ANZ RESEARCH

NEW ZEALAND PROPERTY FOCUS

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INSIDE

CONTRIBUTORS

Sharon Zollner
Chief Economist
Telephone: +64 9 357 4094
E-mail: Sharon.Zollner@anz.com

Philip Borkin
Senior Economist
Telephone: +64 9 357 4065
Email: Philip.Borkin@anz.com

ON ICE BUT NOT ON THE ROCKS

SUMMARY

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

FEATURE ARTICLE: HOUSING MARKET ON ICE DOESN'T MEAN ECONOMY ON THE ROCKS

Over recent months we have outlined our thoughts on where we believe the housing market goes from here. Although activity has shown more signs of life of late, and the risk profile does appear less negatively skewed than it did, we have not changed our overall views. We see prices effectively staying 'on ice' for the foreseeable future, with modest growth overall. But what does that imply for the broader economic outlook? History has taught us that the housing market has a critical bearing on the economic cycle. All else being equal, we expect softer house price growth to be a headwind for consumption growth going forward, although perhaps to a lesser extent than history would suggest, given that the softer housing market has not been driven by a turn in the interest rate cycle, but rather by a more restrictive credit landscape, including macro-prudential policy. Nevertheless, with the household saving rate having deteriorated over recent years (to an unsustainable level in our view), weaker house price performance is expected to see households look to rebuild precautionary saving, and this will be a headwind for overall activity growth.

PROPERTY GAUGES

Housing market activity has shown more signs of life of late, bouncing off low levels, perhaps on the back of recent mortgage rate falls. 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.

ECONOMIC OVERVIEW

We retain a broadly constructive view of the medium-term growth picture, with support from stimulatory fiscal policy, accommodative financial conditions and elevated terms of trade. That said, while risks are arguably not as negatively skewed as they were, we remain a little more circumspect towards the near-term growth picture as the economy transitions in terms of its growth drivers and grapples with a softer housing market. We are still biased towards OCR hikes in time. However, with a lack of clear evidence of a lift in domestic price pressures, the OCR looks to be on hold for some time yet.

MORTGAGE BORROWING STRATEGY

With average 1-year fixed mortgage rates falling in the past month, and the 1-year rate now clearly the low point on the mortgage curve, it offers the most value in our eyes. While the gap to the 2-year rate is not large, and may be attractive for those concerned about the possibility of the OCR moving up within the next year, that is not our expectation. In fact, we don't see the first OCR hike until August next year, and it could be even later than this. Indeed, the RBNZ sees the risks of the next move being a hike or a cut as balanced. But ultimately, borrowers may wish to spread risk by borrowing over a number of fixed terms.

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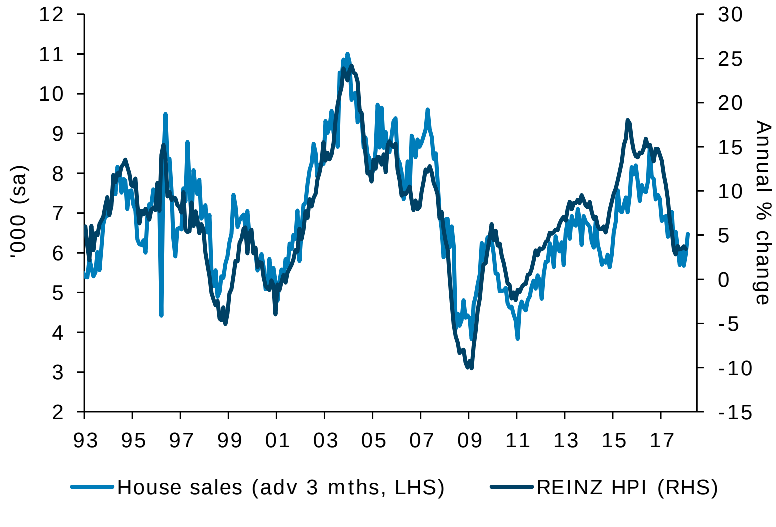
A BOUNCE, BUT NOT RESURGENCE

When it comes to assessing the broader outlook for the economy, one of the key things we continue to watch locally is the housing market. History has taught us that its performance has a critical bearing on not only construction and property-related services and manufacturing, but also on consumer confidence and spending. It therefore has key implications for the path of inflation and hence monetary policy. It is little wonder when you consider that housing is easily the biggest asset class in the country (valued at over $1 trillion).

Recent data confirms the housing market has staged something of a comeback. After falling sharply over the majority of 2017, January figures showed that sales volumes have rebounded 17% from their September 2017 lows. House prices, based on our preferred REINZ House Price Index measure, have risen for six consecutive months after falling over the prior three. The median number of days to sell (a good indicator of market momentum) while admittedly lifting in January, is still well below its historical average. Auckland, which had clearly outperformed, and then underperformed over recent times, has experienced a similar turnaround.

Figure 1: National house sales and prices



Source: REINZ, ANZ Research

This bounce has been large enough that it will reinforce in the minds of RBNZ officials that it was right to take a cautious approach when it comes to rolling back LVR restrictions. In fact, we believe a further softening in those restrictions is unlikely in the near term.

That said, the housing market is still a long way off its lofty heights of 2016. Despite the recent bounce, sales volumes in January were still 12% below the 2016 monthly average. In three-month annualised terms, national house prices are currently growing at 7.2%. At the height of market strength in mid-2016, that pace was 20%. And at 37 days, the median number of days to sell is up significantly from around 30 days in February 2016.

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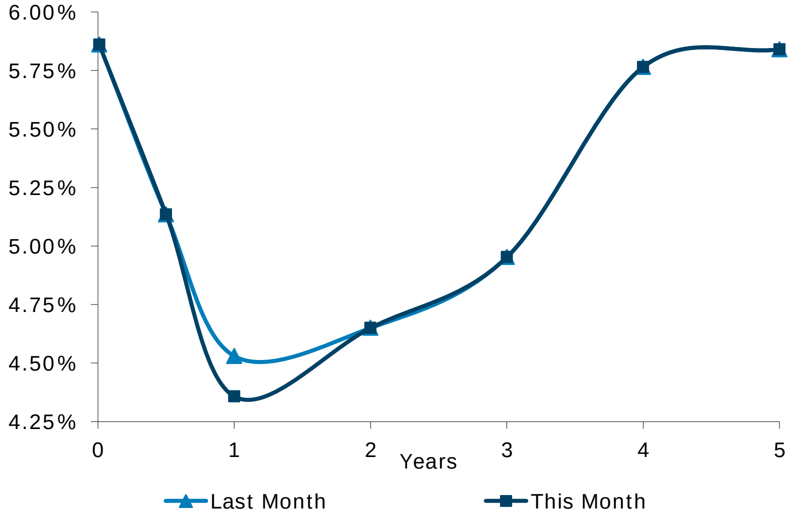
Importantly, we don't see this recent bounce turning into a full-blown resurgence. We have outlined our thoughts on the outlook for house prices in recent editions of our *Property Focus*, and our overall views on the market have not changed.

