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NEW ZEALAND ECONOMICS
ANZ PROPERTY FOCUS

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DRINKS ON THE HOUSE

SUMMARY

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

CHIEF ECONOMIST CORNER

Tighter LVR restrictions have been signalled, and are effectively in place now. It's hard to go past the spirit of why they are needed given debt accumulation, New Zealand's balance sheet, and exuberance across asset prices. A further tightening in the availability of credit via macro-prudential policy looks inevitable. Key challenges will be to ensure a) it doesn't restrain housing supply; and b) it doesn't force lending into the shadow and unregulated banking sector. While the RBNZ is set to cut the OCR again, we doubt the full 25bps will be passed on. Credit growth is outpacing deposit growth, a partial by-product of lower interest rates. Any shortfall needs to either be funded offshore (which is more expensive) or by shifting relative pricing, which means competing more aggressively for deposits and slowing credit growth. Banks' cost of funds continues to rise. Deposit rates are now into the territory where further reductions would negatively impact already falling deposit growth rates. For money to be going out the door (lending), it needs to be coming in as well, and continued falls in deposit rates is incongruous with that. So we appear to be approaching a point where borrowers will not get the full benefit of OCR cuts, but depositors will not receive the full pain either, and in fact may benefit if competition heats up.

THE PROPERTY MARKET IN PICTURES

Across-the-board strength is the only way to describe housing market activity. The market is hot. In fact, it is so strong that some of the associated increases in credit and debt accumulation risk becoming problematic.

PROPERTY GAUGES

House prices remain severely extended and debt levels continue to hit new highs. Debt serviceability continues to be supported by low interest rates. Demand side impetus in the form of huge migration gains remain and supply is not keeping up. So we have a market pushing against valuation metrics, but still underpinned on a number of levels.

ECONOMIC OVERVIEW

The economy is expanding at a respectable rate. There is too much housing and borrowing centricity to the growth so it's not sustainable for long, but we'll take it for now. Firms are finding it more difficult to find labour and this theme will intensify over the year. We forecast GDP growth in excess of 3% over the year ahead. The usual risks and caveats remain; the global scene is uncertain, the local housing market needs to slow down (a tough ask amidst shortages) and dairy doldrums will continue. The counterbalance is ample in the form of tourism, construction, migration and non-dairy exports.

MORTGAGE BORROWING STRATEGY

Mortgage rates haven't moved far compared to last month. Given flagged changes to LVR restrictions announced by the RBNZ, it is the availability of credit rather than the cost (i.e. the interest rate) that is now the major focus. Nonetheless, as was the case last month, the 1 and 2 year rates remain the most competitive, and remain our favoured points on the curve. With the OCR biased lower (despite the booming housing market!), the slightly cheaper 1 year rate looks a little better, but there's not much in it. Longer term rates are not competitive, but are low by historic comparison, and may suit the more risk averse (despite the higher cost).

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MIXING YOUR DRINKS

Tighter LVR restrictions have been signalled, and are effectively in place now. **It's hard to go past the spirit of why** they are needed given **debt accumulation, New Zealand's balance sheet, and exuberance across asset prices.** A further tightening in the availability of credit via macro-prudential policy looks inevitable. Key challenges will be to **ensure a) it doesn't restrain** housing supply; and b) **it doesn't** force lending into the shadow and unregulated banking sector. While the RBNZ is set to cut the OCR again, we doubt the full 25bps will be passed on. Credit growth is outpacing deposit growth, a partial by-product of lower interest rates. Any shortfall needs to either be funded offshore (which is more expensive) or by shifting relative pricing, which means competing more aggressively for deposits and slowing credit growth. Banks' cost of funds continues to rise. Deposit rates are now into the territory where further reductions would negatively impact already falling deposit growth rates. For money to be going out the door (lending), it needs to be coming in as well, and continued falls in deposit rates is incongruous with that. So we appear to be approaching a point where borrowers will not get the full benefit of OCR cuts, but depositors will not receive the full pain either, and in fact may benefit if competition heats up.

ENOUGH IS ENOUGH

Here we go again. Tighter LVR restrictions have been signalled. Technically, the proposed RBNZ rules don't come into play until September, but because most **banks have already moved to implement them**, in practical terms, they are already in place. So, **from now on, investors require a whopping 40% deposit to purchase a house** irrespective of the region that house is located in. While we can debate the merits of LVR restrictions as a tool for cooling the housing market and how tight the restrictions need to be, it's hard to argue with the spirit of what the RBNZ is trying to achieve.

There are some brutal realities:

- **Debt is rising fast.** Household debt is now 163% of disposable income and credit growth is running at more than 8%. Even though income growth has recovered, it is *only* running around 5%. We're borrowing and spending our way to growth. That isn't sustainable in the long-run.
- **There is a strong correlation between house prices and debt accumulation.** Where the former heads, the latter tends to follow, although the causation also runs the other way. Credit availability is also a key driver of asset prices.
- **New Zealand is already heavily indebted to the rest of the world.** Net external debt is 56% of GDP, and most of that is private sector debt. It's an issue. Rating agencies such as Standard & Poor's, Fitch and Moody's note that it is too high. To be fair, it is a lot lower than what it was prior to the GFC (it peaked at 84% of GDP in 2008), but we are starting to see those pre-2008 style behaviours creep in again.

FIGURE 1. NET EXTERNAL DEBT

Source: ANZ, Statistics NZ

FIGURE 2. HOUSING CREDIT GROWTH

Source: ANZ, RBNZ, REINZ

- **Investor lending has been growing rapidly.** It has risen from 29% to 38% of total new mortgage lending since August 2014. Moreover, around 55% of new loans to investors are on interest-only terms (compared to 30% for other buyers). Both are high in our view.

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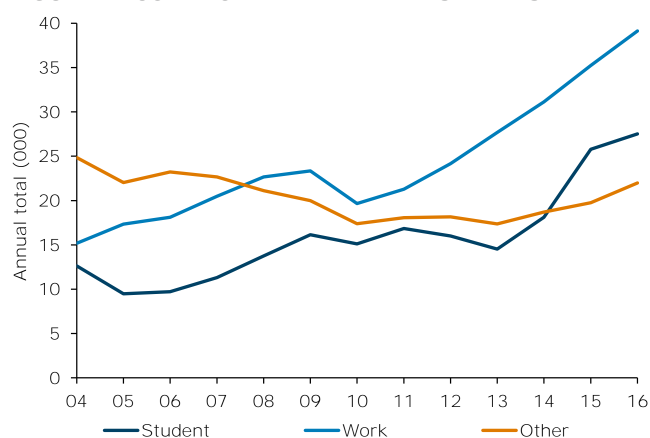
- **The RBNZ has cited global research suggesting that in the post-GFC experience, the default rate on loans to investors is significantly higher than for owner occupiers.**[1]
- **The average Auckland house price is at least 9 times the average income. Average house prices across the rest of the country are around 5 times.** Both are too high. Go back 50-70 years and the average family couldn't afford a car, but they could afford a house. Now it's the other way around, and while we don't want to get political, it's an irony that some people are now living in cars. Nobody wins from unaffordable house prices in the long term.
- **Rental yields continue to fall.** They are at historic lows in Auckland (below 3% in a number of cases); people are obviously purchasing for capital gain. House price expectations – particularly with regard to Auckland – remain high (respondents to our consumer confidence survey put them at 8.4%).
- **Auckland house prices have surged around 40% in two years.** Rents have risen 5% over the same period. So it's not purely a supply shortage story that is driving activity. Exuberance and 'animal spirits' within the market is clear to see.
- **We're seeing spill-overs into the regions.** First it was Hamilton and Tauranga, now it seems to be Wellington and everywhere in between.
- **Net migration continues to guzzle from the top shelf.** A combination of the 'uncontrollable' and the 'controllable' migrant flows has pushed net migration to record highs, adding to housing demand. The 'uncontrollable' part (effectively New Zealand and Australian citizens leaving and returning) has been a big contributor, but it's really just turned from being a less negative number as opposed to a large positive one. A policy lever to stem net migration could be pulled, though it is difficult to know which direction to pull that lever and how far. 'Controllable' work visas have surged 84% since 2011. Some migration is needed to fill skill shortages (we need someone to build those houses in Auckland after all!) but that's still a massive surge. Skill shortages abound so imported labour is critical to tap into. However, a surge from 21k to 39k is still massive. Student visas have increased 63% in the last five years. Interestingly, education exports have *only* grown 24% over the same period. So even in areas where the benefits of migration are told (i.e. they boost education exports), the numbers don't quite add up.

