ANZ RESEARCH

NEW ZEALAND PROPERTY FOCUS

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CATCH ME IF YOU CAN

SUMMARY

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

FEATURE ARTICLE: CATCH ME IF YOU CAN

The housing market has entered 2018 on a firmer footing after cooling through 2017. From here, we expect the housing market to remain stable, with prices rising at a moderate pace. A key headwind is affordability – particularly in Auckland, where eye-watering prices are holding the market back from resurgence. But this is not true everywhere. And now that the Auckland market has cooled, the rest of the country is playing 'catch up'. While there are reasons to expect Auckland house prices to rise faster than elsewhere on average over time, a large and unsustainable divide was created by Auckland's recent astronomical rise. Going forward, this catch-up dynamic is expected to support the rate of house price inflation outside Auckland. And with steam taken out of the Auckland market and affordability at its limits, we expect price pressures there to remain subdued.

PROPERTY GAUGES

Housing market activity has shown more signs of life of late, bouncing off low levels. However, our overall views have not changed. There are clear opposing forces. On the one hand, strong population growth coupled with a challenged supply backdrop argues that a fundamental supply-demand imbalance will continue to drive prices higher. But this is going head-to-head with tighter lending standards, LVR restrictions (although these are gradually being eased), affordability constraints and possibly more restrictive government policy. We continue to see price growth remaining modest – with ongoing regional divergence expected.

ECONOMIC OVERVIEW

The economy entered 2018 with more positive news in the foreground. Growth was stronger than initially estimated over recent years. Firms remain cautious, but surveyed business confidence has come off post-election lows. And near-term indicators suggest the economy is growing at around-trend pace, after cooling from the stronger growth seen over 2015/16. The economy is navigating some late-cycle headwinds, but the medium-term growth picture is positive, with stimulatory fiscal policy and supportive financial conditions doing their part. We expect OCR hikes in time. But with evidence of a lift in domestic pricing pressures lacking, the OCR looks to be on hold for some time yet.

MORTGAGE BORROWING STRATEGY

With average mortgage rates unchanged over the past month, our favoured views on where to fix remains unchanged. The 1-year rate remains the low point on the mortgage curve and offers the most value in our eyes. We are watching the recent lift in bank funding costs, but don't believe pressures will escalate and affect mortgage rates significantly. But borrowers concerned by that possibility, or the possibility of the OCR moving up within the next year (which is not our expectation), may wish to spread risk by borrowing over a number of fixed terms. This strategy always makes sense from a risk-management perspective.

FEATURE ARTICLE: CATCH ME IF YOU CAN

SUMMARY

The housing market has entered 2018 on a firmer footing after cooling through 2017. Nationwide house price inflation is currently running at 3.7% y/y (3m ma) – a healthy, steady pace, and much lower than rates of inflation (~15%) seen through 2015/16. From here, we expect the housing market to remain stable, with prices rising at a moderate pace. A key headwind is affordability – particularly in Auckland, where eye-watering prices are holding the market back from resurgence. But this is not true everywhere. And now that the Auckland market has cooled, the rest of the country is playing catch-up. While there are reasons to expect Auckland house prices to rise faster than elsewhere on average over time, a large and unsustainable divide was created by Auckland's recent astronomical rise. Going forward, this catch-up dynamic is expected to support the rate of house price inflation outside Auckland. And with steam taken out of the Auckland market and affordability at its limits, we expect price pressures there to remain subdued.

A FIRMER FOOTING

The housing market has entered 2018 on a firmer footing. After falling sharply during 2017, sales have lifted and price inflation has found a floor. House sales are up 18% since September 2017, but are still 11% below their 2016 monthly average. Nationwide house prices are growing at a steady pace of 3.7% y/y (3-month average), according to REINZ House Price Index (our preferred measure). This is much lower than the rates of inflation (~15%) seen through 2015/16, which was driven predominantly by the Auckland market. At 37 days, the national median number of days to sell is up from around 30 days in February 2016, indicating a much cooler market.

From here, we expect the housing market to remain stable, with prices rising at a modest pace. We don't see the recent bounce turning into a full-blown resurgence. We have outlined our thoughts on the outlook for house prices in recent editions of our *Property Focus*, and our overall views have not changed in light of recent data. We project annual house price growth to slow to 2% over the next few years. The recent bounce will confirm to the RBNZ that it was right to take a cautious approach in rolling back LVR restrictions; we think further easing in these measures is unlikely in the near term. While this steady-as-she goes outlook might sound uninteresting, the opposing forces affecting this outlook are far from boring.

HEADWINDS AND TAILWINDS

As we have discussed in recent editions of our *Property Focus*, a number of headwinds and tailwinds are currently being navigated in the property market at present.

Tailwinds:

- **Interest rates are low and expected to remain so,** although we see the effect of low interest rates in spurring the housing market as having largely played out.
- **Pent-up demand for housing remains.** Net migrant inflows have eased, but a significant rate of home building is needed to keep pace with population growth and meet underlying demand in Auckland.
- **A sudden jump in housing supply seems unlikely.** Skill shortages and cost pressures are prevalent and the construction sector does not have the ability to ramp up additional building activity quickly. Indeed, the construction sector may face additional pressures at this stage of the cycle, due to delays, cost increases and credit constraints.

Headwinds:

- **Credit constraints.** Banks have put the brakes on new lending in light of slower bank deposit growth over 2016 in order to close their 'funding gap'; we expect this prudence to continue.
- **Measures proposed by the new Government** (banning of non-resident buyers, extension of the bright-line capital gains test, and possible other tax changes) will keep sentiment contained and ensure investors are not the driving force they were during 2016.
- **Affordability constraints.** These are not constrained to Auckland: Tauranga & Western Bay of Plenty made Demographia's list of the top 20 unaffordable housing markets of 293 metropolitan areas in countries they monitor (Australia, Canada, China, Ireland, Japan, New Zealand, Singapore, the UK and the US).

FEATURE ARTICLE: CATCH ME IF YOU CAN

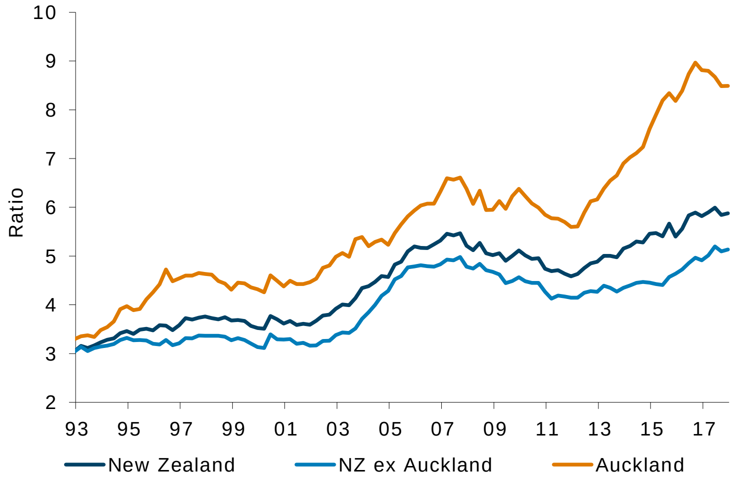
AFFORDABILITY: TAKING THE STEAM OUT OF THE AUCKLAND MARKET

A key headwind for the property market at present is affordability – particularly in Auckland, where eye-watering prices are holding the market back from resurgence. In Auckland, the house price-to-income ratio rose from 6 in 2008 to 9 in 2017 – a 50% increase, after adjusting for household earnings. This has moderated recently, but only modestly.

