BNZ Weekly Overview

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Mission Statement

To help Kiwi businesspeople and householders make informed financial decisions by discussing the economy and its implications in a language they can understand.

School Holidays Again

I will be on leave the coming fortnight so the next Weekly Overview will be released on July 28. These comments here should carry you through the next three weeks though, and what they add up to is this. Our economy is in great shape, and while developments such as even lower interest rates and strong migration will propel house prices higher, deeper currents are stirring. We've been here before and in the next 12 – 18 months old hands will be selling the lower yielding maintenance-due portions of their stock to the current wave of panicking, late-cycle entering, bottom of the pyramid buyers.

Economic analysis cannot tell you when the price of a widely held and easily accessible asset like housing has reached a peak. It cannot tell you what the decline will look like. It cannot tell you when things will bottom out.

This is because while economics deals with human interactions in the trading of goods, services, assets and labour, the motivators of these transactions change over time. These motivators have definitely altered post-GFC hence essentially all economic forecasts since 2007 have been wrong. And the motivators of investment asset purchases cannot be modelled even in steady state times which we liked to think prevailed, sort of, in the period before the GFC of 2008-09.

So nothing can tell you when an asset market represents dangerous buying except gut instinct based upon one's experience of such cycles in the past.

To help you get a gut instinct for the current housing market and why I think we have now entered the earliest stages of the end game, consider the case of the regions, or more specifically Wellington.

Over 2014 and early last year we used to write about how Auckland prices had risen some 90% since 2009 but Wellington had gained just 6%. Wellington was a screaming buy. But few people transacted. Over a year ago you could pick up good property for what people now consider to be a song.

Now we see that prices are soaring, listings have collapsed, and people are flocking to open homes to buy something, anything. Has the economy of Wellington suddenly taken off? No. Have average incomes soared? No. All that has happened is that just over a year ago, or even less that that according to some people, Auckland buyers appeared.

Seeing these buyers purchasing properties at low prices relative to Auckland, offering good yields, the locals jumped on the bandwagon. And around the country it is the locals driving regional housing markets. Not Aucklanders. Not foreign buyers even though to reinforce their buying determination people swap stories of Chinese buying property – Rotorua being a favoured location apparently. But just under a year ago I was told a story of Chinese buying in the Hutt Valley.

It does not matter whether such buying is occurring or not. People simply swap such stories to help them justify their decision to buy anything. Nothing out of the ordinary there. We've seen it before. These are the late-cycle buyers now in play, the market entrants who have capitulated from their view that prices would fall.

But it pays to think in terms of what is becoming, in former PM David Lange's language, a "matter of moment". And what is becoming important is this. Politicians globally are being sideswiped by voters choosing to express their discontent at many of the trends they see around them. Immigration, housing affordability, young losing out to the old, regions suffering compared with the city agglomerations.

Divisions have become more apparent and voters are expressing their concern about these divisions, about those cast aside and derided, or somehow left behind.

Hence the Brexit success in the UK, the strong support for Bernie Sanders and Donald Trump in the United States, the rising support for far right and far left parties throughout Europe, and the miscalculation of Malcolm Turnbull across the Tasman in calling an early election which he may win – just.

How is this relevant to New Zealand and our housing market? We like to think of our society as egalitarian, and we get up ourselves discussing how we are doing well while foreign economies and societies struggle with an amazing range of intense problems. The secular decline of sclerotic Europe which the British have now detached themselves from. The expansion of China which is about to run into the twin problems of a failing economic model and military superiority of other powers – yet again – such as the United States and Japan. The traditional insularity of the United States and divisive Presidential election contest. The inability of Australia to produce a government able to arrest the deterioration in government accounts and competitiveness. The failure – yet again – of the socialist model, this time in Venezuela. And so on.

But divisions are growing here. Our economy is highly flexible courtesy of the painful reforms of the 1980s which threw so many people on the scrapheap to fend for themselves. We had a good GFC and have recovered well. But problems are building. Not employment. Not cost of living outside housing. Not really health. Not really education. Housing availability and cost is the matter of moment issue.

Young people are having to borrow extreme amounts of money to purchase a property in Auckland. The paucity of construction in Auckland since the mid-2000s when Labour were in power means those on low incomes are finding it hard to secure affordable accommodation.