FIGURE 3. UNCONTROLLABLE VS CONTROLLABLE NET MIGRATION

Source: ANZ, Statistics NZ

FIGURE 4. CONTROLLABLE ARRIVALS BY VISA TYPE



Source: ANZ, Statistics NZ

- **The GFC was a telling example of what happens when irrational exuberance extends too far.** Of course, the RBNZ regularly conducts stress tests of local bank balance sheets and they come through well. In its own words, the banking system is "resilient". However, the experience of financial shocks is that there are tipping points at which a chain of events begins and market movements become exponential. That is difficult to model. And no one really knows where those tipping points are.

[1] For the UK see McCann (2014), 'Modelling default transitions in the UK mortgage market', Central Bank of Ireland Research Technical Paper 18//RT/14. And for the UK see Kelly R and T O'Malley (2014), 'A Transitions-Based Model of default for Irish Mortgages' Research Technical Paper 17/RT/14, Central Bank of Ireland.

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In hospitality parlance, the housing market is well into its second bottle of wine, and eying up a third. If left unchecked, an almighty hangover beckons. To be fair, some sympathy for some regions is warranted. They've been late to the party. It's only been in the past year or so that things have started to catch up, and the lifts have been an important source of economic vitality considering some of the challenges a low dairy payout has delivered. Some regions (Taranaki, Taupo and Hawkes' Bay for example) have barely knocked back the second glass and they're now being told the bar is shut given restrictions are now universal across the country. While we don't view house price gains as a "win" to anyone long-term (all it does is make the cost of accommodation higher), the fact that Auckland (and other cities) has left other regions behind has changed the distribution of wealth for the worse.

That said, while housing exuberance is clear to see, the evidence that this 'binging' is a widespread theme across the whole economy is not overwhelming.

- **The current account deficit is lower (3.0% of GDP compared with 7.9% in 2006 just prior to the GFC).** It's been projected to deteriorate each year and hasn't, which we take as a sign that structural forces are becoming more influential (i.e. we are no longer such a bad nation savings wise). **Net external debt (noted above) is also far lower.** Admittedly, the former is still a negative number and the latter still high, so it's more of a case that we're less bad.
- **We're not seeing the traditional flow from a strong property market and debt driven excesses into the retail sector.** Consumption per capita, and consumption growth more broadly, has been contained. Talk to any retailer and they'll tell you how much of a tough gig it is. Some would argue that high house prices has led to increased precautionary savings on the part of first home buyers, and also concern among the middle class that they're going to have to fund their kids into their first homes.
- **Debt levels may be higher, but debt serviceability has improved courtesy of much lower interest rates.**
- **The likes of Kiwisaver are now entrenched within the national psyche.** 2.64 million Kiwis now have a Kiwisaver account, and total balances are growing at a circa $5bn annual clip. Kiwisaver funds have grown as a result of surging equity and bond prices here and abroad, as well as because of contributions.

You can't help but notice the irony though. New Zealander's are being told to stop binging on houses and debt, and have been sent to rehab. Yet around the corner, the RBNZ is offering the allure of an even lower OCR! So the patient headed to rehab is being offered a vodka shot on entry!

With any intervention – such as the LVR restrictions – there are trade-offs:

- **Credit is the life-blood of a modern economy; it needs to keep pumping and it will. But it's a fine balancing act.** Traditionally, the higher risk areas of the market (section and apartment development) are precisely where the supply-side response is needed. LVR restrictions have exemptions aimed at keeping the blood pumping into "new build" housing, so they acknowledge supply-side elements, but the metrics still need to add up for operators in that space. We'll be watching building consent figures closely over the coming months to see if some tailing off occurs.
- **There could be potential impacts on rents** (up) if a side effect is less investor activity and investment in supply. While new build construction is exempt, there is also the reality. People don't invest / create supply unless they assess demand conditions to warrant it. So we have a catch-22 where the RBNZ want to cool demand but keep it sufficient to drive the creation of supply.
- **The longer such restrictions are in place, the greater the potential for forcing lending beyond the banking system itself and into the unregulated shadow banking zone.** The RBNZ will need to be alert to this. The first bout of restrictions appeared three years ago and we're now into round three of changes. The longer they stay, the greater the potential for leakage.
- **As we noted, regional disparities are stark.** You have to feel sorry for some regions that only joined the housing party late and have had the punchbowl removed after a quick sample. That will dampen regional growth at a time headwinds from a low dairy payout are coming to a head.
- **Finally, it is inevitable that "pulling" on one lever (tightening macro-prudential policy) and "pushing" on the other one (easing monetary policy) will create tensions.** In a perfect world, both would be heading in the same direction, working in unison. But the realities of much higher interest rates in

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New Zealand (a OCR of 2.25% may not sound high, but policy rates are negative in some countries, and the G10 average cash rate is just 0.26%) have forced the RBNZ into a corner. In essence, the RBNZ needs to use macro-prudential policy to keep a lid on house prices so that it can ease policy to limit the NZD's advance. Call it robbing Peter to pay Paul, call it alchemy, call it what you will. It's certainly far from ideal.

When it's all boiled down, one thing seems clear: we will see more tightening in the availability of credit over time. Debt-to-income style limits are around the corner. Additional bank capital requirements against housing and the more risky parts of it also appear inevitable. By hook or by crook, then RBNZ is going to slow the rate of credit accumulation.