However you cut it, Auckland house prices have increased to the point where they are unaffordable for many. A house price of 9 times income is a massive stretch for those on the average income, let alone those who are earning less. Mortgage repayments required to purchase the median house are 50% of average household incomes – the same level that prevailed at the peak of the last interest rate cycle, when floating mortgage rates were 11%. Should interest rates rise, this would increase. And resurgence in Auckland house prices would put further pressure on this metric, which we don't think is plausible; affordability has its limits.

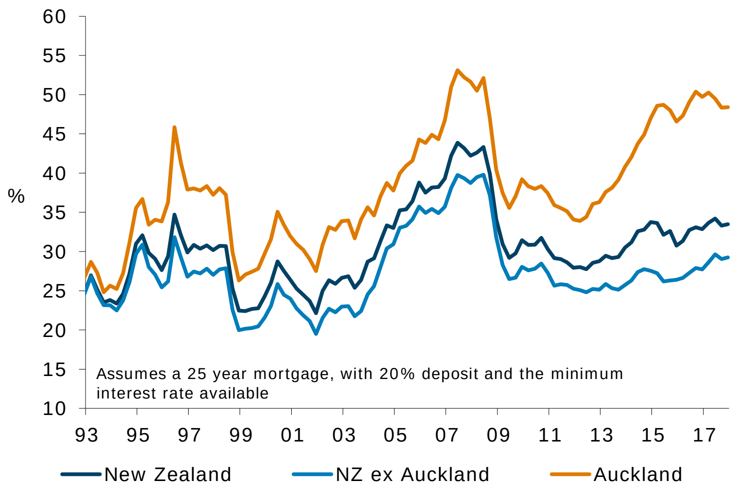
But this is not true everywhere; in some regions, house prices are more affordable, even after adjusting for differences in incomes. Outside Auckland, the average house price-to-income ratio is 5, with house prices having broadly kept pace with income growth since 2008. House prices have barely risen over the past decade in some regions. While house prices in Auckland have doubled over the past decade, house prices have risen less than 30% in some other regions, including Manawatu-Whanganui, Taranaki and Southland, which equates to a real increase of only 1% per year on average. Mortgage payments are 30% of average income outside Auckland. This proportion peaked at 40% in 2008. While servicing this would certainly have been difficult for some, history suggests this ratio has room to go higher.

Figure 1: Regional house price-to-income ratios



Source: ANZ, REINZ, Statistics NZ

Figure 2: Regional mortgage payments to income



Source: ANZ, RBNZ, REINZ, Statistics NZ

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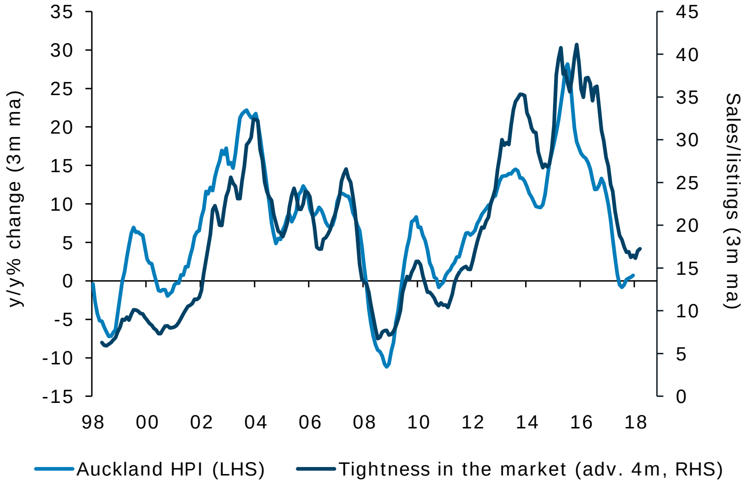
Steam has been taken out of the Auckland market. The Auckland housing market has cooled, with affordability constraints, LVR restrictions, tighter lending standards and caution around proposed Government policies all contributing to the slowing. Auckland house price inflation has softened from highs of 28% y/y (3-month average) in September 2015 to the modest growth rate of 0.7% y/y prevailing currently. The market is no longer 'tight'; available listings have doubled since the start of 2016, and the sales/listings ratio has more than halved as sales have slowed, suggesting house price inflation will remain subdued over the next four months (figure 3).

Figure 3: Tightness in the Auckland market and house price inflation

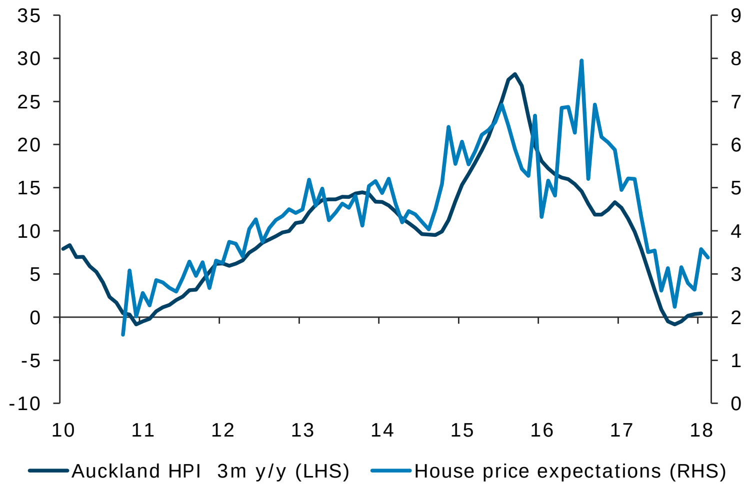


Source: ANZ, Barfoot & Thompson, REINZ

As the market has cooled in Auckland, house price expectations have fallen, according to our ANZ Roy-Morgan Consumer Confidence Survey. While house price expectations in Auckland were below their actual rate of increase during the recent upswing, we have no doubt that expectations played a role in their astronomical rise, with FOMO (fear of missing out) playing into housing purchase decisions.

Although the Auckland housing market has a proud history of second winds, we do not expect it to take off again. Consistent with the recent slowing, more moderate rates of house price inflation are now expected by households, consistent with continued low rates of house price inflation – perhaps just slightly higher than what we are seeing currently. This reflects households coming to terms with what is sustainable for the Auckland market going forward, with affordability limits now reached. Investor caution alongside these affordability concerns will keep the market from getting a second wind. Although house price expectations have lifted a little, we are not seeing the type of sharp lift seen in late 2014, which presaged a sharp lift in actual house price inflation.