The lesson of the UK referendum, US campaigning, Europe, and Australia is that people will express their dissatisfaction with what they see happening around them. The National government since 2008 has been particularly adept at identifying areas of societal concern like this and addressing them. It is very unlikely that they are not taking on board the lessons of what is happening offshore. Hence the near explicit instruction from the Prime Minister to the Reserve Bank to take measures to rein in the high pace of house price rises. The PM's words are shifting.

What is about to happen then is this. While the Labour Party will announce a set of alternative housing policies the Government will look to stamp out this bush fire of housing affordability discontent ahead of next year's general election. It may take some time for them to develop and announce policies which the electorate will view as likely to help address the affordability problem, and they won't seek to push prices lower. But these policies will be announced and implemented before the general election next year. Their focus will not be on boosting demand from young home buyers which is already backed up and strong. Instead it will be on supply and on reducing the attractiveness of purchasing property for investment purposes,

Meanwhile the Reserve Bank will strengthen loan to valuation rules and put in place a system ready to implement debt to income controls. Maybe soon investor buyers in Auckland will need a 50% deposit, and elsewhere 30%. Watch also for implementation of a rule introduced last month in Sweden whereby anyone borrowing at less than 50% deposit must make minimum principal repayments and not have simply an interest-only loan.

The collective aim will be not to suddenly boost housing supply because that is not possible. Instead it will be to change buyer expectations of future supply and therefore future prices. It will be interesting to see exactly what policies are brought forward.

Collapse Prices?

An emailer asked me to make a comment regarding the call by an economist for the government to facilitate construction of so many houses in Auckland that prices would fall 40%. The Prime Minister described the idea as "crazy". I assign little probability of Gold Coast-like development along stretches of Auckland's central waterfront therefore see no reason to alter my view that the shortage of houses in Auckland at current prices will continue to grow. This implies further upward pressure on prices to ration the limited quantity of houses. Nothing new.

Will the $1bn fund to help speed up housing infrastructure development make a difference? Not in the next few years given the shortage of resources to develop the infrastructure and shortage of resources to then build houses on the land. Prices therefore rise further.

But it is starting to feel like we are entering the end-game for the Auckland market's period of very rapid price growth. Come late-2017 or earlier the range on offer is likely to be improved from what is there at the moment and time will be on the buyer's side. But we are not there yet.

Crisis?

When oil prices soared in the early and late 1970s we suffered from two bouts of an oil price crisis. When Marmite production was interrupted five years ago by the Christchurch earthquakes we suffered a Marmite supply crisis. These crises affected essentially everyone who consumed oil products and Marmite and met the Oxford Dictionary definition of a crisis.

"A time of intense difficulty or danger."

Is everyone negatively affected and experiencing intense difficulty because of the soaring pace of house price growth around the country? Definitely not. If you already own property you are experiencing a lift in paper and sometimes realised wealth. You are not having a crisis. In fact the vast majority of Kiwis are not in crisis.

For which groups is soaring house prices a crisis? Here are a few.

The Reserve Bank.
They are worried that some lenders may advance too much money compared with their capital bases, secured against property which could fall in price should a shock come along such as a foot and mouth outbreak. The crisis element is that the RB cannot use changes in the official cash rate to control this risk. They are having to scramble to develop new tools focussing on restricting credit **supply** rather than credit **demand**.

First home buyers.
They are struggling to find a home, competing against investors and each other, and decreasingly able to raise enough money to get a place they consider acceptable.

Low income renters
Rents are rising faster than incomes and some people are being priced out of the rental market. Some become homeless. These people are definitely in crisis.

Groups not experiencing a crisis include all investors. They are either sitting tight and seeing their wealth rise, or buying more to try and make money from rising house prices and/or renting the properties out.

Over-Investment in Housing?

Is this what we Kiwis do? No. Anyone who has invested in extra property these past three decades and managed to keep debt well away from valuation levels has made a lot of money. On that basis one could not say people have over-invested. They did probably, and many of us do, have an investment portfolio heavily weighted toward housing.

But this definition of over-investment is probably only applicable in the sense of being heavily exposed to the risk of house prices falling and not applicable in the sense of having too much volatility in one's portfolio value. House prices are far less volatile than share prices.

