plenty). However, we'd expect that as Auckland's cost of living continues to rise relative to other regions, the attractiveness of moving will increase. Eventually the maths becomes hard to ignore; Auckland house prices trade at a multiple of 9 times incomes; the rest of New Zealand sits at less than 6. Aucklanders already spend close to 20% of their weekly disposable incomes on housing-type costs compared with 17.3% for New Zealand as a whole. So while employment opportunities are of course a relevant consideration, the Auckland region is not a big sucking vortex everyone shifts to; people are more likely to depart, particularly retirees or others who do not need to be located close to employment opportunities. That's economic rationality in operation; when the relative price of one thing turns prohibitive (i.e. an Auckland house), the relative price of another (a house in another region) becomes more attractive. Moreover, high housing costs make it difficult to attract and retain employees. Not to mention time stuck on the motorway getting to and from work.

FIGURE 11: INTER-REGIONAL MIGRATION (5-YEARS)



Source: ANZ, Statistics NZ

FIGURE 12: TOTAL HOUSING COSTS



Source: ANZ, Statistics NZ

- **Larger household sizes.** At an average of 3.0 people per house at the time of the 2013 census, Auckland already had the largest average household size of any region. It compares with an average of 2.6 people per house across the rest of the country. Additionally, this figure has been rising in Auckland, whereas it has been falling in nearly every other region (of course such "intensification" will partly reflect affordability issues; higher house prices "force" larger household sizes). Rates of household formation are quite sensitive to assumptions on this front. For example, under Statistics NZ's "high" population projections described earlier, Auckland household formation would be around 10k per year if the number of people per house stayed at 3.0. It would fall to around 9.3k per year if it rose to just 3.2 people per house. And it is only natural to think that with Auckland's increasing housing affordability problem that children would live with their parents for longer or people look to increasingly share accommodation (flatmates etc). However, it could be even more fundamental than that because the ethnic make-up of Auckland's population is also projected to change dramatically over the coming three decades. Whereas those who identify themselves as Asian, Pacific Islander or Maori made up 49% of Auckland's population in 2013, this is projected to grow to 65% by 2038 and these ethnicities have historically had more people per house than the European equivalent.[1]

[1] Please note, some people identify with more than one ethnicity so these shares should be treated as indicative only.

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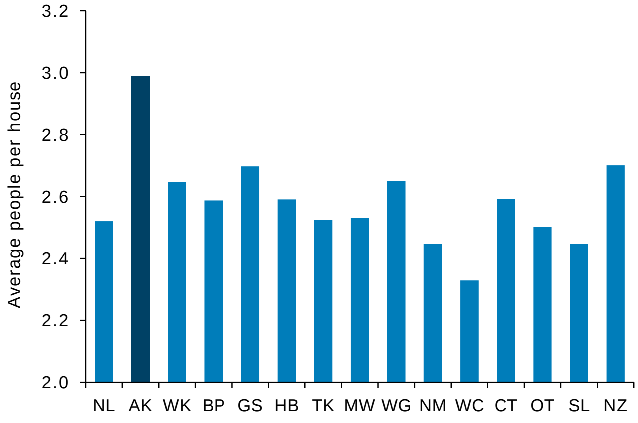
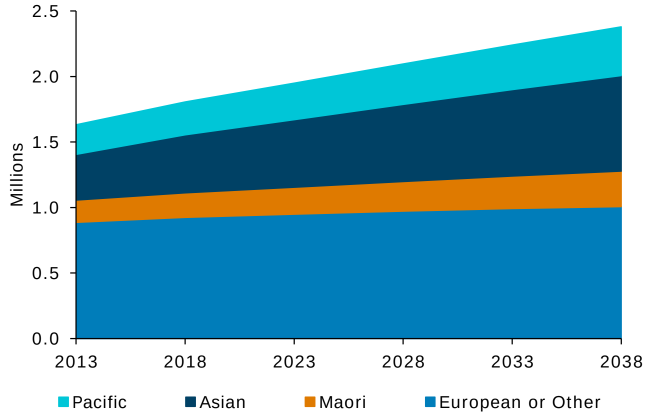
FIGURE 13: AVERAGE PEOPLE PER HOUSE (2013)



Source: ANZ, Statistics NZ

FIGURE 14: STATISTICS NZ AUCKLAND POPULATION PROJECTIONS (BY ETHNICITY)



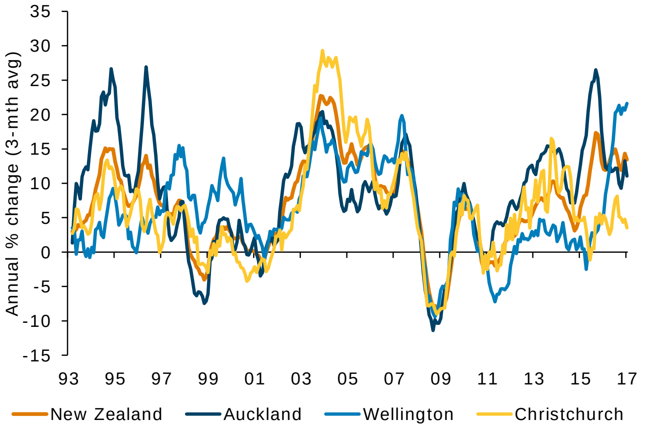
Source: ANZ, Statistics NZ

So there are some ways in which the market could naturally adjust and take some heat out of the demand-supply imbalance. However, we would certainly view this as 'at the margin' rather than changing the story significantly.

