NEW ZEALAND PROPERTY FOCUS

March 2017

INSIDE

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THIS TIME IS DIFFERENT

SUMMARY

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

CHIEF ECONOMIST CORNER: PACKING SOME PUNCH

The property market has cooled rapidly as the combination of loan-to-value ratio restrictions, higher interest rates (a turn in both the local and international cycles) and credit rationing dampen demand. That's provided a near-term hit to recent exuberance, though it's worth bearing in mind that a demand-supply mismatch will provide support and typically that's seen the market run away again after previous similar lulls. What is different this time around is that interest rates are moving up and appear set to continue to do so, and policymakers are more serious in their desire to quell excessive lending growth. This will reduce the potential for the market to lift in a material fashion from here.

PROPERTY GAUGES

The housing market has slowed – markedly in Auckland – as the combination of higher mortgage rates, LVR restrictions, stretched affordability and tighter credit criteria impact. While the pause is welcome and will likely extend for months to come, a fundamental mismatch between supply (building consents are falling) and demand (net migration is still strong) means pent-up demand will keep the market supported and ready to build more momentum down the track should conditions permit. Higher interest rates will restrain conditions from permitting.

ECONOMIC OVERVIEW

The economy is growing at a healthy clip but showing some typical late-cycle behaviours as finding skilled labour and housing-related excesses become challenges. Both will act as handbrakes on growth in 2017. This will help to dampen the potential for nasty imbalances to build up, breaking from the historical pattern where a housing boom is followed by a bust. Credit rationing and lifts in retail rates are helping to dampen excesses, which is positive for the medium-term picture. The next move in the OCR looks to be up. However, with inflation still low, time is on the RBNZ's side and any movement in interest rates looks set to be gradual.

MORTGAGE BORROWING STRATEGY

Mortgage rates remain the same as they were a month ago for most terms, with the 0.08%pt rise in the average floating rate the most notable change. This continues the trend of gradually rising rates that started in the fourth quarter of 2016 and leaves the tick-shaped mortgage curve intact. With the outlook for the economy broadly as it was a month ago and the Reserve Bank insisting that it doesn't intend lifting the OCR any time soon, our view remains the same: the 1 year remains the sweet spot. Long-term mortgage rates are set to rise as global interest rates lift and as term deposit competition intensifies; but this is already well incorporated into the term structure of interest rates. In other words, breakevens remain higher than where we ultimately expect rates to get to.

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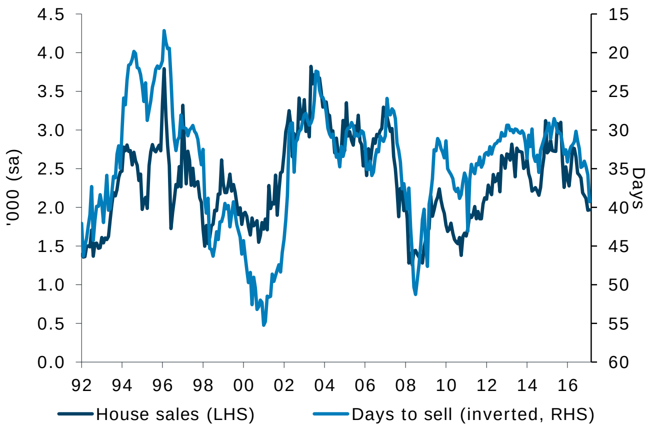
INTRODUCTION

The property market has cooled substantially of late. While we can still see some pent-up and catch-up demand across some regions that were left behind when Auckland surged from 2012 onwards, the signals across the national market indicate moderation. We note:

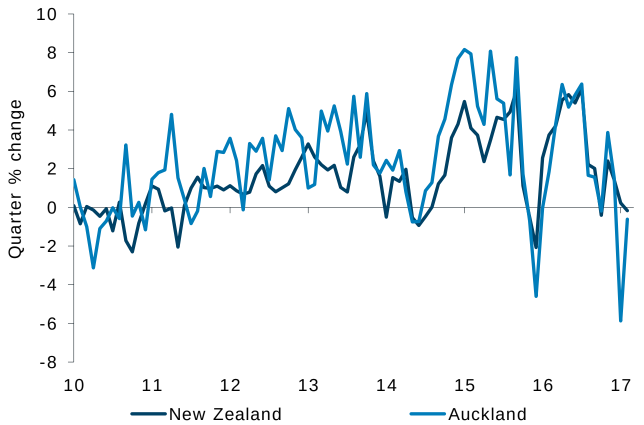
- **While house prices lifted slightly in February according to REINZ's stratified measure (+0.4% seasonally adjusted), the trend is weaker, with prices up a modest 0.5% on a 3m/3m basis. Intra-month volatility is being driven by Auckland**, which showed a bounced back of 5.2% after falling 6.2% the previous month. On a 3-month annualised basis, nationwide prices are running at 1.9%, which is down from over 23% in mid-2016. Auckland and Christchurch prices are actually 6.7% and 10.2% lower respectively on the same measure; even if we account for volatility that's an almighty thump. Wellington is outperforming, with 3-month annualised growth of 14%. Nationally, house prices are still up 10.6% on a year ago according to the stratified measures, but annual changes lag turning points. Quarterly changes are noisier but more adept at picking changes in the market. The signal on this front (just +0.5% 3m/3m in February) indicates a clear slowdown.

FIGURE 1. AUCKLAND HOUSE SALES AND DAYS TO SELL



Source: ANZ, REINZ

FIGURE 2. HOUSE PRICES WANING; A NOTABLE TURN IN AUCKLAND



Source: ANZ, REINZ

- **Seasonally adjusted sales volumes bounced just 1.1% m/m in February after falling 6.1% in January.** House sales have fallen in seven of the past 12 months, with turnover down 24% since April. This weakness is broad-based. Auckland sales volumes are down 13.6% y/y, with the February seasonally adjusted monthly sales more than a third lower than the September-2015 peak, while ex-Auckland seasonally adjusted sales volumes are down 12% y/y (-21% from their April-2016 monthly peak).

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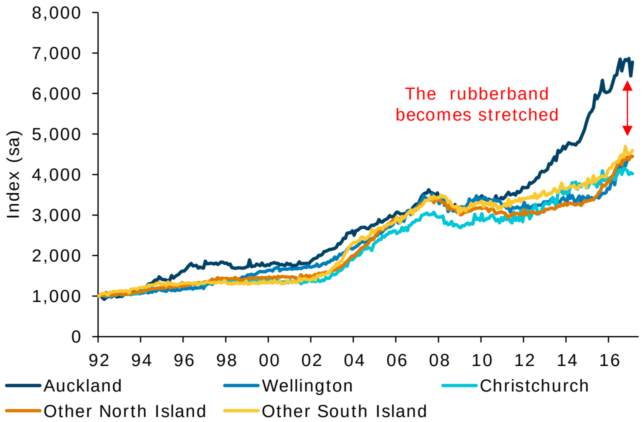
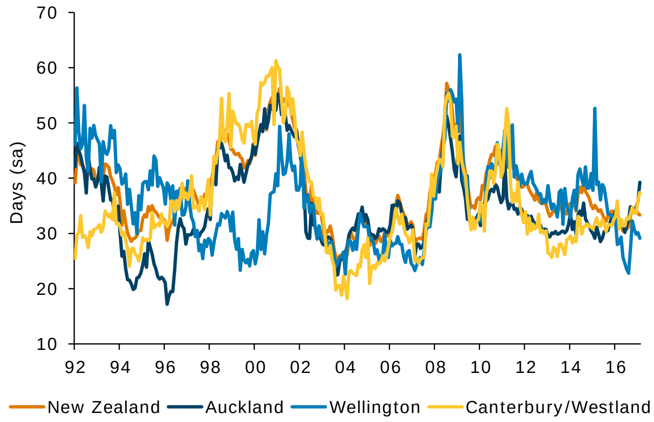
FIGURE 3. REGIONAL HOUSE PRICES



