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.

Our Economy

3 New Housing Factors

This week I'd like to highlight three brand new things we need to think about as we discuss the housing cycle and its progression. The first is revised migration data.

Last week Statistics NZ released a new version of the monthly immigration numbers. What they show is that in recent years the net gain to our normally resident population from actual permanent and long-term migration has been less than thought.

For instance, in calendar 2015 the original pick for net migration based upon asking people coming into NZ what their intentions were was 65,000. The actual outcome based upon data showing what people ended up doing was a net gain of 59,000. In calendar 2016 the original estimate was 71,000. The actual realised net migration gain was 62,200.

In 2017 the original pick was 70,000 but the actual outcome was a much smaller 52,500. That brings us to the latest month for which we can make a comparison, October, in which the original gain was reported as 62,000 but the actual gain was 45,200.

Why the differences? Because people don't always do what they say they intend doing. The difference mainly relates to younger people, foreign students in particular. Have the data always over-estimated net inflows? No. In 2010 the original data were 5,000 too low, in 2009 21,000 too low, and in 2008 14,500 too low.

Are the trends different? No they are not. When the old data showed improving net flows so too did the outcomes data.

What can we gain from this new understanding of net migration flows? Can we say that people have over-estimated NZ population growth and therefore estimates of housing shortages in the likes of Auckland have been too high? Sort of, yeah, nah.

The over-estimation in the year to October of almost 17,000 does not mean that New Zealand needed 7,000 fewer houses than thought – using the nationwide average occupancy rate of 2.5 people per dwelling. The "missing" 17,000 people still needed to live somewhere while studying or on working holidays.

Nevertheless, does this mean house prices are fundamentally too high and equilibrium based on the interaction of changes in demand and supply is lower than current prices, ceteris parebus? If yes then the effect is likely to be very small. At the margin there will be some people who decided to buy a house in Auckland because they looked at population growth numbers. In truth the number of people doing so is likely to have been exceedingly small because demand would still have been strong from the students and working holiday visitors.

But let's count this new housing factor as a negative albeit a very tiny one subject to not existing at all because some analysts have doubts as to the accuracy of the new Statistics NZ data and the model they use for estimating what people have been doing over the past 16 months. Big revisions to the annual numbers could easily occur.

So to the second new factor.

Interest rates will face upward pressure in coming years because the increasingly activist Reserve Bank tells us that banks will be required to hold greater levels of capital in the future than they do currently. Capital holding costs form part of total lending costs hence mortgage rates will rise. The common estimates hover around 0.8% to maybe just over 1.0% added to floating mortgage rates.

Whether this happens or not and to what extent however depends upon what the outcome of the current consultation period on bank capital requirements will produce, when the new rules come into force, and how banks not required to boost capital levels so aggressively alter their mortgage pricing behaviour. If they do not match rises started by the big lenders then those big lenders may have to cut their rates back down again.

We shall have to wait and see and it is all guesswork at the moment. And in reality, if banks do boost lending rates by 0.8%, will mortgage rates stay 0.8% higher than would otherwise be the case? Probably not.

Mortgage rates are the thing the Reserve Bank looks to change when they alter the official cash rate in order to alter the pace of growth in the economy and eventually inflation. If mortgage rates get pushed up because of new capital requirements the Reserve Bank will explicitly offset this by cutting the official cash rate.

This is interesting because higher capital requirements for banks will lead to an overall lower structural level of wholesale interest rates in New Zealand. This effect has already happened to some extent because of the introduction of LVRs. That will reduce the ongoing level of interest rate support for the NZ dollar and deliver a better exchange rate environment for NZ exporters. Exporters will gain from higher bank capital requirements.

Now let’s move to the third new factor for our housing market, and this one you’ll need to take some time to think about. Expectations of price declines.

Recently there has been a return of forecasts that house prices may stage a decent decline in Auckland following falls in Australia. All these forecasts proved wrong from 2009 until now so that appalling forecasting performance needs to be taken into account when reading the dire predictions of some commentators currently.

The key issue is this. If you think prices may decline you will tend to hold back from buying. This can make the expectation self-fulfilling. No argument there. But consider the key fundamental for Auckland. There is a dwelling shortage, the size of which is anyone’s guess depending upon the assumptions you make and whether you believe the housing market adjusts to reflect demand and supply imbalances. I believe it does, hence technically, there is no shortage at current prices.

Addressing the shortage non-economists and economists with social agendas think exists requires more construction. Who does the constructing? Builders/developers. What influences the willingness of builders to construct spec houses and developers to start new projects? Expectations regarding their ability to sell. How will their expectations of selling change as people worry about prices falling? They will fall.