What, then, could this all mean for the outlook for Auckland house prices? Well the market has undeniably cooled over recent months. Turnover is down close to 20% since August. Price growth has softened too. We are a little cautious about placing too much weight on the latest figures, but the REINZ Stratified House Price Index actually fell 6.2% m/m in January, the largest monthly fall since 1999. This can arguably all be seen in the context of more restrictive macro-prudential measures, recent lifts in mortgage rates, affordability headwinds and possibly the impact of stricter Chinese capital controls. **However, it is hard to see weakness, especially in prices, extending too far, when the demand/supply picture doesn't look set to normalise any time soon given increasing supply-side headwinds.**

THE PROPERTY MARKET IN PICTURES

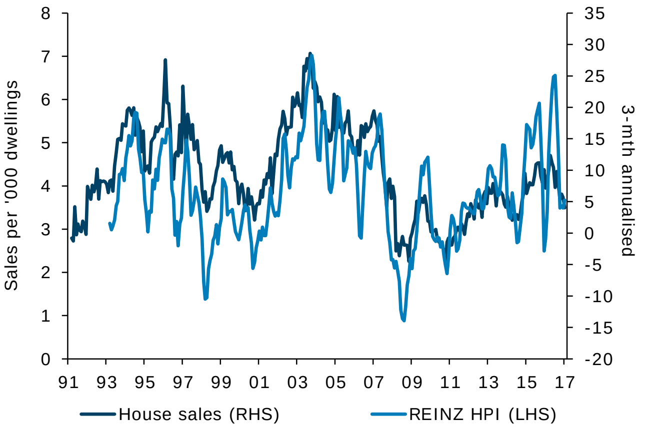
FIGURE 1. REGIONAL HOUSE PRICES



Source: ANZ, REINZ

After rising for four consecutive months, nationwide house prices eased in January. Our preferred measure of prices (the REINZ stratified measure) showed nationwide prices falling 0.9% m/m (sa) in January. The fall was especially pronounced in Auckland (-6.2% sa). Plenty of caution is needed in interpreting figures at this time of year given lower levels of activity and unstable seasonal patterns. Nevertheless, it is clear that momentum in price growth has slowed. On a 3-month annualised basis, nationwide prices are running at 5.2%, which is down from over 25% over mid-2016. Auckland and Christchurch prices are down 1.1% and 4.1% respectively. Wellington is clearly outperforming, with growth of 17%.

FIGURE 2. REINZ HOUSE PRICES AND SALES



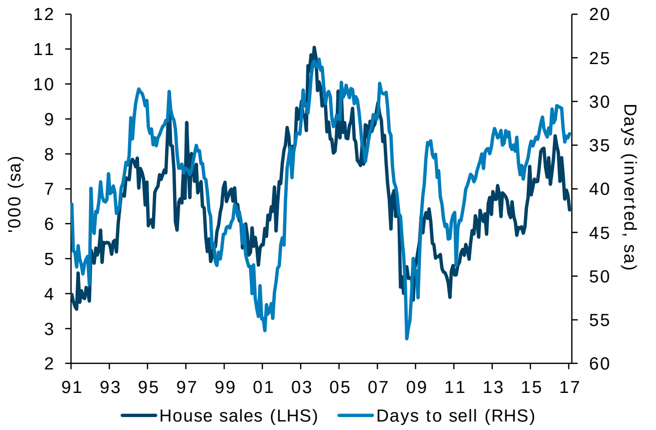
Source: ANZ, REINZ

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

Seasonally adjusted sales volumes fell 6.3% m/m in January. This is the seventh fall in the past nine months, with turnover down 25% over that period. This weakness is relatively broad-based. Auckland volumes are down 29%, while ex-Auckland volumes are down 23% over the same period.

The softer trend in sales activity hints at a continuation of the recent moderation in house price growth going forward. That said, with some of it likely due to a lack of available property listings, there are still some price-supportive elements to it.

FIGURE 3. SALES AND MEDIAN DAYS TO SELL



Source: ANZ, REINZ

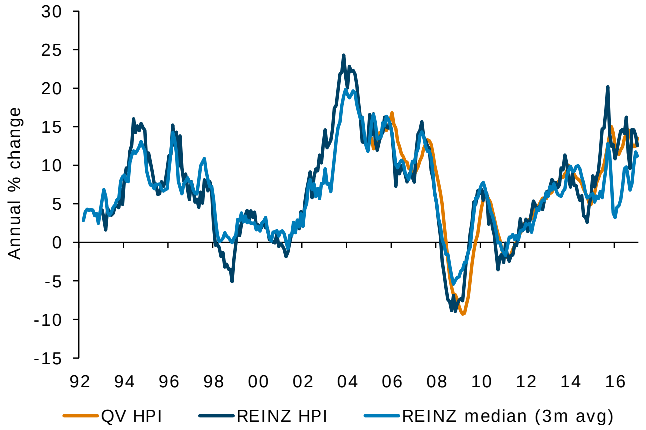
The length of time it takes to sell a house is also an indicator of the strength of the real estate market. It encompasses both demand and supply-side considerations.

Nationally, the median time to sell a house was little changed at 33.7 days (sa) in January. While this is not quite its recent high of 34.6 days seen in October, it is still well up from its mid-2016 lows of close to 30 days.

