BNZ Weekly Overview

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Mission Statement

To help Kiwi businesspeople and householders make informed financial decisions by discussing the economy and its implications in a language they can understand.

Fieldays

As is usual for this time of the year I'm spending Wednesday through Friday this week in the BNZ tent at National Farm Fieldays in Mystery Creek, Hamilton. The number of people attending the event seems to be in line with previous years but by all accounts willingness to spend is mildly down – obviously because of the weakness in the dairying sector.

Having said that there is a noticeable absence of pessimism. Most operators in the dairy sector have seen downturns before and know what to do, and there is anticipation of payouts slowly improving over the next couple of years. That seems like a reasonable expectation on the basis of some eventual rebuilding of stocks in China and reduced growth in European production along with NZ supply being curtailed as marginal land reverts back to something else (manuka bush for honey perhaps), and farmers pull away from costly supplementary feeding systems.

Few farmers have expressed concern about the NZ dollar which at US 70 cents sits below the ten year average of 74 cents, and no-one has moaned about the level of interest rates facing borrowers. Some are concerned about low interest rates being offered to savers. Everyone seems to be wondering what it will mean for the world economy if the UK referendum on June 23 results in a decision to leave the EU – which it probably will – and Donald Trump becomes US President in the November US Presidential election, which seems like a 50:50 call given the quality of his opponent.

Fewer people are moaning about Auckland now that house prices in their local towns are rising at a faster pace than those in our biggest city.

All up sentiment seems good here and it will be interesting to see the spending figures when they eventually emerge.

Housing

CoreLogic this week released some analysis showing that in Auckland an estimated 42% of property sales are to investors, same in Christchurch (thus slamming any notion that Auckland is "special") and Wellington 38% (ditto). The media invite us to adopt the view that such proportions are too high and this is bad for first home buyers.

But it pays to note the other anti-investor commentary which runs along the lines that properties are being bought then on sold quickly for rapid profit. CoreLogic note an average investment property holding time in Auckland of less than one year.

There is an upward bias in the proportion of sales classified as to investors because of this turnover tendency which does not occur for first home buyers or owner-occupiers moving between houses after a few years. This means some 40% of the housing stock is not suddenly shifting to investor ownership.

Table C35 produced by the Reserve Bank on their website since September 2014 shows that between then and the end of March this year total mortgage debt grew by $24bn or 12.4%. But total drawdowns added up to $118bn. Drawdowns, from which data on the proportion of loans going to investors are derived, are over five times the size of debt growth. Loan repayments totalled $115bn. Interest charges largely account for the difference.

New lending data focussing on the proportion undertaken by investors is meaningless.

For the record, in the 12 months to April 34% of gross new lending was to investors.

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But what if the new lending is higher risk than the old lending? It isn't. The proportion of the mortgage stock where lending exceeds 80% of the value of the property has fallen from 18% in September 2014 to 13% in March. The Reserve Bank is being very successful at reducing the threat to financial stability from high risk bank lending.

What really matters is the proportion of the housing stock owned by investors if home ownership is the thing you are interested in. The Reserve Bank provides zero information on that breakdown. They do not know what proportion of household debt represents lending to investors.

The Reserve Bank's Table C22 does include a line entitled "Housing loans (including rental properties)" which we can compare with another line "Housing loans (long-term)" and on the face of it see that 37.3% of the loans outstanding are for rental purchases. But do this percentage calculation for all periods from the start of the table in December 1998 and you get a 37.3% answer every single time. That is because the 37.3% is a Statistics NZ estimate which has nothing to do with the Reserve Bank. Statistics NZ has far less information on the nature of bank lending and borrowing than the Reserve Bank so this 37.3% is a number thrown in there and not derived from any up to date statistical survey. It might derive from some adjustment to home ownership rate numbers.

We do not know what proportion of household debt is held for the purpose of buying an investment property.

We only get a measure of home ownership in the census and that measure itself is imperfect. Last census in 2013 Statistics NZ was unable to specify ownership of just over 20% of the housing stock. The home ownership rate nonetheless was 73.5% in 1991, 66.9% in 2006, and 64.8% in 2013. It has been falling these past few years though perhaps less than shown because of problems with houses going into trusts. One would struggle to realistically challenge the notion that a rising proportion of our housing stock is owned by investors. But you cannot use debt data to determine the current speed of that increase.

Why Falling Home Ownership?

Regarding the downward trend in home ownership, little analysis exists on why this is happening. Here are a few suggestions. The biggest cause is probably the structural decline in low risk investment returns such as term deposits which has encouraged savers to raise the proportion of housing in their asset base built up these past few decades. After all, you can't easily get residential property exposure through managed funds.

