NEW ZEALAND ECONOMICS
ANZ PROPERTY FOCUS

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INSIDE

CONTRIBUTORS

Cameron Bagrie
Chief Economist
Telephone: +64 4 802 2212
E-mail: Cameron.Bagrie@anz.com
Twitter @ANZ_cambagrie

Philip Borkin
Senior Economist
Telephone: +64 9 357 4065
Email: Philip.Borkin@anz.com

David Croy
Senior Rates Strategist
Telephone: +64 4 576 1022
E-mail: David.Croy@anz.com

Sharon Zöllner
Senior Economist
Telephone: +64 9 357 4094
E-mail: Sharon.Zollner@anz.com

LAST CALL

SUMMARY

Our monthly *Property Focus* publication provides an independent appraisal of recent developments in the property market.

CHIEF ECONOMIST CORNER: WILL HISTORY REPEAT?

It's midnight at the bar. We've had a good time. Do we go home or stay out until 4am? History says the New Zealand economy (housing market) stays out and binges. The end result is an economic hangover as a bust follows the boom. Warning signs are starting to flash with regard to leverage (credit expansion relative to incomes) and asset valuations. The term "this time is different" is a phrase that can come back to haunt an economist but there are some key differences now. We have a housing boom but not a consumption equivalent as households show more restraint, which in combination with the high NZD and other deflationary forces is keeping inflation (and the RBNZ) at bay. Housing supply is still not keeping pace with demand so we don't have a surfeit of stock that could pressure prices. We don't have a shadow banking sector. The regulator (RBNZ) is playing bouncer at the door through loan-to-value restrictions and banks the responsible bar-tender tightening up the availability of credit. This will help dampen the extent of excesses built up at the top, which will lessen the pressure for an adjustment on the other side.

PROPERTY GAUGES

The housing market has slowed as the combination of extended valuations, movement in interest rates off lows, prudential policy changes (LVR restrictions) and tighter credit availability act as headwinds. But questions will surround how long the moderation will last given the fundamental shortage of dwellings across the market, which continues to get more pronounced with the impetus from surging migration.

ECONOMIC OVERVIEW

The New Zealand economy is entering its eighth year of expansion with strong momentum. But natural headwinds are now emerging (capacity pressures, a turn in credit cycle, tighter financial conditions, stretched asset valuations) that should see growth ease over the course of the year (from 3½-4% towards 3%). That's a natural moderation, as opposed to a downturn. We view it as healthy in the context of the country's medium-term stability and its resilience to external shocks. The RBNZ remains on the side-lines for now, although price pressures are now building.

MORTGAGE BORROWING STRATEGY

Although there has been little change to floating mortgage rates, rates with terms of 2 years and longer continue to move gradually higher. This has occurred largely as a result of higher global interest rates (which tend to have a larger influence on New Zealand longer-term rates than local factors do), and rising funding costs. As we noted last month, we believe mortgage rates have seen their lows, and although rises from here are likely to be gradual, they are rises nonetheless. Although rates are not quite as attractive as they were a month ago and we maintain our view that it is worthwhile considering fixing some portion of your mortgage for longer than 1-2 years, recent rises do make it a much closer call. With the OCR on hold, 1-2 mortgage year rates won't go up for a while.

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The economy goes through good times and not-so-good times. It is called the business cycle and it is normal. Night follows day just as day follows night. Businesses, households and investors need to manage such volatility.

In the case of New Zealand, it has been the extremities of these swings that have presented the biggest challenges. We affectionately refer to the New Zealand economy as the 3-speed economy: fifth, neutral and reverse. This is particularly so for sectors sensitive to domestic interest rates, such as the housing market.

Large swings in the business cycle can typically be linked to four key dynamics:

- A turn in the global economy. Where they go we follow.
- Mother Nature.
- A build-up of economic imbalances (excesses) that ultimately require purging and the piper being paid.
- Large swings in the stance of monetary policy (interest rates) and the associated fallout for the NZD. The former hits the housing market particularly hard.

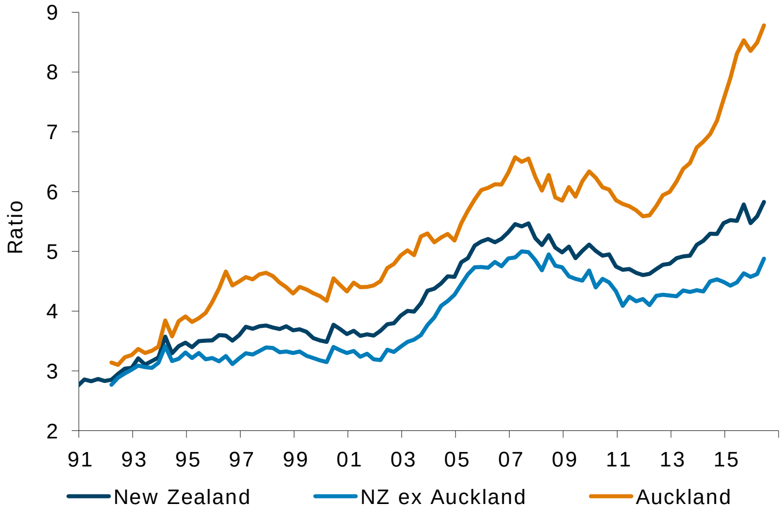
The first two are beyond New Zealand's direct control. Where we are more in control of our own destiny is the latter two.

When we assess the state of the current business cycle, warning signs are starting to flash.

- **Debt is rising fast.** Household debt is now 165% of disposable income (it peaked at 159% prior to the GFC) and annual credit growth is running at more than 8%. Even though income growth has recovered, it is running only around 5%. We're borrowing and spending our way to growth. That isn't sustainable in the long run.
- **There is a strong correlation between house prices and debt accumulation.** Where the former heads, the latter tends to follow, although the causation can also run the other way. Credit availability is also a key driver of asset prices.
- **New Zealand is already heavily indebted to the rest of the world.** Net external debt is 56% of GDP, and most of that is private sector debt. It's an issue. Rating agencies such as Standard & Poor's, Fitch and Moody's note that it is too high. To be fair, it is a lot lower than was around the time of the GFC (it peaked at 84% of GDP in 2009), but we are starting to see those pre-2008 style behaviours creep in again.
- **Households are starting to dip back into the piggy bank.** The household saving rate fell to -2.2% in the year to March 2016, on par with what was seen in 2009.
- **Investor housing lending has been growing rapidly.** It rose from 29% to 38% of total new mortgage lending between August 2014 and mid-2016 (although it has eased most recently). Moreover, around 55% of new loans to investors are on interest-only terms (compared to 30% for other buyers).
- **The average Auckland house price is at least nine times the average income.** Average house prices across the rest of the country are around five times. Both are too high. Go back 50-70 years and the average family couldn't afford a car, but they could afford a house. Now it's the other way around, and while we don't want to get political, it's an irony that some people are now living in cars. Nobody wins from unaffordable house prices in the long term.

CHIEF ECONOMIST CORNER: WILL HISTORY REPEAT?

FIGURE 1. REGIONAL HOUSE PRICES TO INCOME



Source: ANZ, REINZ, Statistics NZ

- **Rental yields continue to fall.** They are at historic lows in Auckland (below 3% in a number of suburbs); people are obviously purchasing for capital gain. House price expectations – particularly with regard to Auckland – remain high (the average response over the past 12 months within our consumer confidence survey is over 6%).
- **Auckland house prices have surged close to 40% in two years.** Rents have risen 6.5% over the same period. So it's not purely a supply shortage story that is driving activity. Exuberance and 'animal spirits' within the market are clear to see.
- **Housing-related inflation (construction costs, property maintenance etc) is strong; historically that has spilled over into general inflation**. Non-tradable inflation is now tracking up. The labour market is tightening, which is typically a precursor to rising service sector inflation. Attention is turning to when the RBNZ will begin withdrawing monetary policy stimulus.