Interestingly, the median time to sell a property is still below historical averages in every region with the exception of Auckland and Canterbury (35.4 and 35.8 days respectively).

THE PROPERTY MARKET IN PICTURES

FIGURE 4. REINZ AND QV HOUSE PRICES

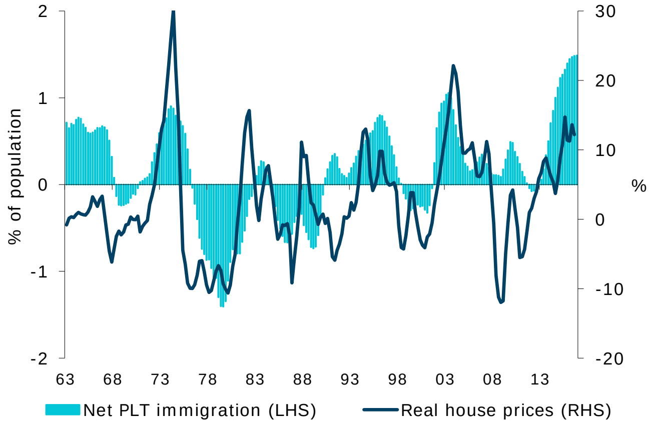


Source: ANZ, REINZ, QVNZ CoreLogic

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 has dipped off its September record high of $516k sa **but was still up 9% y/y in January.** This remains modestly below the REINZ stratified measure and QVNZ measures of price growth (11% and 12% y/y respectively), which both adjust for changes in the quality of houses sold.

FIGURE 5. NET PLT IMMIGRATION AND HOUSE PRICES



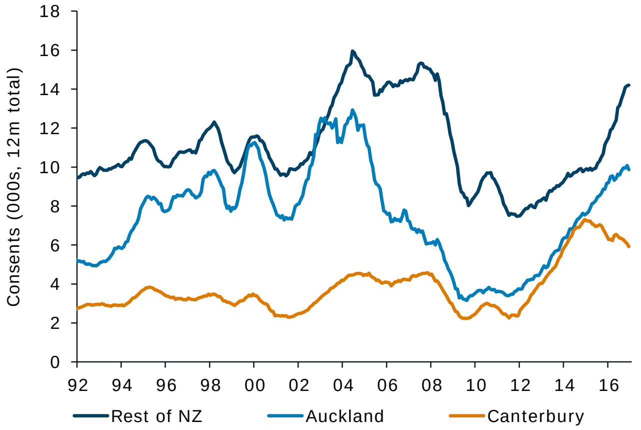
Source: ANZ, Statistics NZ, QVNZ

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 was close to 74k in December, which is near all-time highs and around 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 is the dominant factor.

We are not expecting annual net inflows to ease back to the long-run average of around 15k any time soon. Due to its current 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

Seasonally adjusted dwelling consent issuance fell 7.2% m/m in December, which follows a 9.6% m/m drop in November. Apartments largely accounted for the weakness, falling 31% m/m and 13% m/m respectively in each of these months. Consents for 'houses' rose 3.5% m/m in December. Monthly data is volatile, so caution is needed about drawing strong conclusions too soon, but it does hint at a softening trend in issuance – despite the fact that issuance totalled 30k over the year, which is the highest number since 2004. There are some hints that weakness is occurring in Auckland, joining a clearly softening trend in Canterbury.

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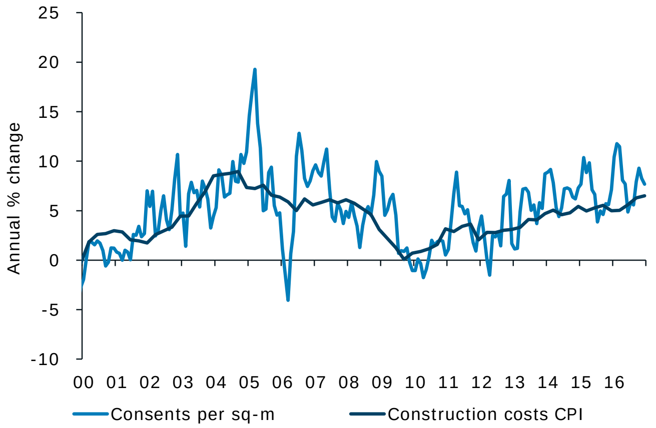
FIGURE 7. CONSTRUCTION COST INFLATION

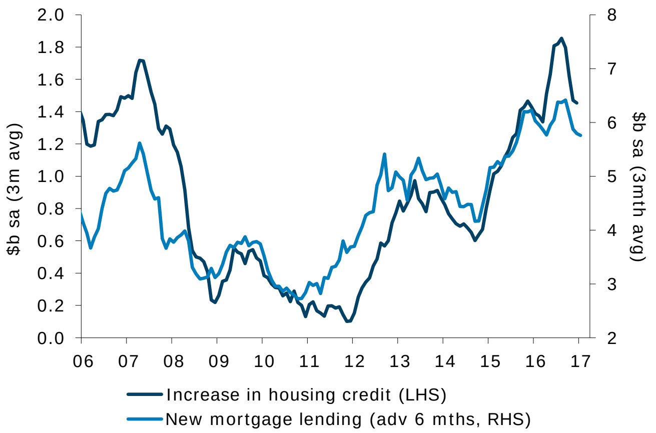


Source: ANZ, Statistics NZ

On a three-month average basis, **the value of residential consents per square metre was up 7.7% y/y in December.** This is a little lower than in November, but is still trending higher and is consistent with the trend seen in the construction cost component of the CPI, which sat at 6.5% y/y in Q4 (8.2% y/y for Auckland). Costs per square metre in Auckland (especially in the multi-dwelling space) have lifted especially strongly of late.