A number of factors balance out. **The topside should be capped to a degree by affordability constraints and the measures proposed by the new Government** (banning of non-resident buyers, extension of the bright-line capital gains test, and possible other tax changes). At the very minimum, we suspect this will keep sentiment contained and ensure investors are not the driving force they were when the market was at its lofty heights over 2016.

But there remain supportive forces too:

- **A little more competition in the mortgage market has surfaced as banks' funding pressures have eased.** Short-term fixed mortgage rates have fallen a little over the past month, which perhaps could also be a sign that banks' appetite to lend is increasing too (i.e. both a volume and price story). That will provide some support to the market (and probably already is doing so).

Figure 2: Average 'special' mortgage rates across the 'Big-4' banks



Source: interest.co.nz, ANZ Research

- **Pent-up demand for housing remains.** Net migrant inflows have eased off all-time highs, but only modestly, and still point to the need for a significant rate of home building. This is not only in order to keep pace with population growth, but also to eat into what we still deem to be an under-build situation in Auckland.
- **A sudden jump in housing supply seems unlikely.** Skill shortages are prevalent and cost pressures are bringing into question the viability of some projects. Despite the best intentions of policymakers, the sector just does not have the ability to ramp up additional building activity quickly.
- **Related to this, we are at the point in the cycle where cash-flow and margin pressures in the construction sector can intensify.** Delays to projects or significant cost inflation (like we have seen) can cause cash-flow problems for over-extended firms. That will act as a further constraint on expansion, especially at a time when these margin pressures will see banks naturally reassess risk metrics and their lending appetites to the sector.

So it all speaks to a market where a number of opposing forces are at play. Is the risk profile for the housing market as negatively skewed as it was a few months ago? No; especially with the economy's credit wheels turning perhaps a little faster. But likewise, we have not changed our view that the market is unlikely to surge higher either. So it is a case of prices more or less being on ice for the foreseeable future. More specifically, we assume annual house price growth slows to, and holds around, 2-2½% over the next few years.

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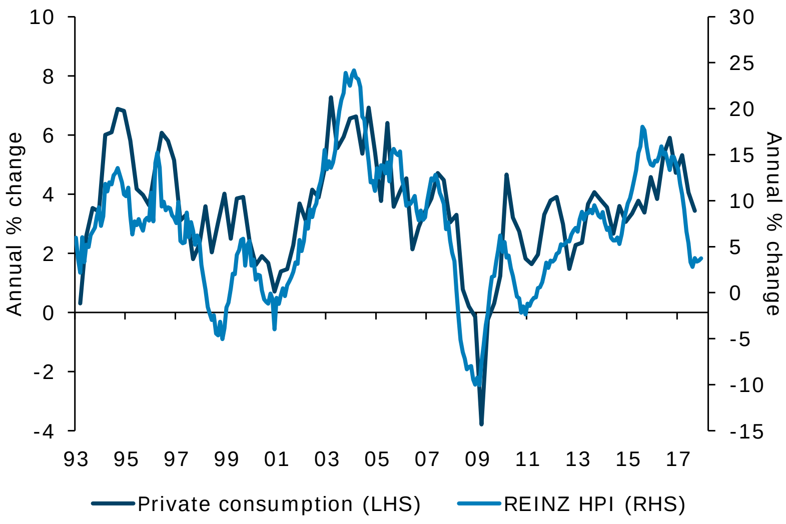
SO WHAT DOES THAT MEAN FOR HOUSEHOLD SPENDING?

As mentioned, the housing market has historically been a key cyclical driver of the economy. Whether that has been through wealth-related channels as households draw down growing equity in their homes to purchasing big-ticket or discretionary type goods and services, or the impact on construction market sentiment as stronger house price growth provides a signal to expanding housing supply, turning points in the housing market have often coincided with turning points in the economic cycle itself.

But one of the conundrums of recent years was the apparent relative softness in household consumption growth despite the strong performance of the housing market. Now don't get us wrong, household consumption was still reported to be growing at a decent pace overall, supported by reasonable disposable income growth, low interest rates and strong population growth. It just was not growing as strongly as one would have expected given the strength in house price inflation. It appeared that households were showing far more spending restraint than had been seen in the past, which, at the time, was one of the reasons proposed for why the current account deficit had remained contained and domestic inflation pressures had not risen to the extent expected. The RBNZ went on the record to highlight this conundrum.[1] **Prudence was the new black.**

However, the historical revisions to GDP changed that story. In combination with the Q3 2017 GDP release in late December, Statistics NZ put through some meaningful upward revisions to both the level and growth of GDP over 2015 and 2016, as a result of incorporating both new information and slightly altered methodologies. It lifted the overall level of GDP by close to 3%, and saw the average quarterly growth rate in GDP growth jump by an average of 0.2%pts per quarter over 2015 and 2016. And as part of that, real consumption is now reported to have grown at close to a 6% y/y pace in Q3 2016, which is right around the time when the housing market was humming. It was the strongest growth since 2005. The circle had been squared, and the conundrum over why consumption growth had not been stronger was not a conundrum anymore. But because of that, the household saving rate is now shown to have deteriorated more than initially thought, to be currently sitting around -3% of disposable income. **So much for that household restraint!**

Figure 3: Real private consumption and house price growth



Source: REINZ, Statistics NZ, ANZ Research

In fact, we have updated a simple but useful model for household consumption that now shows little evidence of any change in household behaviour over recent times. The model estimates household consumption using gross housing wealth, financial wealth (net of financial liabilities) and household disposable income (all in real per capita terms) between 1995 and 2017. We find that the long-run elasticity with respect to consumption of changes in housing wealth is 0.14. That means that a 1% increase in real per capita housing wealth is associated with a 0.14% increase in real per capita consumption on average. And importantly, that elasticity does not change (at least to a significant degree) if we split the sample into pre and post-GFC periods, from 1995 to 2007 and 2008 to 2017 (0.18 and 0.13 respectively). In other words, households' spending decisions appear to still be just as affected by the housing market as they have been historically.

[1] "See Changing dynamics in household behaviour: What do they mean for inflationary pressures?" A speech by Deputy Governor Geoff Bascand in November 2016.

