Sporadic

25 January 2018

Housing Prospects

Welcome to 2018. I've ceased publishing the Weekly Overview and brought back the previously well received 2015 publication Sporadic. This change has been driven by the plethora of economic commentary and analysis now out there plus shortening of reader attention spans making a weekly publication hefty overkill for all but the most devoted readers.

As in 2015 we have no set timetable for publication of Sporadic but frequency will be less than back then. Generally the focus will be on something quite specific rather than an overall summary of the state of the economy. There are plenty of those out there, none better than those produced by our BNZ Markets Economists.

In that vein, lets start with the housing market because this interests so many people, and has been an area where many have got their forecasts completely wrong for decades and especially post-GFC.

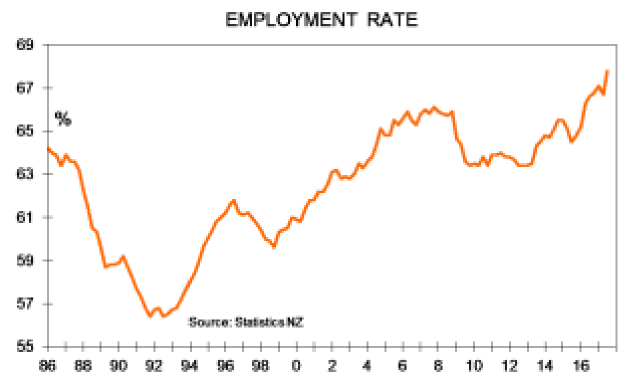
People often get lost in the detail when considering housing markets, placing too much emphasis on things from the past such as old average rental yields and old average ratios of house prices to incomes, or scaring people with stories of soaring interest rates. Such analysis has failed to allow for the structural changes in our housing market which we have discussed at length. These include structural changes in construction quality, house size, household incomes, financing costs, investor cohorts, inspection regimes, materials costs, section costs, demographics, the labour market, migration flows and so on.

Or people focus too much on what "should" be and, taking a stand that eventually their version of "sanity" will prevail, forecast a change to what they would like to see. Lefties tend to do this.

My preference is to ignore monthly and even quarterly developments, pay only scant attention to old ratios and affordability measures, concentrate on the key large factors which have the greatest influence, and ignore completely what I would like to see in an optimal world. Here are the major factors to consider plus a few hangers-on in no particular order of importance.

Labour Market

Jobs growth has been strong in many countries over the past few years, unemployment rates have fallen away, but wages growth remains highly elusive on a generalised basis though strong in some particular sectors – such as construction in NZ. Since the low-point of our labour market in 2009 almost 450,000 new net jobs have appeared of which 85% have been full-time. The employment rate which measures the proportion of the working age population in a job sits at a record 67.8%.



This labour market strength (without average wages growth acceleration) has been one factor supporting retail spending growth and housing in NZ. Will it continue?

The recently released NZIER survey showed that although businesses are on average pessimistic, a net 49% say they cannot find the skilled staff they want and 31% say unskilled people are hard to find. These measures are well above averages of 19% and 3% easy respectively. Labour is in short supply – bring on the robots and AI will be the view of many employers who will be showing more interest in technologies which can help them. A business investment splurge may lie just ahead.

A net 12% of businesses in the NZIER survey plan hiring more people. This is down from 19% three months ago and 27% mid-2016 but above the average of 6% and probably biased downward because of the business sector's distaste for Labour governments.

The NZIER measures taken in conjunction with the already high employment and participation rates, the outlook for continued strong economic growth, and the improvement in Australia's labour market dragging some Kiwis away, says to us that Kiwi householders are going to remain confident in their employment sustainability and prospects. That is positive for the housing market.

Immigration

Which brings us to a big influence on the NZ housing market – Auckland more so than anywhere else – net migration flows.

Many things influence net flows of people in and out of NZ and government policy changes are only one of them and in fact one of the lesser important drivers of flows. Policy changes largely cannot affect outflows and the impact on inflows is mitigated by these factors.

- 29% of gross inflows are Kiwis and Aussies
- 18% are students who drive a strong export sector worth perhaps $4.5bn. Slashing numbers there is unlikely to be a strongly pursued goal of the new government because of the impact on export receipts and employment numbers.
- 12% come in on residents visas and they have only grown 3,000 since the low-point of the migration cycle in 2012.
- Another 5% are long-term visitors.

That leaves just over one-third of the migration inflow as people on work visas. They are likely to be the target of policy changes which will tighten the labour market further. This effect will provide some offset to the negative population effect on housing.

Nonetheless, the tide seems to have finally turned on net migration flows which late in 2012 we picked to soar from -4,000 to 35,000 but ended up at 72,000 a few months back. The annual flow is now 70,400 and it seems quite reasonable to expect this number to decline over the next three or so years. Lets say back to the ten year average of 28,000 by the end of 2021.