The definition is not at all applicable to the situation in Auckland where there is a housing shortage. Not enough houses have been built since the mid-2000s. Not enough subdivisions have been developed. Not enough infrastructure has been put in place to facilitate housing construction. There has been under-investment in housing in Auckland for over a decade and all government and council policies are geared toward boosting investment in housing – not cutting it back.

Be careful how you use the word over-investment. It applies only in the very narrow sense of vulnerability to a big shock such as a foot and mouth outbreak. Outside of that, nope. We need more investment in housing – supply.

Investors To Blame?

Yes and no. It is rarely the case in an open market that only one group of buyers is very active when prices are clearly rising. There are certainly a lot of people responding to low returns on alternative assets buying houses to deliver long-term yield and probably capital gain, and there are people

simply playing the game looking for a quick gain as it seems easy.

But it pays to remember that there are plenty of people who have been sitting on their hands since 2008 waiting for prices to decline according to the incorrect forecasts of most other economists. Now they are catching up on buying they have not done since then.

Government Building Surge?

The Labour Party have a policy of aiming to build 10,000 state houses per annum for ten years. I support the policy because of the need for such accommodation and the housing shortage in Auckland. But it won't happen. There are not enough builders, surveyors, electricians, plasterers, scaffolders and so on.

A key constraint on the supply of extra houses in Auckland is staff and if the government initiated a building programme this would take people away from other projects. But more than that, already 30% of building inspections in Auckland fail. Even with all the awareness of leaky building construction and past use of poor materials we Kiwis still build crap houses. A building surge sponsored by public servants driven by the need to meet quantity targets would risk construction of particularly poor quality. Witness the quality impact of quantity targets post-earthquake in Christchurch.

Frankly we should contract out the job to a respected offshore party, which is probably what Labour would have to do. But there is no big chance of that because it would negatively affect the incomes of Kiwis, union members or not, already working in the building industry.

Removing obstacles identified as contributing to the slow pace of house construction in Auckland is good. But people need to be careful they don't think one obstacle is the big hair ball which once removed from the drain will make the water flow quickly. There are many hair balls and taking out the first merely means the water backs up from another six inches along the pipe.

Staff availability
Staff quality
Materials quality
Materials costs
Staff costs
Land availability
Land willingly offered for development
Infrastructure funding
Infrastructure installation
Consenting processes
Kiwi preference for expensive bespoke houses, not "cookie cutter" houses which we look at down our noses.

And so on for many more obstacles which you can think of but I have run out of time to dig out of the grey matter and write here.

A Repeat of 1985-87?

Some property sector people are apparently opining that this is a repeat of the 1980s boom which ended with the October 1987 sharemarket crash and property market crash. They reference Chase buildings, bankruptcies and so on. But this comparison is incorrect and here are a few reasons why.

Back then borrowing costs soared as the Reserve Bank struggled first to fight inflation entrenched from the 1970s and then to reverse policy easing mistakenly undertaken in 1986 when they thought their job was done. First mortgage rates went from 13% in 1984 to 20% in 1986, dropped to 17.5% late that year, then were pushed to 20.5% mid-1987. Many people paid higher.

This time around borrowing costs are falling as are expectations for future borrowing costs with the average floating mortgage rate of 5.64% down from 6.22% a year ago and 6.7% two years ago, headed down to close to 5.25% soon

Back then credit supply was booming as the banking system was deregulated in fits and starts from 1984-87. This time around more limits are being steadily placed on the ability of banks to supply credit and the regime for controlling lending risks as administered by the Reserve Bank is vastly superior to the lacklustre range of controls back then.

Back then the economy was being shaken by massive deregulation (Rogernomics), including removal of protection from a manufacturing sector which had got increasingly bloated from the late-1930s, and the removal of farm subsidies and price support schemes. This time and largely since 1992 the reform environment is minor and incremental. No big changes shaking up specific sectors let alone the overall economy.