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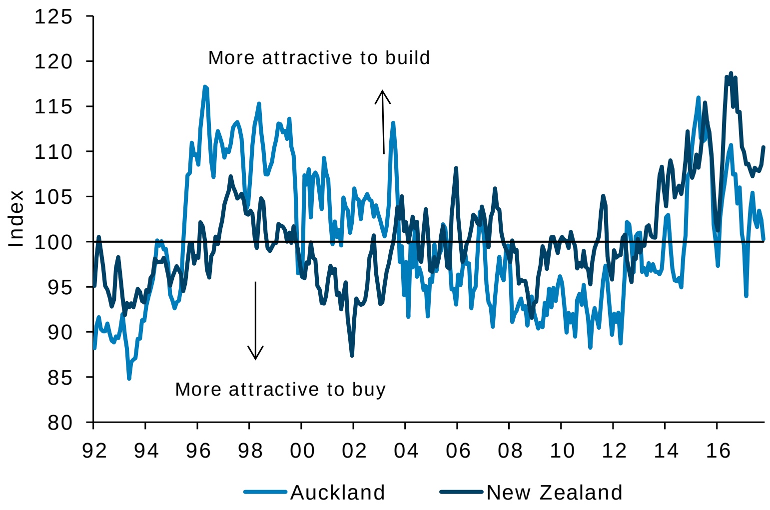
So if the traditional relationship between the housing market and consumption is still alive and well, one must conclude that (all else being equal) the recent slowdown in house price inflation will be a real headwind for spending growth. In fact, real household consumption growth has already close to halved from the 6% pace seen in 2016, and perhaps has further to go. Based on our forecasts for house price inflation, we see real consumption growth slowing to less than 2½% by the end of 2019 – although to be fair, more modest population growth plays a role here too.

WHAT ABOUT OTHER SECTORS?

The housing market – and in particular house prices – also has a key bearing on the construction sector through the impact on the appetite to build. If prices are growing rapidly, then the risk proposition for a developer is very different to a situation where prices were stagnant, for example. That is clearly quite pertinent at present, given we have also seen significant construction cost inflation that has squeezed margins for many. In fact, we estimate using a simple Tobin's Q type analysis, that given the moderation seen in Auckland house price inflation, it is now a toss-up between buying an existing house and building new, although that is not quite the case for the country as a whole.

Figure 4: Relative attractiveness of building or buying a residential property



Source: ANZ Research

All else being equal then, it is another factor perhaps arguing for a cooling in construction growth, at least in Auckland. The irony, of course, is that a construction slowdown would do nothing to help ameliorate the supply shortages currently evident, and will ultimately keep house prices elevated. So it is all swings and roundabouts.

BUT COULD THIS TIME BE DIFFERENT?

There is a complicating factor of which we need to be mindful; this has not been your grandfather's housing market slowdown. Whereas the housing cycle historically has often been arrested by higher interest rates, this time around the cooling has been driven more by macro-prudential policy and arguably more restrictive credit conditions. Is it possible that the observed tight relationship between spending and house price growth is actually primarily just a correlation, a reflection that both variables are impacted by a third influence (interest rates)? Or does the house price cycle influence consumption directly through its impact on household balance sheet strength?

We suspect it's a bit of both.

- Perhaps the fact that interest rates remain historically low – and are expected to remain that way (short-term rates, at least) – means that consumption growth won't follow the pace of house price growth down to the extent that has been seen in the past. After all, mortgage serviceability is at about historically average levels, despite record-high levels of debt.

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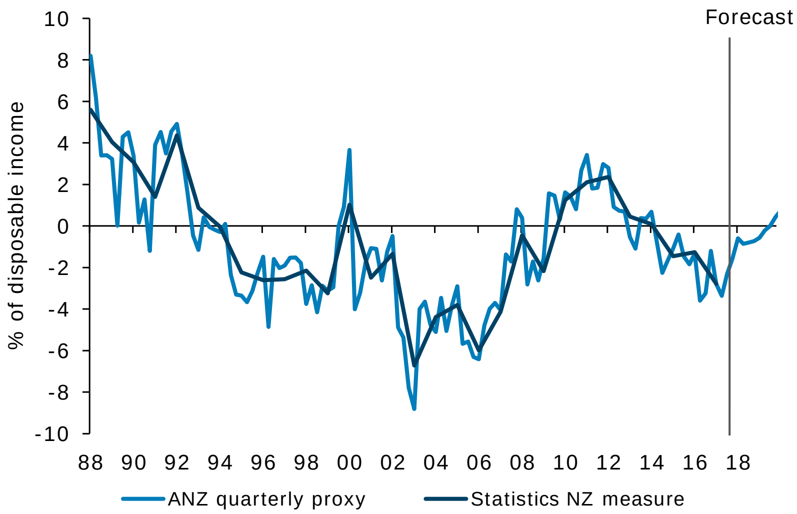
- Likewise, whereas historically a softer outlook for house price inflation would be expected to correspond to lower levels of dwelling construction, at the very least, the downside is likely to be supported by the strong desire of policymakers to ramp up public-led work. The Government is stumping up the initial capital through its KiwiBuild programme to lift housing supply, and there is a strong social rather than financial motivation in this work. This means that the downside of the house building cycle may arguably be more limited than in historical cycles.

However, we still believe there will be some impact, especially as we don't deem the deterioration in the household saving rate to be sustainable. At a time when the asset side of the household balance sheet (housing) is not performing as strongly as it was, we suspect households will look to rebuild precautionary saving, getting their net equity up and debt-to-income ratios down (or at least no higher) the hard way. All else equal, that will be a headwind for consumption growth, and hence GDP growth more broadly.

Figure 5: Household saving rate



Source: Statistics NZ, ANZ Research

In sum, one ignores the housing market at one's peril when considering the broader economic outlook. It is New Zealand households' largest asset, and largest source of debt. Residential construction accounted for 6.6% of GDP growth over the past 12 months, while household consumption accounted for 61%. Recent data revisions have implied that the relationship between housing and consumer spending is as strong as it ever was, and while some elements are different this time (namely the influence of macro-prudential policy and a Government that intends to be more actively involved in house-building) we suspect that a cooling housing market will put a chill on broader economic growth, particularly in context of record-high household debt. Our forecasts are for GDP growth to roughly hover between 2½ and 3% over the next two years; a still-solid outlook but certainly weaker than the 4½% pace evident over mid-2016. While this economic cycle has legs yet, the low-hanging fruit has been picked.

