BNZ Weekly Overview

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Mission Statement

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

Prices Keep Rising

Man it is easy to write about the Auckland housing market. My late-2008 comment was that there was a shortage of houses in New Zealand and prices would not plummet. From the second half of 2009 I made no prediction regarding house prices, but whenever anyone asked whether they should buy a house in Auckland now or wait, every time I said I would buy now, and I still say that. Auckland started with a shortage in 2008, the shortage got a lot worse as NZ house construction fell back to levels of the 1960s in 2011, and the shortage continues to get worse as the number of consents issued in the past 12 months in Auckland has not even reached the 23 year annual average which produced the shortage in the first place.

The Productivity Commission gave us a reminder of some of the housing dynamics this week with the release of yet another of the growing volume of reports looking at housing and concluding more need to be built and shortages will persist. Noting that the NZ population is predicted to reach 5 million 16 years from now in 2031 they said that housing demand would grow proportionately more than population as average occupancy drops from 2.6 in 2011 to 2.4 by 2031.

Note that in 2012 the Auckland Council estimated that 13,000 dwellings need to be built each year. Two years down the track and the annual total in the year to September for Auckland was 7,320 and a year ago that total was 5,595. Prices keep rising.

This week one lender introduced an interest-only mortgage which runs for 30 years, aimed specifically at investors who can maximise their tax deductions by not repaying any principal. This will tend to boost investor buying and reflects a drive by lenders to boost volumes, also discussed just below. Prices keep rising.

The Sunday Star-Times also canvassed this week a point we have been making for some time now regarding the big efforts to free up land around Auckland. Just because it is available does not mean it will get anything built on it for many years. For a land owner, as long as they can service the rates, the easiest hassle-free thing to do if one does not need the land sale money is simply hold it and wait for population pressures to drive the price higher. History shows this to be a fairly good investment strategy, and it worked well for the bloke who recently sold for well over the reported $40mn for the 16 hectares of land he bought 21 years ago for $600,000 on the outskirts of Auckland.

Prices keep rising.

19 Reasons Why Auckland House Prices Will Keep Rising

For your guide, in my Weekly Overview of November 1 2012 I produced a list of 19 reasons why Auckland house prices would keep rising. Here is the list, cut and pasted without alteration from that issue, plus the url where you will find the original publication and the list from page 5.

http://tonyalexander.co.nz/wp-content/uploads/2013/02/WONovember-1.pdf

"Why Auckland House Prices Will Keep Rising

Regular readers of the Weekly Overview will know that I have had a vastly less negative view on the NZ housing market than most other commentators over the past few years with one of my key points being that shortage of supply would limit price declines over 2008-09. Now here is a list of 19 reasons why prices in Auckland in particular are going to keep rising.

Enjoy, or despair, depending upon whether you own or wish to own Auckland property. And ask yourself – where does the greater number of votes lie? With those wanting to get their foot on the ladder, or with those who already own property? Hence no big legislative changes. As the Americans say, turkeys don't vote for an early Thanksgiving.