We've seen this playbook before and the endgame is typically not a happy one. Casting our minds back to just prior to the Asian Crisis and GFC, the same symptoms were apparent. Such forces weakened the economy from a structural perspective. The economy was already slowing rapidly. And the result, when hit by a foreign / Mother Nature shock, was an extreme turn in the cycle. The booms quickly turned into busts.

Is New Zealand setting itself up for the same again? We're not picking that a global recession is around the corner (though we would place non-trivial odds on one) but we do closely monitor how the economy stands when entering periods of heightened uncertainty.

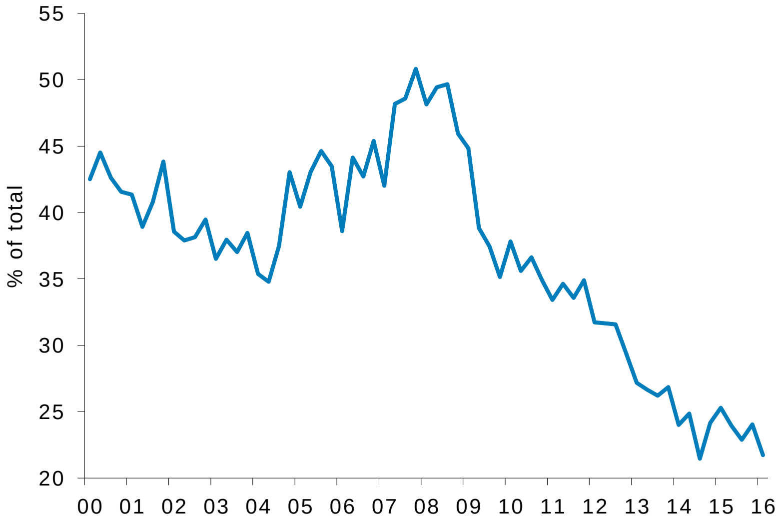
While we indeed have semblances of vulnerability, notably as regards to housing, we don't believe we have wholesale excesses like we have had in the past, and on some levels there are clear differences.

- **The current account deficit is lower** (~3.0% of GDP compared with 7.9% in 2006 just prior to the GFC). It's been projected to deteriorate each year and hasn't, which we take as a sign that structural forces are becoming more influential (i.e. we are no longer such a 'bad' nation saving-wise). Borrow-and-spend growth has not manifested itself in a deteriorating external position. Net external debt (noted above) is also far lower. Admittedly, it's still a high number, so it's more of a case that we're 'less bad'.
- **Households are carrying a lot of debt, but at least business balance sheets are in good shape.** The sector has been generating good cash flow and its net saving position (6.6% of national disposable income) is the highest since 2003. Leverage build-up has also been demure (especially outside of the dairy and property sectors). Despite business sector credit running at 7.8% in the year to September, the RBNZ estimates that debt-to-income ratio in the non-property business sector is only 16.7%, which is below its GFC peak and only a touch above its average since 2000.

CHIEF ECONOMIST CORNER: WILL HISTORY REPEAT?

- **We're not seeing the traditional flow-on from a strong property market and debt-driven excesses into the retail sector.** Consumption per capita, and consumption growth more broadly, has been restrained, and that has contained the spill-over from housing inflation more broadly into non-tradable inflation. Talk to any retailer and they'll tell you how tough a gig it is. Some would argue that high house prices have led to increased precautionary savings on the part of first home buyers, and also concern among the middle class that they're going to have to fund their kids into their first homes. Research by Treasury shows those in their 20s are actually saving like mad, at least relative to how much generations before them did at the same age.
- **There are still massive disinflationary forces shaping the outlook for inflation:** technology, high global leverage, the high NZD and low inflation expectations. The supply side of the labour market is alleviating extreme tightness via migration and participation. It doesn't look like interest rates will be moving up any time soon, and if they do it won't be by much. The last few years have shown it's impossible to be too far out of step with the global scene interest rate-wise as tighter monetary policy here versus loose policy elsewhere sends your currency into orbit.
- **While New Zealand still has a high offshore debt burden, the maturity of that funding has lengthened. Financial firewalls have been strengthened**.

FIGURE 2. GROSS INTERNATIONAL DEBT LIABILITIES MATURITY < 90 DAYS



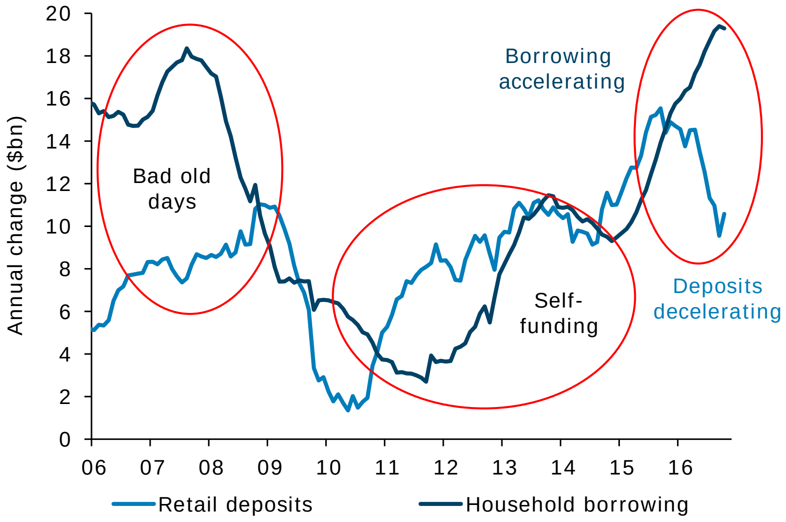
Source: ANZ, Statistics NZ

- **Household debt levels may be higher, but debt serviceability has improved, courtesy of much lower interest rates.** Household debt servicing as a share of income rose to over a whopping 14% in 2008; it sits at 8.7% now. Even if we assume interest rates nudge up over the coming years, the debt-servicing burden will not turn onerous for quite a while.
- **KiwiSaver is now entrenched in the national psyche.** Close to 2.7 million Kiwis now have a KiwiSaver account, and contributions are growing at a circa $5bn annual clip. KiwiSaver funds have grown as a result of surging equity and bond prices here and abroad, as well as because of contributions.
- **We don't have a shadow banking sector.** Finance company lending outside the ambit of the regulator was a problem in the lead-up to the GFC.
- **We're still not building enough houses.** Typically at the top of the cycle we build too many. Now we can't keep up with the demand.
- **The regulator (RBNZ) is into its third round of prudential policy tweaks** and the latest tightening (40% deposit requirement for investors) is not mucking around. It's hit the housing market hard. More (debt-to-income limits) will be on offer if the market takes off again.

CHIEF ECONOMIST CORNER: WILL HISTORY REPEAT?

- **Banks are now actively leaning against the supply of credit at the top of the business cycle.** There are a number of reasons for this.
  - It makes economic sense to lighten up at the top of the cycle for risk reasons.
  - There is a glaring gap between deposit growth and credit growth. Either offshore funding (borrowing) lifts, which has what has happened historically (that's expensive and will lead to a wider current account deficit and reliance on offshore capital markets, raising the ire of rating agencies), or something needs to be done about that gap. Cue more aggressive competition for deposits and credit rationing. It's significant that the last OCR cut was not passed on and competition for deposits is heating up. It's a sign of an internal constraint (save a dollar to spend / borrow a dollar) in operation.