Figure 4: House price expectations and actual – Auckland



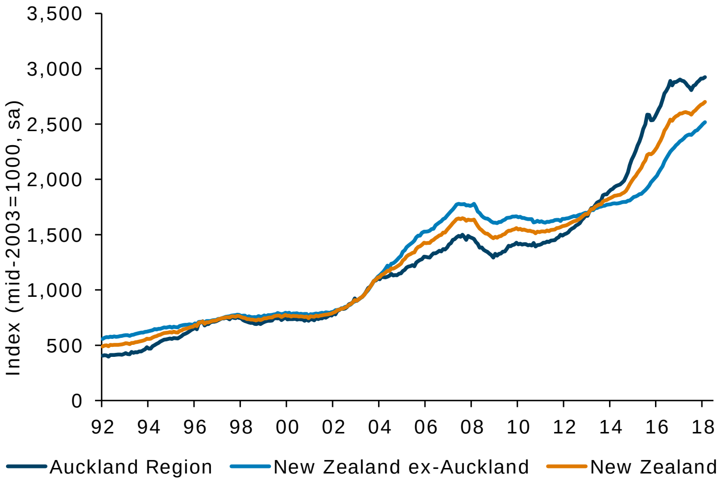
Source: ANZ, Roy Morgan, REINZ

FEATURE ARTICLE: CATCH ME IF YOU CAN

AN UNSUSTAINABLE DIVIDE

While the Auckland market has cooled, the rest of the country is seeing decent growth. While house prices in Auckland have plateaued from mid-2016, they have increased 12% over the same period in the rest of New Zealand. Indeed, outside Auckland house price inflation is running at 6.8% y/y (3-month average) – a robust pace of growth. And particular pockets of growth are evident in Hawke's Bay, Manawatu-Whanganui and Southland, where house price inflation is more than 10% y/y (3-month average).

Figure 5: Regional house prices

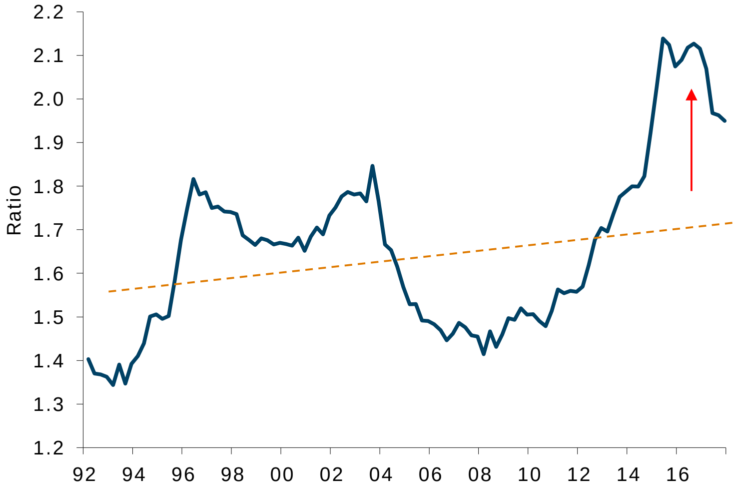


Source: ANZ, REINZ

Over the long term, there are reasons to expect Auckland house prices to be higher, and to have risen faster on average, than elsewhere. Incomes are higher in Auckland, which will mean higher levels of house prices are affordable. But also, supply constraints in Auckland are currently more acute than the rest of the country, given the rapid population growth that we have seen. Such constraints will tend to result in house prices growing faster in Auckland than elsewhere – at least in a trend sense.

Yet a large and unsustainable divide was created by Auckland's recent astronomical rise. Median house prices in Auckland were more than double those in the rest of the country in early 2016, following a huge rise. Over 2017, the gap started to close as house prices in the rest of the country picked up. But there is a long way to go, and we believe that the rest of New Zealand still has some catch-up to do.

Figure 6: Ratio of median house prices in Auckland vs. rest of New Zealand

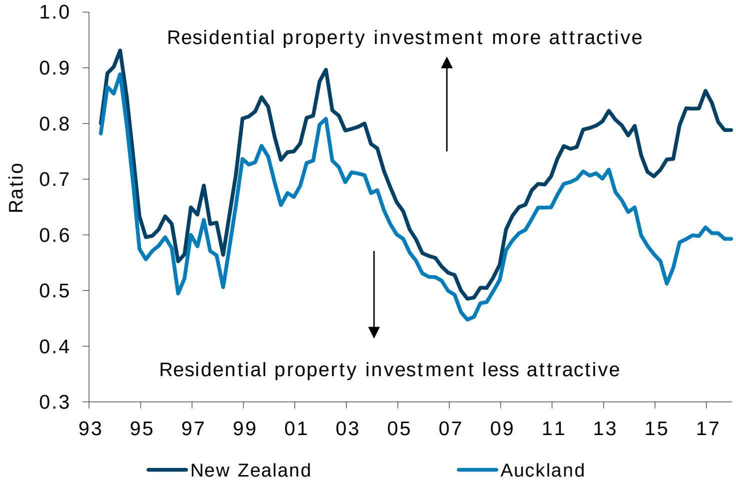


Source: ANZ, REINZ

FEATURE ARTICLE: CATCH ME IF YOU CAN

Property is currently a less attractive investment in Auckland than in the rest of New Zealand, consistent with the gap that has emerged between prices. During the strong Auckland housing market upswing, investors were willing to accept pretty low rental yields, relative to prevailing interest rates – presumably in anticipation of future capital gains. But the prospects for that have now been tempered. We believe investors will continue to be wary around the country, given possible changes to Government policies, but particularly in Auckland.

Figure 7: Rental yields vs. interest rates



Source: ANZ, MBIE, REINZ, RBNZ

SO WHAT'S THE UPSHOT?

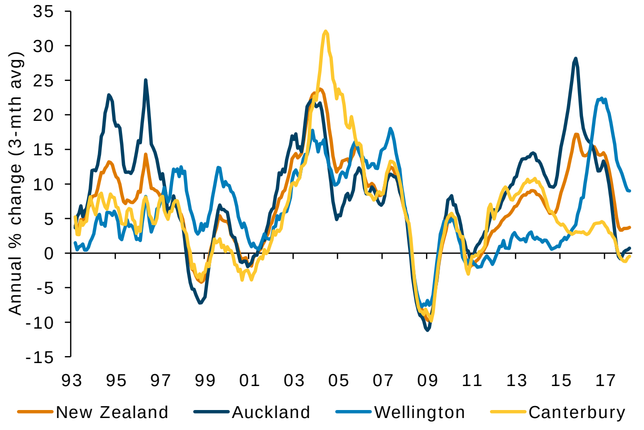
Going forward, the divergence that has opened up between Auckland and the rest of the country is expected to continue to ebb. But how – and when – this happens is uncertain. In previous episodes, it has sometimes taken a decade or more for regional divergence to be eroded. Then again, we haven't seen a divergence as large as this in recent history, so maybe things will play out somewhat differently. Nonetheless, we expect this catch-up dynamic will continue to transpire gradually over the next 5-10 years, through a mixture of subdued Auckland price pressures and catch-up growth in the rest of New Zealand.

Overall, house price inflation is expected to slow towards 2% over the next few years. The nationwide market is arguably still tight, with the inventory of listings on the market low and days-to-sell below average in all regions outside Auckland. But we think house price inflation will not gather pace from here. There are a number of reasons for this, beside affordability. We believe the recent tightening in credit availability will not reverse, net migration is on the way down, and the effects of low interest rates in spurring housing market activity have largely played out, with interest rates not expected to go lower from here. We will watch changes in Government policy closely, given their possible effects on market sentiment, activity and prices. But ultimately, we think house price inflation has found a floor.

And it's probably just as well. Any resurgence in house prices would increase the risk of a sharper correction – especially in Auckland. Debt levels are high and the Reserve Bank is on the watch for any housing market risks that may emerge and leave the financial system vulnerable. This is particularly relevant for Auckland, where house prices and debt-servicing costs remains lofty relative to household incomes. In light of this, we think that the RBNZ will take a cautious approach to gradually removing LVR restrictions, with no policy changes expected in the near term.