Our internal anecdotes continue to highlight that capacity pressures in the construction sector are fairly intense. Forward books are generally full, and in some cases work is reportedly being turned away. Difficulty finding staff is a common theme in the sector.

FIGURE 8. NEW MORTGAGE LENDING & HOUSING CREDIT



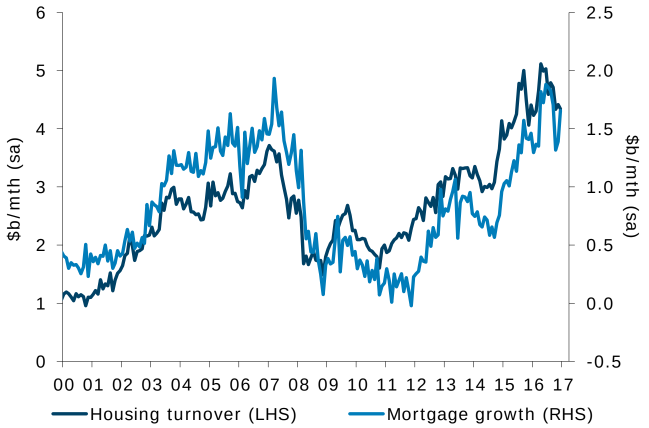
Source: ANZ, RBNZ

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

New mortgage lending has eased off its highs over the past few months. In December, we estimate new lending was $5.77bn. That is still a strong figure, although in 3-month average terms, the rate of growth is softening, albeit gradually, with the $5.76bn rate the softest since August 2015.

Compositionally, there has been a shift away from investors (where new lending is down 22% y/y) toward first-home buyers, where new lending is running at a 16% y/y pace. Nevertheless, the rate of new lending growth is still consistent with the growth in overall housing credit having passed its zenith.

FIGURE 9. HOUSE TURNOVER AND MORTGAGE GROWTH



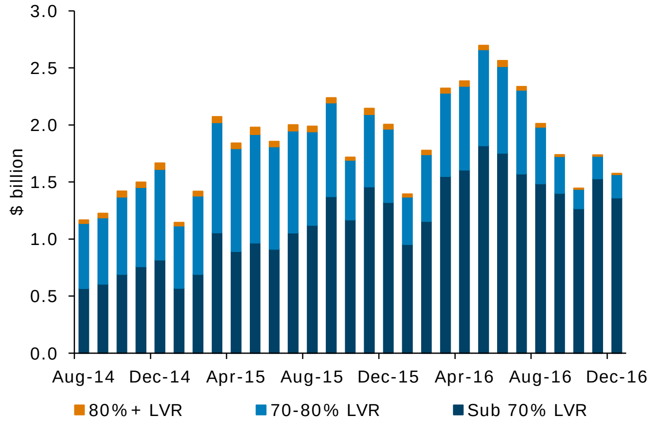
Source: ANZ, REINZ, RBNZ

The overall stock of mortgages has been growing strongly, but growth does appear to have peaked. While December looks to have been a strong month, the 3-month annualised pace of growth has eased to 7.9%, which, while still strong, is off its highs and the softest since April 2016.

The latest tightening of the high-LVR lending restrictions – together with increased credit rationing by banks – appears to be having a marked impact on both house sales and credit availability. Add in recent increases in mortgage rates, and we expect to see mortgage borrowing growth moderate further over the coming months.

THE PROPERTY MARKET IN PICTURES

FIGURE 10. INVESTOR LENDING BY LVR

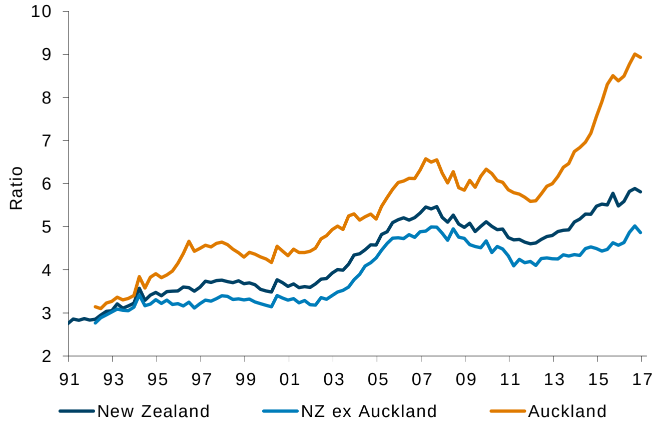


Source: ANZ, RBNZ

New lending to investors is well off its peak. While investor lending is up from its October level (perhaps partly seasonal), it is still 22% below levels 12 months prior, and its share of overall new lending, at 27%, 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.

Following on from 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 14% of the total in December, down from 33% in July and over 50% in mid-2015. That said, of new investor lending, 53% was on interest-only terms. This ratio has been above 50% in every month since July 2015.

