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.

World War 2 and The GFC

This is my first Weekly Overview back from holiday and I thought it would be a good idea to devote the opening section to first home buyers. If you are faint of heart then stop reading. You're not going to like this.

Because of World War 2 and the global financial crisis many of you will be priced out of the housing market for a great number of years. You will not be able to afford the type of house you want in the location you want, and to achieve your home ownership dream you will need to sacrifice spending on other items – for years. There will not be any decent decline in average NZ house prices over the next few years – barring deep recession – and it is pointless paying attention to politicians promising plans which will reduce ratios of house prices to income back to where they were. It won't happen. You are and will remain in a worse off position than those of us who purchased our first homes in the 1980s, 1990s, and 2000s.

Over the past eight years I have outlined many reasons why house prices would initially not collapse over 2008 – 09, then why they would rise. I have watched the various stages of the housing cycle progress with different cohorts of people realising prices would not be falling and entering the housing market.

We have seen the traditional lead provided by Auckland post-GFC, catch-up buying from those who held off over 2008 – 2011, strong buying by immigrants recognising what the predicted population and economic growth for Auckland implied for prices of property, spreading of the Auckland boom to other regions, and most recently capitulation on the part of essentially all price-fall believers and the masses flooding into property driven by FOMO – fear of missing out.

In hindsight these cyclical stages will probably sound logical to most people. But there is a big risk that people think that all that is happening here is that cyclical factors are in play. They are, but there are two huge structural factors which have been touched on many times but not adequately analysed for their long lasting impact – WW2 and the GFC. It goes like this.

Immediately following WW2 people bred like rabbits and the world's economy since the 1950s has been strongly influenced by the effects of this population wave passing through life stages. About 2 – 3 decades ago in New Zealand governments and financial analysts began warning about the effects of baby boomers retiring and causing a structural deterioration in government finances. Warnings were issued of possible reductions in superannuation payouts and campaigns were run to convince the baby boomers that they needed to save more for retirement.

So they have. Some opted for diversified portfolios, older ones tended to favour cash because of their experience of the 1987 crash. Over the years they have been told that as they approach retirement they need to pull back from more volatile investments and favour things like bonds and term deposits. This was not viewed as being likely to pose any problems because interest rates in New Zealand sat at high levels compared with countries overseas. So boomers worked out likely retirement incomes based on things like term deposits yielding 8%.

But along came the GFC over 2008 – 09. This event has made people globally wary of borrowing money and this easing of credit demand has caused interest rates everywhere to fall, assisted by central banks slashing rates to try and stimulate growth and even printing money in the hope that with so much of the stuff floating around people would borrow and spend it. But they haven't offshore.

And at the same time as consumers worldwide have decided to boost their savings inflation has undergone a structural shift to sitting at much lower levels than anticipated. No-one can adequately explain why this has happened and why therefore all forecasters have since 2008 grossly over-estimated national inflation rates and over-predicted interest rate rises.

But the upshot is that low inflation has become cemented in internationally and here in NZ. This has caused our central bank to now take interest rates below where they took them to fight the immediate effects of the GFC – and further cuts are coming.

Now consider all those baby boomers as they face receiving interest rates on their conservative investments of 3% or so. The returns anticipated are not there and logically they have been looking for other places to place their money. They have been buying houses and as each month has gone by since 2009 more and more have realised that interest rates will stay low for a very long period of time. In my opinion probably decades.

They are not buying to sell within a short period of time. They intend holding long term to finance retirement over a longer period than their parents survived after retiring. The two year brightline test is meaningless to them. They have cash they want to put to work. So the new minimum 40% deposit won't be a problem for many.

They have seen returns on term deposits plummet and been burnt. But rents hardly ever decline. They tend to rise and people are predicting further rises. They are buying an asset with a completely different returns profile to simple bank deposits and government bonds.

There is an ongoing structural shift in who owns residential property in New Zealand and it might not reverse for a long, long time because these buyers are not skittish money-grubbers seeking quick gains. Their investment properties won't be returning to the pool available to first home buyers for decades.

Will a building surge make them sell? No. They are long-term holders. Will such a surge occur anyway? Definitely not and it is well beyond the time when politicians seeking votes should be honest and tell people that wild forecasts of surging new house numbers will not be met.

Sorry first home buyers. But you have been and will continue to be outbid for properties by the continuing passage through time of the post-WW2 boom generation, and their reaction to interest rates pushed to 1960s levels by the global financial crisis. And sorry, but there is worse.

The Reserve Bank has been introducing measures to control credit supply and you have been the worst affected group. You have the smallest deposits. You have mainly the lowest incomes. So the likes of LVR restrictions and next year's probable debt to income rules hit you hard.

And you are receiving an extra hit from these restrictions because of the stage we have reached in the housing cycle – capitulation. Those people still holding out for price declines now realise they could have bought any crappy property one or seven years ago and made seemingly easy money. They are trying to catch up on their delayed buying and being joined by every man and his dog feeling something is afoot and they best act so as not to miss out – just like you with the Pokémon-Go game you feel you just have to play. Same FOMO driver.