THE PROPERTY MARKET IN PICTURES

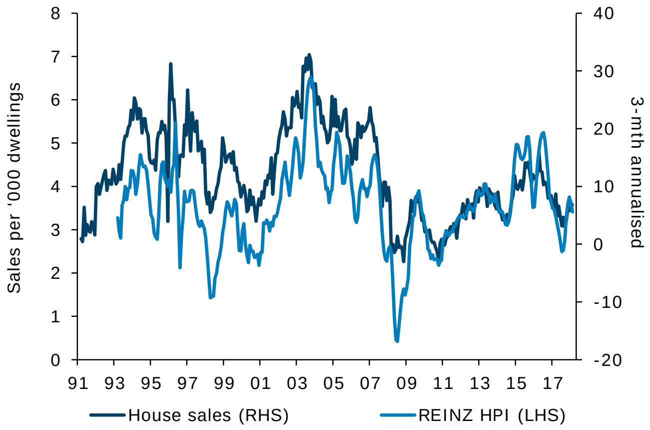
Figure 1. Regional house price inflation



Source: ANZ, REINZ

The REINZ House Price Index rose for a seventh straight month in seasonally adjusted terms in February, lifting 0.6% m/m. In 3-month average terms, annual growth was broadly steady at 3.7% y/y, which is effectively where it has held for the past seven months. On the same basis, Auckland prices were up 0.7% y/y, while they are up 6.8% y/y in the rest of New Zealand. Of the major centres, Wellington continues to record the strongest annual price growth of 9% y/y, but that is off its recent highs. Particular pockets of growth are also evident in Hawke's Bay (+15% y/y), Manawatu-Whanganui (+11% y/y) and Southland (13%y/y).

Figure 2. REINZ house prices and sales

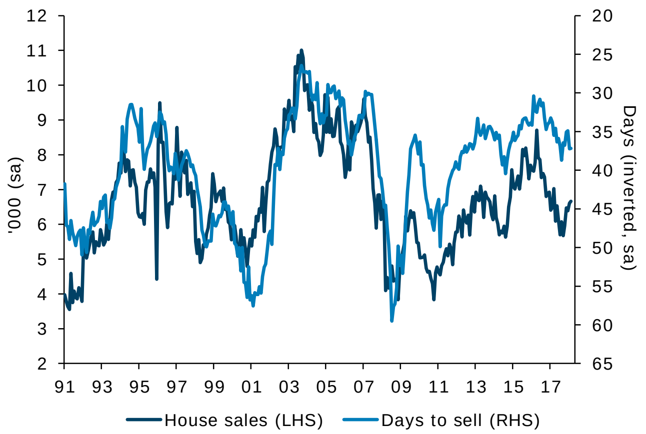


Source: ANZ, REINZ

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

We estimate that seasonally adjusted house sales volumes lifted 0.8% in January to be up 2.7% y/y. Looking through the noise, monthly sales have clearly bounced off the bottom and have broadly stabilised. House sales are up 18% since September 2017, but are still 11% below their 2016 monthly average. From a regional perspective, Auckland sales are up 0.9% (3m average) over the year, while across the rest of the country they are down 0.5%.

Figure 3. Sales and median days to sell



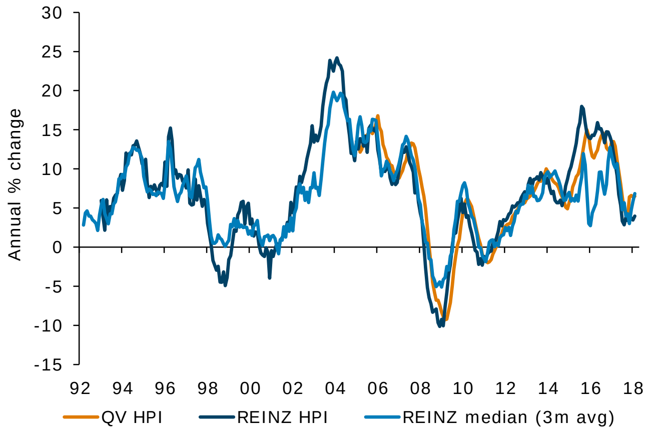
Source: ANZ, REINZ

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 was stable at 37 days (sa) in February. Days-to-sell is below its historical average of 39.6 days, but is up from the low of 30.8 days seen in mid-2016. The median time to sell a property is below historical averages in every region except Auckland.

THE PROPERTY MARKET IN PICTURES

Figure 4. REINZ and QV house prices

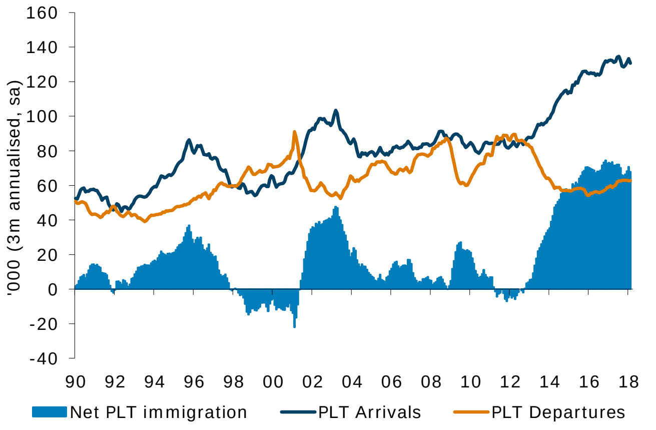


Source: ANZ, REINZ, QVNZ

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

The REINZ median sale price increased 1.4% m/m (sa) in February, with annual growth lifting to 7.1% y/y – a stable rate from January. This is stronger than the REINZ HPI (4.0% y/y) and QVNZ measures of price growth (6.5% y/y).

Figure 5. Net permanent/long-term immigration



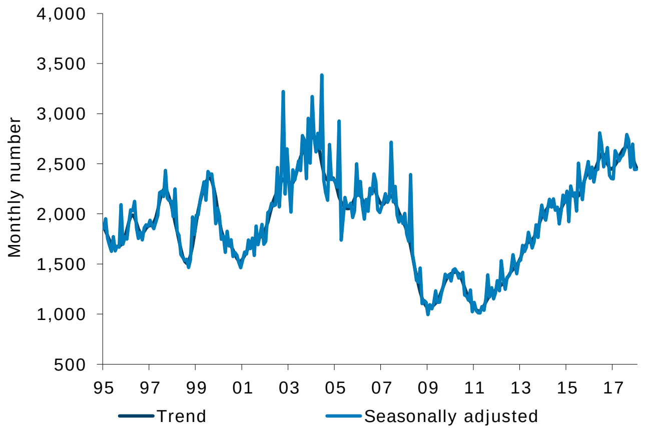
Source: ANZ, Statistics NZ

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

Net migrant inflows were lower in February. In seasonally adjusted terms, a net inflow of 4,970 migrants was recorded in February, down sharply from 6,270 in January. Inflows remain high, but are gradually easing, with long-term arrivals at a 3-year low.

