Crockers Market Research

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Crystal Ball 2014 Issue • Crockers partnering with Infometrics

Ten times a year, Crockers Market Research provides a summary and analysis of recent market conditions. In essence, we try to make sense of what we see in the rear view mirror.

Our April Market Research edition, the first of the financial year, is different.

It's the one issue where we look ahead and **predict** how things are likely to be. To do that, we partner with leading independent economic **forecasting** and consulting company, **Infometrics**.

Our predictions are not infallible (and as a sensible investor you should always exercise your own knowledge and judgement rather than basing investment decisions solely on another's viewpoint). However, it does mean you can be confident that the following analysis is based on extensive **research** and understanding of the housing market – and therein lies its value.

Quiet in the rental market, but growth on the horizon

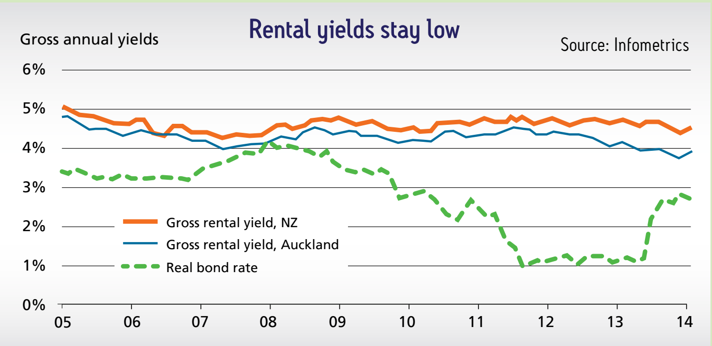
Residential rental inflation has remained relatively subdued in recent months, according to Infometrics' index, which is based on Real Estate Institute and Ministry of Business, Innovation, and Employment data. Rents in the three months to February were up 4.9% from a year earlier. Pressures remain strongest in Christchurch, where rents have risen 11% over the last year.

Rental inflation has been surprisingly weak in Auckland over the last 12-18 months, but there have been signs of more upward pressure in the first two months of 2014, with rental growth in the region reaching a 22-month high of 5.3%pa.

Gross rental yields in the last few months have dropped towards the record lows reached between mid-2007 and early 2008. Since 2010, the relatively low yields may have been palatable for property investors because of the lack of decent returns available elsewhere. But as economic growth has accelerated, returns from other investments such as shares or bonds have also lifted, making property less attractive. The gap between rental yields and real government bond rates is now close to its long-term average, down 180 basis points from January 2013.

Yet anecdotal reports suggest that property investors are starting to become more active in the market again following the introduction of the loan-to-value restrictions last October. With fewer first-home buyers in the market to bid up prices, investors have a greater chance of obtaining property at the lower end of the market at a reasonable and economically viable price.

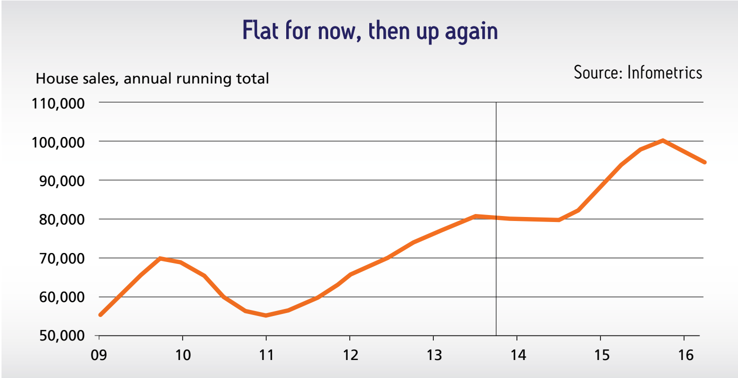
Infometrics expects rental inflation to gain momentum this year and run ahead of house price inflation. Strong population growth and a rapidly expanding economy will boost the rate of household formation and increase demand for rental accommodation. These demand conditions will enable landlords to put up rents at the same time as price growth is slowing due to the LVR restrictions.