Lenders require high levels of pre-sales before committing to advancing funds. Their expectations of pre-sales will also decline.

The effect of articles running stories that the oversupply in Australia producing falling house prices will be repeated here (where we may have shortages) will be to reduce construction of new houses.

And that is one reason why the Auckland cycle will one day kick upward again. Cycles don’t just reflect cyclical changes in interest rates and migration flows influenced by the economic cycle. They also get influenced by inventories in the business sector. These inventories get run down in a downturn or worrying period. When things look neutral the inventories start to get rebuilt, that boosts economic growth, employment and optimism rise and so on.

If house construction is cut in the coming year or two because of stories that house prices may fall and worries about pre-sales then the “shortage” of houses in Auckland will become a lot worse. A newly growing imbalance between demand and supply at current prices will eventually generate fresh price pressure.

At this stage for your guide we can only take stabs at

- the magnitude or timing of this forestalled construction effect,
- the effect on borrowing costs of higher bank capital requirements,
- altered population growth numbers,
- a whole range of other factors we shall discuss in the housing section in coming months.

I will spend the next three years guessing when the price pressures will come back to the surface.

For your guide, I thought about including a fourth factor here – the Prime Ministers' embarrassing backdown on KiwiBuild targets. The implication is less growth in housing supply and therefore upward pressure on prices. But seriously, there was never any strong chance that an organisation now increasingly if not completely dominated by bureaucrats with social agendas, sensitive feelings, and little understanding of how the real world works could ever deliver what the Labour dreamers wanted them to.

This past week has simply produced a partial acknowledgement of the reality of this failed policy and more laying of the groundwork for a shift away from trying to construct "affordable" housing to focussing where the deeper need exists in our society – social housing for the people left out of virtually all forms of the housing market. That move however will probably require "reassignment" of the Housing Minister and the PM has shown an inability to make such big calls so far regarding responding to examples of ministerial incompetence. So we wait for this necessary change – probably before election year therefore before the end of this year.

As for a Capital Gains Tax. Last year I said it was a 50:50 call. Now I'd give it a 30% chance of being part of Labour's 2020 election manifesto.

Housing

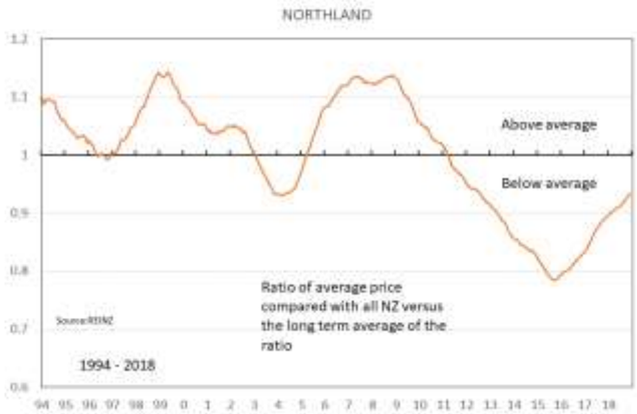
As if the above was not enough, here is an exercise I have not performed for a few years. This time I do so using new, more reliable, data from REINZ.

Housing markets move in cycles of variable length and Auckland's peaked late in 2016 courtesy of a 40% deposit requirement for investors and the cycle simply getting long in the tooth. There was no negative factor in play like slowing economic growth, rising unemployment, rising interest rates, collapsing migration, or plunge in price expectations.

Since October 2016 average Auckland house prices as measured by the REINZ's House Price Index (HPI) averaged over three months have fallen by 1.3%. Sales have fallen by about 20%. Outside of Auckland however average prices continue to rise and since late-2016 they have gained 17% while sales have fallen about 12%.

The regions have been experiencing the same macro factors as Auckland as listed above. But they have benefitted from buyers looking for cheaper assets outside of Auckland in a perfectly normal cyclical pattern. There has been no downgrading of long-term expectations for growth in Auckland versus the rest of the country on average.

As input into where things go from here I have created a series of graphs showing the extent to which the regions have been catching up on Auckland pricewise over the past couple of years. The first graph here is for Northland. The variable displayed is the ratio of Northland's HPI each month to the New Zealand average HPI compared with the average ratio for the past 24 years. Annual totals are used.



