ANZ Research September 2022

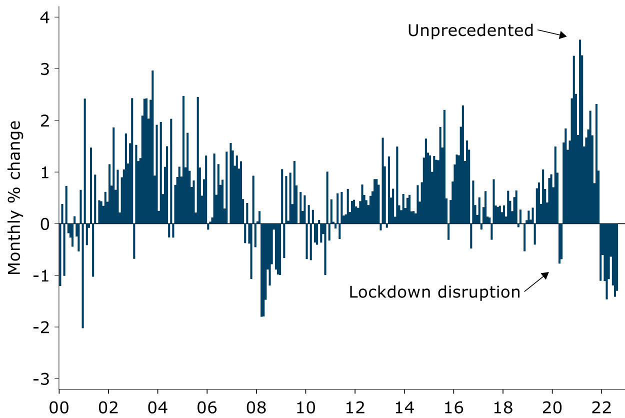
New Zealand Property Focus

Spring bounce or false floor?

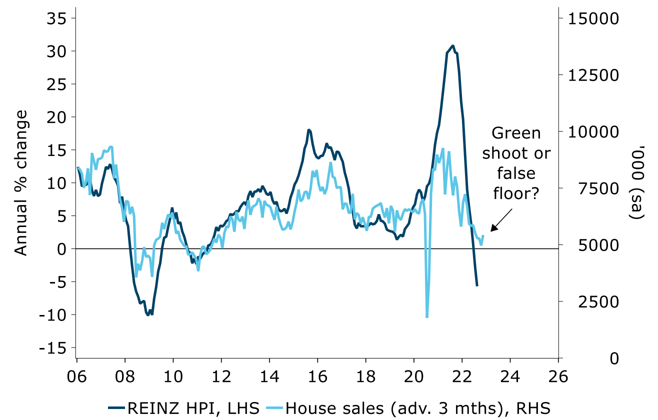
ANZ

At a glance

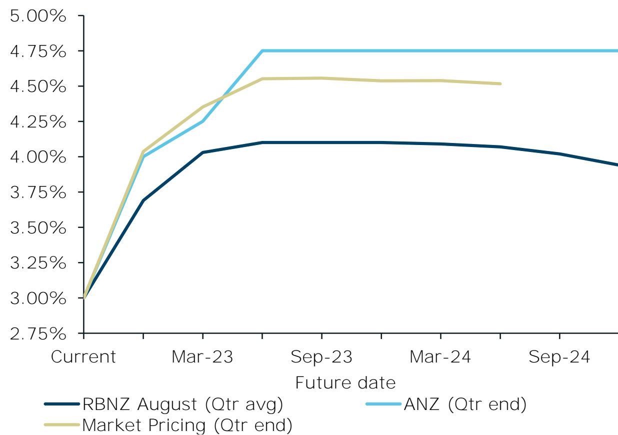
The house price retreat continued in August…



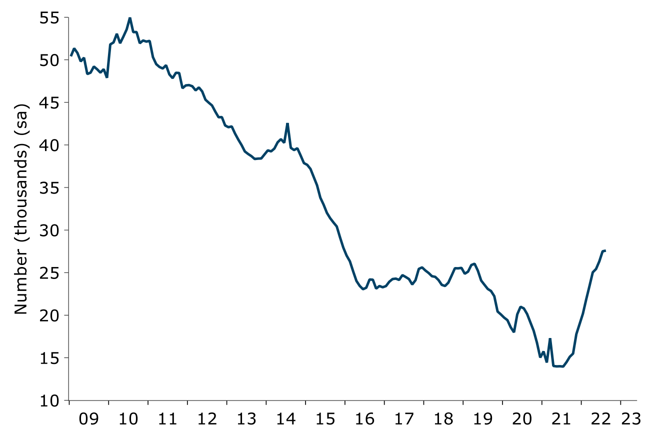
…but was August's 9.4% rise in house sales a "green shoot"?