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

Figure 6. Residential building consents



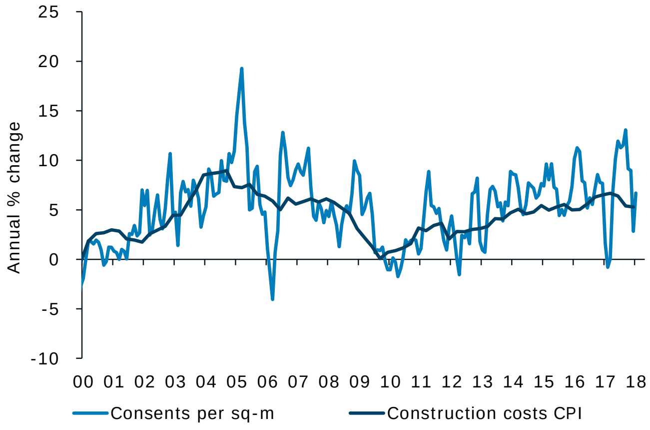
Source: ANZ, Statistics NZ

Dwelling consent issuance has been volatile of late, but was stable in January (up 0.2% m/m). The multi-dwelling component fell 7.4%, after a 21.7% fall in December. Issuance for 'houses' was up 3.8%, a small bounce-back after previous falls. Consent issuance is high historically, with levels of construction high in Canterbury and Auckland.

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

THE PROPERTY MARKET IN PICTURES

Figure 7. Construction cost inflation

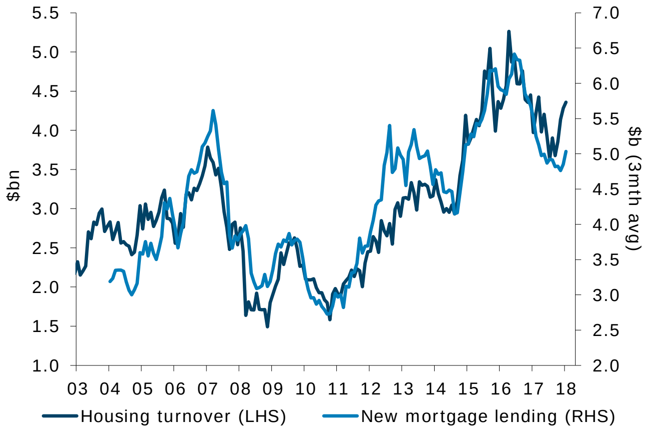


Source: ANZ, Statistics NZ

On a three-month average basis, **the value of residential consents per square metre** – a proxy for construction cost inflation – **increased in January to 6.7% y/y** (3-month average), retracting its December fall. This is down from over 13% in September 2017. The measure is volatile, but points to continued robust construction cost inflation.

That said, the implied measure of construction costs from the CPI has eased off its highs, falling to 5.3% y/y in Q4, from 6.4% y/y in Q2. It is going to be interesting to see whether, with house price growth cooling, construction cost inflation can continue to run at its earlier strong pace.

Figure 8. New mortgage lending and housing turnover



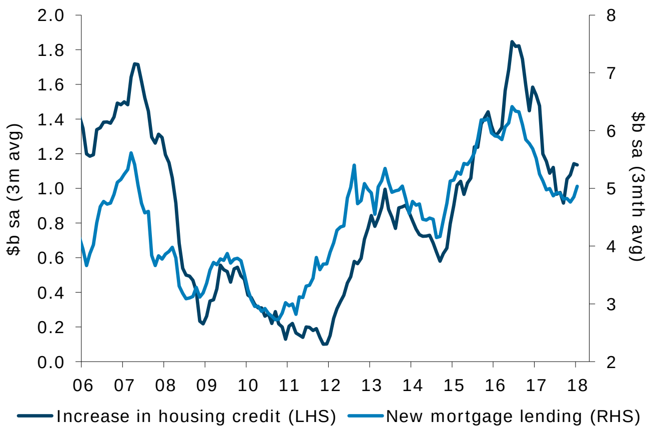
Source: ANZ, RBNZ

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

We estimate that new mortgage lending increased 9.0% in January in seasonally adjusted terms (the chart is in 3-month average terms). That follows increases of 0.2% m/m and 2.0% m/m in November and December. New lending is up 5.3% y/y.

New investor lending remains soft. In January, lending to investors was down 7.2% y/y, making up 21% of total lending – well below the 35% share seen in mid-2016.

Figure 9. New mortgage lending and housing credit



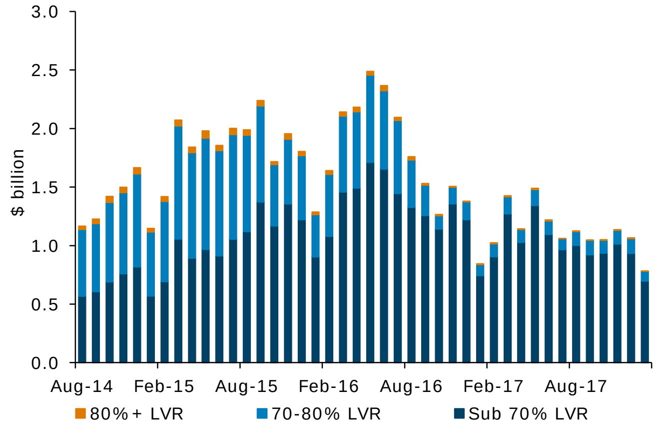
Source: ANZ, REINZ, RBNZ

Total housing lending growth was steady again in January, at 0.4% m/m (sa). This is effectively the same as the average monthly growth rate over the past year. As such, growth in three-month annualised terms has also been relatively steady of late, sitting at 5.6% in January.

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

THE PROPERTY MARKET IN PICTURES

Figure 10. Investor lending by LVR

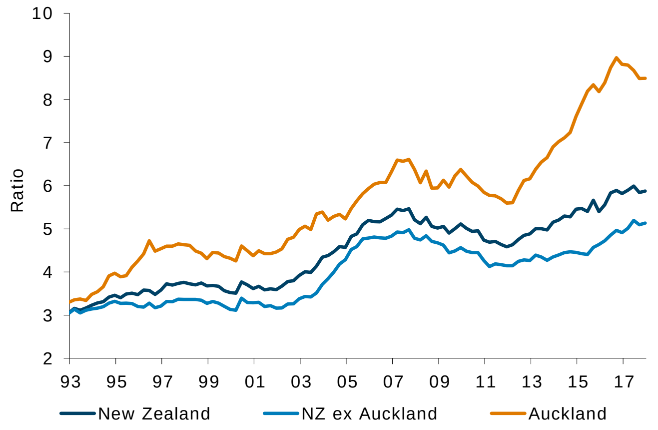


Source: ANZ, RBNZ

New lending to investors is well off its mid-2016 peak, and took another step down in January (-27% m/m; -7.2% y/y). This lower share no doubt relates, at least in part, to the impact of LVR restrictions (which came into force in October 2016). While the RBNZ eased these restrictions modestly at the start of the year, it was only a tweak, and we expect further adjustments to be cautious.

Related to the LVR restrictions, a larger share of new lending is on less-risky terms. In December, the share of total investor lending at LVRs of less than 70% was 89%. That is a far greater share than in late-2014, when it was less than half.

Figure 11. Regional house prices to income

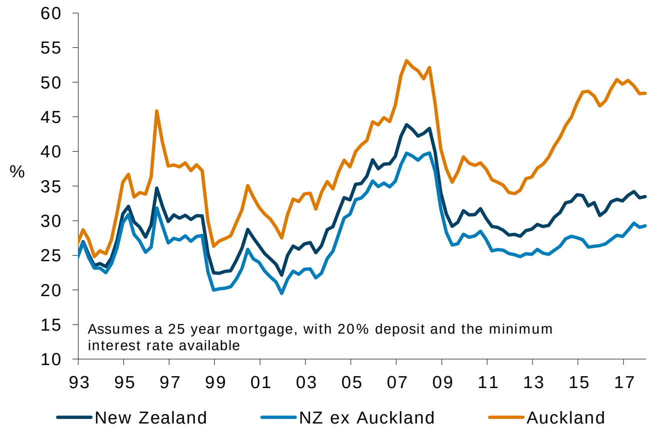


Source: ANZ, REINZ, Statistics NZ

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

Nationally, the ratio has been broadly stable at around six times income for the past 12 months. Auckland has seen its ratio ease from a high of 9 times in Q3 last year to an estimated 8.5 times in Q4. While still extremely high, the easing reflects the recent moderation in house price growth. Outside of Auckland, the ratio has continued to rise, and at 5.1 times, is now a little over where it peaked in 2007.