Source: ANZ, REINZ

FIGURE 4. MEDIAN DAYS TO SELL



Source: ANZ, REINZ

- **Nationally, the median time to sell a house was little changed at 33.4 days (sa) in February.** While this is off its recent high of 34.5 days seen in October, it is still well up from its mid-2016 lows of close to 30 days. The median time to sell a property is still below historical averages in every region except Auckland (39 days, versus a long-run average of 34) and Canterbury (37 days, versus a long-run average of 35 days). So the market moderation appears to be biting more in Auckland; few surprises here – the market that moves up the most should naturally slow more on the other side.
- **New mortgage lending softened further in February.** We estimate that in seasonally adjusted terms, new lending fell 2.1% m/m to $5.0bn, which follows a 9.7% m/m fall in January, and is the lowest dollar amount since November 2014. The data mirrors the fall in the value of housing turnover.
- **Softer new lending looks reasonably broad-based.** Whereas previously the slowing was largely an investor story (and new investor lending is currently down 35% y/y), the growth in lending to first home buyers and other owner occupiers has cooled of late too, with the former flat y/y, and the latter down 4.5% y/y.
- **Investors' share of overall new mortgage lending, at 26%, is well down from a peak of 38% in June 2016.** LVR restrictions are biting.
- **A larger share of new lending is on less-risky terms.** As a share of total investor lending, lending done with LVRs in excess of 70% made up just 13% of the total in February, down from 33% in July and over 50% in mid-2015. However, of new investor lending, there is still a large share on interest-only terms, which in February sat at 51%. That is down from its highs, but only modestly so.
- **Following on from slower growth in new lending, the growth in the overall stock of mortgages has now clearly peaked after a period of strong growth**. Monthly growth of just 0.5% m/m in January is the softest in close to two years, and the 3-month annualised pace of growth has eased to 7.7%, which, while still strong, is well off its 10% peak see in August and September last year.

Of course the moderation needs to be put in perspective. Following a boom, focusing on changes can lead to conclusions of a dramatic slowdown when levels of activity and prices are actually still quite solid.

The drivers of the turn are obvious:

- **The latest round of tighter loan-to-value ratio restrictions for investors have been formally in place since October 1 2016** but were informally implemented as far back as July. APRA, the Australian equivalent of the RBNZ's prudential and financial arm, has been reviewing lending standards in Australia and setting lending limits, which is also having an impact on bank lending appetite in New Zealand.
- **Banks are rationing credit as they attempt to close a funding gap** (the mismatch between money coming in the door – deposits – and money going out the door – loans). Better deals go to the top of the pile. Less credit availability means fewer deals. The latest statistics are showing a moderation in private sector credit growth from a 3-month annualised rate of 8.0% in October 2016 to 5.2% in January. It's also natural (and sensible) to ration credit at the top of the economic cycle.

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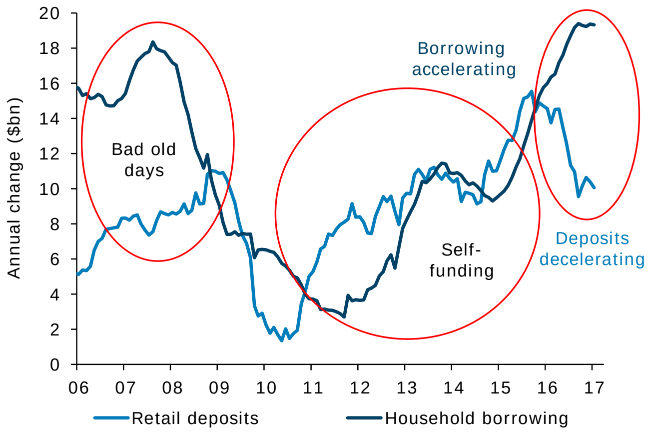
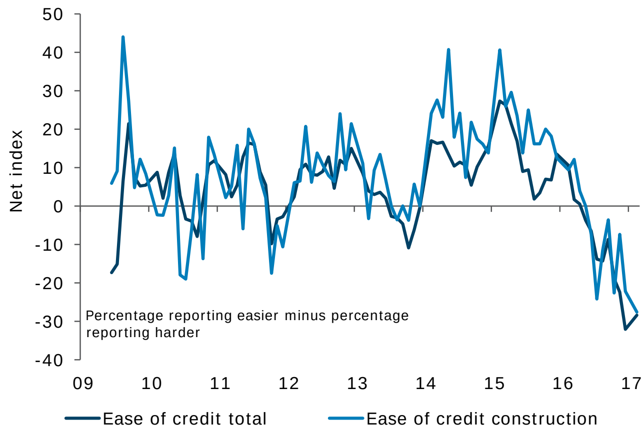
FIGURE 5. BANK HOUSEHOLD FUNDING AND CLAIMS GROWTH



Source: ANZ, RBNZ

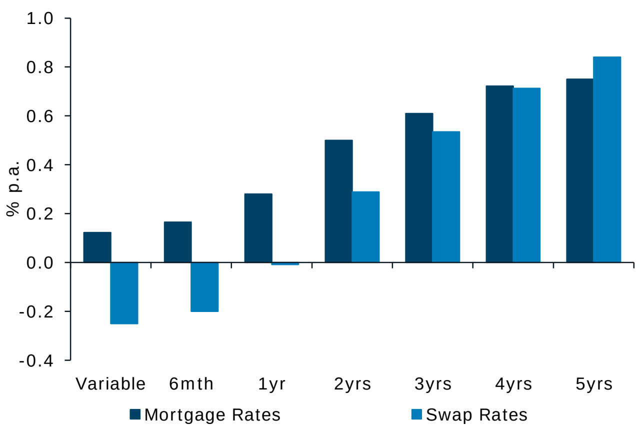
FIGURE 6. DIFFICULTY FINDING CREDIT



Source: ANZ

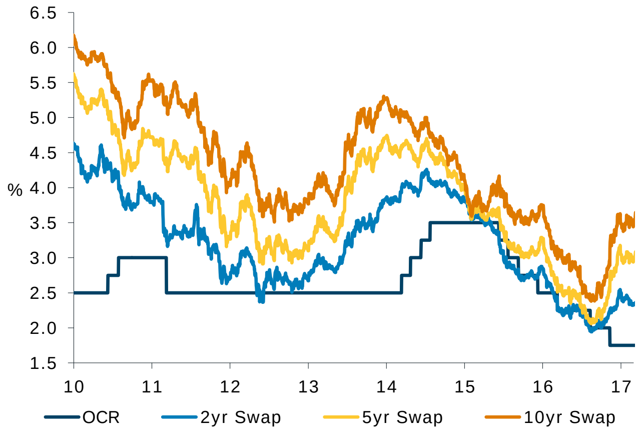
- **Interest rates are no longer falling; they are rising.** That's been influenced by two factors here in New Zealand. First, it is now broadly expected that the RBNZ will no longer be cutting the OCR and the next move is up, though not for a while. Second, there is also aggressive competition for deposits across the banking industry. That's forced deposit rates up, and where deposit rates go, borrowing rates follow.