1. Auckland did not enter the 2008 recession then late-2008 into 2009 global financial crisis with an over-supply of property. Shortages of personnel constrained house construction from 2004 through 2008.
2. The shortage has become worse in the past four years and last year annual consent numbers were at a four decade low.
3. The government is explicitly aiming to grow Auckland's population as a means of achieving "agglomeration" benefits for economic growth which accrue from high interaction amongst economic players.
4. Despite the biggest global financial crisis since the 1930s NZ house prices only fell 11% at their worst and now sit on average above 2007 levels.
5. Removing the ability to use LAQCs to offset housing investment losses against other income has produced no flood of properties onto the market.
6. Removing the ability for property investors to deduct depreciation expense has not produced any flood of property onto the market.
7. Over the past four years young people have put off their normal household formation (leaving home, buying their own house) because of worries about mortgage availability, falling house prices, employment, and ability to raise a deposit. Now those four years worth of people are entering the market and looking to "catch-up" on their purchase.
8. Construction standards in New Zealand are always rising (watertightness, earthquake strength, energy efficiency) and this boosts construction costs.
9. A big fall in apprentice numbers in the past five years coupled with the loss of skilled people to Australia and older tradespeople leaving the sector rather than get licensed means labour-related construction costs will rise and labour will not be available to build houses even were more land available.
10. Banks are not going to step back into the property development sector left bereft of funds from the closure of finance companies.
11. Poor growth prospects in the next few years for Western economies mean their and our interest rates will remain at low levels for many years. This means low borrowing costs for home buyers.
12. Low returns on bank deposits mean older savers in particular will be seeking extra yield through investment in residential property either directly or through a yet to appear wave of property investment vehicles. (Be in no doubt. They will come.)
13. The migration cycle appears to be on the cusp of turning and if the housing market has performed so well with net outflows over 3,000 in the past year the implications of positive gains are clear.
14. The nature of net inward migration is changing toward greater numbers of people coming from Asia and with Asia's middle class booming in size potential inflows of wealthier people are large.
15. The NZ unemployment rate of 6.8% is likely to fall quite quickly over 2013 as the construction sector booms on the back of the rebuilding of Christchurch.
16. The aging population will produce a decrease in the average house occupancy rate and therefore a need for more houses for any given population size. People will retain their old homes with many bedrooms to allow visits by grandchildren, gyms, home offices, home cinemas etc.
17. The government has announced its efforts to improve housing affordability (lower prices) and they are minor and unlikely to have a noticeable impact if any for many years.
18. Any credibility people may have assigned to those who have been predicting big price declines simply because prices have risen a long way and now fallen sharply in some other countries has gone out the window. Few people will now listen to their price decline views.
19. Members of the Opposition believe monetary fairies can make the exchange rate settle permanently lower by forcing interest rate cuts and printing money while letting inflation therefore go up. Given the non-

zero possibility that such economically ignorant policies get introduced it is worth getting inflation protection by investing more in property – not less."

You may be interested to know that since the three month period ending in November 2012 Auckland house prices on average have risen by 23%. Wish I was this good with exchange rates. Or interest rates. Or Lotto.

Will LVR Rules Be Eased?

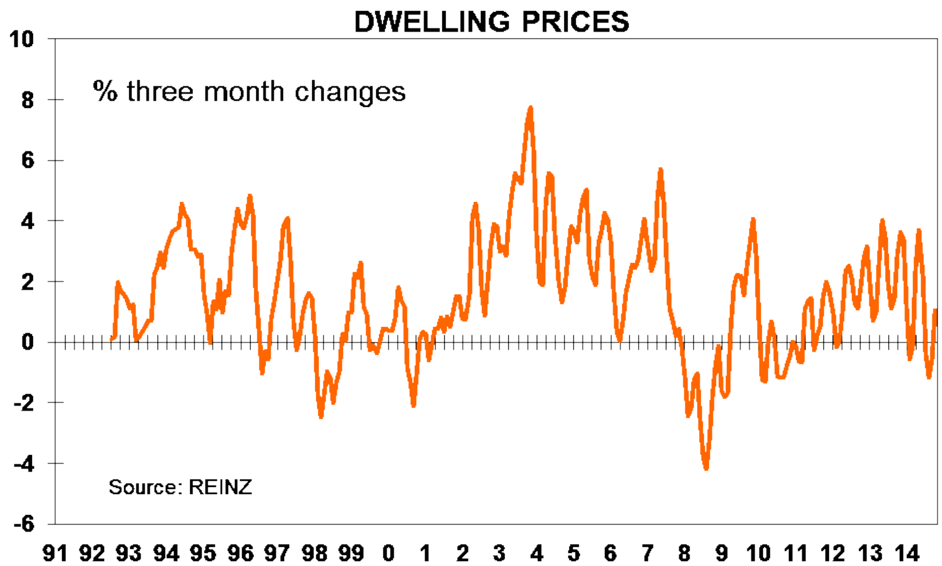
Some people got quite excited early this week thinking that the Reserve Bank on Wednesday might announce an easing in the loan to value ration restrictions. I gave a radio interview listing a number of reasons why it is much, much too soon to expect such an easing and the Reserve Bank eventually stated on Wednesday