Figure 12. Regional mortgage payments to income



Source: ANZ, REINZ, RBNZ, Statistics NZ

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

We estimate that for a purchaser of a median-priced home (20% deposit), the average mortgage payment to income nationally is around 33.5%. However, there are stark regional differences, with the average mortgage payment to income in Auckland just short of 50% for new purchasers. While (just) off its highs, it is still on par with the highs reached in 2007, despite mortgage rates being near historic lows currently. It highlights how sensitive some recent home-buyers in Auckland would be to even a small lift in interest rates.

PROPERTY GAUGES

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

We use ten gauges to assess the state of the property market and look for signs that changes are in the wind.

AFFORDABILITY. For new entrants into the housing market, we measure affordability using the ratio of house prices to income (adjusted for interest rates) and mortgage payments as a proportion of income.

SERVICEABILITY / INDEBTEDNESS. For existing homeowners, serviceability relates interest payments to income, while indebtedness is measured as the level of debt relative to income.

INTEREST RATES. Interest rates affect both the affordability of new houses and the serviceability of debt.

MIGRATION. A key source of demand for housing.

SUPPLY-DEMAND BALANCE. We use dwelling consents issuance to proxy growth in supply. Demand is derived via the natural growth rate in the population, net migration, and the average household size.

CONSENTS AND HOUSE SALES. These are key gauges of activity in the property market.

LIQUIDITY. We look at growth in private sector credit relative to GDP to assess the availability of credit in supporting the property market.

GLOBALISATION. We look at relative property price movements between New Zealand, the US, the UK, and Australia, in recognition of the important role that global factors play in New Zealand's property cycle.

HOUSING SUPPLY. We look at the supply of housing listed on the market, recorded as the number of months needed to clear the housing stock. A high figure indicates that buyers have the upper hand.

HOUSE PRICES TO RENTS. We look at median prices to rents as an indicator of relative affordability.

Indicator	Level	Direction for prices	Comment
Affordability	Unaffordable	↔/↓	Affordability constraints are very relevant. It is the main reason we see the Auckland market underperforming over the next few years.
Serviceability/ indebtedness	High debt, low rates OK. High rates not.	↔/↓	Serviceability looks okay as long as interest rates stay low and the unemployment rate keeps trending lower.
Interest rates / RBNZ	Slow ascent	↔/↓	The case can be argued that the OCR is not moving for a long time. We're still favouring a couple of OCR hikes eventually.
Migration	Peaked	↔	The cycle appears to have turned ahead of potential policy changes. But inflows are not set to fall sharply.
Supply-demand balance	Demand > Supply	↔/↑	We need to be building 35-40k plus dwellings, not ~30k.
Consents and house sales	Shortage	↔/↑	Dwelling consent issuance ultimately flat-lining around 30k annualised, with the construction sector reaching its limits.
Liquidity	Tight	↔/↓	Credit rationing still apparent. Closure of bank funding gap suggests a little more wriggle room, but resurgence not expected.
Globalisation	Mixed bag	↔	Non-resident buyers no longer that influential. Other big global housing markets looking stable too.
Housing supply	Too few	↔/↑	The Government is going to take a more active role, but there are still questions about crowding out other work and labour shortages.
House prices to rents	Too high	↔/↓	Rents are moving up, but only gradually, suggesting that existing housing shortages aren't the only game in town.
On balance	**Flat-lining**	↔	**Positives offset the negatives, leaving the market steady. Auckland to remain weak as affordability bites hard.**

PROPERTY GAUGES

Figure 1: Housing affordability

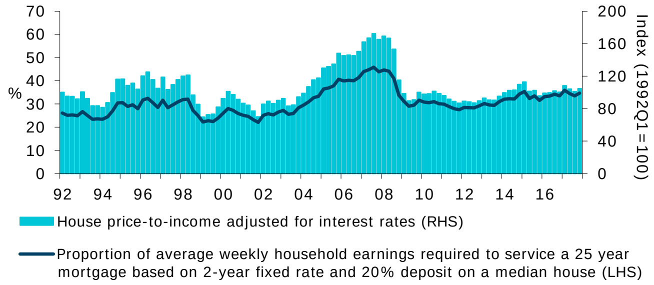


Figure 2: Household debt to disposable income

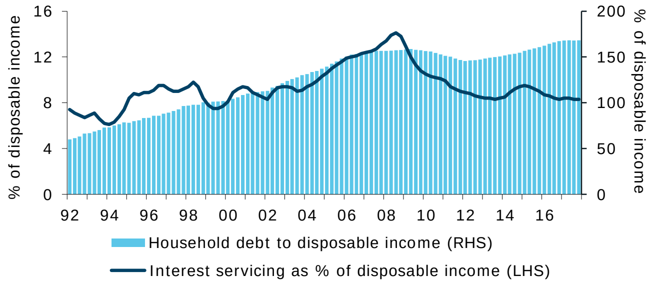


Figure 3: New customer average residential mortgage rate (<80% LVR)