FIGURE 7. CHANGE IN NZ INTEREST RATES SINCE 30 SEPTEMBER 2016



Source: ANZ, Bloomberg

FIGURE 8. NZ OCR AND SWAP RATES



Source: ANZ, Bloomberg

- **In addition, the era of incredibly cheap (some would say absurdly cheap) money around the globe is coming to an end.** Global interest rates (which tend to influence New Zealand 3-5 year wholesale rates) are on the ascent. The world's most powerful and important central bank – the US Federal Reserve – is lifting the Fed Funds rate. Conversations are drifting towards how quantitative easing will be unwound. US 10-year Treasury bond yields are around 100 basis points off their July-2016 lows. Real yields haven't risen as much but that's the next movement to watch for, as it means an increase in the global cost of capital. This flags a turn in the liquidity cycle and eventually a return to more fundamentals-based investing, a slightly alarming thought given the stretched valuations in many asset markets.

- **A natural petering-out effect driven by extremely stretched affordability, notably in areas that had led the surge, such as Auckland.** The valuation divide between Auckland and the rest of New Zealand is leading to more catch-up as people respond logically to the incentives that such stark house price mismatches across regions provide.

On top of that we look set for more intervention by policymakers. The RBNZ is undertaking a review of bank capital; if banks have to hold more capital that will put more upwards pressure on interest rates. Regulators on both sides of the Tasman are not standing idle; this will impact both the price and availability of credit as they

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eye curbing the credit accelerator model and leveraging behaviour (growing borrowing in excess of income growth), which are seen as a threat to financial stability.

The interest rates factor is significant. We've see loan-to-value ratio restrictions brought in before – after an initial lull, the market turned up again with a vengeance as interest rates continued to fall. House prices can look semi-affordable at a house price to income ratio of 9.5 when interest rates are extremely low, but the key point is that it is not sustainable; the equation can change dramatically when interest rates nudge higher.

A directional change in interest rates has three important implications:

- **Lifts in borrowing rates change the economics of the entire borrowing equation and can turn affordability metrics sharply, especially when the levels of debt are far larger.** House prices have risen to such an extent that we estimate that for the average Auckland household to purchase the average house (at a 20% deposit, 25 year mortgage term and at the cheapest mortgage rate on offer), debt servicing costs (principle and interest) would now represent 51% of average disposable incomes. A 1 percentage point increase in mortgage rates would see this jump to nearly 56%, which is far higher than in 2007, when the minimum mortgage rate was closer to 9%!
- **Higher interest rates get the market (buyers) thinking about where rates could be a couple of years down the track –** and that's critical for market psychology.
- **Higher rates force a shift to the fundamentals and more cash-flow based investing.** It needs to be more of a numbers game and less of a capital gain one. There are still strong expectations for capital gain though; 4.6% according to the ANZ Roy Morgan expected house price inflation measure.

Interest rates are going to keep nudging higher. It won't be rapid, and it won't be driven by the RBNZ, primarily. The key driver (as we've noted in previous editions of the *Property Focus*) is the massive funding gap, which is forcing a change in bank's behaviour. Deposit growth continues to trail credit growth. In household parlance, that's more money going out the door than is coming in. Banks can fill such a gap temporarily by borrowing offshore, but it would not be in New Zealand's long-term interest to let such a gap persist. The current account deficit (and external debt levels) would blow out, New Zealand's credit rating would likely get reviewed, and inflation would turn up if a spending boom were to join the housing equivalent, necessitating tighter monetary policy and a higher OCR. Credit-driven booms invariably end in a bust as the piper gets paid.

The funding gap portends more pressure on deposit rates to lift and credit growth to slow, which is precisely what we are seeing. And on top of that we expect a gradual rising bias to international interest rates, which will impact longer-term rates here.

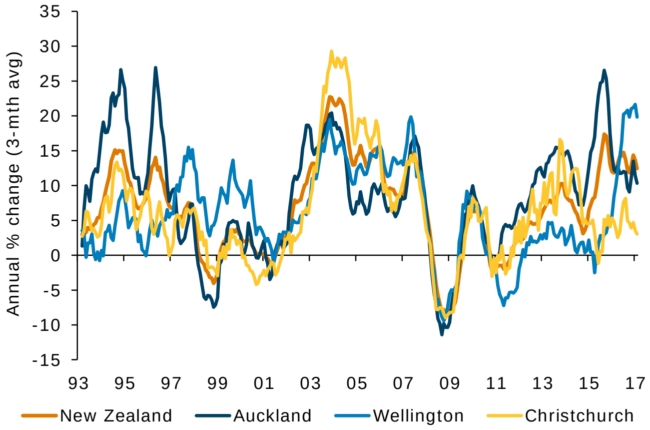
Which is going to win out? Rising interest rates and diminished credit or a shortage of housing supply in the face of still-strong migration? The former will actually dampen the supply side response, making the supply-demand imbalance even starker. Witness all those stories in the paper about projects struggling to get finance – although a big reason for this is also an explosion in construction costs, which makes it even more difficult to get the deals to stack up (refer last month's Property Focus). Economics 101 tells us prices will need to lift if an even larger shortage opens up.

We're backing interest rates and credit to dominate supply-demand imbalances, or at least buy some time for the latter to catch up. That seems to go against the aforementioned Economics 101 conclusion, but if the supply thesis was really all that's driving property prices we wouldn't have seen such a wedge open up between house prices and rents. The latter would have risen more sharply too. This doesn't mean we discount supply tension. Such tension will still be apparent for a long time yet. We simply need to put it in context and think more broadly.

There are some 'fixes' that the market will come up with itself, beyond simply building more houses. When pricing pressures become acute (i.e. the cost of building a home), or financing it becomes difficult, and affordability metrics start to bite on rises in interest rates, "leakage" will appear. There will be greater economic incentive to shift somewhere more affordable; intra-regional migration flows will pick up. The average number of people per house will rise. Young people will live at home for longer. Migration trends will turn; watch the gap between Brisbane and Auckland house prices. **New Zealand (Auckland) may be promoted as a great place to live but people still need to get ahead, and unaffordable houses relative to incomes puts you on a downward escalator, not an upward one.**

THE PROPERTY MARKET IN PICTURES

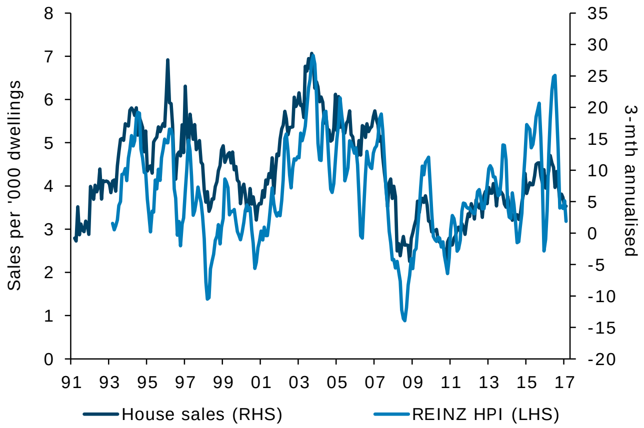
FIGURE 1. REGIONAL HOUSE PRICES



Source: ANZ, REINZ

According to the REINZ stratified measure, nationwide house prices bounced back 0.4% in February after falling 0.9% in January (sa). The volatility was driven by Auckland, which bounced back 5.2% after falling 6.2% the previous month. Plenty of caution is needed in interpreting figures at this time of year given lower levels of activity and unstable seasonal patterns. Nevertheless, it seems clear that momentum in price growth has slowed. On a 3-month annualised basis, nationwide prices are running at 1.9%, which is down from over 23% over mid-2016. Auckland and Christchurch prices are 6.7% and 10.2% lower respectively on the same measure. Wellington is outperforming, with annualised growth of 14%.