Do these arguments mean that this boom in average house prices is sustainable? Definitely not. It will end, the only questions are when and how. My pick for when is late-2017 to mid-2018 in response to

-the end of falling interest rates
-the end of falling interest rate expectations
-some worries about rising interest rates as inflation moves higher
-slowing net inward migration (though still above average)
-higher annual house supply growth
-high prices taking more buyers out of the market who don't already have property to gear up
-extra constraints on bank credit supply
-new restrictions on bank funding of investors
-programmes initiated/boosted to supply more building staff, materials, and land.

The extent to which house price flattening turns into house price declines will depend upon

-whether the global economy is heading downward anew
-what the sharemarket is doing
-whether or not the Reserve Bank repeats its past tendency to tighten too much as it fights to slow the pace of credit growth.

For now the ride continues and any day the Reserve Bank is likely to announce new lending restrictions. If they have learnt from previous tightening periods when the only tool they had was the official cash rate then they will realise that their incentive is to bring the hammer down hard, repeatedly early in the cycle rather than hope each time that just a little bit more will be enough. The previous Reserve Bank Governor eventually admitted that they should have raised rates more quickly over 2005 to 2007 – as we were telling them at the time.

Were I in charge I'd take the 30% investor deposit requirement in Auckland to 50%, place a 30% requirement everywhere else, then watch the impact for three months. If things eased not enough I'd impose rates of 75% and 50%, then 100% and 75% in extremis. I'd also get the regime in place for debt to income rules next year and hold them in reserve.

But keep in mind the warning we delivered here a few weeks ago. The Reserve Bank's job is not to control the pace of house price rises. It is to control threats to stability of the financial system and so far they have been quite successful at reducing low deposit lending. Once their expanding controls remove almost all such lending and banks are assessed as being very well placed to handle 20% - 40% house price falls, their job is done. But we can still get prices rising 5% - 10% per annum when that happens because not everyone is buying with high debt.

NZ Dollar

The Kiwi dollar has risen to 55 British pence from 49 a fortnight ago as the Pound has been pushed lower by expectations of weak economic activity following the Brexit vote. Sellers of the Pound have been flocking into greenbacks, the Yen, and the Swiss franc so against the USD we sit near 71.4 cents from 71.1 last week and 71.7 two weeks ago. Against the Yen we sit lower near 72.2 from 73. A week ago and 74.9 two weeks back.

The Euro has been sold on the back of economic worries though to a lesser degree than the Pound. We now sit near 64.2 centimes from 63.9 last week and 63.5 two weeks ago.

Picking currency movements when a shock such as the Brexit vote comes along is a fraught business. It may be obvious that the vote means a lower Pound. But gauging when the currency has been over-sold is extremely difficult. For that reason anyone contemplating shifting funds into the Pound in the near future would be unwise to hold off, speculating that a lot worse is to come. Instead shifting some of the funds one needs in Pounds now would seem a good risk management idea, locking in a rate not considered possible just two weeks ago.

As noted here for a long time now, the Kiwi dollar is well supported by the relatively strong state of the NZ economy and government accounts. While NZ interest rates are likely to be cut again come August 11, this is largely factored in. Chances remain strong that the Kiwi dollar stays strong.

If I Were A Borrower What Would I Do?

We see a high probability that the Reserve Bank will cut the official cash rate from 2.25% to 2.0% at the next review on August 11. Floating rates will fall by at most that amount with lesser declines possible depending upon what offshore funding costs have done by then in response to Brexit.

With yields on government bonds globally falling in many cases to historic lows, the chances are that we will soon see declines in fixed mortgage interest rates.

If I were borrowing at the moment I would have near 20% of my debt floating and the rest at either a two or three year rate – assuming that the rates I would face are the same as the BNZ published ones.
https://www.bnz.co.nz/personal-banking/home-loans/compare-home-loans#compare-rates

If I Were An Investor ...I'd see a BNZ Private Banker

The text at this link explains why I do not include a section discussing what I would do if I were an investor.
http://tonyalexander.co.nz/regular-publications/bnz-weekly-overview/if-i-were-an-investor/

The Weekly Overview is written by Tony Alexander, Chief Economist at the Bank of New Zealand. The views expressed are my own and do not purport to represent the views of the BNZ. To receive the Weekly Overview each Thursday night please sign up at www.tonyalexander.co.nz
To change your address or unsubscribe please click the link at the bottom of your email. Tony.alexander@bnz.co.nz

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