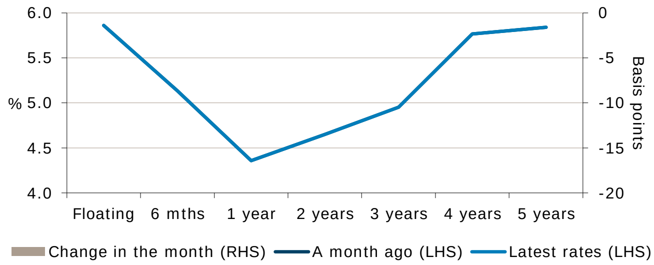


Figure 4: Net migration

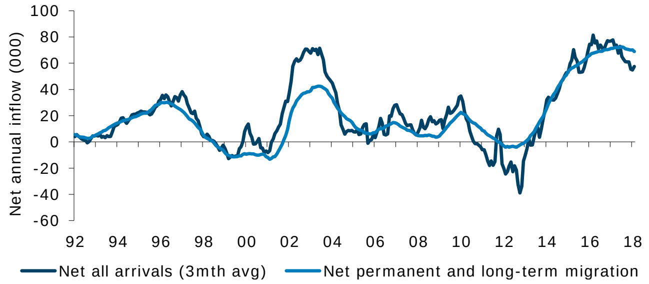


Figure 5: Housing supply-demand balance

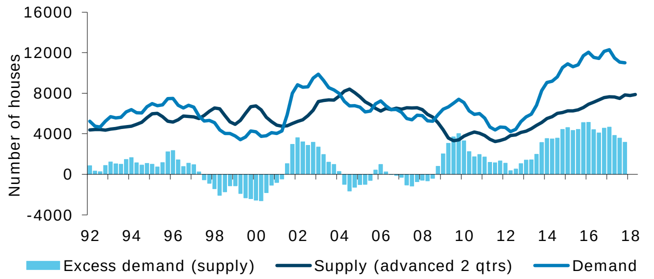


Figure 6: Building consents and house sales

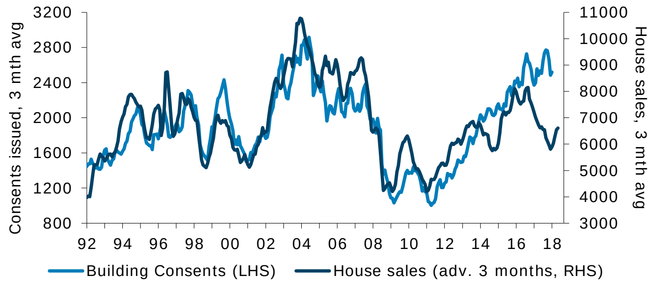


Figure 7: Liquidity and house prices

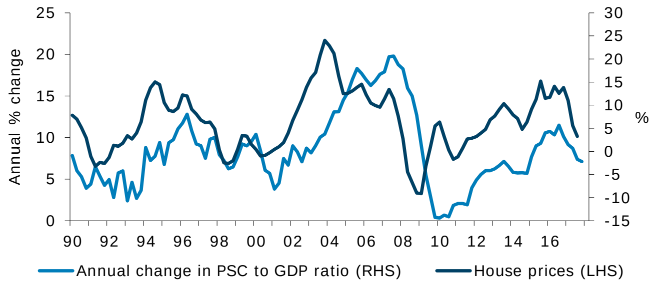


Figure 8: House price inflation comparison

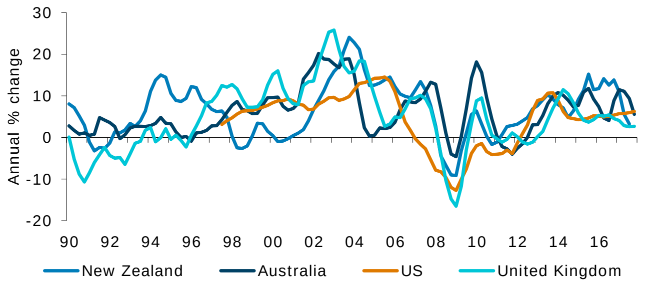


Figure 9: Housing supply

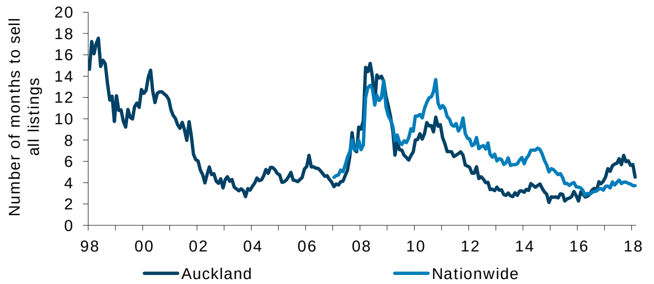
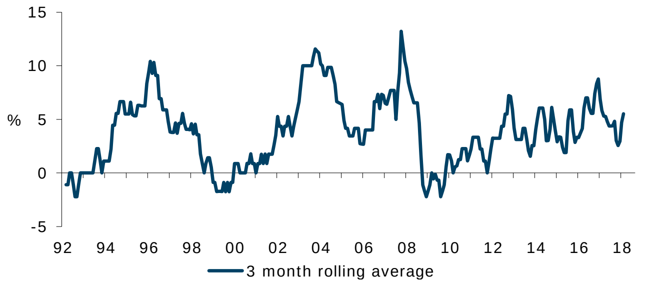


Figure 10: Median rental, annual growth



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

ECONOMIC OVERVIEW

SUMMARY

The economy entered 2018 with more positive news in the foreground. The economy grew faster than initially estimated over recent years. Firms remain cautious, but surveyed business confidence has come off post-election lows. And near-term indicators suggest the economy is growing at around-trend pace, after cooling from the stronger growth seen over 2015/16. The economy is navigating some late-cycle headwinds, but the medium-term growth picture is positive, with stimulatory fiscal policy and supportive financial conditions doing their part. We expect OCR hikes in time. But with evidence of a lift in domestic pricing pressures lacking, the OCR looks to be on hold for some time yet.

OUR VIEW

The economy entered 2018 with more positive news in the foreground. The recent flow of data points to an economy that is doing relatively well:

- **Firms remain cautious, but surveyed business confidence has come off post-election lows.** It appears the economy has navigated the spike in political uncertainty relatively well.
- **Current activity looks healthy**, with near-term indicators suggesting that the economy is getting on with it. GDP is growing at around-trend pace, after cooling from the stronger growth seen over 2015/16.
- **Housing market activity has bounced off low levels** and household sentiment remains solid.
- **The terms of trade remains high and population growth is strong** although migration is now easing.

That said, the economy is navigating some late-cycle headwinds and it is not firing on all cylinders (which would be unusual at this stage of the cycle anyway). Migration and construction – key drivers of recent strength – appear to have topped out. And late-cycle challenges are tempering the outlook going forward. Capacity pressures, housing excesses and margin pressure will temper activity – and household debt is high. Even in the best case scenario, high household debt will constrain consumption growth and overall activity growth in the future. That said, the current account is contained, the banking system is resilient, and credit growth is relatively subdued – the economy has strengthened its buffers against a bad scenario.

Despite some challenges, the medium-term growth picture is positive, with stimulatory fiscal policy and supportive financial conditions both doing their bit. The fiscal position is strong, providing the new Government with options – and those options will be exercised. The fiscal stimulus over the next couple of years will be large, particularly since it will put additional money in the pockets of those who are most likely to spend it. Prospects for household income growth are solid, given our expectation that wage growth is set to finally increase (albeit modestly). The high terms of trade will also boost national incomes. Interest rates are low and despite recent global financial market volatility, domestic financial conditions are supportive.

As conditions unfold, there are a couple of things we've got our eyes on:

- **Consumer confidence** has proven remarkably resilient to the housing market slowdown. But this is in contrast to historical experience. A pull-back in sentiment could hamper economic activity.
- Firms have weathered post-election uncertainty well, and business confidence is off recent lows, but **investment** is weak for this stage in the cycle and we will be looking to see a pick-up.
- Conditions are in place for **wage growth** to increase, which could be the catalyst needed to see a ramp up inflation – but this is far from guaranteed. Wage inflation has been slow to increase globally.
- The terms of trade are elevated, but **dairy prices** are expected to face some downward pressure. The extent and impact of this, alongside movements in the NZD, will be important going forward.

We expect reasonable rates of GDP growth over the medium term, but achieving above-trend growth will be a challenge, with population growth set to slow and a productivity miracle unlikely. That said, we are not seeing the same imbalances or inflationary pressures that have often been the catalyst for a sharper downturn.

We expect OCR hikes in time. But with evidence of a lift in domestic price pressures lacking, the OCR looks to be on hold for some time yet. Underlying inflationary pressures are low and are expected to increase only gradually. We expect wage inflation to eventually increase as skill shortages bite, which should see core inflation approach 2% over time. At the same time, we expect the NZD to face more downward pressure on narrowing interest rate differentials, which will also give inflation a nudge. But these forces are not evident right now – meaning that the RBNZ will take an extremely cautious approach to tightening policy for some time yet.