"..., there remains a risk of a resurgence in house price inflation, particularly in light of strong immigration flows. Consequently, we do not consider it appropriate to ease the LVR speed limit at this time. The Reserve Bank will continue to closely monitor the housing market,"

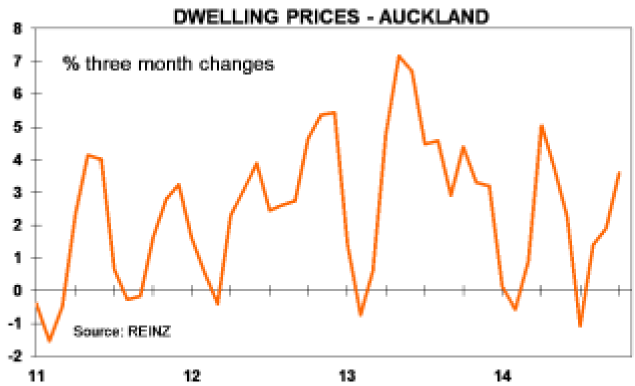
The case has been put for an easing recently based on data showing slowing house price inflation put alongside the ongoing concerns about the regions failing to keep up with Auckland and Christchurch with regard to price rises (nothing to do with LVRs, simply population shifts, space limitations, economic growth rates and prospects), plus the way the rules fall mainly on young buyers. As predicted over a year ago these buyers have been shoved out of the housing market and investors have taken up the slack, recognising two things. Firstly that prospects for rental occupation and growth are good as young people will be forced to rent for longer. Second, prospects for capital gains are good because a growing backlog of young buyers is building up and when the rules are removed they will pile in.

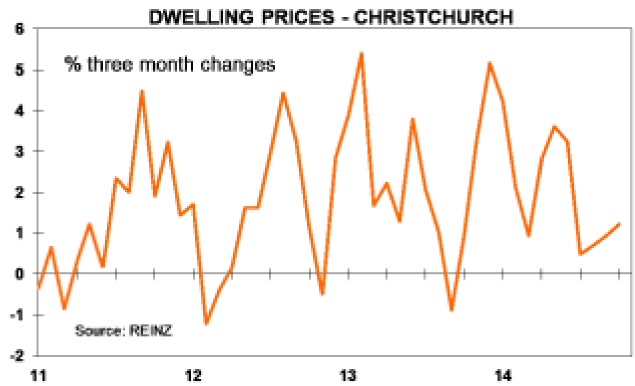
The incentive we have always pointed out is to buy entry level houses before the young people do then flog them off to them at much higher prices further down the track. Data from Corelogic show that investor presence in the market has risen and that price gains have been strongest for exactly those entry level houses.

So first of all, lets check the evidence of house price growth slowing down. I like to use the monthly REINZ data as it is more up to date than the QVNZ numbers which are three month averages weighted toward the most distant months. In the three months to October average NZ-wide house prices were up by 1.1% from the three months to July when they fell 0.4% and before that rose 2.5%. Prices are trending upward and rose in fact 1.4% in the month of October.