So sorry first home buyers if this message here is quite blunt. But on average you will not buy at as early an age as your parents and grand-parents. Your debt will be much larger though your interest rates will be a lot lower. You will on average live further from your place of work and spend more time commuting. You will on average take many more years before you can move into the location you want to be in. And, in spite of this you will not shift overseas to get cheaper housing.

You see terrorist attacks on TV, economies struggling to grow, and people voting with their feet to stay in New Zealand or move here – back here in many instances. There are up to one millions Kiwis offshore able to shift back.

For your guide, the net migration inflow over the past year was 69,000 people. The gross inflow was 125,000 of which 70,000 were Kiwis, Aussies, students, and long-term travellers. That leaves 55,000 people of which 40,000 came in to work and 15,000 for simple residence – probably family alongside people with work visas.

So on top of the effects of WW2 and the GFC you also face a structural lift in NZ's population growth rate courtesy of higher than anticipated net immigration. And lets not forget that there has also been a massive structural decline in the proportion of new houses built for entry-level buyers, and the cost of construction relative to income has soared courtesy of higher standards for building techniques, materials, inspections and so on.

Auckland's Unitary Plan

Output needed = 2.5 times 23 year average for 25 years.
Post-earthquake Canterbury achieved 1.5 times 25 year average from 2012 - 2016

→ Chances of 422,000 extra houses the next 25 years, minimal.

The proposals to beef up the September 2013 Auckland Unitary Plan released yesterday by the Independent Hearings Panel will provide capacity for an extra 422,000 dwellings to be constructed in Auckland by 2041. Come August 20 the Council will need to ratify the plan unchanged or propose changes which risk being over-ruled by the Government or dragging the plan's develop and implementation on for an indefinite period of time.

Putting implementation risk to the side as affected parties vigorously debate intensification etc., is it reasonable to expect that an extra 422,000 dwellings will be built over the next 25 years in Auckland? Traditionally only about 80% of consents issued actually add to the housing stock, but lets assume 90% for such a massive construction push. Total consent issuance for the next 25 years will need to be 470,000 or an average of almost 19,000 per year.

The average issuance for the past 23 years has been 7,500. Thus issuance will need to sit 2.5 times what it has been for almost the past quarter of a century. Is this feasible?

In Canterbury average issuance for the past 23 years has been 3,730 per annum. Average issuance since construction started ramping up post-quake in early-2012 has been 5,500 per annum for this four year period. This is only 1.5 times the long-term average. Auckland needs 2.5 times its long-term average.

More that that, consider the recommendation from the panel that the Council enable construction of an extra 131,000 houses over the next seven years. This works out at about 146,000 consents or almost 21,000 per annum compared with 9,434 in the year to May and an average 5,422 over the past seven years.

House construction will need to be around 3.8 times levels of the past seven years, 2.8 times levels of the past 23 years, or average 2.2 times the level of the past year.

The proposed Unitary Plan may well technically provide scope for an extra 131,000 houses in the next seven years and 422,000 in the next 25 years if adopted as is. But required output will not be achieved unless migration policy is changed to radically boost builder inflows. Given that the pressure is on the government to cut migration inflows because of the perception in some quarters that migrant numbers are contributing to the housing issue this is very unlikely. Catch-22.

Auckland house construction will rise, but growth will not meet population increase requirements let alone address the existing and worsening 40,000 unit shortage. Therefore house prices will continue to rise though with various elements probably contributing to a flattening in about 18 months' time.

For many Kiwis the rising level of Auckland house construction will provide great employment opportunities. If you are stuck for what to do with yourself or sick of pushing a pen and watching a screen all day, get into the building trade with its many facets.

NZ Dollar

Three weeks ago the NZ dollar was trading at US71.3 cents now it is near 70.7 cents. That is a fairly small change though a peak above 73 cents was achieved for a while as investors grew wary of most other currencies for reasons of weak economic data. That sentiment regarding the USD however eased when the very strong June jobs report was released and shortly after that expectations of easier monetary policy here rose after the Reserve Bank all but implemented right away tighter LVR rules for property investors.

There was some mild selling after the Reserve Bank Governor spoke about the desire for a lower NZD. But we have seen such comments from RB Governors scores of times over the years and they mean little. Fundamentally the NZD is very well supported by an economy set to be underpinned by construction for many years, strong tourism and most other non-dairy exports, good government finances, a low current account deficit, and still easing monetary policies and interest rate expectations outside NZ. Plus in Australian and UK media more and more positive articles are appearing discussing living in New Zealand, especially Wellington.

The chances still remain good that even with further interest rate cuts the NZD will see US75 cents before one day oscillating down to 65 cents.

If I Were A Borrower What Would I Do?

I still like the two to three year fixed rates. Given the still worsening global growth outlook, low NZ inflation, and the high probability that our central bank will cut the official cash rate one and maybe two more times, I'd be happy having 20% - 30% of my mortgage at a floating rate.

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

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

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