FIGURE 11. REGIONAL HOUSE PRICES TO INCOME

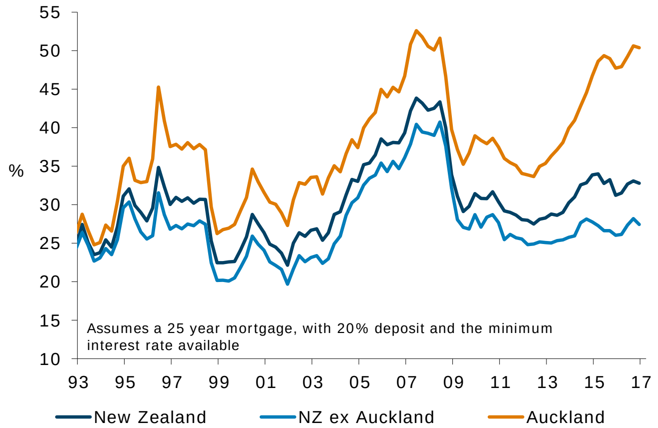


Source: ANZ, REINZ, Statistics NZ

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 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 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 52% 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

The market is taking a well overdue breather as the combination of higher interest rates, LVR restrictions and tighter credit criteria impact. Consolidations invariably follow surges. While the pause is welcome and will likely extend for months to come, a fundamental mismatch between supply and demand will keep the market supported and ready to build more momentum down the track.

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	Unaffordable	↔/↓	People are stilling borrowing at a faster rate than income growth
Serviceability/ indebtedness	Deteriorating	↔/↓	Higher interest rates and more debt is not a great combination
Interest rates / RBNZ	Off lows but still low	↓	Lows for mortgage rates are behind us and banks have lifted rates as competition for deposits remains intense, but RBNZ is in no hurry to lift the OCR.
Migration	NZ is Godzone	↔/↑	Political ructions elsewhere will continue to encourage people to NZ’s shores.
Supply-demand balance	Excess demand	↔/↑	Demand is outstripping supply still and the latter looks to be slowing.
Consents and house sales	Shortage	↔/↑	Consents turning over; a worrying sign
Liquidity	Tight	↓	LVR restrictions are biting and banks are curtailing supply of credit
Globalisation	Liquorice allsorts	↔	Auckland (9 times income) no longer looks cheap on a global comparison but the rest of NZ does (5 times).
Housing supply	Still too low	↔/↑	Less credit + higher costs + no labour = less supply
House prices to rents	Mismatch	↔/↓	Rents not keeping pace with house prices
On balance	**Flat-lining**	↔	**Market taking a long overdue breather**

PROPERTY GAUGES

FIGURE 1: HOUSING AFFORDABILITY

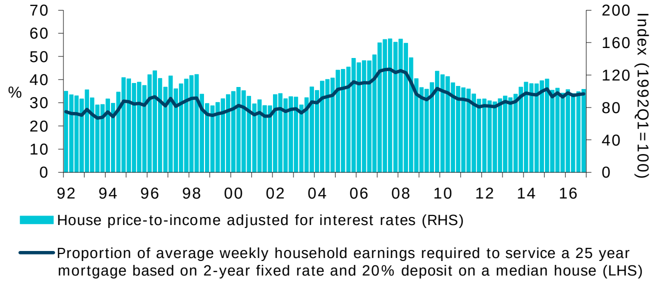


FIGURE 2: SERVICEABILITY AND INDEBTEDNESS

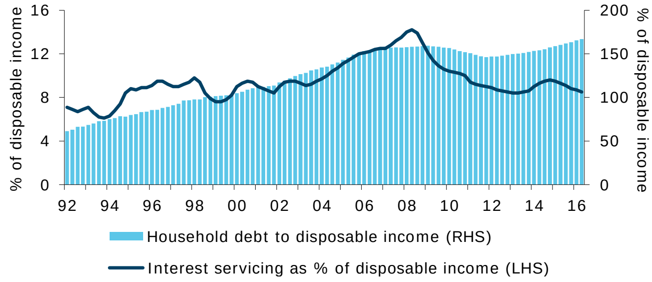


FIGURE 3: NEW CUSTOMER AVERAGE RESIDENTIAL MORTGAGE RATE (<80% LVR)