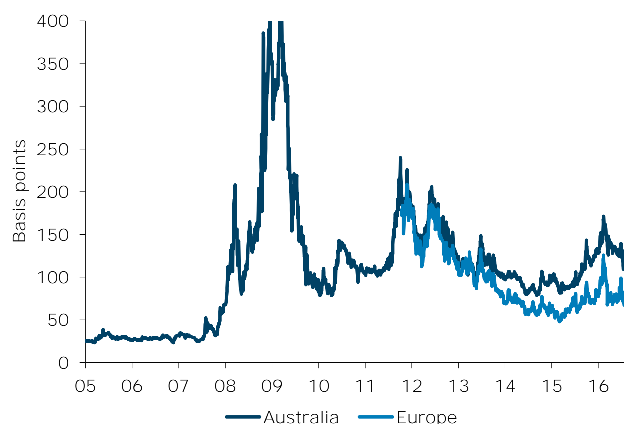
HOW LOW CAN THEY GO?

Meanwhile we can look forward to a lower OCR. The domestic economy certainly doesn't need it, and pouring more fuel on the property market fire makes little sense either, but the RBNZ has an inflation target not a housing one, and inflation – courtesy of the high NZD – is low. So the OCR is set to go down.

But don't expect mortgage rates to follow in unison. As we detailed in the May *Property Focus*, it does not automatically follow that retail rates will follow wholesale rates lower.

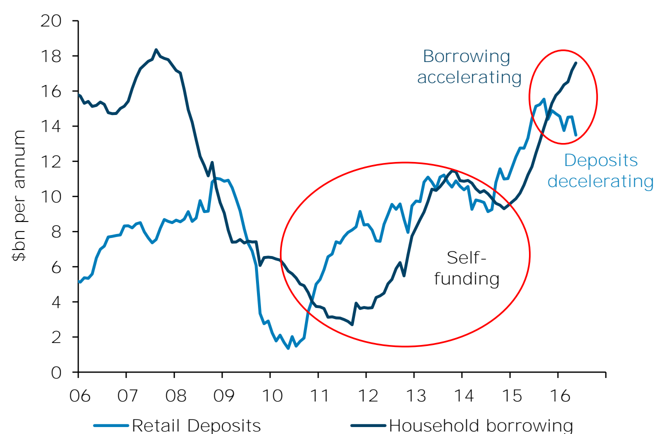
- **Offshore funding markets are more expensive than they were in 2015.** Pricing has oscillated but the general spirit has been higher costs not lower ones. New Zealanders don't save enough, so offshore markets need to fund the shortfall. The financial system has lessened its reliance on offshore funding post the GFC (which has been a good thing) but a savings shortfall remains.

FIGURE 7. CORPORATE BOND CDS SPREADS (5 YEAR ITRAXX)



Source: ANZ, Bloomberg

FIGURE 8. BANK FUNDING AND CLAIMS GROWTH



Source: ANZ, RBNZ, interest.co.nz

- **Credit growth continues to outstrip deposit growth.** In the banking sector, for money to go out the door, money also needs to be coming in the door. Banks were basically self-funding post the GFC as deposit growth grew in line with credit growth. That's changed. There is now more going out (credit), but less coming in (deposits). This gap can be filled by going offshore (refer point above), but as noted, it's more expensive and arguably not in New Zealand's long-term interests to become more dependent on offshore markets. Offshore issuance needs to be hedged in the basis swap market. That not only comes at a cost (see chart below, right) but it chews up capital and credit lines.

- **Bank funding costs are trending higher.** We have seen some correction since March, but it's the trend that matters, and funding costs are higher than they were two years ago (the RBNZ estimates the increase to be around 0.4%pts). In an environment of falling mortgage margins (largely the result of competitive pressures), banks are getting hit on both the cost side and the income side. It's natural that the pressure will be on to recoup margins as interest rates fall and the credit cycle matures (and is thus riskier).

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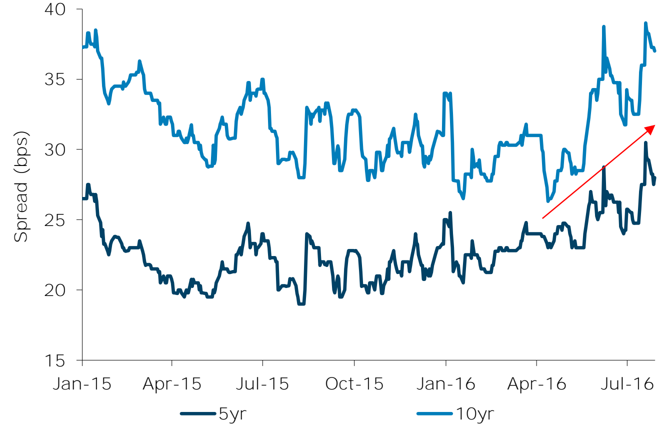
FIGURE 9. RBNZ ESTIMATE OF SYSTEM-WIDE WEIGHTED AVERAGE NEW BANK FUNDING SPREAD

Source: ANZ, RBNZ

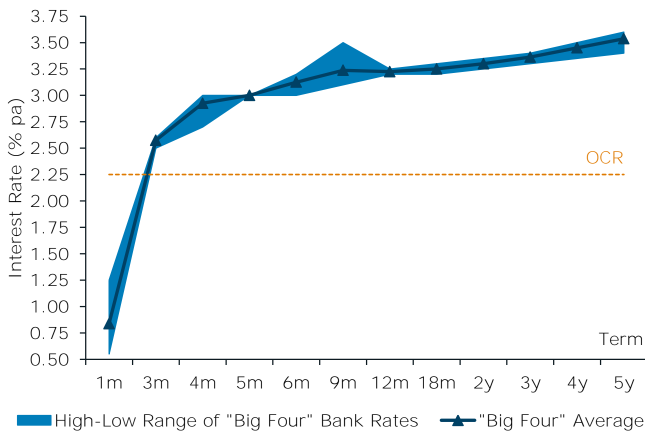
FIGURE 10. NZ BASIS SWAP SPREADS (COST TO SWAP USD DEBT BACK TO NZD OVER AND ABOVE CREDIT SPREAD)



Source: ANZ, Bloomberg

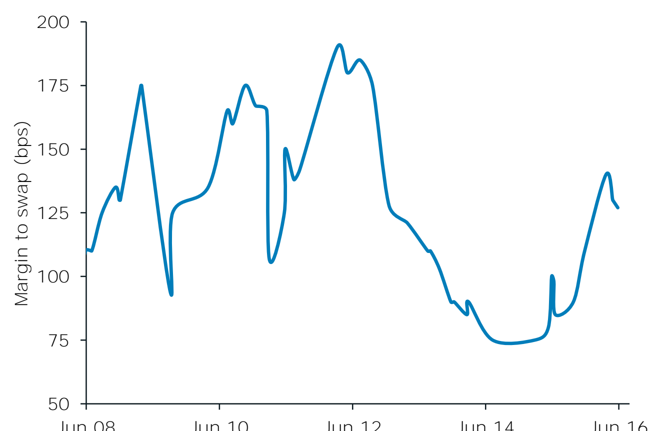
- **Banks need more deposits and less credit growth.** You can see semblances of this manifesting already via self-regulation (bank's tightening up the availability of credit) and being forced upon theme (tighter LVR restrictions).
- **However, each marginal nudge lower in the OCR puts more pressure on deposits to slow and credit growth to rise!**
- **There is a limit or level that deposit rates fall to where people just won't put money in the bank.** A lot of bank deposits and funding are what is called 'sticky' – they are insensitive to movements in interest rates. However, each push lower will challenge this assumption. Readers simply need to ask themselves how low rates would need to go before they'd revisit what they do with their own cash. It is notable that carded interest rates already sit well above the OCR, which sits at 2.25% (refer figure 11).