One driver will be the strong improvement in Australia's labour market over 2017. Over 400,000 extra jobs have been created and this is relevant to our migration flows because the turning in the net flow with Australia from -40,000 in 2012 to +2,000 just over a year ago was a big driver of the overall flow change.

We don't expect to head back to -40,000 in the next few years. But a return to the 20 year average of -19,000 by the end of 2021 seems a reasonable assumption.

All up then net migration flows have turned and look like turning further. But because we expect them to remain firmly positive for some time yet we think it is still valid to include net migration flows on the list of factors supporting housing turnover and prices on average over the next four years.

Interest Rates

Historically interest rate hikes have been the cause of housing market weakness in New Zealand. But every single forecast of a decent jump in interest rates since 2009 – often used as justification for a forecast of big house price falls – has been wrong.

Globally interest rates have stayed far lower than expected for almost a decade as inflation has proved less reactive upward to accelerating economic and labour market growth than has ever before been the case over the past few decades.

We got yet another example of that today in the form of the December quarter Consumer Price Index rising only 0.1% rather than the 0.4% almost all analysts had predicted. Annual inflation has now slipped to only 1.6% from 1.9%. Core inflation using a measure I like – the CPI excluding food and energy – has fallen to 1.1% from 1.5%.

Looking ahead we see a world of accelerating economic growth and tightening labour markets which in theory will drive higher wages and business pricing ability. But in practice we do not fully understand why around the world wages and prices have not responded to faster growth and that means one cannot strongly conclude that things have finally changed back to the way they were.

Frankly, even though our examination of indicators like pricing intentions, economic growth, and capacity measures says to us that inflation and therefore interest rates will rise, we have to be

cautious. Central banks have repeatedly since 2010 raised interest rates too soon. They have become a lot more cautious now.

Our expectation is that our central bank will start to raise its 1.75% cash rate in the first half of next year. Before then we expect higher interest rates overseas to feed through into higher fixed lending rates here in NZ. Maybe this year we will get that forecast right. Maybe.

For borrowers the overall outlook still looks relatively benign, especially for those who borrowed funds before 2008 when the older world of higher interest rates prevailed. We expect the Reserve Bank to take the official cash rate to 3% from its current 1.75% come 2020. That means floating and short term fixed rates rising about 1.25%.

Interest rates creeping higher to a very uncertain but probably minor extent over the next three years will be a source of restraint in the housing market – but probably not a particularly big one.

Credit Controls

The Reserve Bank introduced loan to value ratio rules in October 2013 then expanded them in October 2015 and again from July 2016. The aim of the rules was not so much to suppress house prices or necessarily suppress the overall rate of growth in lending for housing purposes. The aim instead was to curb risky lending involving low deposits in particular.

This reflects the switch in central bank focus globally since 2008 toward a bit less attention on (stubbornly low) inflation and more on preventing the conditions which saw the world on the cusp of a new Great Depression.

Banks have been forced to strengthen their balance sheets with new capital requirements and lending restrictions while monitoring regimes have been expanded.

Late last year the Reserve Bank noted that there has been a reduction in risk attached to the NZ banking sector, housing especially with far less low deposit and interest only lending. They concluded that there is less need for tight credit controls so from January banks can now have up to 15% of their housing lending to people with deposits smaller than 20% of the purchase price. And investors can have just a 35% deposit rather than 40%. 5% of lending to investors can involve smaller than 35% deposits.

Feedback recently discussed in the media is that bank lending with smaller deposits has picked up slightly which is a change following an extended period when lending was reduced not just because of RBNZ rules but also voluntarily imposed changes. These have included not allowing foreign income to count toward debt servicing calculations in New Zealand.

It is possible that the Reserve Bank will ease lending rules further. We cannot predict when or by how much, especially with a new Governor coming along in a couple of months. But the slight easing already undertaken will tend to give a small boost to housing turnover and prices at the very margin.

Dwelling Supply

“If you build it he will come.” Sure, but can you build it? It took a few years for people to acknowledge it, but from 2012 there developed general acceptance that there is a housing shortage in NZ, concentrated in Auckland but present also in Wellington and Central Otago Lakes.

The government has plans to boost construction of affordable houses to 10,000 per annum by 2020. We have seen total dwelling consent numbers recover from a multi-decade low of 13,500 in 2011 to near 31,000 recently. Sounds good.

But we do not have enough builders, engineers, plasterers, electricians, quantity surveyors, barrow pushers, concrete cutters, and so on. Neither do many other countries. There cannot be a building boom in New Zealand because the resources are not available and the new government will not open the immigration gates to allow in the sort of workforces which have allowed rapid and massive construction in countries like Singapore and cities like Dubai. And all the talk we continually hear about pre-built houses is unlikely to result in more than a handful of such places being built here. We simply don’t have the scale.