FIGURE 2. REINZ HOUSE PRICES AND SALES



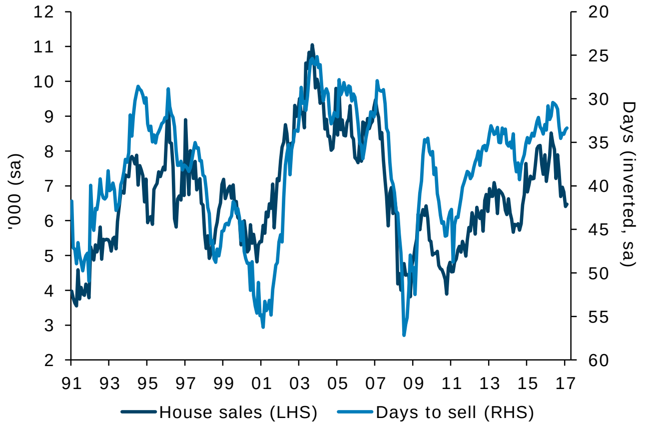
Source: ANZ, REINZ

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

Seasonally adjusted sales lifted just 1.1% m/m in February after falling 6.1% in January. House sales have fallen in seven of the past 12 months, with turnover down around a quarter over that period. This weakness is broad-based. Auckland sales volumes are down 29% over those 10 months (-24% versus their April-2016 peak), while ex-Auckland volumes are down 12% y/y (-21% from peak).

The softer trend in sales activity suggests that the recent moderation in house price growth will continue. That said, with part of the weakness in sales driven by a shortage of listings, there may still be an element of pent-up demand to underpin the market.

FIGURE 3. SALES AND MEDIAN DAYS TO SELL



Source: ANZ, REINZ

How long it takes to sell a house is also an indicator of the strength of the market, encompassing both demand and supply-side considerations. Larger cities tend to see houses sell more quickly, but deviations in a region from its average provide an indicator of the heat in a market at any given time.

Nationally, the median time to sell a house was little changed at 33.4 days (sa) in February. While this is off its recent high of 34.5 days seen in October, it is still well up from its mid-2016 lows of close to 30 days.

Interestingly, the median time to sell a property is still below historical averages in every region except Auckland (39 days, versus a long-run average of 34) and Canterbury (37 days, versus a long-run average of 35 days).

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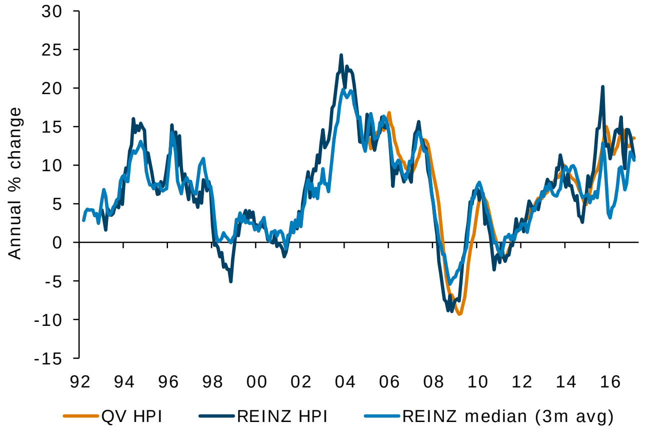
FIGURE 4. REINZ AND QV HOUSE PRICES

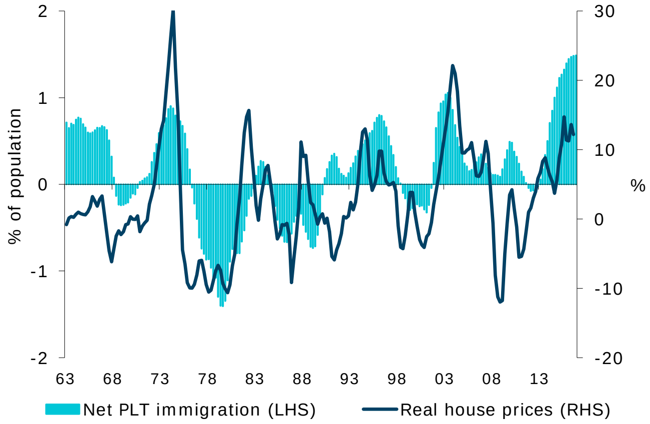


Source: ANZ, REINZ, QVNZ

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. 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 has dipped off its September record high of $516k sa **but lifted 0.4% in February and is up 10.3% y/y.** This roughly matches the REINZ stratified measure (10.5% y/y) but is a little lower than the QVNZ measure of price growth (13.5% y/y), with the latter two measures adjusting for changes in the quality of houses sold.

FIGURE 5. NET PLT IMMIGRATION AND HOUSE PRICES



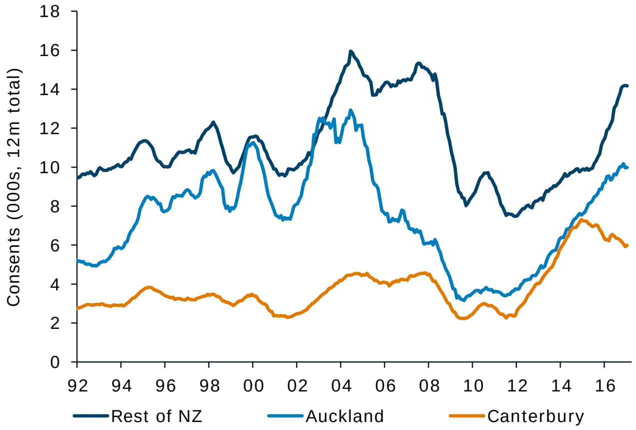
Source: ANZ, Statistics NZ, QVNZ

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 house price booms coincided with large net migration inflows.

On a three-month annualised basis, net permanent and long-term migration was close to 74k in February, which is near all-time highs and over 1½% of the resident population. More arrivals and fewer departures have both contributed to this large net inflow, although over the past 12 months or so, the former has been the dominant factor.

Migration inflows are expected to remain strong. New Zealand's current strong labour market (particularly relative to Australia, by far the most relevant comparator) will allure people home. In a world of fractured international politics (Brexit, US political uncertainty), there'll be no shortage of people with a desire to move to New Zealand.

FIGURE 6. RESIDENTIAL CONSENTS



Source: ANZ, Statistics NZ

Seasonally adjusted dwelling consent issuance lifted just 0.8% m/m in January following large falls in both November and December. The headline was driven by apartments, which bounced back 19% after falling 31% in December. Consents for 'houses' actually fell 3.5% m/m in January, and have fallen in four of the past five months. Monthly data is volatile, but it is clear that issuance is softening, which we put down to credit, capacity and cost constraints.

Annual nationwide issuance has held over 30k in recent months, which is the highest number since 2004. However, on current trends this annual total will soon decline – the level of issuance is now 17% below its June-October 2016 average. Weakness in Auckland (despite housing shortages) has joined a clearly softer trend in Canterbury.