FIGURE 3. BANK HOUSEHOLD FUNDING AND CLAIMS GROWTH



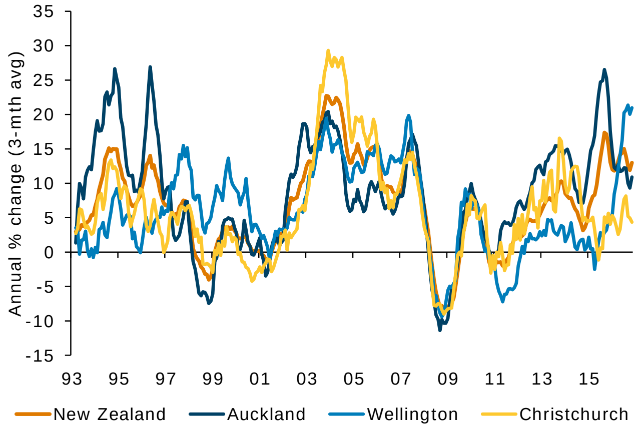
Source: ANZ, RBNZ

Some of these differences present their own challenges for the economy to manage. A reduced supply of credit, for instance, will hinder growth and constrain the ability of the market to meet housing supply needs. However, that needs to be put in perspective and considered within the broader picture of what turbo-charged credit growth can also do to asset prices, balance sheets and the vulnerability of the economy. There is no free lunch.

The phrase 'this time is different' often comes back to bite an economist. Nonetheless, New Zealand is embarking on a different, safer path so far. Sticking to this path will not eliminate the business cycle. However, it will help dampen the volatility and extreme swings across it and that's a huge plus for the economy and investors.

THE PROPERTY MARKET IN PICTURES

FIGURE 1. REGIONAL HOUSE PRICES

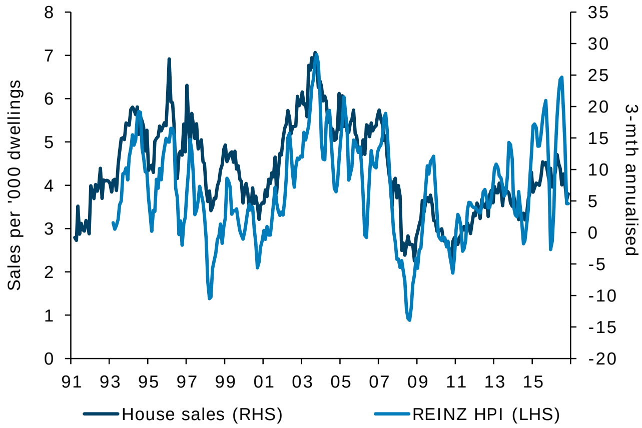


Source: ANZ, REINZ

Nationwide house prices ticked a little higher in November. Our preferred measure of prices (the REINZ stratified measure) showed nationwide prices rising 0.9% sa in November, which is the third consecutive monthly increase. However, momentum is cooling. On a 3-month annualised basis, price growth is running at 4.6%, which is well down from the 25% growth rate seen in June/July. Compared with a year ago, nationwide prices are 13% higher (3-month average).

Across the regions, Auckland house price momentum has cooled, running at 5.6% on a 3-month annualised basis. This compares with an 11% pace in Wellington, 10% in regional North Island and 12% in ex-Canterbury South Island.

FIGURE 2. REINZ HOUSE PRICES AND SALES



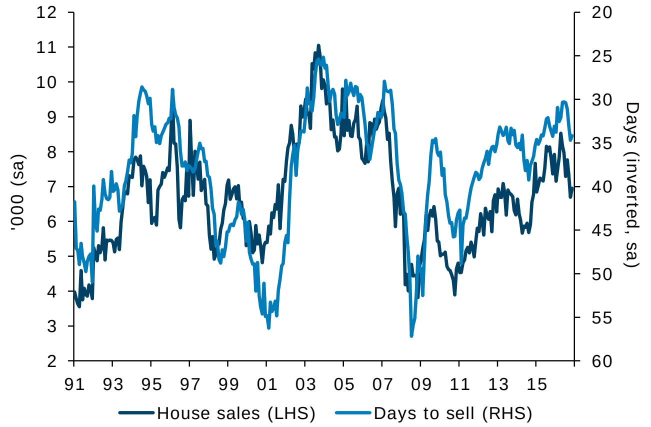
Source: ANZ, REINZ

Sales volumes and prices tend to be closely correlated, although tight dwelling supply can complicate the relationship.

Seasonally adjusted sales volumes bounced 3.8% m/m in November, only partially retracing earlier weakness (turnover fell in five of the prior six months, to be down 6% on a year ago). Auckland volumes remain soft, falling 1.4% sa in November, while ex-Auckland volumes rose 6.4% sa (although they're still down 6% y/y).

The softer trend in sales activity hints at a continuation of the recent moderation in house price growth going forward. That said, with some of it likely due to a lack of available property listings, there are still some price-supportive elements to it.

FIGURE 3. SALES AND MEDIAN DAYS TO SELL



Source: ANZ, REINZ

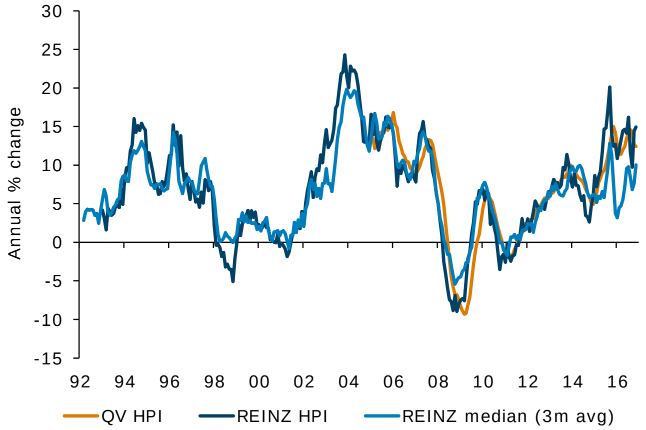
The length of time it takes to sell a house is also an indicator of the strength of the real estate market. It encompasses both demand and supply-side considerations.

Nationally, the median time to sell a house fell by half a day in November to 34.2 days (sa). This is the first fall in five months, although it is still well above the lows of close to 30 days seen in June/July. That said, it is also still below the historical average of 38 days, suggesting that while weaker sales activity is in part due to a softer demand, a lack of supply is also contributing.

Over the past 12 months, the median time to sell a house has risen most dramatically in Canterbury (+2.3 days) and Waikato (+2.0 days), but is dramatically lower in Manawatu/Whanganui, Taranaki and Southland.

THE PROPERTY MARKET IN PICTURES

FIGURE 4. REINZ AND QV HOUSE PRICES

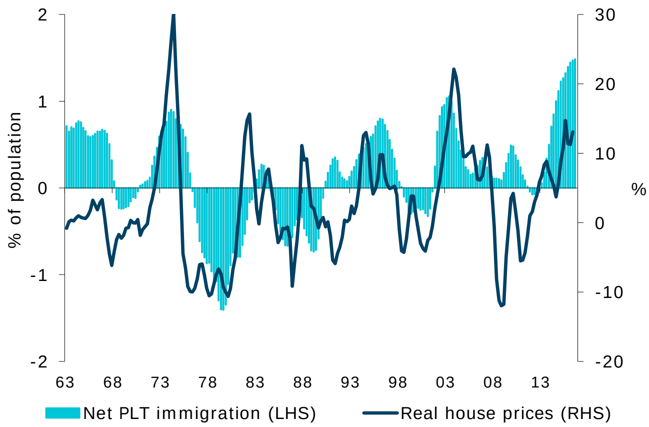


Source: ANZ, REINZ, QVNZ CoreLogic

There are three key measures of house prices in New Zealand: the median and stratified house price measures produced by REINZ, and the monthly QVNZ house price index published by Property IQ. The latter tends to lag the other measures as it records sales later in the transaction process. Moreover, movements do not line up exactly given differing methodologies, with the REINZ median typically more volatile as it is sensitive to the composition of sales taking place.