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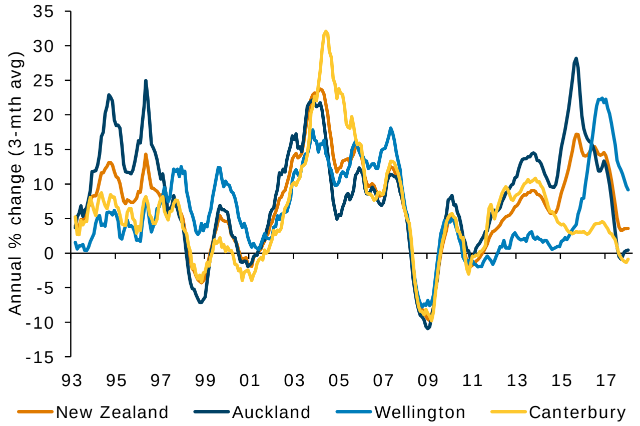
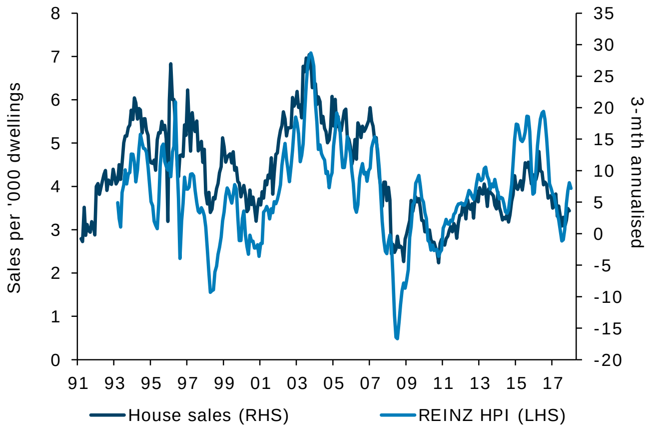
Figure 1. Regional house price inflation



Source: ANZ, REINZ

The REINZ House Price Index rose for a sixth straight month in seasonally adjusted terms in January, lifting 0.3% m/m. Annual growth was broadly steady at 3.4% y/y, which is effectively where it has held for the past seven months (the chart is presented in 3-month average terms). After rising solidly over the prior five months, Auckland prices were unchanged in the month, to be all but unchanged on the year (0.2% y/y). Across the rest of the country, prices rose 0.7% m/m in January, and are up 6.7% y/y. Of the major centres, Wellington continues to record the strongest annual price growth of 8.1% y/y, although this is off its highs.

Figure 2. REINZ house prices and sales



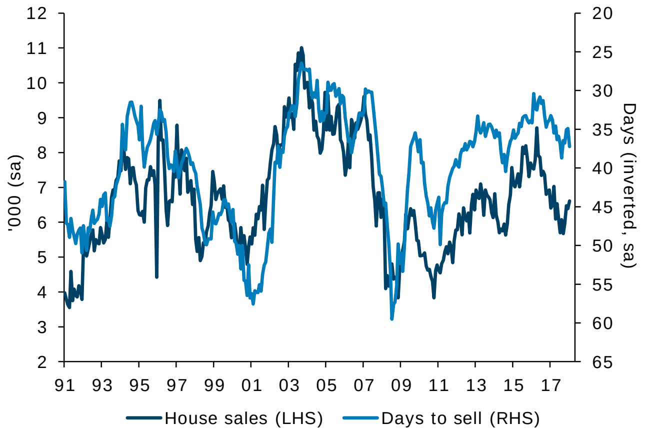
Source: ANZ, REINZ

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 3.5% in January to be up an impressive 10.0% q/q – but only 3.2% y/y. Looking through the noise, monthly sales have clearly bounced off the bottom (up 17% from their September lows) but have a way to go before they reach recent highs (still 6% below the 2017 high, and 12% below the average experienced over 2016).

From a regional perspective, Auckland partially unwound December's strong performance (9.7% m/m), falling 1.1% m/m (sa). That compares with a 6.4% m/m (sa) lift across the rest of the country.

Figure 3. Sales and median days to sell



Source: ANZ, REINZ

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

Nationally, the median time to sell a house rose by 2.3 days to 37.2 days (sa) in January. That is the longest period since August last year. It is still below the 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, Canterbury and the West Coast.

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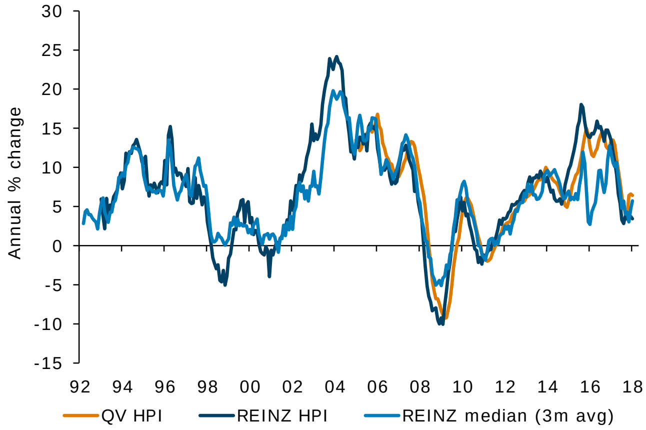
Figure 4. REINZ and QV house prices

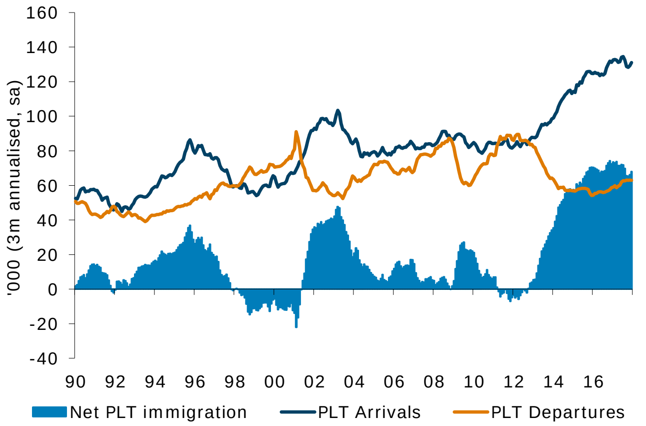


Source: ANZ, REINZ, QVNZ

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 rose 0.2% m/m (sa) in January, with annual growth lifting to 7.1% y/y – the highest in five months. This is stronger than the REINZ HPI (3.4% y/y) and QVNZ measures of price growth (6.4% y/y).