Further growth for house sales, in time

For the three months to February, total house sales **volumes** were down 4.5% from a year earlier, **compared** with positive annual **growth** of 14% as recently as September 2013.

The Reserve Bank's loan-to-value restrictions have had a discernible effect on house sales volumes. High-LVR mortgages dropped from 25% of lending in September to just 4.8% by January – well below the Bank's 10% threshold, especially given that these figures do not take exemptions into account.



The share of high-LVR lending has been low because at least some trading banks have underestimated demand for low-LVR lending and, therefore, how much high-LVR lending they could safely approve. The banks have also initially taken a cautious approach to high-LVR lending to ensure they stayed well within the mandated limit. Some banks have recently suggested that they will be able to increase their share of high-LVR lending given their experience with how the system is working and how far below the 10% limit they have come to date.

Infometrics forecasts that house sales will remain static throughout much of 2014 due to the LVR restrictions. However, Infometrics also believes that the dampening effect of the restrictions on sales will be relatively temporary. Twenty-three percent of respondents to the latest Crockers Property Investment Index (CPII) survey identified loan-to-value restrictions as being one of the top two influences on demand in the Auckland housing market this year (CPII survey data cited here and below excludes those answering the questions 'don't know').

Strong net migration will be a key driver of the renewed pick-up in house sales in late 2014. Although net migration is set to peak in the first half of this year, there is typically a lag between changes in migration flows and movements in house sales. Furthermore, Infometrics believes the LVR restrictions might mean that the flow-on effects of the current migration surge take longer than normal to show up in the housing market. In the CPII survey, net migration was cited by 61% of respondents as an important influence on the Auckland housing market this year. This result meant that net migration was the most commonly chosen influence, reflecting the effects of similar migration surges on the Auckland market in the mid-1990s and 2002-03.

The sustained period of strong GDP growth and buoyant labour market throughout 2014 and 2015 should also ensure ongoing growth in house sales next year, taking sales volumes above 100,000pa by the end of 2015. Economic growth was seen by survey respondents as the second-biggest influence on the Auckland housing market this year, chosen by 47% of respondents to the CPII survey.

Counteracting the stronger demand conditions will be rising interest rates, which will start to take the heat out of the housing market by mid to late 2015. As economic growth slows as well during 2016, house sales will pull back from their peak. In the CPII survey, forty-five percent of respondents identified interest rates as an important influence on the Auckland housing market this year.

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Economic conditions conducive for further house price rises

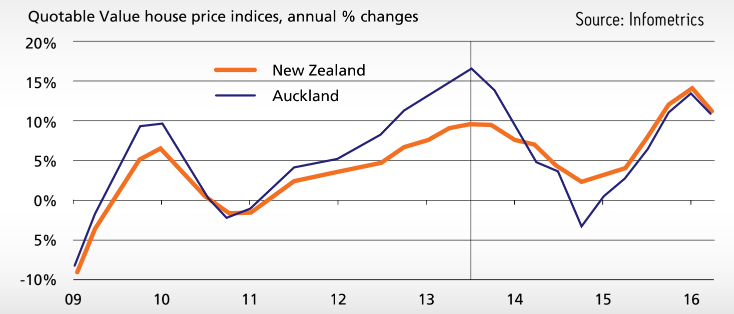
House prices continued to **rise** strongly through the latter part of 2013, with house price **inflation** according to Quotable Value reaching 10%pa in December, **easing** slightly to 9.3%pa by February this year.

Auckland and Christchurch remain the key drivers of nationwide price growth, recording house price inflation of 14% and 11%pa respectively.

However, the signs of a recent drop-off in house sales are likely to be translated into a slowdown in house price inflation this year. With the bulk of low-equity buyers having been squeezed out of the market by the LVR restrictions, reduced buyer competition is taking the heat out of house prices, especially at the lower end of the market. Infometrics expects this reduced demand to ripple through other segments of the market, leading to slower house price inflation across the board. By the end of 2014, Infometrics predicts that house price inflation will have eased to 2.4%pa.