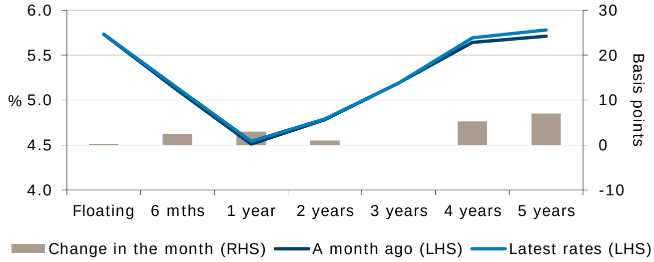


FIGURE 4: NET MIGRATION

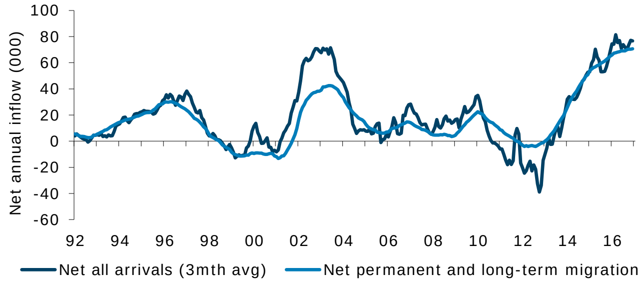


FIGURE 5: HOUSING SUPPLY-DEMAND BALANCE

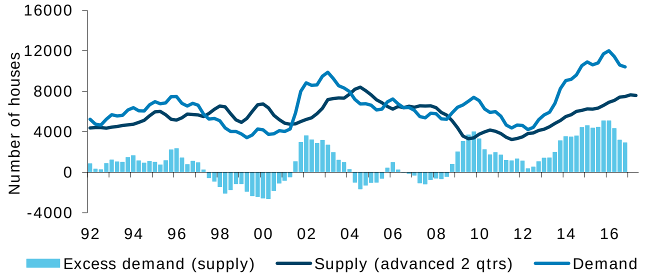


FIGURE 6: BUILDING CONSENTS AND HOUSE SALES

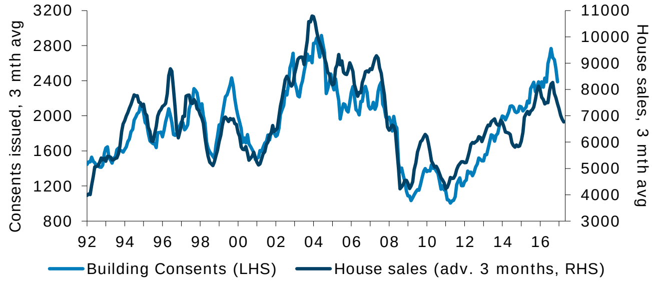


FIGURE 7: LIQUIDITY AND HOUSE PRICES

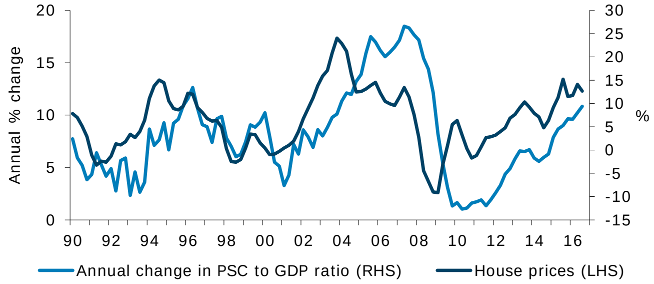


FIGURE 8: HOUSE PRICE INFLATION COMPARISON

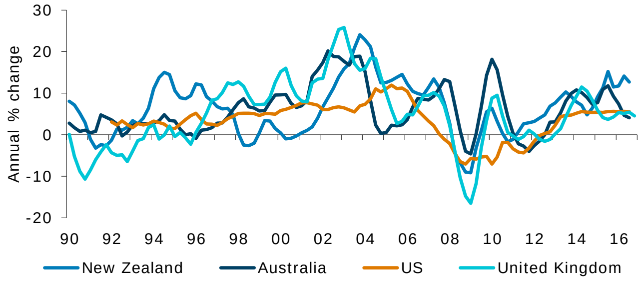


FIGURE 9: HOUSING SUPPLY

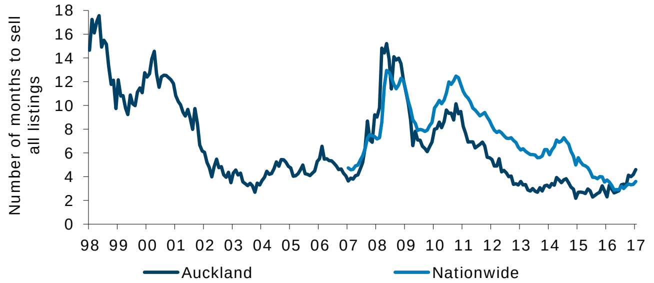
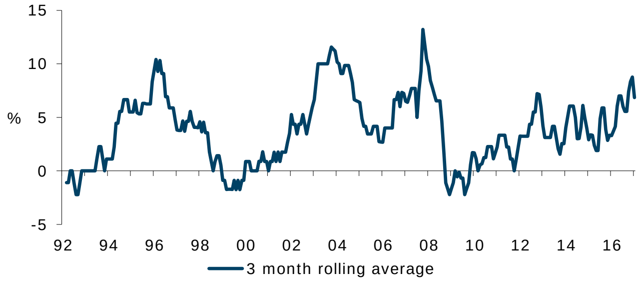


FIGURE 10: MEDIAN RENTAL, ANNUAL GROWTH



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

ECONOMIC OVERVIEW

SUMMARY

The economy is expanding briskly but growth is set to moderate over 2017. Key factors driving this softening include capacity bottlenecks (notably finding skilled labour) and a winding down of credit growth. A moderation is required to ensure no build-up in nasty imbalances that would require purging. The next move in the OCR looks to be up. However, with inflation still low, time is on the RBNZ's side.

OUR VIEW

The economy is growing above trend, eating into spare capacity. Key growth drivers include booming migration, strong construction activity, lifts in tourism activity and earlier supportive financial conditions. However, the story is far broader than these factors alone, with across-the-board strength across sectors and regions. **Business and consumer confidence are both elevated and firms are employing.**

We project GDP growth of around 3% over the year ahead. Our confidence composite gauge is pointing towards even stronger growth. Job ads remain on a positive trend. Income growth is running in excess of 5%. Headwinds from low dairy prices have dissipated (New Zealand's terms of trade have started to lift again) though some cash flow pressures remain. However, financial conditions have tightened somewhat and our Truckometer's Light Traffic Index has moderated.