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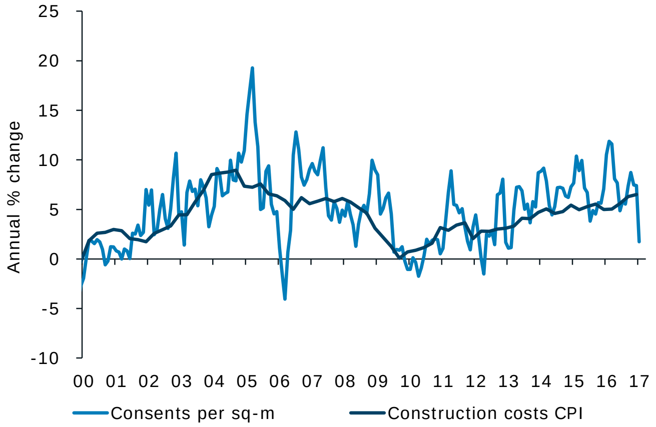
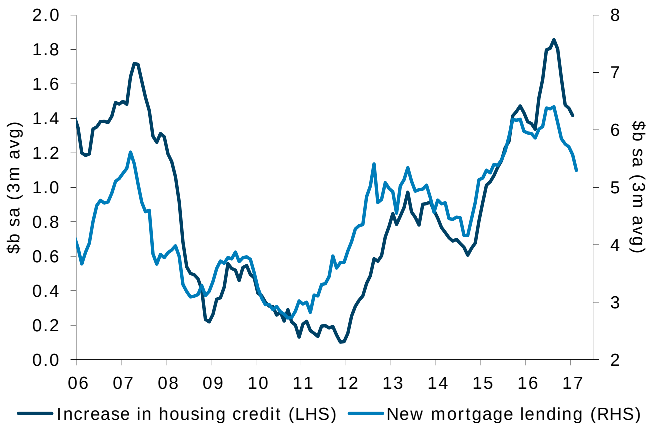
FIGURE 7. CONSTRUCTION COST INFLATION



Source: ANZ, Statistics NZ

On a three-month average basis, **the value of residential consents per square metre was up 1.7% y/y in January.** This is sharply down from 7.4% in January and is the lowest since early 2013. This may indicate that construction cost inflation is finally starting to wane, but we suspect it is mostly compositional. Given the extreme volatility in this cost measure we will await further data before drawing any conclusions. Costs per square metre in Auckland (especially in the multi-dwelling space) have lifted especially strongly of late, and our internal anecdotes continue to highlight that capacity pressures in the construction sector are intense, with a severe shortage of labour.

FIGURE 8. NEW MORTGAGE LENDING AND HOUSING CREDIT



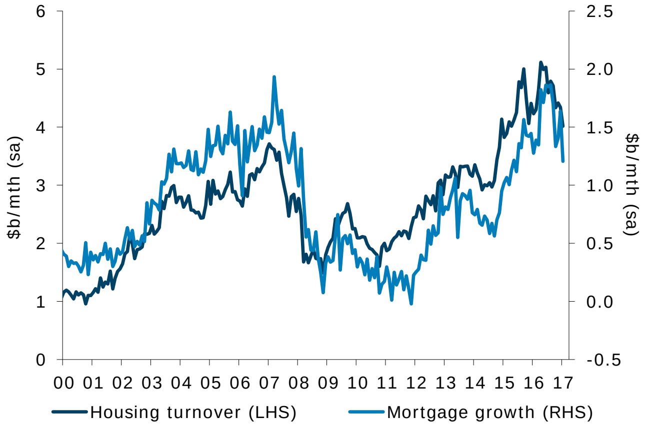
Source: ANZ, RBNZ

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

New mortgage lending softened further in February. We estimate that in seasonally adjusted terms, new lending fell 2.1% m/m to $5.0bn, which follows a 9.7% m/m fall in January, and is the lowest amount since November 2014. The data mirrors the fall in the value of housing turnover.

Softer new lending was reasonably broad-based. Whereas previously the slowing was largely an investor story (and new investor lending is currently down 35% y/y), the growth in lending to first home buyers and other owner occupiers has also cooled of late too, with the former flat y/y, and the latter down 4.5% y/y.

FIGURE 9. HOUSE TURNOVER AND MORTGAGE GROWTH



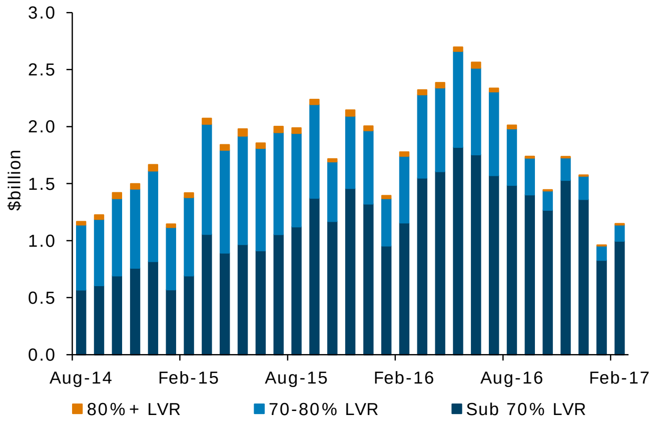
Source: ANZ, REINZ, RBNZ

Growth in the overall stock of mortgages has now clearly peaked, after a period of strong growth. Monthly growth of just 0.5% m/m in January is the softest in close to two years, and the 3-month annualised pace of growth has eased to 7.7%, which, while still strong, is well off its 10% peak see in August and September last year.

The latest tightening of the high-LVR lending restrictions – together with increased credit rationing by banks – appears to be having a marked impact on both house sales and credit availability. Add in recent modest increases in mortgage rates (and widespread expectations of more to come), and we expect to see mortgage lending growth moderate further over the coming months.

THE PROPERTY MARKET IN PICTURES

FIGURE 10. INVESTOR LENDING BY LVR

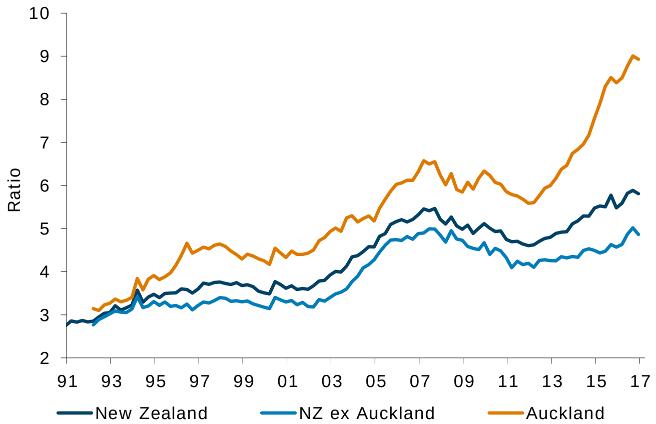


Source: ANZ, RBNZ

New lending to investors is well off its mid-2016 peak, down 35% y/y in February. Its share of overall new lending, at 26%, is well down from a peak of 38% in June 2016. This is no doubt related to the latest round of RBNZ LVR restrictions, which officially came into force on 1 October 2016 but influenced lending decisions in the months prior.

Related to this, a larger share of new lending is on less-risky terms. As a share of total investor lending, lending done with LVRs in excess of 70% made up just 13% of the total in February, down from 33% in July and over 50% in mid-2015.