The REINZ median sale price (which in September reached a new record high of $517k in seasonally adjusted terms) **was up 13% y/y in November.** This remains below the REINZ stratified measure, but is comparable to the QVNZ measure of price growth (15% and 12% y/y respectively), which both adjust for differences in the quality of houses sold.

FIGURE 5. NET PLT IMMIGRATION AND HOUSE PRICES



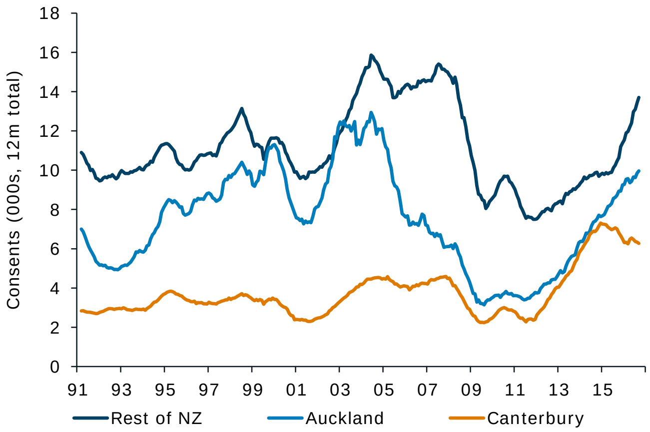
Source: ANZ, Statistics NZ, QVNZ

Migration flows to and from New Zealand are one of the major drivers of housing market cycles. The early-1970s, mid-1990s and mid-2000s booms coincided with large net migration inflows.

On a three-month annualised basis, net permanent and long-term migration rose above 73k in October, which is around 1½% of the resident population and at all-time highs. More arrivals and fewer departures have both contributed to this large net inflow.

We are not expecting annual net inflows to ease back to the long-run average of around 15k any time soon. Due to its economic outperformance, perceived safety and political ructions elsewhere, New Zealand will remain an attractive destination for migrants.

FIGURE 6. RESIDENTIAL CONSENTS



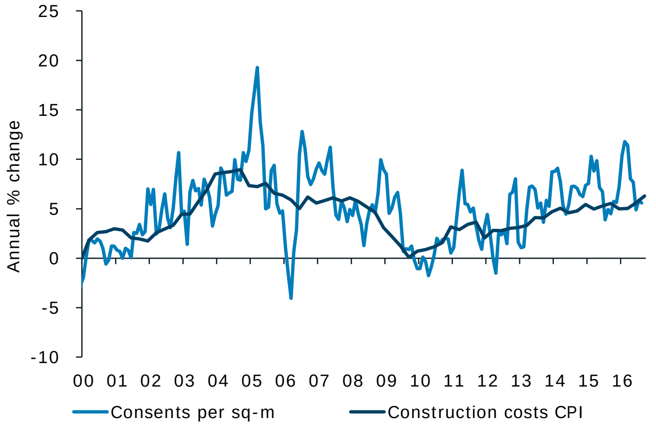
Source: ANZ, Statistics NZ

Nationwide residential consent issuance has been strengthening. While on a three-month annualised basis, seasonally adjusted total issuance eased to 31.5k in September, down from 32.7k the previous month, to put it in context, the previous reading was the strongest since mid-2004.

A large part of the increase has been due to the Auckland region (annual issuance of 10K, which is the highest since mid-2005), although growing capacity and credit pressures may slow the ascent from here. Canterbury issuance continues to ease off its highs, consistent with other evidence suggesting that the residential component of the earthquake is past its peak. Issuance in Wellington and other regional North Island areas has accelerated strongly, though the pace of growth now appears to be flattening off.

THE PROPERTY MARKET IN PICTURES

FIGURE 7. CONSTRUCTION COST INFLATION

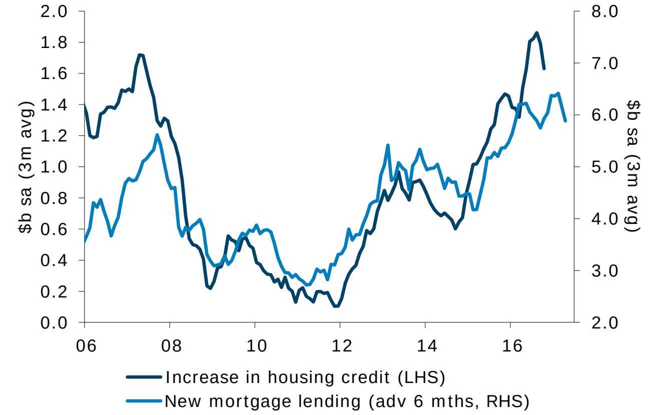


Source: ANZ, Statistics NZ

On a three-month average basis, **the value of residential consents per square metre was up 7.9% y/y in September, which is an increase on the previous month but below the strong rates of growth experienced earlier in the year.** However, because it is a volatile measure, we are not reading much into it. The broad upward trend is consistent with the trend seen in the construction cost component of the CPI, which sat at 6.3% y/y in Q3 (7.9% y/y for Auckland).

Our internal anecdotes continue to highlight that capacity pressures in the construction sector are reasonably intense, and not limited to any one region. Forward books are generally full, and in some cases work is reportedly being turned away. Difficulty finding staff is a common theme in the sector.

FIGURE 8. NEW MORTGAGE LENDING & HOUSING CREDIT



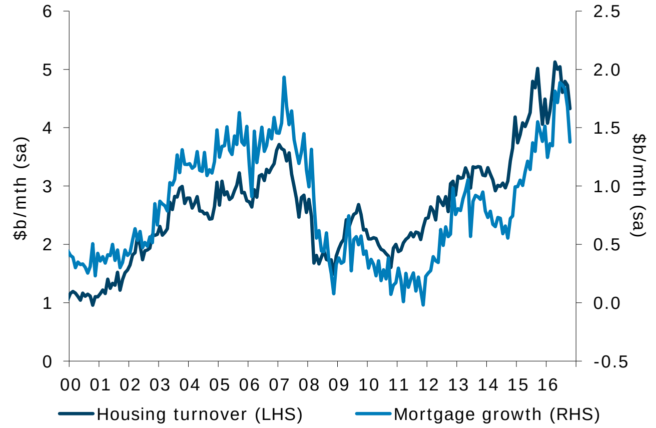
Source: ANZ, RBNZ

New residential mortgage lending figures are published by the RBNZ. They tend to provide leading information on the state of household credit growth and housing market activity.

Over the past couple of months the pace of new mortgage lending has begun to slow. In October, we estimate new lending was $5.4bn in seasonally adjusted terms, which is down by over $1bn since June. New lending to investors has slowed particularly sharply as the RBNZ's latest LVR restrictions have bitten.

As such, it is not surprising to see that the overall rate of housing credit growth also looks to have peaked.