FIGURE 11. CARDED RATES FOR THE "BIG FOUR" BANKS ARE TRADING ABOVE THE OCR



Source: ANZ, interest.co.nz

FIGURE 12. NEW ZEALAND 5 YEAR BANK MARGINS (SPREAD TO SWAP ON "AA" RATED NZ BANKS)



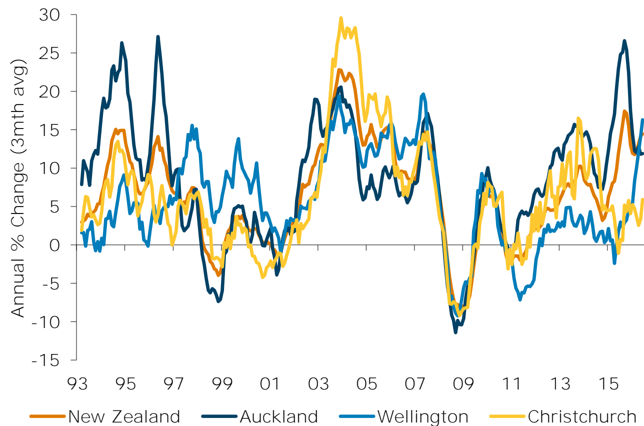
Source: ANZ, Bloomberg

We have a situation where something has to change. You can't logically expect the OCR to fall and for it to be fully passed on to lower deposit rates and borrowing rates in a savings-deficit nation. It seems inevitable we are going to see more of a scramble for local deposits in the coming year, unless credit growth collapses (unlikely) or banks simply keep tapping offshore markets. The latter can be done – in practical terms, there is no shortage of cash around – but from a financial stability point of view it doesn't make sense. What's more, if you have to pay up to get offshore money why wouldn't you price more aggressively to attract local deposits?

So it seems likely the OCR will fall but borrowers won't get the benefit of the full 25bps. There will be angst and complaints. Ironically, not much mention is made of the other side of the equation. Each nudge lower in the OCR penalises the responsible folks of the world – the savers (depositors), if deposit rates follow.

THE PROPERTY MARKET IN PICTURES

FIGURE 1. REGIONAL HOUSE PRICES



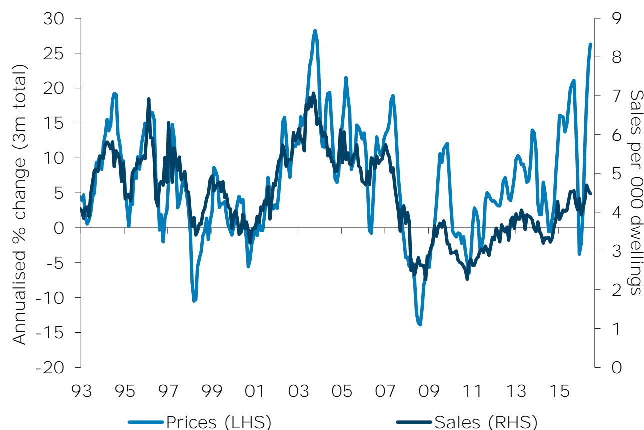
Source: ANZ, REINZ

Nationwide house prices continue to grow strongly. Our preferred measure of prices (the REINZ stratified measure) showed nationwide prices rising 1.8% sa (6.6% 3m/3m) in June, with annual growth holding at 14% y/y. June was the fifth consecutive month of circa 2% monthly house price growth.

While annual price growth is off its highs in Auckland, prices still surged 3.8% sa in June. For the June quarter, Auckland prices rose a strong 7.5% q/q.

Non-Auckland regions have also been experiencing strong growth of late. On a three-month average basis, Wellington, regional North Island and non-Canterbury South Island prices are running at 16%, 22% and 11% y/y respectively. Low mortgage rates, strong net migration, an earlier loosening in non-Auckland credit restrictions and the 'ripple effect' of previously stronger Auckland house price growth has supported other regional areas. Regions that were well behaved after the GFC are now playing catch-up.

FIGURE 2. REINZ HOUSE PRICES AND SALES



Source: ANZ, REINZ

Sales volumes and prices tend to be closely correlated, although tight dwelling supply has seen a correspondingly greater ramping-up of prices over the last five years or so.

Following a lull over the latter part of 2015 as investor restrictions and tax changes were implemented, sales volumes have accelerated sharply. Although seasonally adjusted sales volumes did dip 1.6% m/m in June, they were up over 11% on a 3m/3m basis.

More recently, much of this nationwide sales growth is being led by non-Auckland regions. In June, Auckland sales volumes were down 2.3% y/y, compared with 11% y/y sales growth outside of Auckland.

FIGURE 3. MEDIAN DAYS TO SELL

Source: ANZ, REINZ

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

Nationally, the median time to sell a house has fallen to just 30.1 days (sa), which is the lowest level since June 2007. It remains well below the historical average of 38 days.

After rising to 35 days in January, the median time to sell a house in Auckland has fallen back to 30 days. It has also fallen in the majority of other regions, with Otago (22), Nelson/Marlborough (25), Wellington (24) and Hawke's Bay (28) notable standouts.

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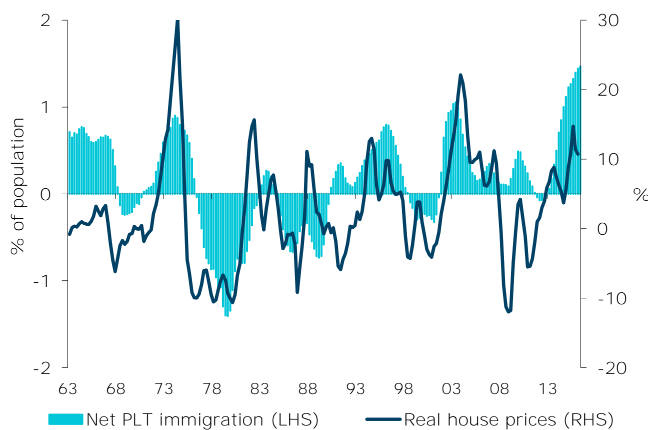
FIGURE 4. REINZ AND QV HOUSE PRICES

Source: ANZ, REINZ, QVNZ CoreLogic

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

After a period of more modest price growth, all three measures are showing acceleration in price growth once again. The median sale price, which held above $500K in June (after breeching this level for the first time ever in May), increased 11% y/y. The gap is closing, but this is still below both the stratified measure and the QVNZ measure of price growth (both growing at 14% y/y), which adjust for difference in the quality of houses sold.