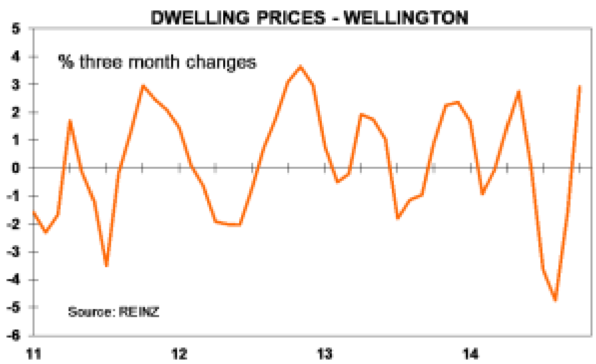


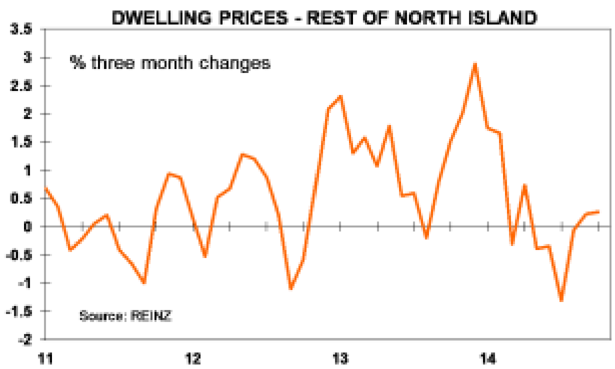
There is a mild easing trend in place the graph above suggests. But what is driving it? This is where things get interesting.

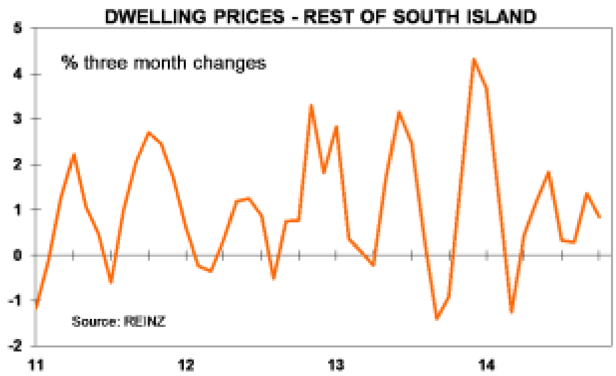




Auckland house price growth has not slowed convincingly, especially as October sale prices were 2.9% above September. Christchurch has slowed more convincingly but the October month change was a large 2.8% rise. In Wellington prices have risen 2.9% for the October quarter and things are recovering after a pre-election slump. The rest of the North Island is also recovering, the rest of the South Island steady.







The case is not strongly made for house price inflation settling at a low level.

Now take into account the following.

- The general election appears to have had quite an impact on the economy and now that it is out of the way some indicators are moving back up again. The post-election ANZ Business Outlook survey recorded a jump in confidence to a net 27% optimistic from 13% in September.
- Back in July and August the commonly expressed view was that mortgage interest rates would start hiking up again in October or December. Now the common view is very late next year, or 2016, or not at all. Not only that but fixed interest rates have declined in response to a worsened world growth

outlook. The incentive for people to borrow has risen, the incentive to seek higher yields outside of over-stretched equity markets and low yielding fixed interest securities has grown.

- Banks are getting more aggressive in their mortgage competition.
- The Barfoot and Thompson data for Auckland in October reveal further declines in listings and prices trending upward at a 10% annualised pace in the latest three month period compared with 4.4% three months earlier.
- The net migration inflow has climbed from an annual 38,000 three months ago to 45,400 in the latest numbers, with forecasts of a level soon near 55,000. Awareness of the migration boom is greater now than before.
- A downward trend has emerged in the issuance for consents for new dwellings (supply) to be built. Consent numbers were down 5% seasonally adjusted in the September quarter from the June quarter. This probably won't persist, but it would be foolish to ignore the trend just in case it sticks.
- The Reserve Bank have calculated that the LVR rules are doing the job of 0.25% - 0.5% worth of increases in the official cash rate. Easing the rules now would be equivalent to easing monetary policy (though by a lesser amount in their estimation) which would not be consistent with their statement in the October cash rate review that **"A period of assessment remains appropriate before considering further policy adjustment.**"
- If the RB ease the rules this increases the chances of extra reliance upon cash rate movements in the future which could place additional upward pressure on the NZ dollar. The RB have expressed a strong desire for the NZD to decline noting recently "**However, its current level remains unjustified and unsustainable and continues to constrain growth in the tradables sector. We expect a further significant depreciation**." If they expect a big decline then they will not want to exacerbate the inflationary impact that would bring by also explicitly easing monetary policy by easing LVR rules.
- The Reserve Bank introduced the LVR rules in October last year. If they ease them then they will want to feel quite certain that they won't be caught out and have to tighten them again soon after. Flip-flopping around on both monetary policy and quantitative credit controls is not something central banks want to do and not something which gives people much confidence in the abilities and credibility of the central bank. The RB have stated that they view the rules as temporary.