FIGURE 9. HOUSE TURNOVER AND MORTGAGE GROWTH



Source: ANZ, REINZ, RBNZ

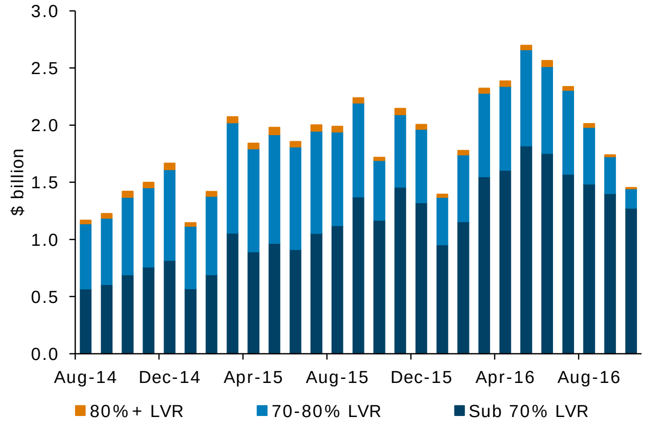
The overall stock of mortgages has been growing strongly, but does appear to have peaked. The 3-month annualised pace, while still near 10% in October, has eased off its highs. Admittedly, it did not rise as strongly as overall housing turnover, which has only just stated to ease off all-time highs.

The latest tightening of the high-LVR lending restrictions appears to be having a marked impact on both house sales and credit availability, and we accordingly expect to see mortgage borrowing growth moderate further.

But a key element explaining why mortgage borrowing growth has been more contained than the past is that existing mortgage holders are using current low interest rates to maintain regular payments and reduce principal more quickly.

THE PROPERTY MARKET IN PICTURES

FIGURE 10. INVESTOR LENDING BY LVR

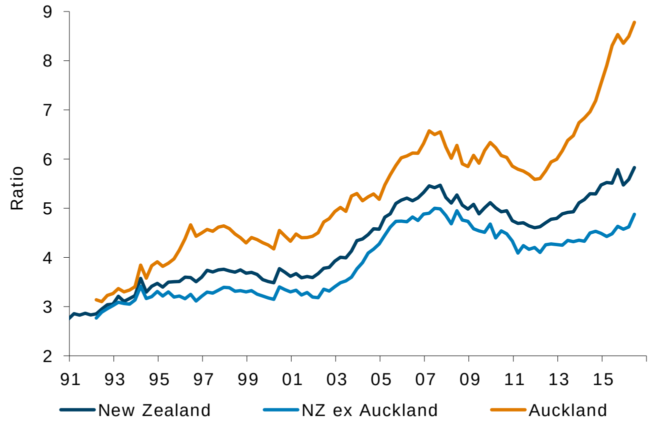


Source: ANZ, RBNZ

There are now clear signs that the growth in new investor housing lending is cooling. This is no doubt related to the latest round of RBNZ LVR restrictions (which banks largely implemented ahead of the official 1 October start date). In October, new investor lending was down 15% y/y, making up just 27% of total new lending – the lowest share since this data started being released in August 2014.

As a share of total investor lending, lending done with LVRs in excess of 70% made up 12% of the total in October. This is down from 33% in July and over 50% in mid-2015. Of new investor lending, 53% was on interest-only terms, which is down from 54.5% in September.

FIGURE 11. REGIONAL HOUSE PRICES TO INCOME

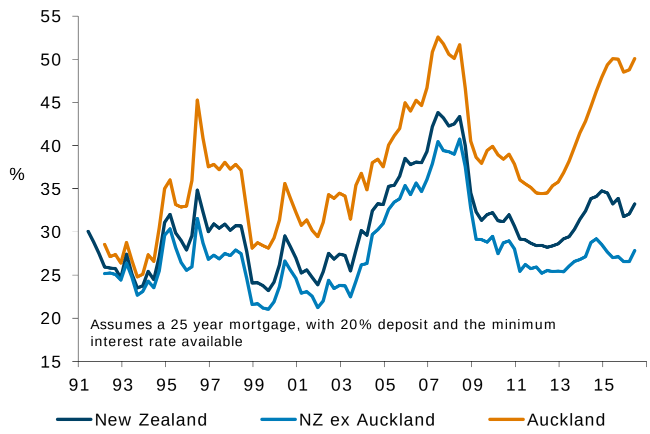


Source: ANZ, REINZ, Statistics NZ

One standard measure of housing affordability is the ratio of average house prices to income. It is a common measure used internationally to compare housing affordability across countries. That said, it does not take into account things like average housing size and quality, interest rates and financial liberalisation. Therefore, it is really only a partial gauge as some of these factors mean that it is logical for this ratio to have risen over time.

Nationally, the ratio sits just below a ratio of 6, which is slightly above the previous highs recorded prior to the GFC. However, there is a stark regional divide. We estimate the average house price to income in Auckland has now risen to close to 9 times, suggesting a severely unaffordable market. Elsewhere, the ratio is around 5 times, which is back where it peaked prior to the financial crisis.

FIGURE 12. REGIONAL MORTGAGE PAYMENTS TO INCOME



Source: ANZ, REINZ, RBNZ, Statistics NZ

Another, arguably more comprehensive, measure of housing affordability is to look at it through the lens of debt serviceability, as this takes into account interest rates, which are an important driver of housing market cycles.

We estimate that the average mortgage payment to income nationally is around 33% at the moment. Despite rising house prices it has fallen below its highs due to recent mortgage rate falls.

However, once again there are stark regional differences, with the average mortgage payment to income in Auckland around 50%. That is near the highs reached in 2007 despite mortgage rates being at historic lows currently. It highlights how sensitive some Auckland borrowers would be to even a small lift in interest rates.

PROPERTY GAUGES

The housing market has slowed as the combination of extended valuations, movement in interest rates off lows, prudential policy changes (LVR restrictions) and tighter credit availability act as headwinds. But questions will surround how long the moderation will last given the fundamental shortage of dwellings across the market, which continues to get more pronounced with the impetus from surging migration.

We use ten gauges to assess the state of the property market and look for signs that changes are in the wind.

AFFORDABILITY. For new entrants into the housing market, we measure affordability using the ratio of house prices to income (adjusted for interest rates) and mortgage payments as a proportion of income.

SERVICEABILITY / INDEBTEDNESS. For existing homeowners, serviceability relates interest payments to income, while indebtedness is measured as the level of debt relative to income.

INTEREST RATES. Interest rates affect both the affordability of new houses and the serviceability of existing mortgage payments.

MIGRATION. A key source of demand for housing.

SUPPLY-DEMAND BALANCE. We use dwelling consents issuance to proxy growth in supply. Demand is derived via the natural growth rate in the population, net migration, and the average household size.

CONSENTS AND HOUSE SALES. These are key gauges of activity in the property market.

LIQUIDITY. We look at growth in private sector credit relative to GDP to assess the availability of credit in supporting the property market.

GLOBALISATION. We look at relative property price movements between New Zealand, the US, the UK, and Australia, in recognition of the important role that global factors play in New Zealand's property cycle.

HOUSING SUPPLY. We look at the supply of housing listed on the market, recorded as the number of months needed to clear the housing stock. A high figure indicates that buyers have the upper hand.

HOUSE PRICES TO RENTS. We look at median prices to rents as an indicator of relative affordability across the regions.