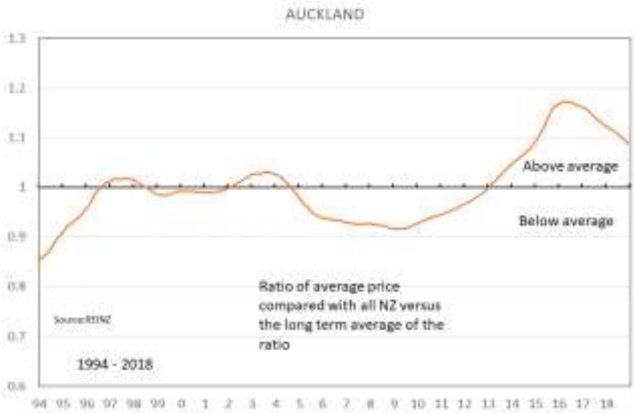
Northland was quite expensive versus its long-term relationship with NZ overall in 1994, 1998-99, and 2006-08. Northland was quite cheap around 2004 and from 2011 to now. The catch-up has been underway since 2016.

Does the graph allow us to say anything quite concrete about how much further prices have to go? Certainly nothing strong for two reasons. First, if we consider this to be some sort of "fair valuation" purely mathematical exercise then it tells us nothing because if it shows under-valuation of, say, 10%, that might simply mean the relationship is on its way to showing undervaluation of 20%, or 30%. So always be careful about these sort of something versus average measures in areas like exchange rates, share prices etc. The graphs look pretty and we are attracted to them as simple investors looking for answers. But they can be vacuous and deceptive in fashion.

Secondly however, there appears to be a downward trend in place if you run a line through the low points. So blindly saying prices have over 20% catch-up left to get back to old peaks would seem overly optimistic.

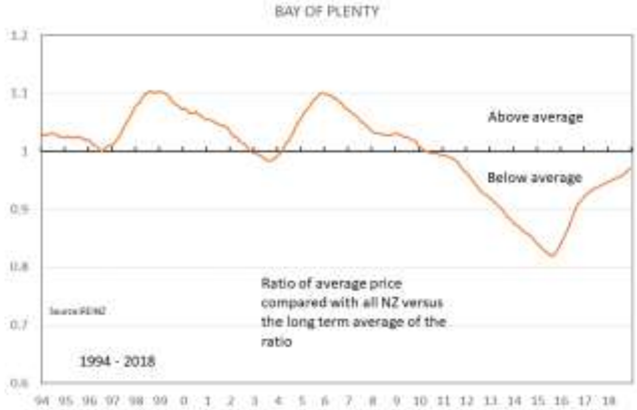
All I aim to show from the graph is the way in which a catch-up in prices has been underway and that the region has gone through periods of above average prices – by definition. I look at the graph and it says to me, I'd personally not be too concerned about Northland pricing strength petering out in the very near future. That's all.

Here are graphs for other regions. Enjoy but be careful in your interpretation.

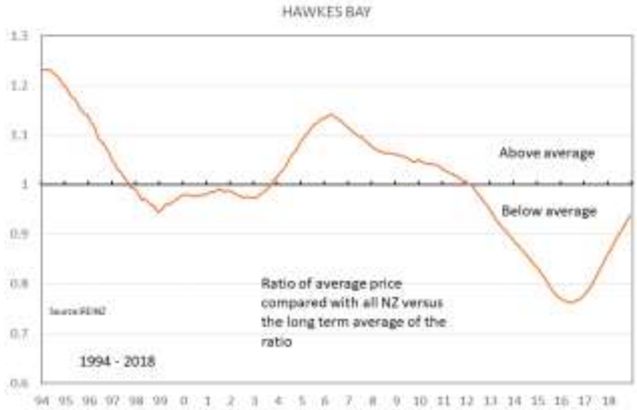


Waiting for the rest of NZ to catch-up further. Note the below average period from 2006-2011 which preceded the period of biggest Auckland house price gains. We are not in that territory again, hence our expectation of continued Auckland price flatness the next 2-3 years.

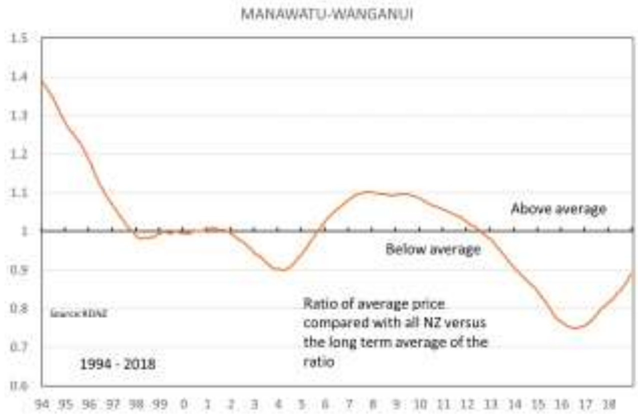
Not much off average now.