Not only that, but developers have for the past year been struggling to get credit from banks. Banks have had to tighten up their lending standards and this has meant cutting exposure to a traditionally very high risk sector – residential construction. In particular, new developers seeking to profit from the Auckland Unitary Plan freeing up most city land for subdivision have found themselves unable to

get funding. There is ironically an over-supply of sub-dividable land in Auckland.

The chances are that the level of house construction in New Zealand will creep higher over the next three years. But the extent of the gain is not likely to be all that much – especially once the many Kiwis who put off shifting to Australia in the past five years start to head over there now that the Aussie labour market is showing high strength.

The shortage of houses will persist for a long time and this will underpin prices.

FOMO
= Fear of Missing Out

This is an element on display for all to see at the moment in the Bitcoin and other cryptocurrencies market. There is virtually nothing beyond illicit weapons, drugs, and ransoms for which you need a cryptocurrency to make a purchase. But prices for these non-legal tender synthetics have soared because prices have soared because prices have soared because people think prices will soar again and they don't want to miss out on what look like simple gains. Some people have made fortunes, others will lose them as real world imperatives such as central bank controls eventually curtail the new tulip mania. The smart money will be well out of the sector before that happens. History has repeatedly taught us there is no way we can predict when an asset bubble will collapse and ultimately where the pain will be felt.

FOMO was a big element in the NZ housing market from perhaps 2012. By then many people could see that every single forecast of big price declines had been wrong. They started to ignore the remaining Cassandras and making the home purchase they had been delaying for years. Prices started rising more rapidly, people seemed to be making easy money, the newspapers encouraged us all to tut-tut about it and to cry over young folk struggling to make a purchase and the red rag was basically out for every bull to run at.

FOMO led people to jump in to try and buy any piece of crap land in Auckland (even meth houses) and the market developed strong momentum, underpinned by not just FOMO but the many other long-term fundamental factors we have been highlighting for years now.

But seeing the great unwashed getting in on the game and fearing a rapid deterioration in bank lending quality and ability to withstand a shock the Reserve Bank made a very timely move in October 2013 with its first set of LVR credit controls. Those controls gave the market pause and assisted by the extra imposts of 2015 and 2016 kept a high number of under-capitalised inexperienced FOMO-driven people from getting into the market.

The RB's brilliant timing helps explain why the market is not going to crash in the near future and why the slowing in Auckland in particular has been quite a smooth affair. There have not been all that many poorly capitalised people to be weeded out.

FOMO for the NZ housing market has now either ended or is ending this year in the regions. It will one day come back but probably not for a few years. This then acts as a negative influence for the next three years, though a good one from the point of view of system stability and good personal financial management.

Miscellaneous

Now lets consider some other elements very quickly.

Construction costs continue to rise with extra upward pressure coming this year from rising transport costs as oil prices have risen, and higher materials prices as world commodity prices such as for steel have gone back up. Higher construction costs tends to keep up/push up the price of existing houses.

Tenant legislation. We have for some years been warning landlords that the change in our society toward more people renting for longer periods will eventually lead to legislative changes giving tenants greater security and quality of tenure. We said this would not happen under National but would under Labour. Labour are now in power so the legislation will shift. Being an investor will become slightly more difficult and more expensive at the margin. This will cause some investors to sell. It will by that reduction in rental supply plus increase in operating costs cause a rise in average rents beyond what they would otherwise be.

This then will tend to have a negative and positive impact on house prices. Downward through marginally greater supply on the market. Upward because of higher rents.

Add all these factors up and throw in accelerating world growth, a firm outlook overall for the NZ

economy, and focussing heavily on the absence of soaring interest rates, presence of some shortages, inability of supply to boom, and strong jobs growth which one day might lift wages – and you get more upward pressure on house prices than downward. If I were making an investment in the average house at the moment and wanted to use a price change assumption I'd pick something in the range of 3% - 5% per annum.

Then however I would need to make an adjustment for the part of the country I was looking at. For Auckland I would err toward the top of that range, same for Central Otago Lakes. For the rest of the country I would move toward the lower end and for some parts of NZ I would completely ignore the 3-5% range because population growth projections coupled with a recent surge in construction suggest long-term housing over-supply.

Sporadic 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. Please sign up at www.tonyalexander.co.nz
To change your address or unsubscribe please click the link at the bottom of your email. Tony.alexander@bnz.co.nz

This publication has been provided for general information only. Although every effort has been made to ensure this publication is accurate the contents should not be relied upon or used as a basis for entering into any products described in this publication. To the extent that any information or recommendations in this publication constitute financial advice, they do not take into account any person's particular financial situation or goals. Bank of New Zealand strongly recommends readers seek independent legal/financial advice prior to acting in relation to any of the matters discussed in this publication. Neither Bank of New Zealand nor any person involved in this publication accepts any liability for any loss or damage whatsoever may directly or indirectly result from any advice, opinion, information, representation or omission, whether negligent or otherwise, contained in this publication.