Indicator	Level	Direction for prices	Comment
Affordability	Still extended	↔/↓	House prices too high relative to incomes.
Serviceability/ indebtedness	Turning up	↔/↓	Interest rates are off lows and people have more debt, which means the serviceability ratio is lifting.
Interest rates / RBNZ	Steeper curve	↓	With the RBNZ finished with cutting and global yields rising, rates have likely troughed, short of a global accident.
Migration	NZ the place to be	↔/↑	NZ still has good credentials in an uncertain world. People won't stop wanting to come.
Supply-demand balance	Too few houses	↔/↑	Too few houses and no solution in sight.
Consents and house sales	More builders required	↔/↑	A lot of consents going through but struggling for more simply because who is going to build the houses we need?
Liquidity	Tighter stance	↓	LVR restrictions being applied. Debt-to-income limits may be next, and banks are tightening credit at the top of the cycle.
Globalisation	Auckland vs Sydney	↔	Auckland doesn't look that bad when you compare it to Sydney.
Housing supply	Chasing a moving target	↔/↑	Migration, migration and more migration equals the need for a lot more houses.
House prices to rents	Extreme	↔/↓	The numbers don't work unless you get the capital gain.
On balance	**A slow rate of appreciation**	↔	**Market has slowed as credit tightens but questions surround whether it can be sustained, given shortage of supply.**

PROPERTY GAUGES

FIGURE 1: HOUSING AFFORDABILITY

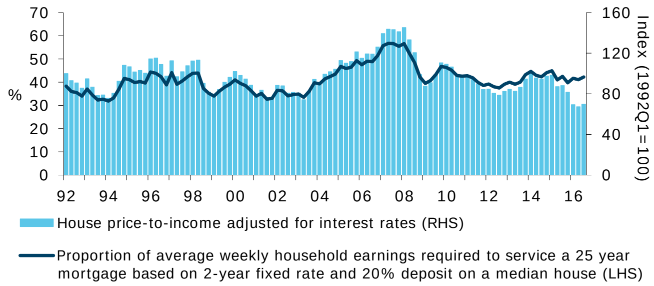


FIGURE 2: SERVICEABILITY AND INDEBTEDNESS

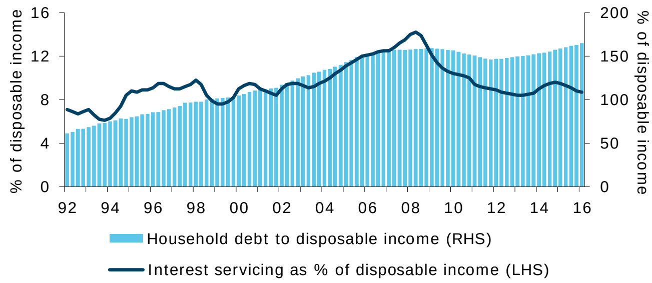


FIGURE 3: NEW CUSTOMER AVERAGE RESIDENTIAL MORTGAGE RATE (<80% LVR)

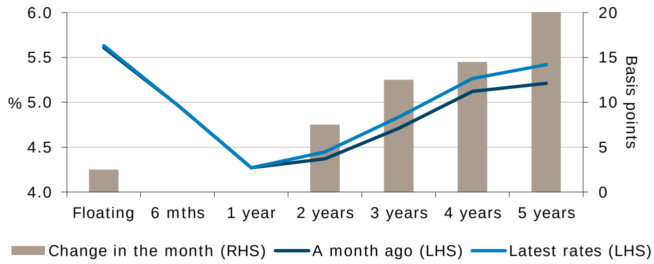


FIGURE 4: NET MIGRATION

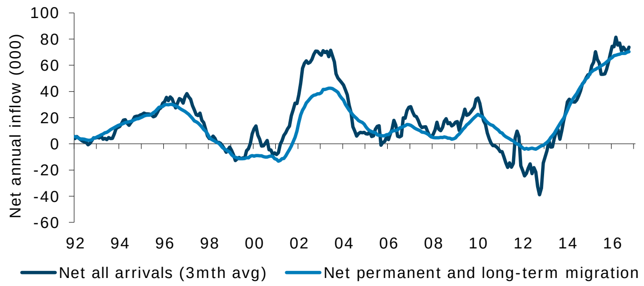


FIGURE 5: HOUSING SUPPLY-DEMAND BALANCE

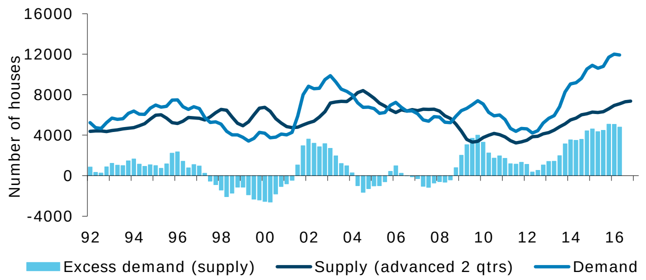


FIGURE 6: BUILDING CONSENTS AND HOUSE SALES

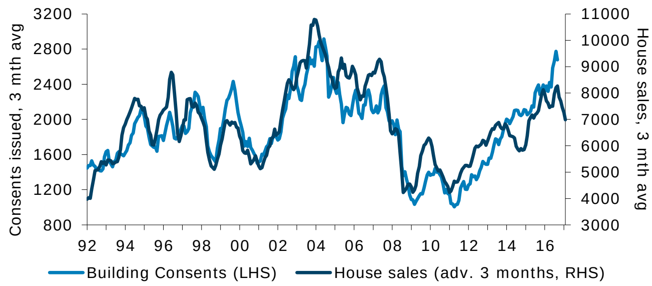


FIGURE 7: LIQUIDITY AND HOUSE PRICES

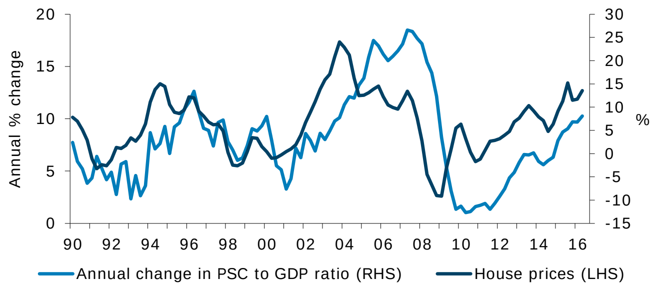


FIGURE 8: HOUSE PRICE INFLATION COMPARISON

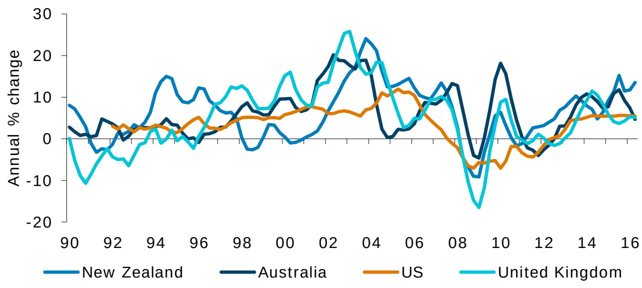


FIGURE 9: HOUSING SUPPLY

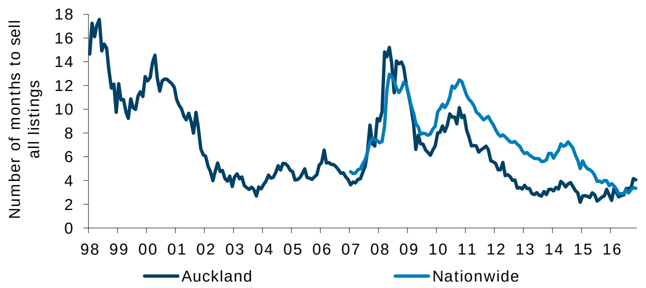
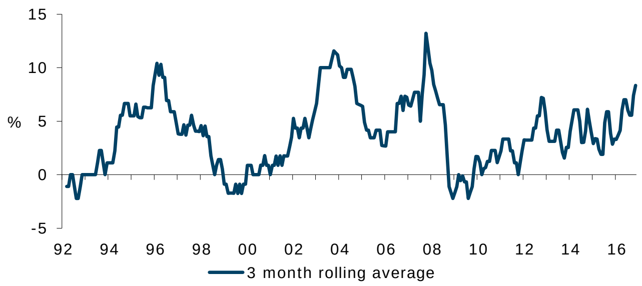


FIGURE 10: MEDIAN RENTAL, ANNUAL GROWTH



Source: ANZ, Statistics NZ, REINZ, RBNZ, QVNZ, Nationwide, Bloomberg, Barfoot & Thompson, www.realestate.co.nz, Department of Building and Housing.