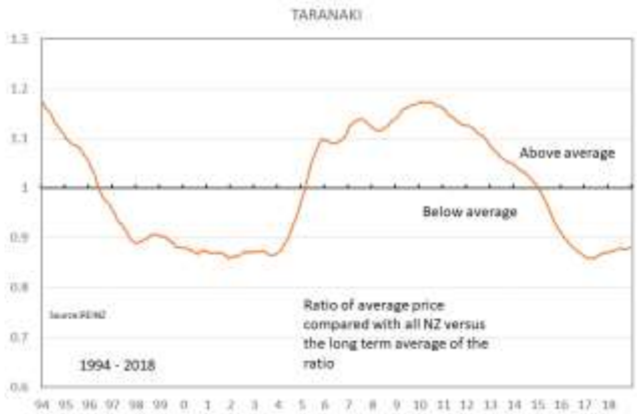
Ditto.



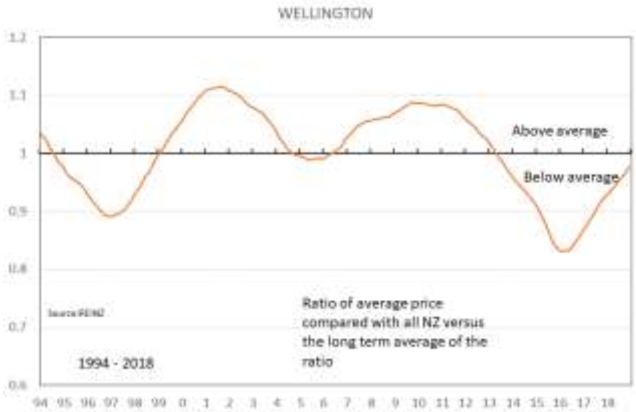
Some upside left.



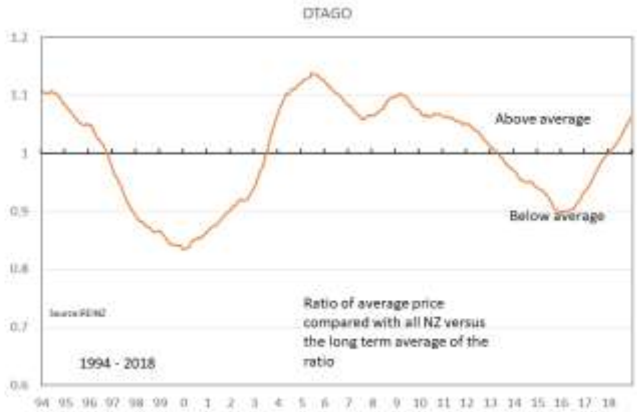
Same.



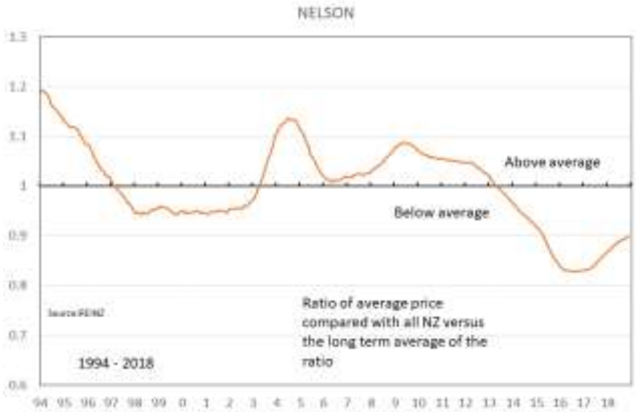
Still further to go.



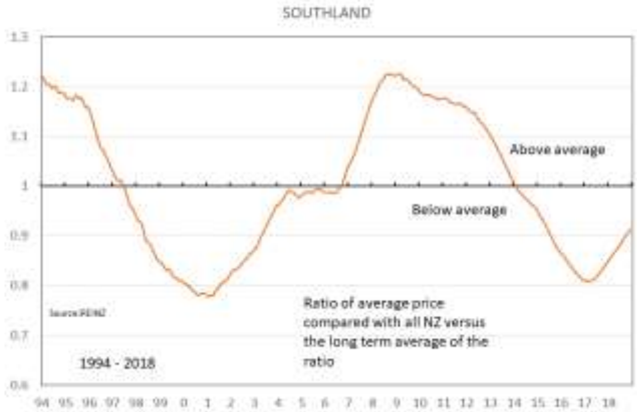
Will be slowing soon.