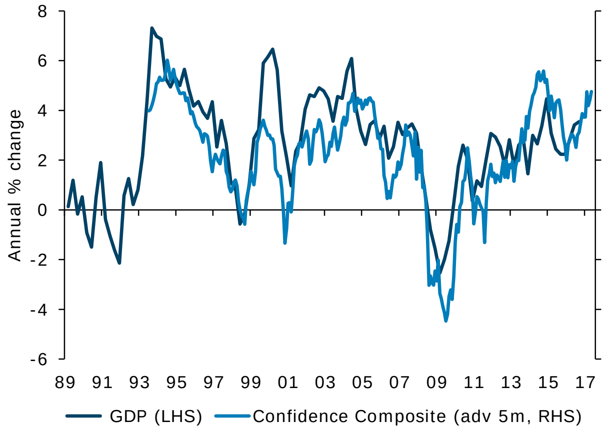
We expect a 'gallop to a canter' style moderation in growth over 2017. Key influences include:

- **Capacity bottlenecks.** Firms are finding it more difficult to find skilled staff, notably in sectors such as construction. The task of filling this void will increasingly fall on offshore labour, but the migration lever faces political sensitivities. Finding skilled staff is now the biggest constraint on business according to our Small Business Monitor. The job vacancy rate (the ratio of jobs advertised to the working age population) is the highest we have seen since 1994; that flags pressure for wages to rise and the unemployment rate to fall.
- **Slower credit growth.** The financial sector continues to manage a mismatch between strong credit growth and more modest deposit growth. The former needs to slow and latter needs to rise. A failure to do so risks extending imbalances across the economy (lifting dependence on offshore funding, increasing leverage, higher inflation, and a likely blow-out in the current account deficit). Such imbalances would lift the risk of an economic correction in the future and a larger swing in the economic cycle (which has been the historical tendency). A side effect of dampening credit growth will be less activity growth (and housing supply).

The next move in the OCR will likely be a hike, though time is still on the RBNZ's side. Inflation is still low, the NZD is still high (with a strong economy supporting it), and banks are lifting retail interest rates, doing the RBNZ's job for it.

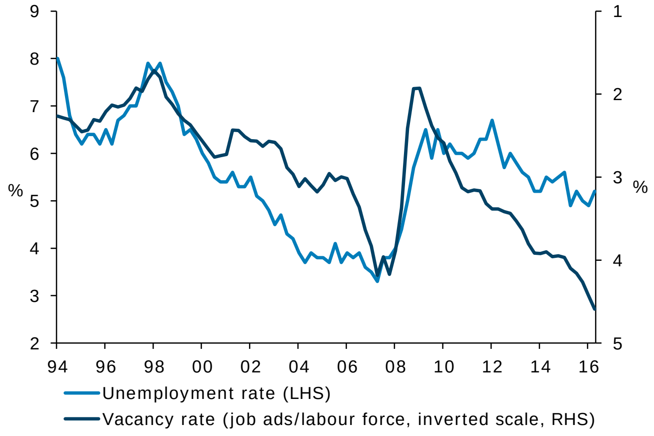
The biggest risk facing the economy is the global scene, which continues to perplex us. Emerging market Asia has high leverage. Europe faces structural and political challenges. Market distortions are aplenty. Low interest rates are creating imbalances. Western countries face a demographic headwind courtesy of slower working age population growth and more retirees. The social contract between mainstream politics and the electorate is broken. That's not a great recipe for good policy outcomes.

FIGURE 1. GDP VS CONFIDENCE COMPOSITE



Source: ANZ, Roy Morgan, Statistics NZ

FIGURE 2. ANZ JOB AD VACANCY RATE AND THE UNEMPLOYMENT RATE



Source: ANZ, Statistics NZ, Seek, Trade Me

MORTGAGE BORROWING STRATEGY

SUMMARY

Mortgage rates have risen slightly for most terms over the past month, continuing the trend of gradually rising rates that started late last year. The mortgage curve retains its "tick" shape, and as was the case last month, very little separates 4 and 5 year rates. The 1 year remains the cheapest rate, and although we expect the next move in the OCR to be up (rather than down), the Reserve Bank has flagged that any move will be some time away. Despite our view that interest rates are in a rising environment, this is now adequately factored into the term structure of mortgage rates, suggesting the cheaper 1 year is the "sweet spot" for borrowers.

OUR VIEW

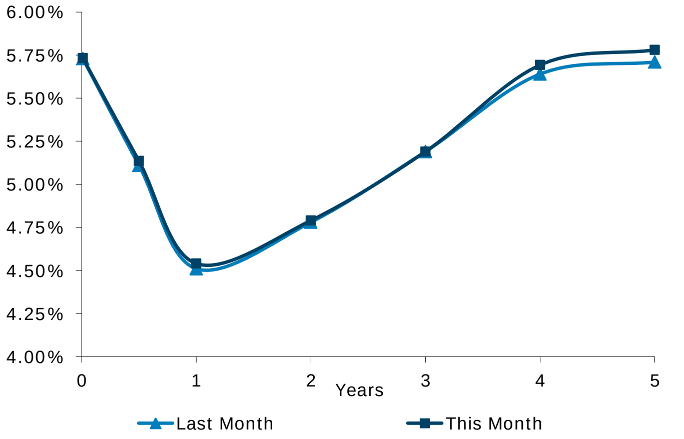
Mortgage interest rates have been climbing for some months now, having bottomed out late in 2016. Increases in average rates observed over the past month have been mild, with no change in the average floating rate, and rises of 3 to 7 points seen across fixed rates. Consequently, the mortgage curve retains its tick shape, and the 1 year remains the sweet spot (from a pure price perspective).