ECONOMIC OVERVIEW

SUMMARY

The New Zealand economy is entering its eighth year of expansion with strong momentum. But natural headwinds are now emerging (capacity pressures, a turn in credit cycle, tighter financial conditions, stretched asset valuations) that should see growth ease over the course of the year (from 3½-4% towards 3%). That's a natural moderation, as opposed to a downturn. We view it as healthy in the context of the country's medium-term stability and its resilience to external shocks. The RBNZ remains on the side-lines for now, although price pressures are now building.

OUR VIEW

As we look towards 2017, the economy is growing briskly. We estimate the economy grew around 3½% over 2016 and forward indicators, like our own confidence composite and financial conditions gauges, suggest that a similar pace of annualised growth (if not a little stronger) is on track for at least the first half of 2017.

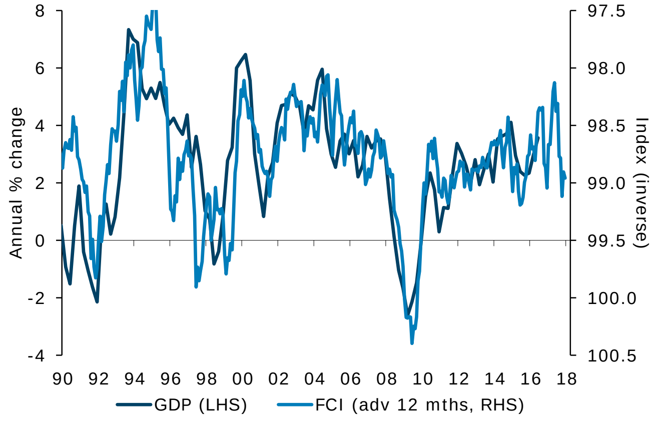
The drivers of this growth are reasonably familiar – and we expect them to generally continue. Strong population growth on the back of record net migrant inflows is boosting demand. The construction sector pipeline remains large (with the damage resulting from the latest earthquakes creating another source of impetus) even if capacity and capital are becoming increasingly constraining factors. The strengthening labour market is supporting household confidence and consumption, as are historically low borrowing costs. The tourism sector is booming. Prospects in the dairy sector have improved as prices have recovered and non-dairy agriculture sectors continue to perform strongly. The terms of trade looks to be at, or near, its cyclical low, with the outlook now one of modest improvement, supporting national incomes (and income growth).

We expect growth to slow over 2017 but we are talking about a 'gallop to a canter' style moderation.

- **Firms' are finding it more difficult to get staff;** it's now firms' biggest problem.
- **Financial conditions have tightened.** While providing a supportive signal for growth over the next 12 months or so, conditions have tightened recently on equity and house price softness. The interest rate cycle has turned higher too.
- **The credit cycle has turned.** Credit growth is now slowing, in part due to regulatory changes (LVR restrictions), but also reflects questions of sustainability (already high indebtedness) and the bank funding environment (credit rationing and deposit competition). We expect it to slow further towards 5%-6%, a rate more comparable with income growth and far more sustainable over the longer-run.
- **The housing market is cooling.** Turnover has fallen and price growth has moderated. On a 3m/3m basis, nationwide price growth cooled to just 1.1% in November, down from over a 6% rate only a few months earlier. For some of the factors listed above (financial conditions, credit cycle) we do believe this cooling will persist, removing a source of tailwind for consumer confidence and services sector activity.

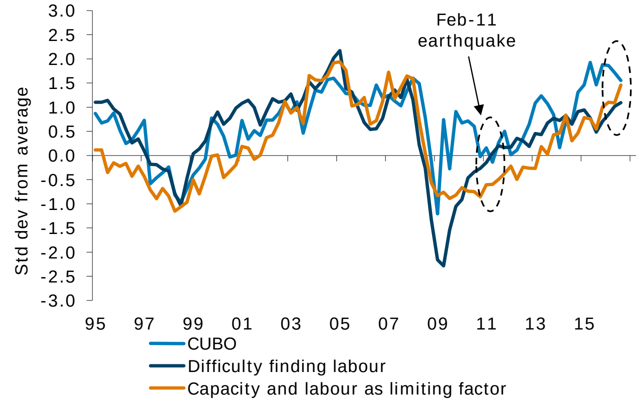
Growth is expected to remain robust at around 3%. The RBNZ is expected to keep the OCR unchanged at 1.75% and the NZD looks set to remain elevated.

FIGURE 1. FINANCIAL CONDITIONS HAVE TIGHTENED



Source: ANZ, Statistics NZ

FIGURE 2. INDICATORS OF RESOURCE AND CAPACITY PRESSURES



Source: ANZ, NZIER

MORTGAGE BORROWING STRATEGY

SUMMARY

Although there has been little change to floating mortgage rates, rates with terms of 2 years and longer continue to move gradually higher. This has occurred largely as a result of higher global interest rates (which tend to have a larger influence on New Zealand longer-term rates than local factors do), and rising funding costs. As we noted last month, we believe mortgage rates have seen their lows, and although rises from here are likely to be gradual, they are rises nonetheless. Although rates are not quite as attractive as they were a month ago and we maintain our view that it is worthwhile considering fixing some portion of your mortgage for longer than 1-2 years, recent rises do make it a much closer call. With the OCR on hold, 1-2 mortgage year rates won't go up for a while.

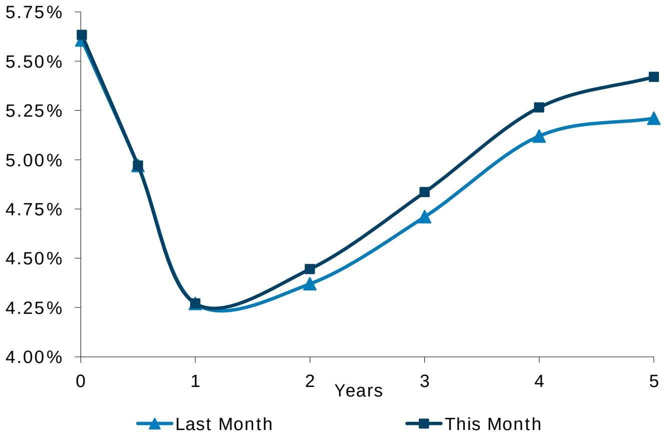
OUR VIEW

Mortgage interest rates have continued to move gently higher, with larger rises seen in 3-5 year rates and almost no movement in floating, 6 month and 1 year rates. As we noted in last month's edition, **we now believe the lows are in for mortgage rates. However, we are coy about extrapolating the trend and expect rises in coming months to be more subdued.** This reflects our judgement that US bond yields – the key driver of New Zealand longer-term interest rates – are in for a period of "muddling through" rather than trend higher.