FIGURE 5. NET PLT IMMIGRATION AND HOUSE PRICES

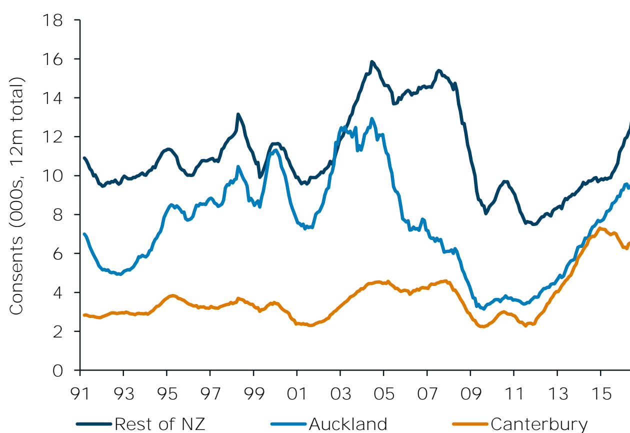


Source: ANZ, Statistics NZ, QVNZ

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

On a three-month annualised basis, net permanent and long-term migration sat at 66.8K in June, which is around 1½% of the resident population. Both more arrivals and fewer departures have contributed to this large net inflow. That said, a large part of the increase over the past 12 months has been due to more arrivals. In the 12 months to June, arrivals were close to 125k, with New Zealand and Australian citizens (29%) and those on work visas (31%) making up similar shares. Students made up 22% of PLT arrivals.

FIGURE 6. RESIDENTIAL CONSENTS



Source: ANZ, Statistics NZ

Nationwide residential consent issuance has been strengthening. On a three-month annualised basis, total issuance topped 30K in June for the first time since mid-2004.

A large part of the increase has been due to the Auckland region (annual issuance of 9.7K), although there are some signs that this has begun be capped by increasing capacity constraints in the construction sector. Canterbury issuance is off its highs, but only modestly so. Nevertheless, it is consistent with other evidence suggesting that the residential component of the earthquake is past its peak. Positive trends have also been clearly evident in likes of Wellington and other regional North Island areas. In fact, issuance in these regions is now accelerating strongly.

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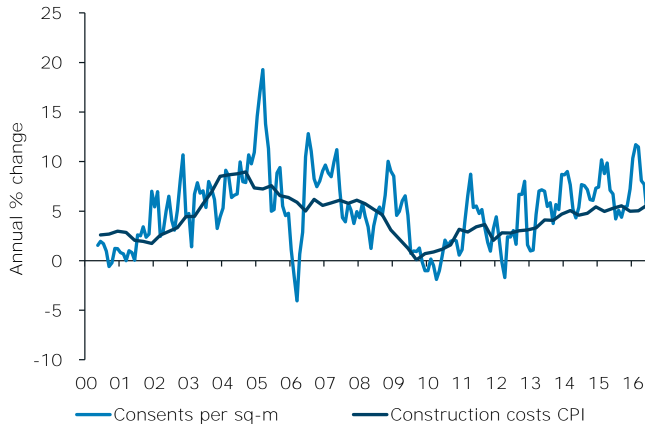
FIGURE 7. CONSTRUCTION COST INFLATION

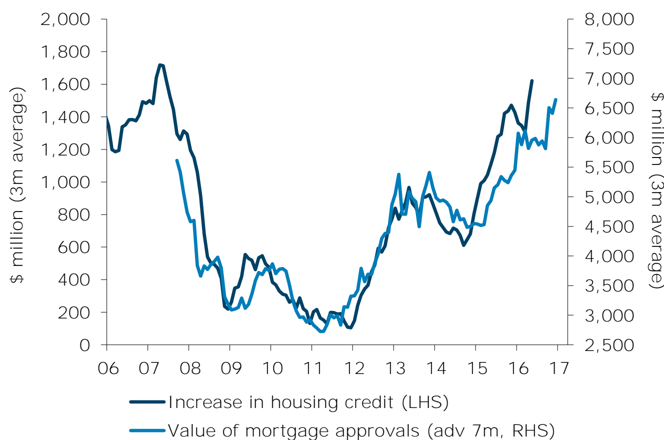


Source: ANZ, Statistics NZ

On a three-month average basis, the value of residential consents per square metre was ***only*** up 4.8% y/y in June. This is the lowest it has been in a while. However, because it is a volatile measure, we are not reading much into it at this stage. Looking through the volatility, an upward trend is apparent, and this is consistent with the upward trend seen in the construction cost component of the CPI, which sat at 5.6% y/y in Q2 (7.6% y/y for Auckland).

Our internal anecdotes continue to highlight that capacity pressures in the construction sector are reasonably intense, and not just limited to any one region. Forward books are generally full, and in some cases work is reportedly being turned away. Difficulty finding the appropriate staff (or any staff) was a common theme in the sector.

FIGURE 8. MORTGAGE APPROVALS & HOUSING CREDIT



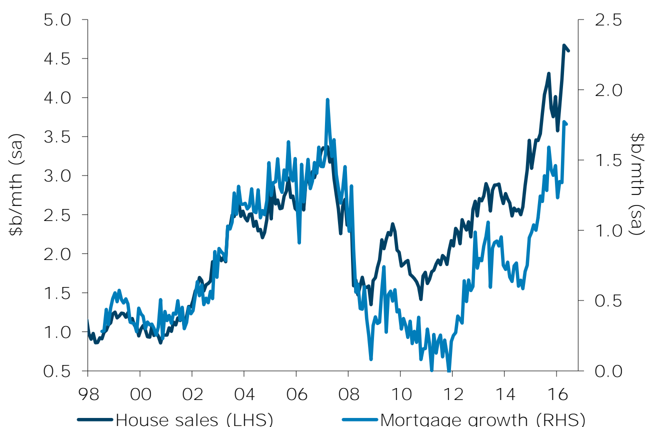
Source: ANZ, RBNZ

Weekly housing loan approval figures are published by the RBNZ. These tend to provide leading information on the state of household credit and housing market activity.

The mid-2015 surge in approvals preceded the strengthening in mortgage borrowing and housing market lift as investors rushed to get into the market prior to the looming Government and RBNZ changes.

After a period of flat growth over the final part of 2015, approval values have surged again over recent months, signalling another acceleration in housing credit growth – from already elevated levels.

FIGURE 9. HOUSE SALES AND MORTGAGE GROWTH



Source: ANZ, REINZ, RBNZ

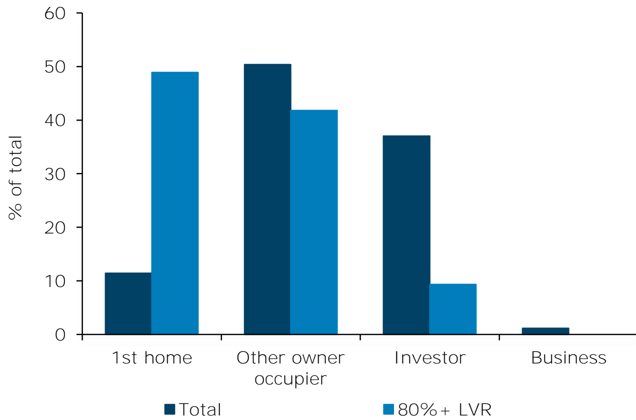
Despite house sales values being at all-time highs, mortgage borrowing levels are only just approaching pre-GFC peaks (although the rate of growth is strong).

The LVR lending restrictions that have been in place since October 2013 have also played a role in slowing the pick-up in mortgage borrowing. They were tightened in November for Auckland investors (deposit requirement of 30%) but relaxed in other areas (up to 15% of new lending could be for borrowers with less than a 20% deposit).