Figure 5. Net permanent/long-term immigration



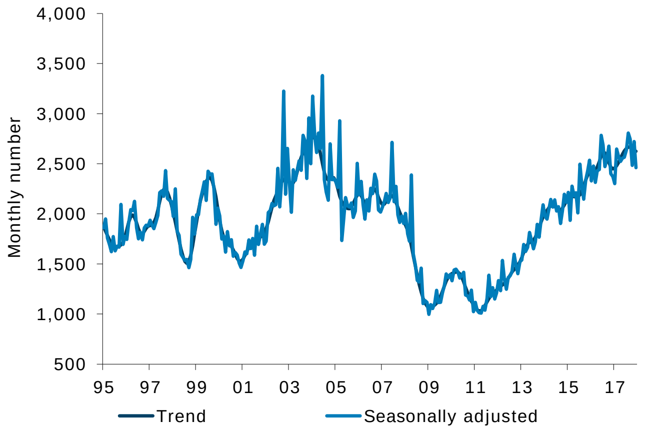
Source: ANZ, Statistics NZ

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.

After easing off highs, net migrant inflows have been a little more stable of late. In seasonally adjusted terms, a net inflow of 5,700 migrants was recorded in December. That is the highest net inflow in five months, although only modestly so.

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. Issuance fell 9.6% m/m in December. Somewhat coincidently it follows a 9.6% m/m lift in November and 9.6% m/m fall in October. This volatility has been led entirely by the erratic multi-dwelling component, which we estimate fell 21% m/m. Issuance for 'houses' fell 2.3% m/m, its fifth consecutive fall.

When we step back from monthly volatility, 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.

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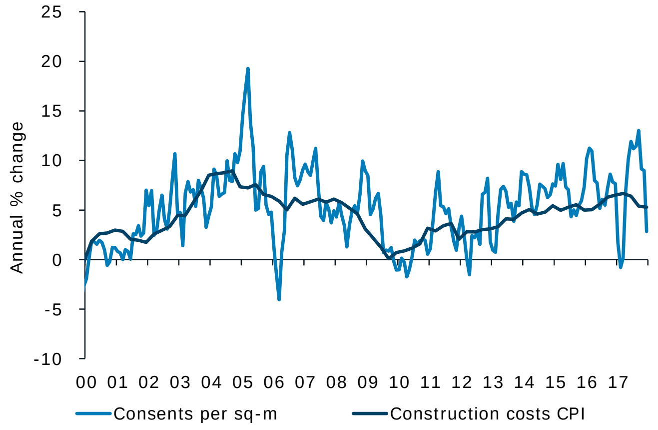
Figure 7. Construction cost inflation

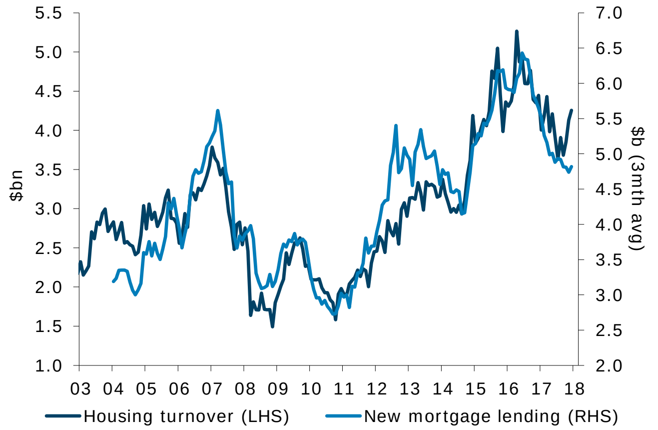


Source: ANZ, Statistics NZ

On a three-month average basis, **the value of residential consents per square metre** – a proxy for construction cost inflation – **dropped sharply in December to just 2.8% y/y** (3-month average). This is down from over 13% in September 2017. This measure is volatile, so we are not reading into the fall at this stage – it can often get thrown around by compositional effects.

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



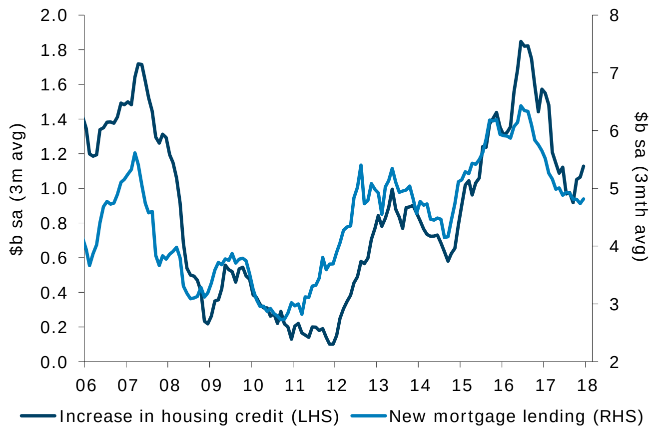
Source: ANZ, RBNZ

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 was unchanged in December in seasonally adjusted terms (the chart is presented in 3-month average terms). That follows increases of 3.3% m/m and 1.8% m/m in October and November respectively. However, new lending remains down 13% y/y.

New investor lending continues to be soft. In December, lending to investors was down 23% y/y, making up less than 21% of total lending. That is well below the 35% share seen in mid-2016.

Figure 9. New mortgage lending and housing credit



Source: ANZ, REINZ, RBNZ

Total household lending growth was steady in November, at 0.4% m/m (sa). This is effectively the same as the average monthly growth rate over the past six months. As such, growth in three-month annualised terms has also been relatively steady of late, sitting at 5.3% in November.

High-LVR lending restrictions, increased credit rationing by banks, and evolving expectations regarding capital gains – are all 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.

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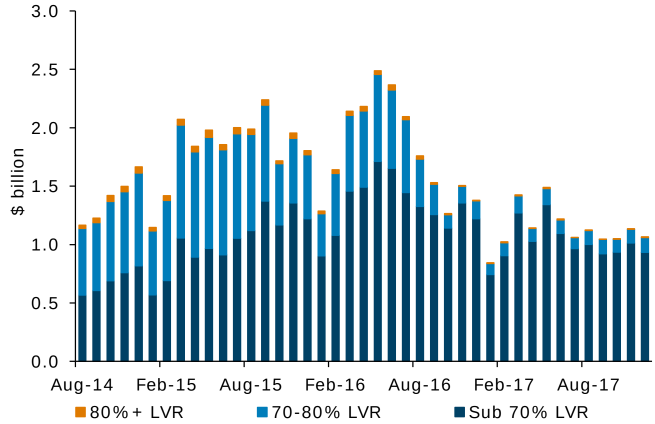
Figure 10. Investor lending by LVR