Several factors make us cautious, and while we don't have the column inches here to do a deep dive, we are mindful of: (1) **the degree of tightening in US financial conditions** that has occurred since Trump's victory; (2) **ongoing monetary expansion in Europe and Japan**, which is set to continue although the US has started tightening; (3) **political and economic fragilities** elsewhere, notably a huge pool of leverage which means the world will be sensitive to movements in rates; and (4) the **capacity New Zealand interest rates have to absorb some of the globally-driven push higher in yields** (with the RBNZ on hold for at least another year).

These factors suggest that **rises in here will be more gradual**, and **while we do believe it is worthwhile considering fixing a portion of your mortgage for longer than 1-2 years, the steeper curve does make it less compelling than a month ago.** That's especially so when you consider that with the RBNZ on hold, 1-2 year rates are likely to remain at current levels for some time yet. Consider, for example, the choice between 2 years at 4.45% (for a borrower able to access special rates) or 4 years at 5.27%.

CARDED SPECIAL MORTGAGE RATES^



Special Mortgage Rates		Breakevens for 20%+ equity borrowers			
Term	Current	in 6mths	in 1yr	in 18mths	in 2 yrs
Floating	5.63%				
6 months	4.97%	3.57%	4.53%	4.71%	5.42%
1 year	4.27%	4.05%	4.62%	5.06%	5.62%
2 years	4.45%	4.56%	5.12%	5.57%	6.09%
3 years	4.84%	5.06%	5.60%	5.84%	6.07%
4 years	5.27%	5.39%	5.71%		
5 years	5.42%	#Average of "big four" banks			

Standard Mortgage Rates		Breakevens for standard mortgage rates*			
Term	Current	in 6mths	in 1yr	in 18mths	in 2 yrs
Floating	5.61%				
6 months	5.06%	4.49%	5.30%	4.95%	5.50%
1 year	4.77%	4.89%	5.13%	5.23%	5.62%
2 years	4.95%	5.06%	5.37%	5.51%	5.78%
3 years	5.17%	5.30%	5.56%	5.77%	6.07%
4 years	5.37%	5.55%	5.83%		
5 years	5.62%	*may be subject to a low equity fee			

The immediate cost difference is 0.82%pts, which is hardly immaterial. Moreover, our breakeven analysis shows that the 2-year rate would need to rise from 4.45% to 6.09% (i.e. by 1.64%pts) over the next 2 years for the "4 year straight" strategy to be cheaper than the "2 years + 2 years" strategy. That looks questionable to us, given our expectation of only two 25bps OCR hikes over the next two years. It still makes sense to spread your mortgage over several terms to reduce your overall risk too.

^ *Average of carded rates from ANZ, ASB, BNZ and Westpac. Sourced from interest.co.nz*

KEY FORECASTS

Weekly mortgage repayments table (based on 25-year term)

Mortgage Size ($'000)	Mortgage Rate (%) 4.00	4.25	4.50	4.75	5.00	5.25	5.50	5.75	6.00	6.25	6.50	6.75	7.00	7.25
200	243	250	256	263	270	276	283	290	297	304	311	319	326	333
250	304	312	320	329	337	345	354	363	371	380	389	398	407	417
300	365	375	385	394	404	415	425	435	446	456	467	478	489	500
350	426	437	449	460	472	484	496	508	520	532	545	558	570	583
400	487	500	513	526	539	553	566	580	594	608	623	637	652	667
450	548	562	577	592	607	622	637	653	669	684	701	717	733	750
500	609	625	641	657	674	691	708	725	743	761	778	797	815	833
550	669	687	705	723	741	760	779	798	817	837	856	876	896	917
600	730	750	769	789	809	829	850	870	891	913	934	956	978	1,000
650	791	812	833	854	876	898	920	943	966	989	1,012	1,036	1,059	1,083
700	852	874	897	920	944	967	991	1,015	1,040	1,065	1,090	1,115	1,141	1,167
750	913	937	961	986	1,011	1,036	1,062	1,088	1,114	1,141	1,168	1,195	1,222	1,250
800	974	999	1,025	1,052	1,078	1,105	1,133	1,160	1,188	1,217	1,246	1,274	1,304	1,333
850	1,035	1,062	1,089	1,117	1,146	1,174	1,204	1,233	1,263	1,293	1,323	1,354	1,385	1,417
900	1,095	1,124	1,154	1,183	1,213	1,244	1,274	1,306	1,337	1,369	1,401	1,434	1,467	1,500
950	1,156	1,187	1,218	1,249	1,281	1,313	1,345	1,378	1,411	1,445	1,479	1,513	1,548	1,583
1000	1,217	1,249	1,282	1,315	1,348	1,382	1,416	1,451	1,486	1,521	1,557	1,593	1,630	1,667

Housing market indicators for November 2016 (based on REINZ data)

	House prices (ann % chg)	3mth % chg	No of sales (sa)	Mthly % chg	Avg days to sell (sa)
Northland	18.3	4.3	270	+17%	46
Auckland	11.5	1.5	2,383	-1%	34
Waikato/BOP/Gisborne	19.6	2.1	1,246	+8%	38
Hawke's Bay	15.4	2.8	258	+19%	35
Manawatu-Whanganui	17.9	1.5	384	+1%	30
Taranaki	19.3	7.7	189	+3%	37
Wellington	14.8	1.3	854	-13%	31
Nelson-Marlborough	24.0	8.9	260	+2%	31
Canterbury/Westland	4.6	1.1	984	+9%	34
Central Otago Lakes	32.3	-2.0	162	-7%	36
Otago	8.2	1.3	276	+9%	29
Southland	15.5	2.3	207	+22%	31
NEW ZEALAND	**13.2**	**2.1**	**7,347**	**+4%**	**34**

Key forecasts

	Actual			Forecasts						
Economic indicators	**Dec-15**	**Mar-16**	**Jun-16**	**Sep-16**	**Dec-16**	**Mar-17**	**Jun-17**	**Sep-17**	**Dec-17**	**Mar-18**
GDP (Ann Avg % Chg)	2.5	2.5	2.8	3.2	3.5	3.6	3.6	3.5	3.2	3.2
CPI Inflation (Annual % Chg)	0.1	0.4	0.4	0.4(a)	1.1	1.4	1.4	1.7	1.7	2.1
Unemployment Rate (%)	5.0	5.2	5.1	4.9(a)	4.8	4.8	4.7	4.6	4.6	4.5
Interest rates (carded)	**Jun-16**	**Sep-16**	**Latest**	**Dec-16**	**Mar-17**	**Jun-17**	**Sep-17**	**Dec-17**	**Mar-18**	**Jun-18**
Official Cash Rate	2.25	2.00	1.75	1.75	1.75	1.75	1.75	1.75	1.75	2.00
90-Day Bank Bill Rate	2.4	2.2	2.0	2.1	2.0	2.0	2.0	2.0	2.2	2.3
Floating Mortgage Rate	5.7	5.6	5.6	5.6	5.6	5.6	5.6	5.6	5.6	5.9
1-Yr Fixed Mortgage Rate	4.9	4.9	4.9	5.0	5.0	5.0	5.0	5.0	5.2	5.3
2-Yr Fixed Mortgage Rate	5.1	5.1	5.1	5.2	5.3	5.4	5.4	5.5	5.6	5.7
5-Yr Fixed Mortgage Rate	5.6	5.6	5.8	6.1	6.3	6.4	6.5	6.6	6.6	6.7

Source: ANZ, Statistics NZ, RBNZ

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Ph 64 4 802 2212, e-mail nzeconomics@anz.com, http://www.anz.co.nz