A further tightening in LVR limits recently announced by the RBNZ is likely to see mortgage growth slow. But figures are not yet available on their impact, with the latest data showing an acceleration in credit growth.

THE PROPERTY MARKET IN PICTURES

FIGURE 10. VALUE OF NEW RESIDENTIAL MORTGAGES BY BORROWING TYPE



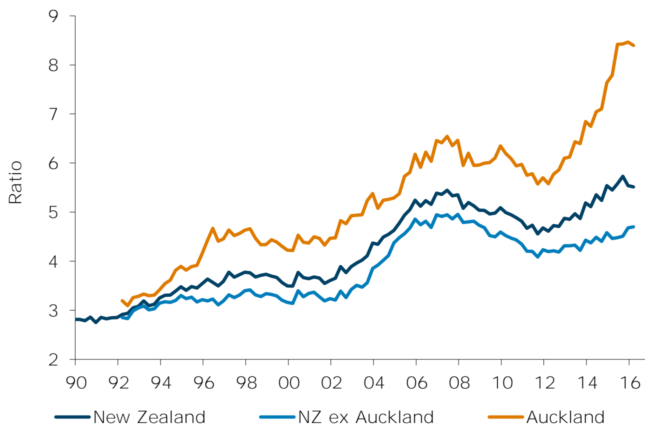
Source: ANZ, RBNZ

Despite the further tightening of lending restrictions to Auckland investors in November 2015, investor lending has been increasing as a share of total new residential mortgage lending. In June, new lending to investors grew at a 38% y/y pace and made up 38% of total new lending, which is the highest share since this data started being released in August 2014.

That said, this lending is being done with reasonable levels of equity. In June, effectively two thirds of investor lending was done at an LVR less than 70%. Only 11% of lending to investors had an LVR above 80%.

However, as a clear sign that speculative activity is still evident, of the new lending to investors, 55% is on interest-only terms.

FIGURE 11. REGIONAL HOUSE PRICES TO INCOME



Source: ANZ, REINZ, Statistics NZ

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

Nationally, the ratio sits around 5½ times, which is slightly above the previous highs recorded prior to the GFC. However, there is a stark regional divide. We estimate the average house price to income in Auckland has now risen to close to 9 times, suggesting a severely unaffordable market. Elsewhere, the ratio is around 4.7 times, which is below where it peaked prior to the financial crisis.

FIGURE 12. REGIONAL MORTGAGE PAYMENTS TO INCOME

Source: ANZ, REINZ, RBNZ, Statistics NZ

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

We estimate that the average mortgage payment to income nationally is around 30% at the moment. It has even fallen a little of late due to recent mortgage rate falls.

However, once again there are stark regional differences, with the average mortgage payment to income in Auckland close to 50%. That is near the highs reached in 2007 despite mortgage rates being at historic lows currently. It highlights how sensitive some Auckland borrowers would be to only a small lift in interest rates.

PROPERTY GAUGES

House prices remain severely extended and debt levels continue to hit new highs. Debt serviceability continues to be supported by low interest rates. Demand side impetus in the form of huge migration gains remain and supply is not keeping up. So we have a market pushing against valuation metrics, but still underpinned on a number of levels.

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

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

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

INTEREST RATES. Interest rates affect both the affordability of new houses and the serviceability of existing mortgage payments.

MIGRATION. A key source of demand for housing.

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

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

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

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

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

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

Indicator	Level	Direction for prices	Comment
Affordability	Binging	↔/↓	Debt metrics continue to hit new highs.
Serviceability/ indebtedness	Hard work	↔/↓	Serviceability looks fine so long as interest rates remain low, which they look set to.
Interest rates / RBNZ	Watch & wait	↔	Historically low mortgage rates supportive. Pressures on bank funding costs likely to be offset by OCR cuts leaving retail rates broadly at current levels.
Migration	No sign of slowing	↔/↑	NZ simply looks better than other countries and fewer New Zealanders are leaving.
Supply-demand balance	Akld vs Rest of NZ	↔/↑	Auckland shortages are growing; so are those in Wellington. Canterbury shortages have eased; more balanced elsewhere.
Consents and house sales	More to do	↔/↑	Issuance not keeping pace with demand.
Liquidity	Whacked by LVR restrictions	↓	Quantity of credit to slow into the investor market.
Globalisation	In synch	↔	NZ houses expensive to us but cheap to everyone overseas.
Housing supply	Low	↔/↑	At just three months of sales, a record low nationwide, with the regions catching up to Auckland.
House prices to rents	Squeeze	↔/↓	Rents drifting up, given strong demand. Auckland prices elevated to rents, other regions less so.
On balance	**Pushing up**	↔	**Regionally broad-based strength, with Auckland valuations stretched. Slower credit growth set to slow exuberance, but it's pushing against population growth.**

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PROPERTY GAUGES

FIGURE 1: HOUSING AFFORDABILITY

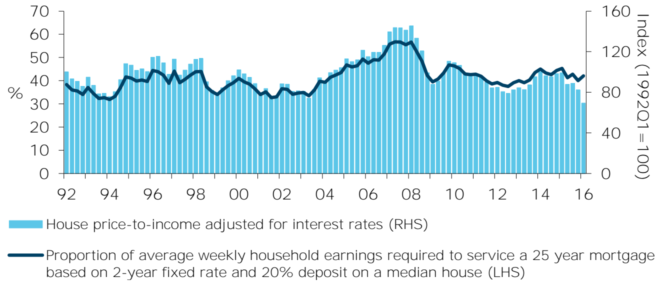


FIGURE 2: SERVICEABILITY AND INDEBTEDNESS

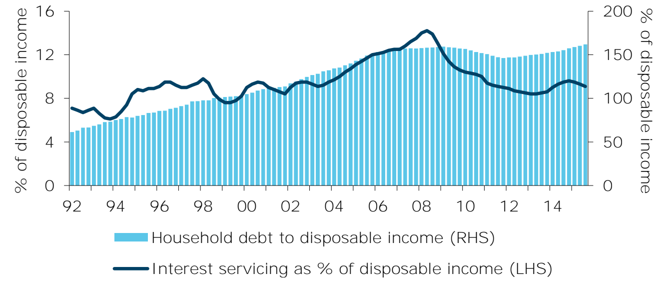


FIGURE 3: NEW CUSTOMER AVERAGE RESIDENTIAL MORTGAGE RATE (<80% LVR)