FIGURE 11. REGIONAL HOUSE PRICES TO INCOME

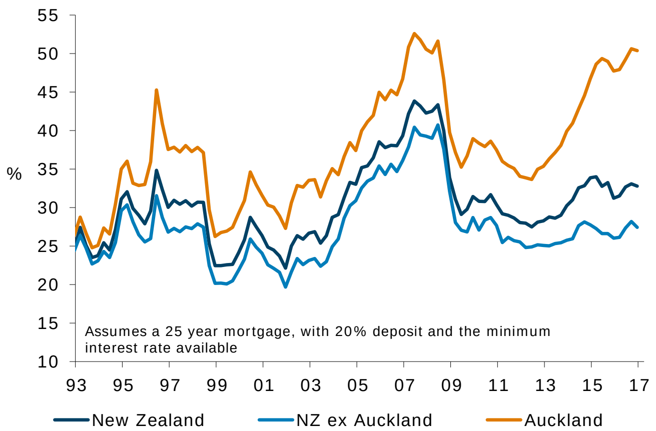


Source: ANZ, REINZ, Statistics NZ

One standard measure of housing affordability is the ratio of average house prices to incomes. It is a common measure used internationally to compare housing affordability across countries. It isn't perfect; 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 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 around 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 also takes into account interest rates, which are an important driver of housing market cycles.

We estimate that for a purchaser of a median-priced home (20% deposit), the average mortgage payment to income nationally is around 34% at the moment.

However, once again there are stark regional differences, with the average mortgage payment to income in Auckland around 51% for new purchasers. That is on par with the highs reached in 2007 despite mortgage rates being near historic lows currently. It highlights how sensitive some recent home-buyers in Auckland would be to even a small lift in interest rates.

PROPERTY GAUGES

The housing market has slowed – markedly in Auckland – as the combination of higher mortgage rates, LVR restrictions, stretched affordability and tighter credit criteria impact. While the pause is welcome and will likely extend for months to come, a fundamental mismatch between supply (building consents are falling) and demand (net migration is still strong) means pent-up demand will keep the market supported and ready to build more momentum down the track should conditions permit. Higher interest rates will restrain conditions from permitting.

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	Unaffordable	↔/↓	Bargains are few and far between.
Serviceability/ indebtedness	Deteriorating	↔/↓	More debt and higher interest rates is not a great combination.
Interest rates / RBNZ	Rising	↓	Lows for mortgage rates are behind us and banks have lifted rates as competition for deposits remains intense. The RBNZ is in no hurry to lift the OCR but global rates are rising.
Migration	Coming in droves	↔/↑	A stronger labour market than Australia's will keep departures low, and continue to encourage people to NZ's shores.
Supply-demand balance	Excess demand	↔/↑	Demand is outstripping supply still and the latter looks to be slowing.
Consents and house sales	Shortage	↔/↑	Consents have rolled over – a worrying sign. Auckland house sales are well down, likely due to a mix of demand & supply factors.
Liquidity	Fewer loans	↓	LVR restrictions are biting and banks are curtailing supply of credit, particularly at the riskier end.
Globalisation	Mixed bag	↔	Auckland (9 times income) no longer looks cheap in a global comparison but the rest of NZ still does (5 times).
Housing supply	Behind the 8-ball	↔/↑	Less credit + higher construction costs + no labour = less supply
House prices to rents	Mismatch	↔/↓	Rents not keeping pace with house prices but rising rents do support the housing shortage thesis.
On balance	**Flat-lining**	↔	**Housing market is cooling, not before time.**

PROPERTY GAUGES

FIGURE 1: HOUSING AFFORDABILITY

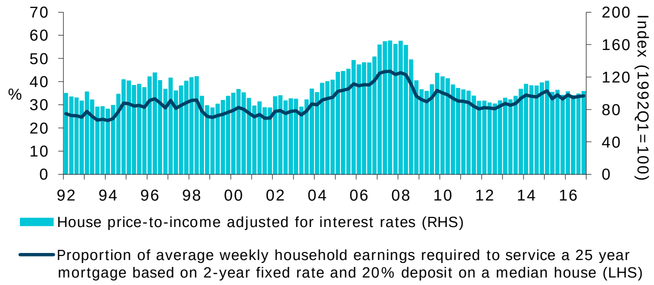


FIGURE 2: SERVICEABILITY AND INDEBTEDNESS

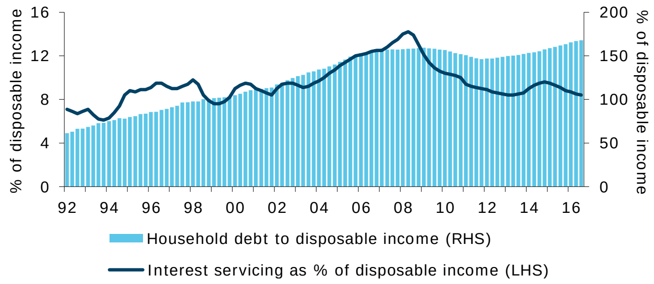


FIGURE 3: NEW CUSTOMER AVERAGE RESIDENTIAL MORTGAGE RATE (<80% LVR)