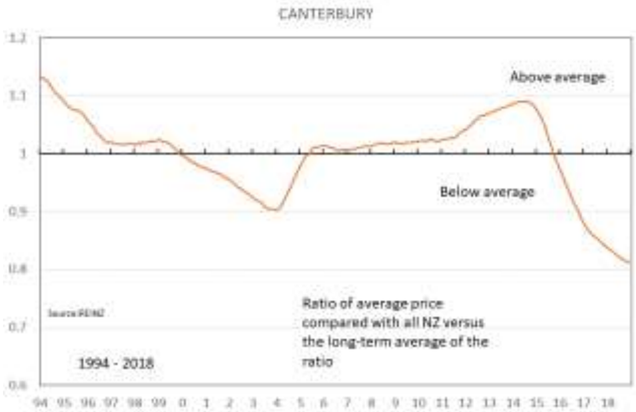
Looking over-cooked.



More upside seems likely.



Further to go still.



One day this sort of "analysis" will be useful for the Canterbury market. For there are probably a few years left still whereby things remain distorted by the earthquake effects. I read nothing from this graph given that effect beyond a feeling that the scene is being set for stronger Canterbury price growth – down the track.

Good luck if using these graphs in your decision making. Just remember the key caveat – if a thing is x% away from its average that does not mean it now starts reverting back to average. It could be on its way to being y% away from average. After all, every bit of analysis suggesting house prices will fall because the ratio of house prices to income is well above an old and "desired" ratio of three times has been wrong. It could be that the average shifts over time and in this particular case it has for reasons discussed here strongly since 2010. I'll run through the list again soon.

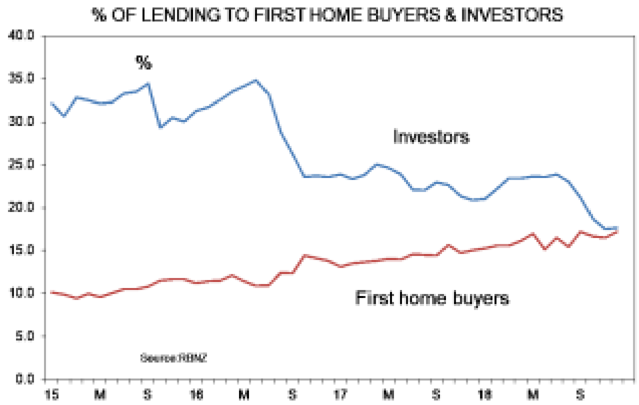
Your Strategy

-Things to consider in your next annual strategy session.

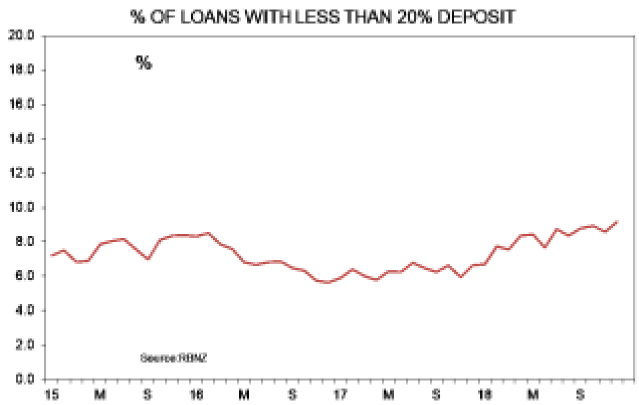
Nothing this week. Housing commentary has taken up all the space.

If I Were A Borrower What Would I Do?

Nothing new. There is strong competition between banks for mortgage business and this competition is manifesting itself as some good rates at the two and to a lesser extent three year terms. There is no evidence that the competition is newly promoting higher risk lending. In fact in December the proportion of the $5.4bn which was newly lent that went to investors was just 17.7% from 20.9% a year before and 30.1% three years ago. The proportion lent to first home buyers was 17.2% from 15.1% a year back and 11.7% three years ago. The 0.5% gap between the proportions of lending going to these two groups is the smallest on record.



The proportion of lending which involved less than a 20% deposit was 9.2% in December – well below the 15% permitted by the Reserve Bank.



That limit has now been raised to 20%. And in December only 29% of all lending was interest only versus 32% a year ago and 40% three years back.

Note that 59% of lending to investors is still interest only from 50% a year ago and 53% three years ago. So the reduction in interest only lending these past three years entirely reflects less lending overall to investors. But only 0.3% of lending to investors interest only was with less than 20% deposit. That was 1.1% three years ago.

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. **This edition has been solely moderated by Tony Alexander.** To receive the Weekly Overview each Thursday night please sign up here. http://feedback.bnz.co.nz/forms/lFdYSs5FGEq4kAjP95uzTA
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