It is not inconceivable that the rules will be eased down the track. But the timing is too soon and were I running the RB I would want to see much more evidence of a sustained suppression of house price inflation before backing away from using this new tool, especially when such rules are being increasingly taken up by other central banks around the world.

Just for your guide, for the first time ever, this week the Reserve Bank published data newly gathered from banks in recent months showing lending for mortgages broken down by the type if borrower. In September 10% of lending ($430mn) went to first home buyers, 59.6% to other owner occupiers, 28.8% to investors, and 1.6% for business purposes. Thus lending to investors is almost three times as big as lending to first home buyers.

If I Were A Borrower What Would I Do?

What I have been writing here in recent weeks is that I would be looking for a lender offering a discounted rate in the 2 – 3 year area, such as we recently offered at 5.85% for three years. Now I see that some of the other lenders are also lowering rates to try and get business and maybe market share in an environment where people are wary of debt and residential real estate turnover is falling. One lender recently offered a rate just below 6% for five years. I like the certainty which that rate offers. Within five years it is highly probable that monetary policy will be eased. But I don't think that for much if any of the coming five year period the official cash rate will be at 2.5% and therefore floating mortgage rates will be much below 6%.

Were I borrowing at the moment I would take my time and see who is offering not the best standard rates, but the best discounted rates. Competition between the lenders is hotting up and I would feel that the power is in my hands, not the lenders. I would pick and choose and if I could get a sub-6% rate for five years I would take the low rate and great certainty that it offers. But I would check how much I could repay early without penalty and if that rule is tight I would place some of the mortgage at one and two year fixed rates to give me better early repayment flexibility. I'd aim for near to nothing left sitting floating given the cost relative to fixing.

	This week	**Week ago**	**4 wks ago**	**3 mths ago**	**Year ago**
Official Cash Rate	3.50	3.50	3.50	3.50	2.50
90-day bank bill	3.72	3.72	3.72	3.73	2.70
1 year swap	3.84	3.81	3.85	3.93	3.12
2 year swap	3.99	3.93	4.02	4.14	3.58
3 year swap	4.13	4.04	4.14	4.30	4.00
4 year swap	4.21	4.13	4.21	4.41	4.29
5 year swap	4.29	4.21	4.27	4.50	4.53
7 year swap	4.40	4.34	4.36	4.61	4.86
10 year swap	4.55	4.46	4.45	4.74	5.13

Just briefly on the NZD. We are up from a week ago with the British Pound depressed by a Bank of England prediction of inflation falling below 1%, possible snap election coming in Japan depressing the Yen, the usual despondency in Europe depressing the Euro, and the NZD boosted by Fonterra not cutting their $5.30 forecast and the RBNZ sounding slightly more hawkish than expected in their Financial Stability Review. After it all the NZD trades near the USD just below 79 cents from 77.3 cents last week. Note the jump against the Yen.

	This Week	**Week Ago**	**4 Weeks Ago**	**3 Months Ago**	**Year Ago**
NZD/USD	0.787	0.773	0.798	0.846	0.833
NZD/AUD	0.903	0.9	0.906	0.91	0.887
NZD/JPY	91	88.6	84.6	86.8	82.7
NZD/GBP	0.499	0.484	0.499	0.507	0.519
NZD/EUR	0.633	0.619	0.622	0.633	0.617
NZD/CNY	4.82	4.73	4.89	5.21	5.07
USD/JPY	115.63	114.62	106.02	102.60	99.28
GBP/USD	1.58	1.60	1.60	1.67	1.61
USD/EUR	1.24	1.25	1.28	1.34	1.35
AUD/USD	0.87	0.86	0.88	0.93	0.94
USD/CNY	6.1263	6.1145	6.1216	6.1634	6.0915

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