Although there is only 0.25%pts separating the average 1 and 2 year rate, on balance we believe that's enough to make the 1 year the better choice. Admittedly, there's not much in it, but with the Reserve Bank reiterating that it is in no hurry to raise the OCR, back-to-back 1 year rates are likely to end up being less costly than a single 2 year term. As our breakevens show, you'd need to see the 1 year rate rise by 0.5% (from 4.54% to 5.04%) over the next year for the 2 year to work out cheaper in the long run. That could happen, but with the average 1 year mortgage rate already up 0.28%pts since September, we think another move of almost twice that magnitude is less likely. Remember, while the 2 year rate can get well ahead of the OCR, the 1 year rate has less scope to do so (and tends to be less volatile than the 2 year rate).

However, as we have discussed at length in the past, mortgage fixing is not always just about price. Certainty is something that generally appeals to many borrowers, and with the overall term structure of mortgage rates within 0.75%pts of all-time lows, they are all "cheap" in the context of history (and in the context of the pace of recent house price gains). We do also, as noted in earlier editions, generally expect longer-term rates to continue to rise gradually, as global interest rates (which tend to have more of an influence on local longer-term rates) rise. So those who value certainty highly and accordingly intend to fix for a longer term are likely to benefit from fixing now for a given term, rather than waiting.

The shape of the curve matters too. Just as it makes sense to avoid higher rates for floating and 6 months, for those considering longer terms we also think it makes sense to avoid "outlier" points like the 4 year. By splitting a loan in two, and fixing half for 3 years at 5.19% and the other half for 5 years at 5.78%, that gives an average term of 4 years, but at an average rate of 5.49% – 0.2%pts less than the 4 year rate of 5.69%.

CARDED SPECIAL MORTGAGE RATES^



Special Mortgage Rates		Breakevens for 20%+ equity borrowers			
Term	Current	in 6mths	in 1yr	in 18mths	in 2 yrs
Floating	5.73%				
6 months	5.14%	3.95%	4.92%	5.17%	5.79%
1 year	4.54%	4.43%	5.04%	5.48%	5.99%
2 years	4.79%	4.95%	5.52%	6.02%	6.60%
3 years	5.19%	5.49%	6.08%	6.27%	6.44%
4 years	5.69%	5.81%	6.09%		
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	5.73%				
6 months	5.24%	4.70%	5.72%	5.22%	5.90%
1 year	4.97%	5.21%	5.47%	5.56%	6.04%
2 years	5.22%	5.38%	5.75%	5.96%	6.37%
3 years	5.49%	5.71%	6.07%	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 January 2017 (based on REINZ data)

	House prices (ann % chg)	3mth % chg	No of sales (sa)	Mthly % chg	Avg days to sell (sa)
Northland	16.1	2.2	269	-23%	45
Auckland	11.7	-1.9	2,380	-8%	35
Waikato/BOP/Gisborne	21.3	0.8	1,242	-5%	37
Hawke's Bay	13.9	4.7	257	+1%	33
Manawatu-Whanganui	19.7	4.3	384	+5%	33
Taranaki	6.4	3.8	190	+4%	33
Wellington	19.1	4.0	867	-19%	31
Nelson-Marlborough	25.2	6.9	260	-11%	30
Canterbury/Westland	-0.5	1.1	1,003	-11%	36
Central Otago Lakes	20.2	-4.7	162	-8%	35
Otago	7.7	3.0	277	-12%	26
Southland	20.4	7.3	208	-10%	34
NEW ZEALAND	**9.6**	**-0.1**	**7,356**	**-8%**	**34**

Key forecasts

	Actual			Forecasts						
Economic indicators	**Mar-16**	**Jun-16**	**Sep-16**	**Dec-16**	**Mar-17**	**Jun-17**	**Sep-17**	**Dec-17**	**Mar-18**	**Jun-18**
GDP (Ann Avg % Chg)	2.4	2.7	3.0	3.2	3.4	3.4	3.3	3.3	3.2	2.9
CPI Inflation (Annual % Chg)	0.4	0.4	0.4	1.3(a)	1.7	1.7	1.9	1.7	2.1	2.2
Unemployment Rate (%)	5.2	5.0	4.9	5.2(a)	5.0	4.8	4.7	4.7	4.6	4.5
Interest rates (carded)	**Jun-16**	**Sep-16**	**Latest**	**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	5.7	5.7	5.7	5.7	5.7	6.0	6.2
1-Yr Fixed Mortgage Rate	4.9	4.9	4.9	5.0	5.0	5.0	5.0	5.1	5.2	5.3
2-Yr Fixed Mortgage Rate	5.1	5.1	5.1	5.2	5.3	5.3	5.3	5.4	5.5	5.7
5-Yr Fixed Mortgage Rate	5.6	5.6	5.7	6.1	6.2	6.2	6.3	6.4	6.5	6.7

Source: ANZ, Statistics NZ, RBNZ

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