Another is the aging population. More older people own investment properties to fund retirement than young people, the proportion of the population which is old is rising, therefore the proportion of the housing stock in the hands of young people will naturally fall.

Life expectancy is also rising seemingly rapidly and young people are choosing to delay home purchasing – especially as it locks them into a location and occupation. In this modern world we are repeatedly told that people entering the workforce should expect to hold multiple roles if not careers during their lengthening lifespan. Flexibility is to be valued and that is hard to achieve when you are locked into home ownership.

Bank lending standards are also rising. Central banks are requiring banks to reduce the level of risk in their portfolios and that means people offering the highest security, such as a mortgage secured over two properties, are better deals than those borrowing to the hilt to get into their first home with minimal equity. First home buyers are high risk and we banks are being explicitly steered by the Reserve Bank toward avoiding such risks.

Additionally, few entry level houses get built these days. The proportion of the housing stock which is affordable/accessible to first home buyers is structurally declining as developers build big houses on small expensive sections. With nothing else changing, this tendency in the past three to four decades will naturally lower home ownership for first home buyers.

But Houses Can Fall In Price!

Ignoring the structural factors driving the rate of home ownership down is not the most dishonest ploy to generate headlines which grab reader attention. The killer is this one. Apparently there are times when house prices fall and people need to be wary of that when they contemplate their housing investment. Oh how shocking.

Anyone buying any investment product will be aware that prices are not fixed and they go up and down. Were we to however back off massively from buying investment properties because of the occasional period when house prices fall then all arguments for buying other assets like shares go completely out the window.

Share prices go up and down on a daily basis and there will be hundreds of thousands more people who have seen their wealth decline for a while and worried about being wiped out because of a rout in share prices in New Zealand than have ever worried about going down the gurgler because their house price has gone down.

The following graph shows annual changes in the REINZ measure of Auckland house prices since 2004 and annual changes in the NZX 50 share index calculated as three month averages versus a year earlier. The red line showing share index changes is far more volatile than the line showing house price changes. Share prices dipped over 30% come late-2008, house prices 10%.

Note that this graph is just presented to show volatility, not total annual returns and not long-term returns. But as an aside, in the Reserve Bank's Financial Stability report Excel data file sheet 4.2 you will find a time series of Auckland rental yields. They decline from 5.1% in March quarter 2000 to 2.8% March quarter 2016 with a 16 year average of 4.1%. But the average bank six month term deposit rate has declined from 5.5% to 3.2% with an average of 5.3%. Rental yields are less below average than term deposits.

Plus, the average mortgage rate has fallen from 7.6% to 5.6% with an average of 7.5%.

Any argument that one should avoid houses because they can sometimes fall in price needs to be put in context.

Challengers to this angle will note that house purchases are invariably financed with debt whereas hardly anyone borrows money to invest in shares. True. And the reason why? Because banks with hundreds of analysts consider houses to be much safer than shares as security against a debt. It should hardly be any surprise then that the average person feels the same way and so is choosing to purchase houses rather than shares as they try to boost their returns where those returns are calculated as potential for capital gain and income.

But there is another angle to consider. House prices do sometimes fall. But trends have been strongly upward. If you buy fully acknowledging prices will probably fall for a while one day your perceived incentive is to buy sooner rather than later in the cycle. That is because you will expect to build up a buffer to handle the price pullback – three steps forward, one step back. Not bad progress.

This next graph shows the levels of the NZX 50 and Auckland house price index in three month rolling average terms since 2004.

As shown in commentaries here in recent weeks and in fact years, it is not hard to find fundamental economic factors which explain the strong rises in house prices and declining home ownership. But the main question people have asked us for many years is not about what is causing house prices to move, but whether it is a better idea to buy now or to wait for a price correction before buying.

So, would I still buy now? Yes. Why? Because the Auckland shortage is getting worse, all efforts to

stop prices rising have failed, the chances of a stringent regime of debt to income rules being applied and proving effective are low, people are still decreasing their expectations for interest rates over the long-term, population growth looks set to stay above the 1.1% per annum norm for a while longer, and because in the regions the sight of Aucklanders buying properties has spurred local investors to storm into their markets in force.

But when is it likely I will analyse the balance of factors and probabilities and err on the side of caution? First, there is essentially no chance any of us will correctly forecast a rout should one come along so no-one should try to base their decisions on forecasts of one happening. We can't do it.

However, there will come a time when vulnerability to small shocks will be great enough that any tiny shock will throw up some opportunities for those actively looking for them. When? This is where it gets interesting and you'll need to pause before moving beyond the next paragraph to truly grasp an understanding.