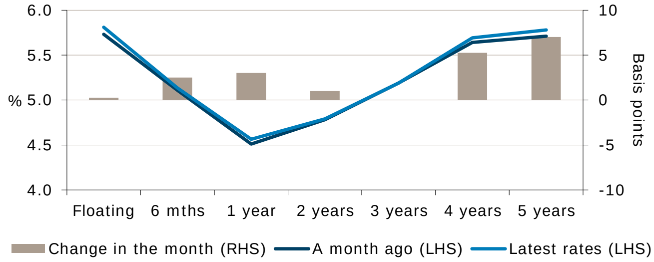


FIGURE 4: NET MIGRATION

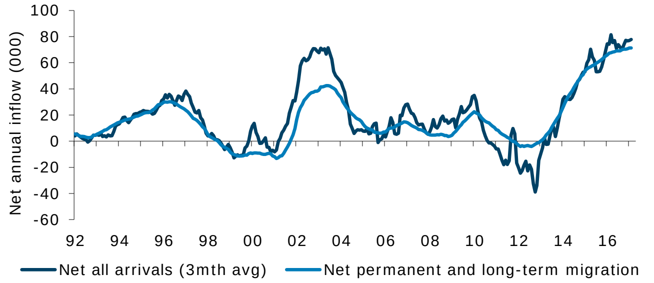


FIGURE 5: HOUSING SUPPLY-DEMAND BALANCE

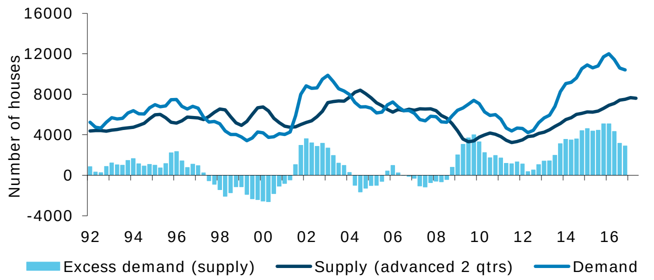


FIGURE 6: BUILDING CONSENTS AND HOUSE SALES

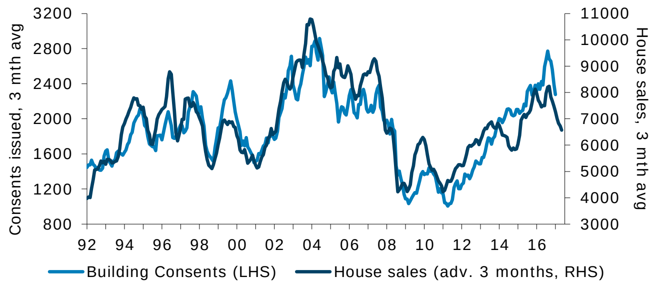


FIGURE 7: LIQUIDITY AND HOUSE PRICES

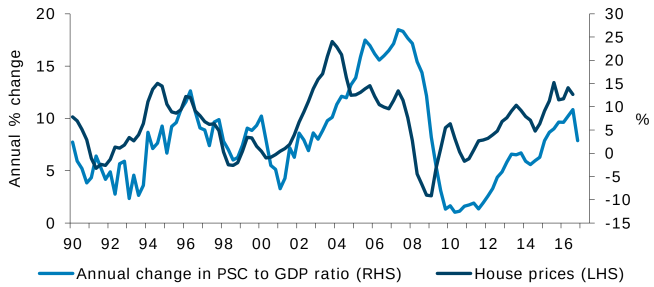


FIGURE 8: HOUSE PRICE INFLATION COMPARISON

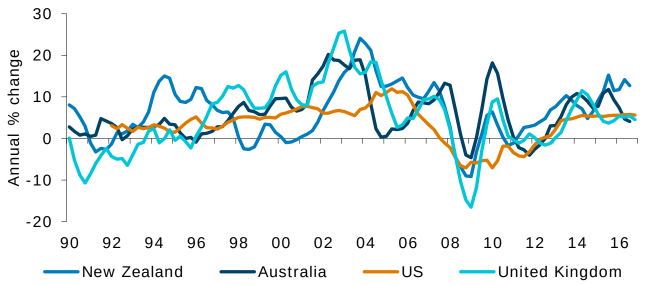


FIGURE 9: HOUSING SUPPLY

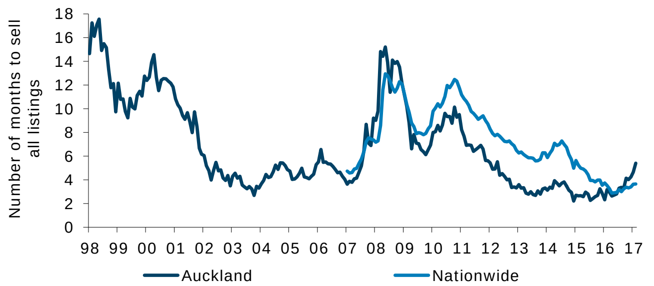
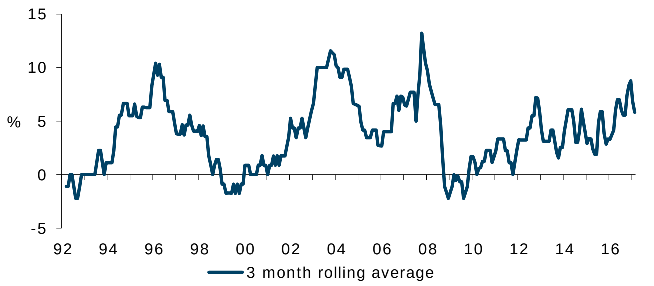


FIGURE 10: MEDIAN RENTAL, ANNUAL GROWTH



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

ECONOMIC OVERVIEW

SUMMARY

The economy is growing at a healthy clip but showing some typical late-cycle behaviours as finding skilled labour and housing-related excesses become challenges. Both will act as handbrakes on growth in 2017. This will help to dampen the potential for nasty imbalances to build up, breaking from the historical pattern where a housing boom is followed by a bust. Credit rationing and lifts in retail rates are helping to dampen excesses, which is positive for the medium-term picture. The next move in the OCR looks to be up. However, with inflation still low, time is on the RBNZ's side and any movement in interest rates looks set to be gradual.

OUR VIEW

Economic growth remains solid and forward indicators are positive. Business and consumer confidence are elevated. Our Truckometer is showing forward momentum. Financial conditions – while tightening of late – remain supportive. Construction sector activity remains strong. The tourism sector continues to flourish and migration inflows are booming. Dairy prices have recovered from lows, though some cash-flow challenges remain for the sector.

The economy is showing classic late-cycle behaviour on two levels:

- **Firms are struggling to find skilled staff.** It's now firms' biggest constraint. Employment intentions are strong. The unemployment rate has fallen to 5.2%. We still expect the unemployment rate to fall below 5% over 2017 and wage growth to lift. New Zealand critically needs migrants to fill skill shortages but this will face political push-back over the coming years.
- **Excesses are becoming apparent.** Households are leveraging (taking on debt in excess of income growth). Credit growth is strong. Houses continue to become more unaffordable, notably in Auckland.

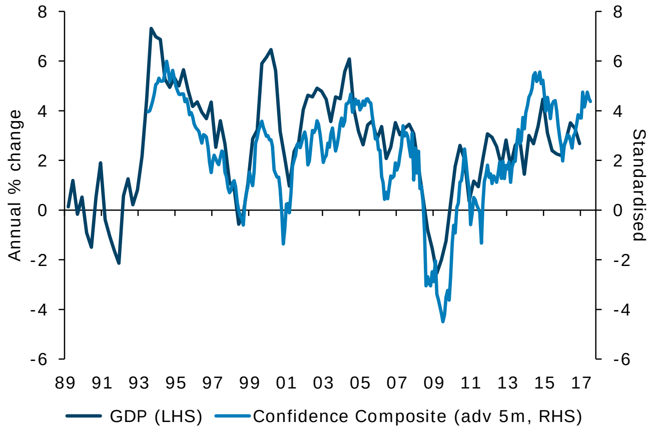
While both present challenges, they are welcomes ones, and signify an economy that is doing well.

A sizeable funding gap (credit growth in excess of deposit growth) flags continued pressure for credit growth to slow and relative prices to shift more in savers' favour at the expense of borrowers. This has lifted retail borrowing rates and seen pro-cyclical housing-related pockets of the economy slow. The housing market has slowed most notably in Auckland, where the combination of valuation excesses, higher interest rates, less credit and LVR restrictions are constraining demand. A substantial shortage of houses remains though, which will support the market. Nevertheless, the slowdown is welcome. The fact that banks are lifting retail rates is taking pressure off the RBNZ to lift the OCR. Tamed housing excesses will help elongate the economic expansion and lessen the risk of a correction down the track.

The RBNZ will eventually lift the OCR. Time is, however, on its side. Core measures of inflation are still below target. Global risks abound. Banks are doing the RBNZ's work for it by lifting retail rates.

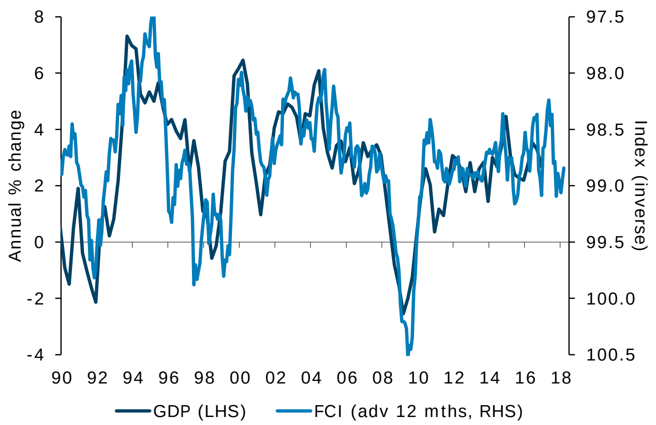
The greatest threat to the economy resides offshore. We are entering a period of heightened global uncertainty. The US Federal Reserve is hiking and it faces a delicate balancing act lifting rates from extreme lows while keeping the economy – and financial markets – on an even keel. Central banks appear more alert to the side-effects of keeping rates low for too long. The resentment vote and emergence of populist leaders is leading to questionable policy decisions. Protectionist nuances are emerging and that's not great for trade-dependent nations such as New Zealand and our key trading partners such as Australia and China.