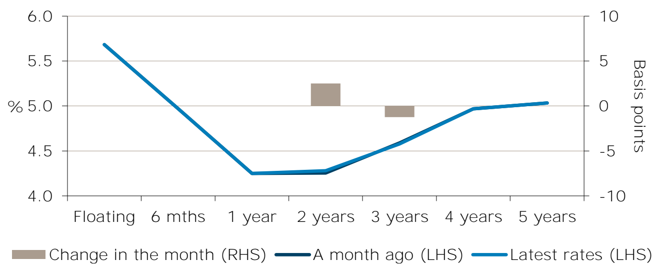


FIGURE 4: NET MIGRATION

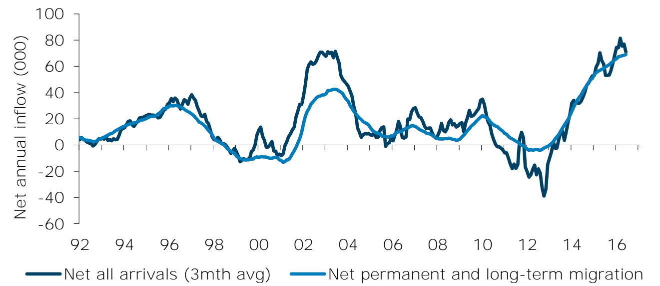


FIGURE 5: HOUSING SUPPLY-DEMAND BALANCE

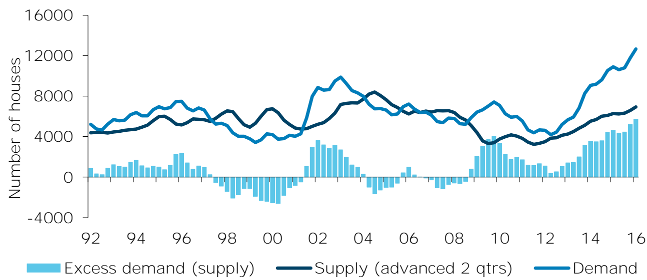


FIGURE 6: BUILDING CONSENTS AND HOUSE SALES

FIGURE 7: LIQUIDITY AND HOUSE PRICES

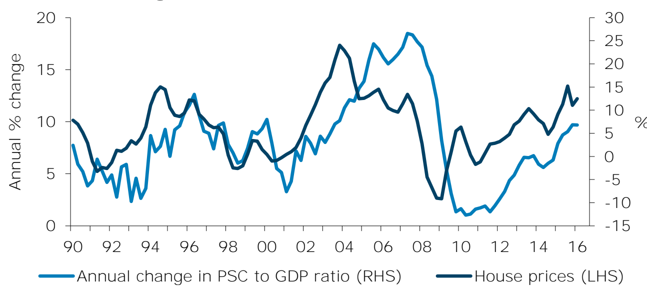


FIGURE 8: HOUSE PRICE INFLATION COMPARISON

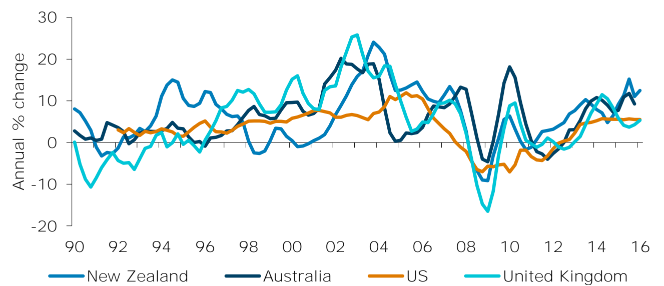
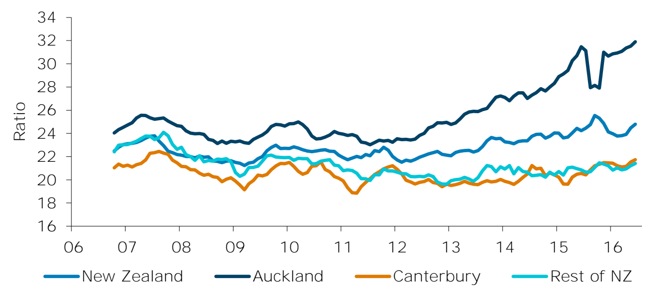


FIGURE 9: HOUSING SUPPLY

FIGURE 10: MEDIAN HOUSE PRICES TO RENTS



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

ECONOMIC OVERVIEW

SUMMARY

The economy is expanding at a respectable rate. There is too much housing and borrowing centricity to the growth so it's not sustainable for long, but we'll take it for now. Firms are finding it more difficult to find labour and this theme will intensify over the year. We forecast GDP growth in excess of 3% over the year ahead. The usual risks and caveats remain; the global scene is uncertain, the local housing market needs to slow down (a tough ask amidst shortages) and dairy doldrums will continue. The counterbalance is ample in the form of tourism, construction, migration and non-dairy exports.

OUR VIEW

The economy is growing at a decent clip. Annual GDP growth has accelerated to 2.8% y/y. A lot of this growth is population based via migration. The challenge is to drive lifts in productivity and GDP per capita.

We forecast GDP growth to accelerate modestly in the near term, continuing at an above-trend pace. We project full-year growth of 3.2% over 2016 and 3.3% over 2017. Our confidence composite, financial conditions gauge and the Truckometer are indicating annual GDP growth tracking around 3%. Financial conditions are still supportive despite the high NZD. Business and consumer confidence sit at decent levels, and firms are continuing to signal a desire to go out and hire and invest. The unemployment rate is trending lower and real household income growth is running at an above-average pace.

There is a strong housing centricity to this acceleration in momentum. Housing markets continue to boom across the country negating the negative effect of a low dairy payout in the regions. Credit growth is strong. We are seeing leveraging behaviour and deteriorating savings amidst housing fervour; that's fine as a short-term phenomenon but it cannot continue for a sustained period. Encouragingly we are starting to see the financial sector self-regulate the availability of credit, though this risks tightening housing supply (if apartment and land developments become harder to get off the ground) amidst shortages already.

Tighter LVR restrictions will dampen housing-related activity, but this needs to be put in perspective. We don't expect it to alter the volume of construction activity much, and a levelling out in house prices is long overdue. It's not sustainable to have house prices rising faster than incomes.

Considerable impetus is also being provided by tourism (booming), construction, and non-dairy export industries. While the likes of kiwifruit, horticulture, viticulture and high tech manufacturing do not have the scale of dairying, they collectively pack some punch.

Capacity bottlenecks are coming more to the fore. Firms' are finding it more difficult to find skilled staff (NZIER Quarterly Survey of Business Opinion, ANZ Small Business Microscope, MYOB). Such bottlenecks are testament to the rapid growth being seen across a number of sectors including construction (where skill shortages are described as acute) and tourism.

Another negative cash-flow year for the dairy sector beckons. That's a material headwind. We are encouraged by the reduction in farm working expenses to date. It is also worth noting that the terms of trade (ratio of export to import prices) is only down 6% from its peak. Import prices have also fallen and non-dairy commodity prices have held up. So the economy's purchasing power has held up reasonably well.

We have concerns over political fragmentation globally and expressions of the "push-back" vote. Globalisation and economic integration is being replaced by the antithesis. Politics now matters equally, if not more, than the actions of central banks. The endgame is policymakers with less flexibility to respond to exogenous shocks amidst a world prone to them, with excessive leverage and poor credit signals.

New Zealand's political "lightning rod" is housing affordability. Expect the Government to keep throwing the kitchen sink at it. Supply needs to crank up a lot to meet demand. Auckland's Unitary Plan will help, but questions will remain over where the resources are to build the houses.

Despite the solid economic backdrop and housing strength, the OCR is headed lower. We forecast an OCR cut in August and a further cut in early 2017. Inflation remains low and the global scene precarious. The RBNZ is responding to housing pressures with additional macro-prudential measures. Moreover, currency strength will continue in a world where NZ long-end interest rates, while low by historic standards, are high by global comparison. And when currencies are diverging from local fundamentals, interest rates will ultimately need to converge.