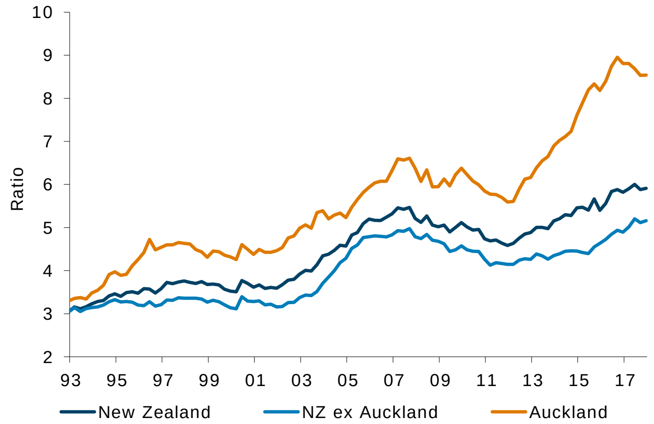


Source: ANZ, RBNZ

New lending to investors is well off its mid-2016 peak, and was down 23% y/y in December, but is showing signs of basing. Investors' share of overall new lending, at 20.9%, is well down from a peak of 35% in June 2016. This lower share no doubt relates, at least in part, to the impact of the RBNZ's latest round of LVR restrictions (which came into force in October 2016). While the RBNZ has recently announced that these restrictions will be eased modestly (from 1 January 2018), the easing to date is best defined as a tweak.

Related to the LVR restrictions, a larger share of new lending is on less-risky terms. In December, the share of total investor lending done at LVRs of less than 70% was 88%. That is a far greater share than in late-2014, when it was less than half.

Figure 11. Regional house prices to income

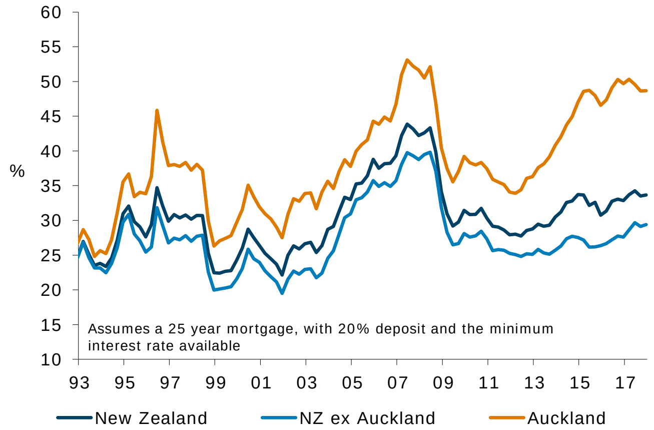


Source: ANZ, REINZ, Statistics NZ

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, however, has seen its ratio ease from a high of nine 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 5.2 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% at the moment.

However, once again 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 broadly 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, perhaps on the back of recent mortgage rate falls. 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.

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 still clearly relevant. It is the main reason we see the Auckland market underperforming over the next few years.
Serviceability/ indebtedness	High debt and low rates okay. High rates not.	↔/↓	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	Peaking	↔	Appears to have peaked even ahead of potential policy changes. But 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.
Liquidity	Tight	↔/↓	Credit rationing still apparent, although closure of bank funding gap suggests a little more wriggle room.
Globalisation	Mixed bag	↔	Non-resident buyers no longer that influential. Other big global housing markets cooling a little 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 the argument that housing shortages are the key market driver is fiction.
On balance	**Flat-lining**	↔	**Positives offsetting the negatives, leaving the market in limbo. Auckland weaker as affordability bites harder.**

PROPERTY GAUGES

Figure 1: Housing affordability

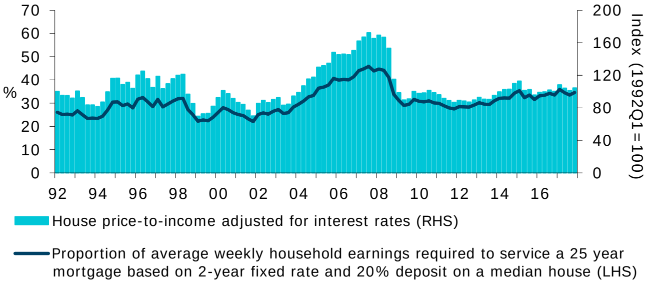


Figure 2: Household debt to disposable income

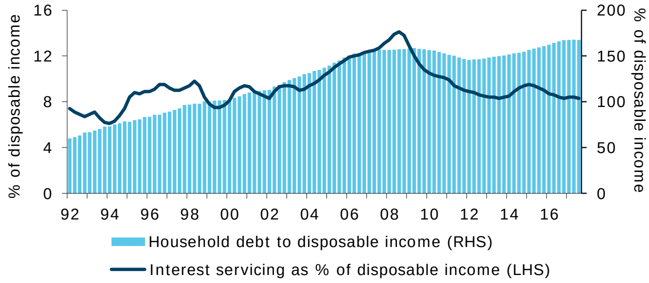


Figure 3: New customer average residential mortgage rate (<80% LVR)