FIGURE 1. GDP VS CONFIDENCE COMPOSITE



Source: ANZ, Roy Morgan, Statistics NZ

FIGURE 2. GDP VS FINANCIAL CONDITIONS INDEX



Source: ANZ, Statistics NZ, Bloomberg

MORTGAGE BORROWING STRATEGY

SUMMARY

Mortgage rates remain the same as they were a month ago for most terms, with the 0.08%pt rise in the average floating rate the most notable change. This continues the trend of gradually rising rates that started in the fourth quarter of 2016 and leaves the tick-shaped mortgage curve intact. With the outlook for the economy broadly as it was a month ago and the Reserve Bank insisting that it doesn't intend lifting the OCR any time soon, our view remains the same: the 1 year remains the sweet spot. Long-term mortgage rates are set to rise as global interest rates lift and as term deposit competition intensifies; but this is already well incorporated into the term structure of interest rates. In other words, breakevens remain higher than where we ultimately expect rates to get to.

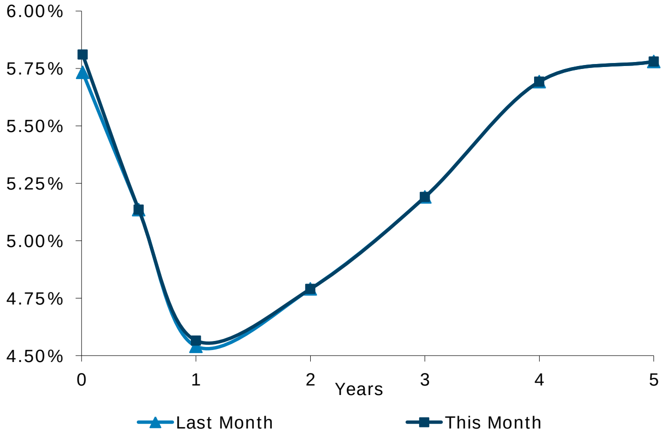
OUR VIEW

Mortgage interest rates have altered little over the month, but the changes we have seen have been small increases, continuing the trend of gradually higher mortgage rates that has been in place since late last year. The mortgage curve remains tick-shaped, with the 1 year rate the lowest point for both standard and special rates.

We continue to favour the 1 year rate. As was the case last month, this reflects our judgement that we won't see OCR increases for some time, especially now that we are seeing signs of house price growth moderating. By contrast, this is not what the term structure of the mortgage curve is implying. Indeed, as we note below, breakevens are generally higher than where we expect mortgage rates to end up (if they move by around the same amount as wholesale interest rates).

In terms of the risk profile, compared to a month ago, if anything we are more, rather than less, comfortable with our forecast for the OCR to remain on hold until next May. In the past month we have seen several downside data surprises locally as housing slows up, more uncertainty emerges about the global economy, the outlook for dairy prices remains murky, credit growth slows, and as noted, retail interest rates have risen. The latter in particular buys the RBNZ time, and if we see term deposit competition intensify further, thereby placing pressure on borrowing rates too (which looks to be the risk, given the still-wide gap between deposit and lending growth); that will potentially buy the RBNZ even more time. More intense competition also has the potential to push mortgage rates a touch higher, but they are unlikely to move up as quickly as breakevens do. Consider, for example, the choice between fixing for 1 year at 4.57% or 2 years at 4.79%. Not much separates those rates, but with the 1 year/1 year breakeven at 5.02%, if your decision was based purely on cost, you'd need to expect the 1 year rate to rise by 0.45%pts over the next year in order to prefer the 2 year option. That could happen, but we think it's a line call at best, even given the risk of mortgage rates rising independently of the OCR. Other breakevens also rise fairly sternly over the next year or two, discouraging longer terms. For some, there will be an attraction to fix for longer terms simply for certainty. While understandable, with almost a full percentage point separating 1 year and 5 year rates, this certainty does come at a cost at present.

CARDED SPECIAL MORTGAGE RATES^



Special Mortgage Rates		Breakevens for 20%+ equity borrowers			
Term	Current	in 6mths	in 1yr	in 18mths	in 2 yrs
Floating	5.81%				
6 months	5.14%	4.00%	4.90%	5.13%	5.79%
1 year	4.57%	4.45%	5.02%	5.46%	5.99%
2 years	4.79%	4.95%	5.50%	6.01%	6.60%
3 years	5.19%	5.49%	6.07%	6.27%	6.44%
4 years	5.69%	5.81%	6.08%		
5 years	5.78%	#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	5.81%				
6 months	5.24%	4.75%	5.67%	5.22%	5.90%
1 year	4.99%	5.21%	5.44%	5.56%	6.04%
2 years	5.22%	5.38%	5.74%	5.96%	6.37%
3 years	5.49%	5.71%	6.06%	6.22%	6.49%
4 years	5.79%	5.97%	6.23%		
5 years	5.98%	*may be subject to a low equity fee			

^ 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 February 2017 (based on REINZ data)

	House prices (ann % chg)	3mth % chg	No of sales (sa)	Mthly % chg	Avg days to sell (sa)
Northland	22.3	1.1	269	+24%	44
Auckland	7.7	-1.9	2,383	+0%	39
Waikato/BOP/Gisborne	15.2	0.0	1,242	+0%	35
Hawke's Bay	7.7	3.8	257	-8%	33
Manawatu-Whanganui	9.4	2.0	384	-8%	27
Taranaki	3.2	-1.8	190	+4%	37
Wellington	15.0	5.3	867	+6%	29
Nelson-Marlborough	13.3	2.9	260	+16%	32
Canterbury/Westland	1.6	0.2	996	+2%	37
Central Otago Lakes	28.9	2.2	162	+0%	47
Otago	16.3	4.2	277	+13%	28
Southland	-1.3	3.8	208	-15%	34
NEW ZEALAND	**10.9**	**-0.3**	**7,356**	**+1%**	**33**

Key forecasts

	Actual			Forecasts						
Economic indicators	**Jun-16**	**Sep-16**	**Dec-16**	**Mar-17**	**Jun-17**	**Sep-17**	**Dec-17**	**Mar-18**	**Jun-18**	**Sep-18**
GDP (Ann Avg % Chg)	2.7	3.0	3.1	3.1	3.0	3.0	3.1	3.0	2.9	2.6
CPI Inflation (Annual % Chg)	0.4	0.4	1.3	1.9	1.9	2.2	2.1	2.0	2.2	2.2
Unemployment Rate (%)	5.0	4.9	5.2	5.0	4.8	4.7	4.7	4.6	4.5	4.5
Interest rates (carded)	**Jun-16**	**Sep-16**	**Latest**	**Mar-17**	**Jun-17**	**Sep-17**	**Dec-17**	**Mar-18**	**Jun-18**	**Sep-18**
Official Cash Rate	2.25	2.00	1.75	1.75	1.75	1.75	1.75	1.75	2.00	2.25
90-Day Bank Bill Rate	2.4	2.2	2.0	2.0	2.0	2.0	2.0	2.1	2.3	2.5
Floating Mortgage Rate	5.7	5.6	5.7	5.7	5.7	5.7	5.7	5.7	6.0	6.2
1-Yr Fixed Mortgage Rate	4.9	4.9	4.9	5.0	5.0	5.0	5.0	5.1	5.3	5.4
2-Yr Fixed Mortgage Rate	5.1	5.1	5.1	5.3	5.3	5.3	5.4	5.5	5.6	5.7
5-Yr Fixed Mortgage Rate	5.6	5.6	5.7	6.3	6.3	6.4	6.5	6.5	6.6	6.8

Source: ANZ, Statistics NZ, RBNZ

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