The biggest slowdown in house price inflation is likely to occur in Auckland, where affordability issues suggest that the LVR restrictions should have the greatest effect. However, in Christchurch, the influx of migrants into the city is exacerbating the region's shortage of housing, and Infometrics expects less of a drop-off in house price growth to occur there.

Temporary price restraint from LVR restrictions



Healthy economic and income growth throughout 2014 and 2015 will underpin strong demand for housing next year and lead to another round of house price inflation. Supply issues should ensure that house prices in Auckland and Canterbury continue to rise relatively rapidly. A substantial 82% of respondents to the CPII survey expect the Auckland housing market to still be undersupplied at the end of this year, with just 9% expecting there to be an excess stock of housing by the end of 2014.

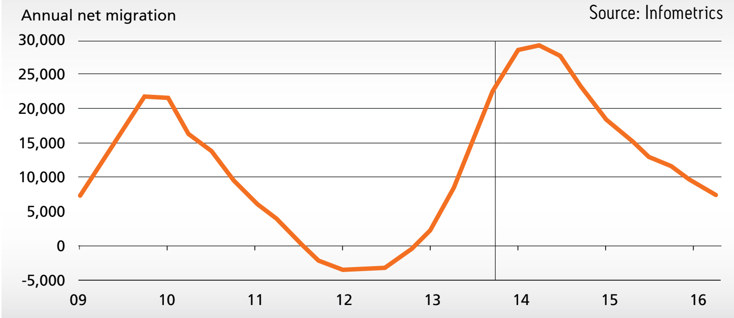
The strength of export incomes and their stimulatory effect on provincial economies is likely to drive up property prices around the rest of the country as well. Infometrics expects nationwide house price inflation to peak at 14%pa in 2015/16, with higher interest rates eventually sufficient to restrict both the housing market and more general economic activity. Some reversal in prices is possible in 2017 and 2018 as economic growth slows and the undersupply of housing in Auckland and Canterbury is largely resolved.

Migration surge to peter out in 2015

Net migration **flows** have continued to **surge** throughout the closing months of 2013, with a **seasonally** adjusted net inflow of 8,590 people in the December quarter.

If net migration inflows held up at this level for a year, the annual inflow would rise to about 34,000pa.

Net migration inflows touch 30,000



With the New Zealand labour market improving (including some skill-specific demand stemming from the Canterbury rebuild) at the same time as the Australian economy and labour market have cooled, there has been a rapid drop in the number of people leaving New Zealand permanently. There has also been an increase in the number of New Zealanders and Australians heading to New Zealand for work.

Infometrics expects net migration to remain strongly positive, but is not forecasting the recent pace of migration to be maintained. The annual inflow is forecast to peak at almost 30,000 people by mid-2014 and dip to 18,600 by March 2015.

There are two key reasons for net migration to peak in the coming quarters. The Australian labour market will start to stabilise, and inflows associated with the Canterbury rebuild will wind down.

In recent months there have been signs that the monetary easing in Australia has started to push up domestic demand across the Tasman. With domestic economic activity ticking along, firms will become more willing to hire, helping to gradually push down the Australian unemployment rate from mid-2014.

Adding to this view has been continued weakness in visa approval numbers and the number of visa applications on hand at Immigration NZ. These factors should limit future non-citizen arrivals to New Zealand.

Two years of interest rate rises

The Bank's decision to **raise** interest rates was **unsurprising** given the **strength** of economic indicators, which has been almost universally positive.

Strong economic growth, the tightening labour market, and rising price pressures will make it relatively easy for the Bank to justify further interest rate rises. Infometrics is picking rate increases to total 150 basis points this year.

The only main set of numbers that will be softer during 2014 is housing market data. However, the softness in the housing market will be outweighed by the other positive economic indicators and will not dissuade the Reserve Bank from its tightening cycle.

At 4.0% by the end of 2014, the OCR will only be back at a neutral level, but the strength of the economy will be demanding tight monetary conditions. The New Zealand dollar is still likely to be high, which will provide some measure of constraint on economic activity. But economic growth of up to 4.0% during 2015 means that further interest rate rises will occur next year, and Infometrics predicts the OCR will reach 5.25% by early 2016.

Servicing the mortgage gets more expensive