The higher prices go the greater the risks. Right? Not necessarily. Note our comment above and comments in fact from the Reserve Bank that risky bank lending has decreased. Prices can rise while fewer borrowers and less bank capital becomes exposed to a price pullback if lending standards are improved.

Those standards are improving courtesy of efforts by our central bank and as seen this past week our own decisions on risk management. Only 13% of outstanding mortgage debt is now above an 80% LVR versus 18% one and a half years ago. The Financial Stability report released in May showed just 4% of top 5 bank lending as at the end of 2015 was at an LVR of 90% or above compared with 7.8% at the end of 2012.

The way things are going there will soon come a time when in spite of Auckland house prices still rising in a 10% - 15% range the Reserve Bank will be so happy with the low level of risky bank lending that when asked about the pace of price rises their comment can only realistically be "meh". Issues of affordability, homelessness, home ownership, etc. are outside their purview.

At this stage I anticipate continuing to say I would be happy to be a buyer until some point in 2018. The risk is I become neutral in the second half of next year.

Lending to Foreigners

Almost all major NZ banks have this past week changed rules regarding lending to people who are not Kiwis or Aussies or do not have permanent residency. There are slight variations so just focussing on our BNZ changes, from now on we will not count the income foreigners earn overseas when calculating their ability to service a mortgage. This is being done because it is extremely difficult to verify the accuracy of information volunteered regarding that foreign income and this raises the risk of incurring losses or lending to someone who cannot really afford the mortgage.

So this is an internal and customer risk management-driven change rather than a reaction to worries about the role of foreigners in driving house prices higher in New Zealand. Will there be much impact? At the margin some people will not be able to borrow funds from us lenders in order to buy a property. If they still want to make a purchase they can go to another lender in New Zealand, or pay cash using funds from offshore. Or if they already have assets in New Zealand they might gear them up further.

The actual market impact is likely to be small so this will join the list of things which have changed in the past five years making it harder for investors to buy a property but which ultimately don't much alter market dynamics. Included here are the two year bright line test, need for an IRD number, loan to value rules, removal of easy depreciation claims, removal of ease of using LAQCs to offset losses against other income, higher bank capital requirements for investor financing.

Tinkering with little policy changes which attract big headlines is worthless if main players in the regulatory environment don't even understand the fundamentals causing a market to move, as has been the case in the NZ and especially Auckland housing market since at least 2008.

NZ Dollar

The NZD has ended this afternoon unchanged from last week against the USD just below 70 cents. But against the Aussie dollar we have jumped to just under 96 cents from 94.5 cents on the back of stronger than expected NZ GDP data this morning (economy ahead 0.7% in the March quarter rather than the expected 0.5%, 2.8% annual growth now).

Against the British Pound the NZD has risen to almost 50 pence from 49 last week as more polls have shown voters will almost certainly opt to leave the dysfunctional European Union next week. The likelihood of this happening was one reason behind the US Federal Reserve last night deciding not to raise their funds rate, along with the recent poor employment report. The chances are good that the Fed. will not raise rates again this year.

In fact around the world bond yields are rallying to new lows on the back of this building expectation, a flight to safety on expectations of Brexit, and weak growth and inflation numbers coming out of Japan and Europe. The US ten year government bond yield has fallen to only 1.55% from 1.72% last week. This is the lowest yield since late 2012. The low was just below 1.5% that year and before that somewhere before 1970.

If the world were looking good this would not be happening – hence money coming down our way.

The chances are that the NZD will see US 75 cents before it sees 65 cents, and if you believe dairy prices are rising (they were flat at the auction last night) then you best start thinking of when we get back to 80 cents because relying on rising US interest rates to push the NZD lower has long been a sucker bet.

Just for your guide, at US 70 cents the NZD is four cents below the ten year average. But at near 95 Aussie cents we are well above the 84 cent average, at almost 50 pence well above the 45 pence average, at 63 Euro well above the 56 centime average, and at 74 Yen right on the 74 Yen average.

If I Were A Borrower What Would I Do?

Nothing new. I would fix most of my debt at a two or three year period. Strong NZ growth data mean we will at best see one further rate cut here. But falling foreign yields suggest fixed rates might come down again soon though this is not guaranteed. Could be worth holding off for that to happen if you like a punt.

If I Were An Investor ...I'd see a BNZ Private Banker

The text at this link explains why I do not include a section discussing what I would do if I were an investor.
http://tonyalexander.co.nz/regular-publications/bnz-weekly-overview/if-i-were-an-investor/

The Weekly Overview is written by Tony Alexander, Chief Economist at the Bank of New Zealand. The views expressed are my own and do not purport to represent the views of the BNZ. To receive the Weekly Overview each Thursday night please sign up at www.tonyalexander.co.nz
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