MORTGAGE BORROWING STRATEGY

SUMMARY

With average mortgage rates unchanged over the past month, our favoured views on where to fix remains unchanged. The 1-year rate remains the low point on the mortgage curve and offers the most value in our eyes. We are watching the recent lift in bank funding costs, but don't believe pressures will escalate and affect mortgage rates significantly. But for borrowers concerned by that possibility, or the possibility of the OCR moving up within the next year (which is not our expectations), they may wish to spread risk by borrowing over a number of fixed terms (which is always a strategy that makes sense from a risk-management perspective).

OUR VIEW

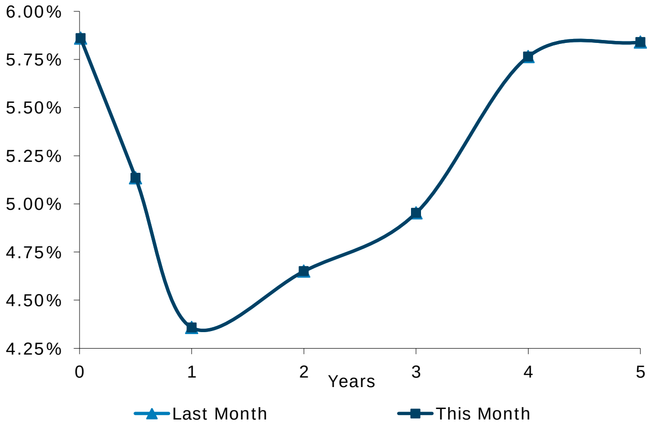
Average mortgage rates across the 'big four' banks were unchanged over the past month. The average special 1-year fixed mortgage rate, at 4.36%, remains the lowest point on the curve.

With mortgage rates unchanged, so too is our favoured views on where to fix. We still believe that fixing for one year offers the most value. That is reinforced by our expectations for the OCR outlook. Despite the economy still performing relatively well and a labour market that continues to tighten, a clear lack of inflation pressure means that the RBNZ is going to be in no hurry to withdraw stimulus. We do not see the first OCR hike until August next year, and even then, there is a reasonable chance that hikes are even later than this. Moreover, when a tightening cycle does begin, it is highly likely to be gradual, which keeps the 'value' in rolling short-dated fixes.

Breakeven analysis supports this message. For instance, the average 2-year special rate is 29bps above the 1-year rate. It means that the 1-year rate would need to rise by 59bps (from 4.36% to 4.94%) over the next year in order for it to be cheaper fixing for 2 years at 4.65% than rolling two 1-year terms. **While not out of the question, that degree of increase is not our expectation.** There is a similar-sized step-up between the 2 year and 3 year (30bps); the breakeven on a 2-year at 4.65% versus a 3-year at 4.95% is 5.25%. Again, that degree of lift in the 2-year rate is not out of the question, but would require either more confidence that the OCR is moving up or the global inflation pulse is shifting. It is hard to have much conviction in that prospect right now.

One thing we are watching that could alter the picture for mortgage rates is a recent lift in bank funding costs (represented by a lift in bills-OIS spreads). We don't expect these pressures to escalate and impact significantly on mortgage rates. **However, if borrowers are concerned by this risk, or by the fact that we believe there is a greater chance that interest rates are likely to rise than fall, they may wish to spread their borrowing over a number of fixed terms.** That is always a strategy that makes sense from a risk-management perspective; having a number of 'tranches' rolling over more regularly does smooth interest expenses.

Carded special mortgage rates^



Special Mortgage Rates		Breakevens for 20%+ equity borrowers			
Term	Current	in 6mths	in 1yr	in 18mths	in 2 yrs
Floating	5.86%				
6 months	5.14%	3.58%	4.80%	5.09%	5.41%
1 year	4.36%	4.19%	4.94%	5.25%	5.56%
2 years	4.65%	4.72%	5.25%	6.00%	6.88%
3 years	4.95%	5.40%	6.23%	6.45%	6.63%
4 years	5.77%	5.89%	6.21%		
5 years	5.84%	#Average of "big four" banks			

Standard Mortgage Rates		Breakevens for standard mortgage rates*			
Term	Current	in 6mths	in 1yr	in 18mths	in 2 yrs
Floating	5.86%				
6 months	5.21%	4.60%	5.70%	5.17%	5.88%
1 year	4.91%	5.15%	5.44%	5.52%	6.02%
2 years	5.17%	5.34%	5.73%	6.03%	6.56%
3 years	5.45%	5.73%	6.19%	6.36%	6.66%
4 years	5.87%	6.06%	6.36%		
5 years	6.07%	*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 February 2018 (based on REINZ data)

	House prices (ann % chg)	3mth % chg	No of sales (sa)	Mthly % chg	Avg days to sell (sa)
Northland	9.1	0.4	214	+4%	44
Auckland	3.9	1.2	2,016	+2%	43
Waikato	10.5	5.6	687	-2%	39
Bay of Plenty	10.5	3.0	438	+1%	44
Gisborne	-3.3	2.3	51	-12%	33
Hawke's Bay	18.3	3.3	220	-5%	29
Manawatu-Whanganui	13.5	3.7	412	+4%	34
Taranaki	4.4	-2.4	172	+3%	39
Wellington	3.5	1.2	739	+8%	32
Tasman, Nelson and Marlborough	1.9	-0.2	65	+48%	45
Canterbury	4.3	-0.1	850	-7%	42
Otago	7.7	4.2	381	-5%	37
West Coast	-11.0	-16.2	44	+19%	114
Southland	14.8	2.4	171	-2%	33
NEW ZEALAND	**7.1**	**3.5**	**6,665**	**-1%**	**37**

Key forecasts

	Actual			Forecasts						
Economic indicators	**Jun-17**	**Sep-17**	**Dec-17**	**Mar-18**	**Jun-18**	**Sep-18**	**Dec-18**	**Mar-19**	**Jun-19**	**Sep-19**
GDP (Ann Avg % Chg)	3.3	3.0	2.9	2.8	2.8	2.9	3.0	3.1	3.2	3.1
CPI Inflation (Annual % Chg)	1.7	1.9	1.6	1.1	1.4	1.5	1.6	1.7	2.1	2.2
Unemployment Rate (%)	4.8	4.6	4.5	4.3	4.3	4.2	4.2	4.1	4.1	4.1
House Prices (Annual % Chg)	7.0	3.3	3.5	2.3	2.2	2.0	0.5	1.0	1.5	2.0
Interest rates (RBNZ)	**Jun-17**	**Sep-17**	**Dec-17**	**Mar-18**	**Jun-18**	**Sep-18**	**Dec-18**	**Mar-19**	**Jun-19**	**Sep-19**
Official Cash Rate	1.75	1.75	1.75	1.75	1.75	1.75	1.75	1.75	1.75	2.00
90-Day Bank Bill Rate	2.0	2.0	1.9	1.9	1.9	1.9	2.0	2.0	2.0	2.3
Floating Mortgage Rate	5.9	5.9	5.9	5.9	5.9	5.9	5.9	5.9	5.9	6.1
1-Yr Fixed Mortgage Rate	5.1	5.0	5.0	5.2	5.1	5.2	5.2	5.2	5.3	5.4
2-Yr Fixed Mortgage Rate	5.3	5.2	5.3	5.3	5.3	5.4	5.4	5.4	5.6	5.7
5-Yr Fixed Mortgage Rate	6.3	6.3	6.2	6.2	6.3	6.4	6.5	6.5	6.7	6.8

Source: ANZ, Statistics NZ, RBNZ, REINZ

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