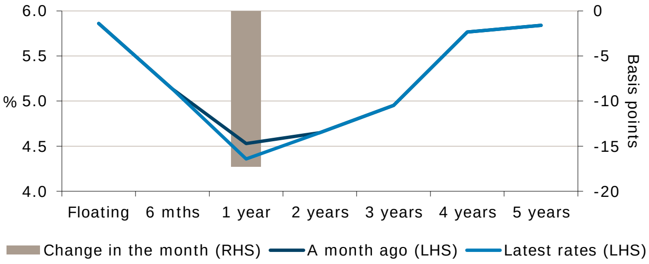


Figure 4: Net migration

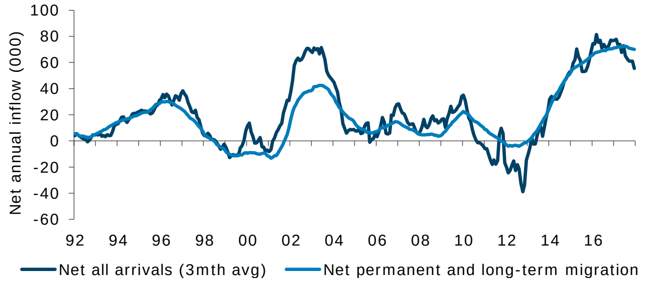


Figure 5: Housing supply-demand balance

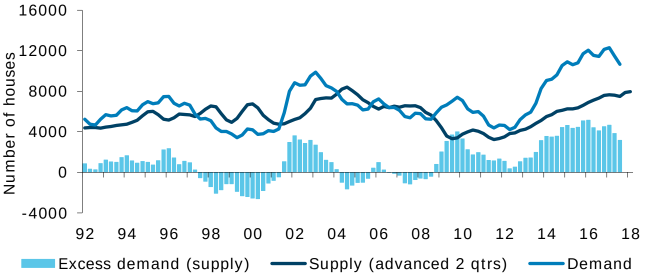


Figure 6: Building consents and house sales

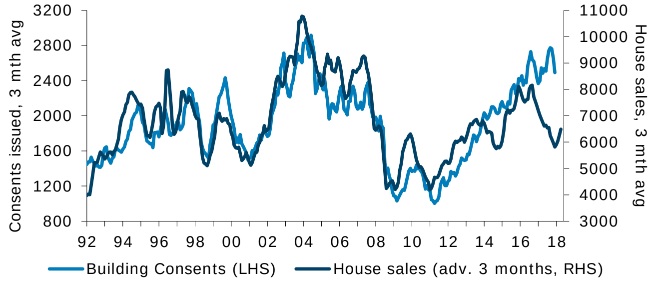


Figure 7: Liquidity and house prices

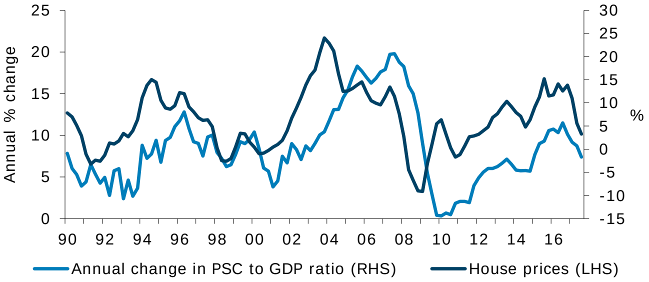


Figure 8: House price inflation comparison

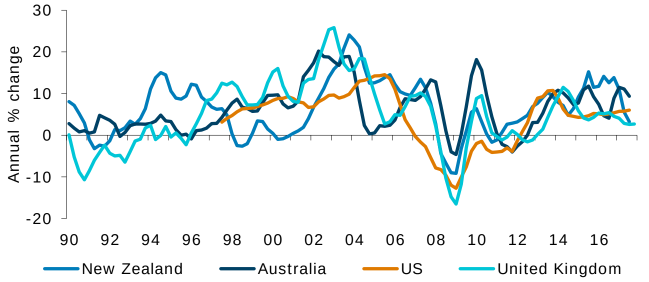


Figure 9: Housing supply

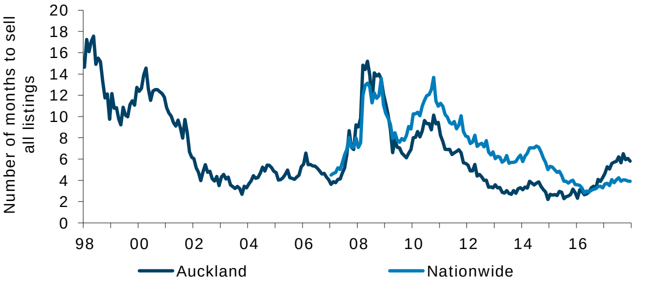
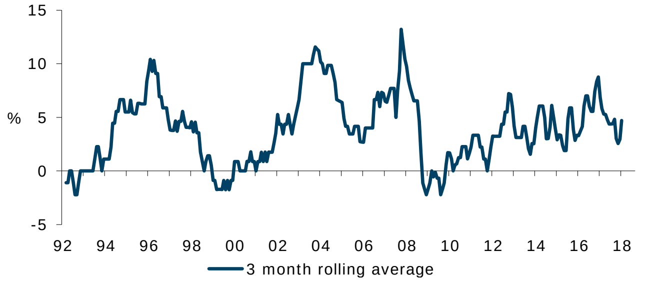


Figure 10: Median rental, annual growth



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

ECONOMIC OVERVIEW

SUMMARY

We retain a broadly constructive view of the medium-term growth picture, with support from stimulatory fiscal policy, accommodative financial conditions and elevated terms of trade. That said, while risks are arguably not as negatively skewed as they were, we remain a little more circumspect towards the near-term growth picture as the economy transitions in terms of its growth drivers and grapples with a softer housing market. We are still biased towards OCR hikes in time. However, with a lack of clear evidence of a lift in domestic price pressures, the OCR looks to be on hold for some time yet.

OUR VIEW

Recent data revisions imply the economy has been growing better than initially estimated. That said, we still anticipate something of a growth wobble in the near term but for activity to rebound after that – but not to growth rates previously seen, with population growth set to slow and a productivity miracle unlikely.

We are seeing some typical late-cycle challenges (capacity pressures, housing excesses, stretched household balance sheets and margin pressure). However, cautious banks and a proactive central bank mean it hasn't been 2007 all over again – the current account is contained; credit growth is relatively subdued. But household debt is high and even in the best-case scenario this will dampen consumption growth and hence overall activity growth in the future.

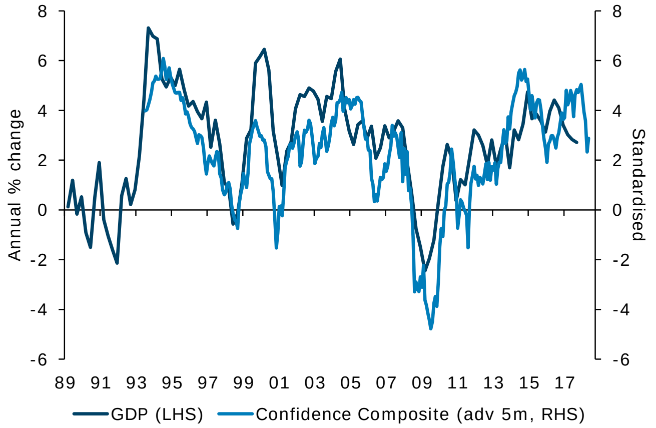
What we are watching:

- **The housing market.** This time is different? It is, in that the slowdown seen over the past 12 months has not been caused by higher interest rates. But the impact on consumption growth could nonetheless be marked as people reassess their strained balance sheets without the prospect of easy capital gains.
- **The impact of heightened policy uncertainty.** We are reasonably agnostic on the new Government's proposed policy platform overall, but change can be unsettling, leading to restrained spending and hiring decisions. We are assuming the decline in business confidence contains a protest element and that firms will eventually get on with it.

There are some broader growth headwinds. The labour market is maturing. Migration appears to have topped out. The construction sector is maxed out. But a strong fiscal impulse is looming and the prospects for household income growth are solid, given our expectation that wage growth is set to finally increase (albeit modestly). In addition, despite recent global financial market volatility, domestic financial conditions remain supportive. **All up, we remain reasonably constructive on the medium-term picture.** We are not seeing the same degree of imbalances or inflationary pressures that have often been the catalyst for a sharper downturn.