ANZ

MORTGAGE BORROWING STRATEGY

SUMMARY

Mortgage rates haven't moved far compared to last month. Given flagged changes to LVR restrictions announced by the RBNZ, it is the availability of credit rather than the cost (i.e. the interest rate) that is now the major focus. Nonetheless, as was the case last month, the 1 and 2 year rates remain the most competitive, and remain our favoured points on the curve. With the OCR biased lower (despite the booming housing market!), the slightly cheaper 1 year rate looks a little better, but there's not much in it. Longer term rates are not competitive, but are low by historic comparison, and may suit the more risk averse (despite the higher cost).

OUR VIEW

Mortgage rates are little changed this month, with minor tweaks seen in the 2 year and 3 year only. As has been the case for some time, the most striking feature of the term structure of both **mortgage curves** (specials and high-LVR) is that they **are "tick-shaped"**, with the low point at 1 year.

As with last month, this makes the 1 year the most attractive at face value. While we would caution that expected upcoming OCR cuts (we expect cuts in August and February) have potential to drive mortgage rates even lower, as we discuss at length in the Chief Economist Corner, there is no guarantee that retail rates will follow wholesale rates lower given the potential for competition for deposits to intensify.

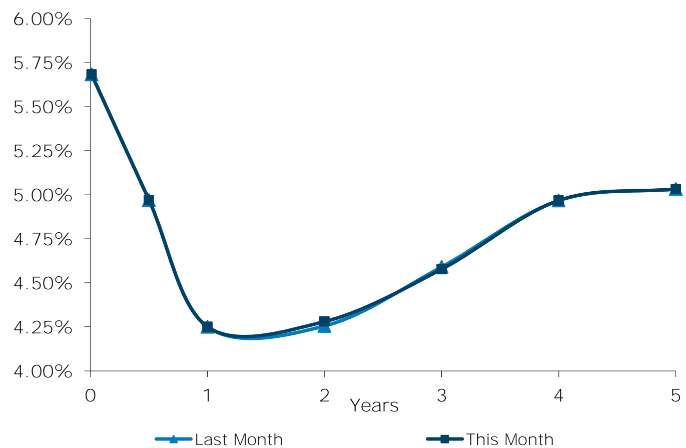
Moreover, even if mortgage rates do fall, they'd have to fall by considerably *more* than we expect the OCR to fall for it to be worthwhile going floating (which costs around 1.4%pts more for those with >20% equity) or to select a shorter term like 6 months (which costs close to 0.7%pts more). As our breakeven table shows, you would, for example, need to see the 6 month rate fall by over 1.4%pts (from 4.97% to 3.53%) over the next 6 months for back-to-back 6 month terms to be less costly than a single 1 year term at the average "Big-4" bank rate of 4.25%. It could happen, but if OCR cuts aren't fully passed on, it is less likely.

Longer-dated breakevens start to rise, going against the grain of our expectation of a lower OCR. Again, this suggests that the 1 year (or possibly the similarly-priced 2 year) fixed rate is the most attractive.

That said, it is worth reiterating that long term fixed rates are at or close to 50+ year lows. The 5 year rate is 0.8%pt higher than the 1 year rate. But what is striking about it is that it is just 5.03% on average. That's low, and may well appeal to more risk-averse or certainty seeking borrowers.

We don't favour longer terms on the basis of cost, but we do recognise the certainty they offer.

SPECIAL CARDED MORTGAGE RATES^



Special Mortgage Rates		Breakevens for 20%+ equity borrowers			
Term	Current	in 6mths	in 1yr	in 18mths	in 2 yrs
Floating	5.68%				
6 months	4.97%	3.53%	4.30%	4.33%	5.02%
1 year	4.25%	3.91%	4.31%	4.67%	5.17%
2 years	4.28%	4.29%	4.74%	5.15%	5.66%
3 years	4.58%	4.74%	5.21%	5.37%	5.53%
4 years	4.97%	5.00%	5.23%		
5 years	5.03%	#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	5.68%				
6 months	5.06%	4.49%	4.97%	4.83%	5.16%
1 year	4.77%	4.73%	4.90%	5.00%	5.23%
2 years	4.84%	4.86%	5.06%	5.17%	5.35%
3 years	4.97%	5.02%	5.20%	5.33%	5.50%
4 years	5.09%	5.18%	5.35%		
5 years	5.23%	*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 June 2016 (based on REINZ data)

	House prices (ann % chg)	3mth % chg	No of sales (sa)	Mthly % chg	Avg days to sell (sa)
Northland	14.7	3.2	304	-3%	41
Auckland	8.6	4.3	2,737	-3%	30
Waikato/BOP/Gisborne	26.5	7.3	1,452	-3%	30
Hawke's Bay	12.4	0.9	284	+5%	28
Manawatu-Whanganui	7.4	4.2	382	0%	32
Taranaki	4.0	5.4	203	+12%	34
Wellington	17.2	6.5	886	+5%	24
Nelson-Marlborough	16.1	1.0	224	-20%	25
Canterbury/Westland	1.5	0.8	1,050	+10%	31
Central Otago Lakes	42.5	15.2	150	-10%	36
Otago	18.5	6.0	323	-3%	22
Southland	-7.5	-2.7	210	0%	38
NEW ZEALAND	**11.1**	**5.5**	**8,133**	**-2%**	**30**

Key forecasts

	Actual			Forecasts						
Economic indicators	**Sep-15**	**Dec-15**	**Mar-16**	**Jun-16**	**Sep-16**	**Dec-16**	**Mar-17**	**Jun-17**	**Sep-17**	**Dec-17**
GDP (Ann Avg % Chg)	2.9	2.5	2.5	2.7	3.0	3.3	3.4	3.5	3.4	3.3
CPI Inflation (Annual % Chg)	0.4	0.1	0.4	0.4(a)	0.4	0.9	1.3	1.2	1.6	1.7
Unemployment Rate (%)	6.0	5.4	5.7	5.5	5.4	5.4	5.3	5.2	5.2	5.1
Interest rates (carded)	**May-16**	**Jun-16**	**Latest**	**Sep-16**	**Dec-16**	**Mar-17**	**Jun-17**	**Sep-17**	**Dec-17**	**Mar-18**
Official Cash Rate	2.25	2.25	2.25	2.00	2.00	1.75	1.75	1.75	1.75	1.75
90-Day Bank Bill Rate	2.4	2.4	2.3	2.2	2.2	2.2	2.0	2.0	2.0	2.0
Floating Mortgage Rate	5.7	5.7	5.7	5.4	5.4	5.4	5.2	5.2	5.2	5.2
1-Yr Fixed Mortgage Rate	4.9	4.8	4.8	4.8	4.8	4.8	4.7	4.8	5.0	5.0
2-Yr Fixed Mortgage Rate	5.0	5.0	4.8	4.8	4.8	4.8	4.8	4.9	5.0	5.1
5-Yr Fixed Mortgage Rate	5.6	5.2	5.1	5.0	5.0	5.0	5.1	5.1	5.1	5.1

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