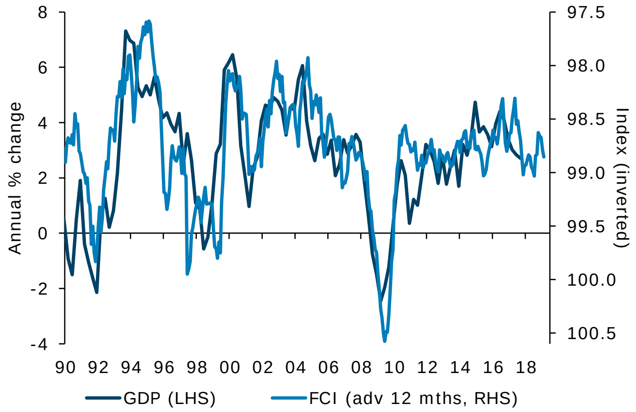
We are still biased towards OCR hikes in time. That is based on an expectation of a gradual lift in wage inflation as skill shortages bite, which should eventually see core inflation approach 2%. We also expect the NZD to face more downward pressure on narrowing interest rate differentials. However, neither of these forces are evident right now, meaning that the RBNZ will take an extremely cautious approach to tightening policy. We have pencilled in the first hike for August 2019.

Figure 1. GDP vs Confidence Composite



Source: ANZ, Statistics NZ

Figure 2. Financial conditions and GDP



Source: ANZ, Statistics NZ

MORTGAGE BORROWING STRATEGY

SUMMARY

With average 1-year fixed mortgage rates falling in the past month, and the 1-year rate now clearly the low point on the mortgage curve, it offers the most value in our eyes. While the gap to the 2-year rate is not large, and may be attractive for those concerned about the possibility of the OCR moving up within the next year, that is not our expectation. In fact, we don't see the first OCR hike until August next year, and it could be even later than this. Indeed, the RBNZ sees the risks of the next move being a hike or a cut as balanced. But ultimately, borrowers may wish to spread risk by borrowing over a number of fixed terms.

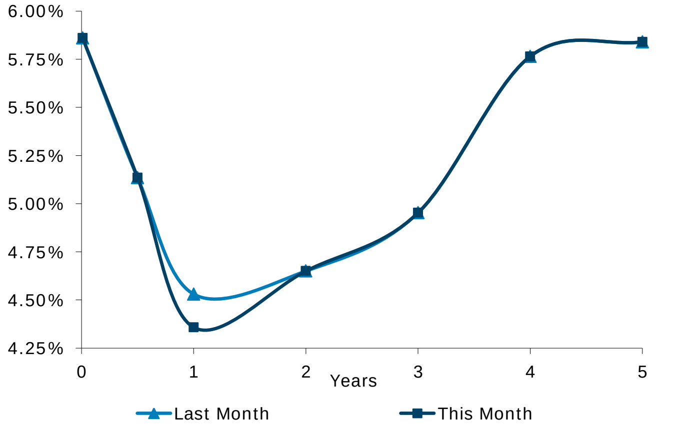
OUR VIEW

Average 1-year mortgage rates have fallen in the past month. Across the 'big four' banks, the average special 1-year fixed mortgage rate has fallen by 17bps to 4.36%. Rates for all other tenors were unchanged.

For the past couple of months we have noted that the decision between fixing for one or two years was a relatively close call. **But given the recent falls, and a wider gap between the 1- and 2-year fixed rates, we now see clearer value in the 1-year rate.** 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 and recent strength in the NZD mean 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, we toyed with the idea of flat-lining our OCR profile altogether. What's more, when hikes do get underway, what is clear is that the OCR will only be lifted gradually. That keeps the "value" in rolling short-dated hedges.

Breakeven analysis supports this message. For instance, the average 2-year special rate is now 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.

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			

Some borrowers may wish to spread their borrowing over a number of fixed terms. That makes sense from a risk-management perspective, and having a number of tranches rolling over more regularly does smooth interest expenses. We're also mindful that we do still expect rates to ultimately rise rather than fall – even if we think the rise will occur later rather than sooner. That may leave some borrowers feeling a bit nervous, and make them more inclined to select a longer term. **These are all valid considerations**, even if, as noted, a pure cost emphasis would shift the focus towards shorter-dated fixes.

^ 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 2018 (based on REINZ data)

	House prices (ann % chg)	3mth % chg	No of sales (sa)	Mthly % chg	Avg days to sell (sa)
Northland	7.7	-0.4	198	+1%	42
Auckland	-1.2	1.3	1,953	+2%	37
Waikato	11.0	3.0	694	+6%	42
Bay of Plenty	4.1	3.7	436	-1%	42
Gisborne	4.9	7.4	57	+16%	37
Hawke's Bay	17.0	3.0	228	+15%	35
Manawatu-Whanganui	11.6	3.9	389	+0%	38
Taranaki	4.2	-1.8	167	-8%	44
Wellington	11.8	2.3	670	0%	31
Tasman, Nelson and Marlborough	3.2	3.4	44	-8%	42
Canterbury	2.1	1.7	894	+22%	39
Otago	32.7	7.2	391	+3%	35
West Coast	4.8	-19.5	29	+10%	170
Southland	11.8	3.8	171	+15%	37
NEW ZEALAND	**6.8**	**2.2**	**6,612**	**+6%**	**37**

Key forecasts

	Actual			Forecasts						
Economic indicators	**Mar-17**	**Jun-17**	**Sep-17**	**Dec-17**	**Mar-18**	**Jun-18**	**Sep-18**	**Dec-18**	**Mar-19**	**Jun-19**
GDP (Ann Avg % Chg)	4.2	3.6	3.0	2.9	2.8	2.7	2.8	2.9	3.0	3.1
CPI Inflation (Annual % Chg)	2.2	1.7	1.9	1.6(a)	1.1	1.3	1.4	1.5	1.7	2.1
Unemployment Rate (%)	4.9	4.8	4.6	4.5(a)	4.3	4.3	4.2	4.2	4.1	4.1
House Prices (Annual % Chg)	12.0	7.0	3.3	3.5(a)	2.3	2.2	2.0	0.5	1.0	1.5
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	2.0	2.0	2.0	2.1	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	5.0	5.0	5.1	5.1	5.1	5.2	5.4
2-Yr Fixed Mortgage Rate	5.3	5.2	5.3	5.3	5.4	5.4	5.5	5.5	5.7	5.8
5-Yr Fixed Mortgage Rate	6.3	6.3	6.2	6.3	6.5	6.6	6.7	6.7	7.0	7.0

Source: ANZ, Statistics NZ, RBNZ, REINZ

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Ph 64 9 357 4094, e-mail nzeconomics@anz.com, http://www.anz.co.nz