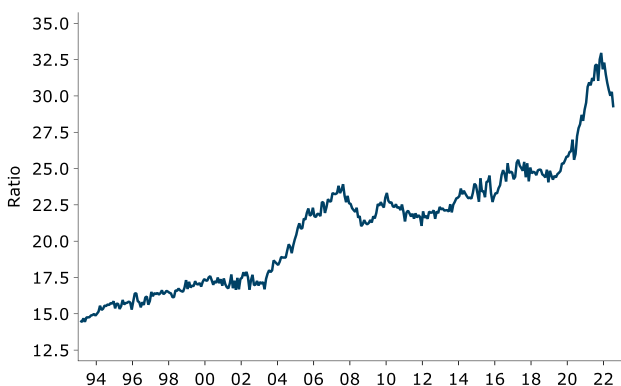
If so, that would be against the fundamentals of a rising OCR…



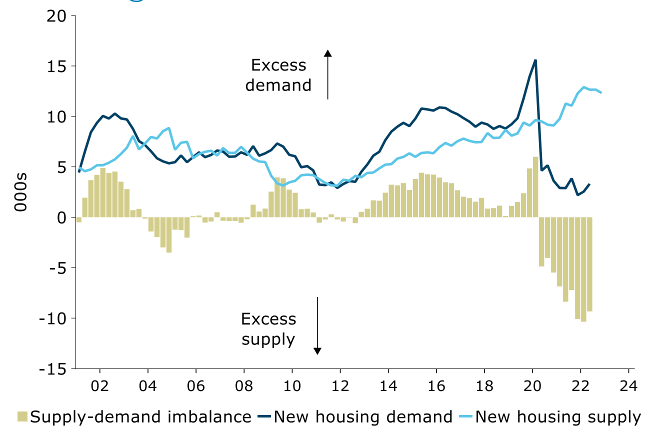
More properties available for sale…



…still-dire, but improving unaffordability (prices to rents)



…and significant erosion of the housing deficit



Source: RBNZ, REINZ, Stats NZ, CoreLogic, Macrobond, Bloomberg, ANZ Research

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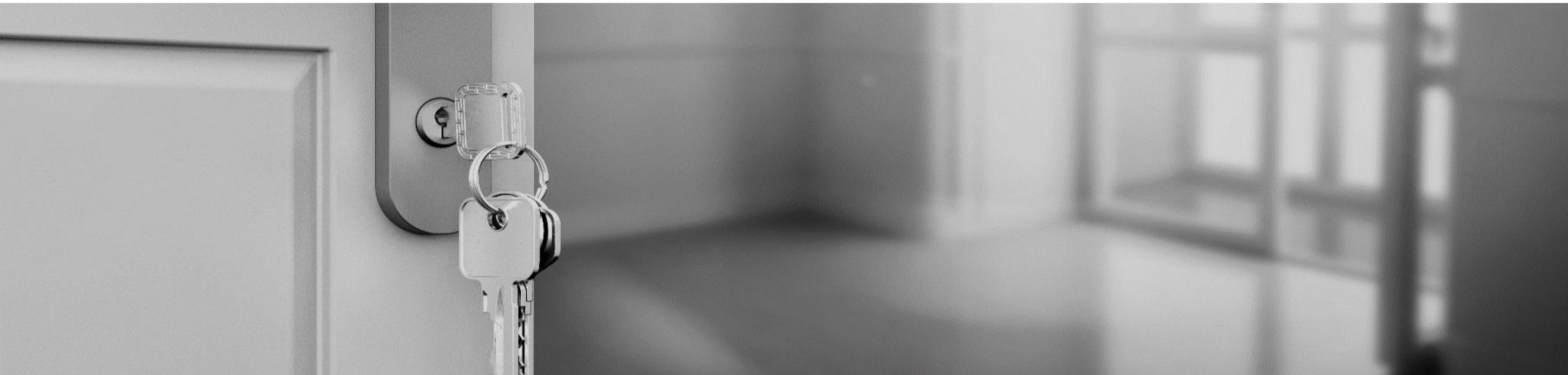

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Summary

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

Housing market overview

The housing market continues to evolve in line with our forecast for a 15% peak-to-trough decline in prices, with the August data suggesting we're about two thirds of the way through that. From a fundamentals perspective, we don't see any good reasons why the housing market might suddenly turn a corner over the coming months. Mortgage rates are still lifting, housing scarcity has been greatly eroded, and affordability remains dire (albeit a little better). Importantly, if the market does put out any green shoots while the labour market remains too tight and CPI inflation too high, the OCR (and mortgage rates) will very likely need to go higher than otherwise. And for households with a high debt-to-income ratio, that would be particularly bad news. But the RBNZ has to tame inflation, and if tightening isn't working as quickly as needed, they will do more until they get the balance right. We've recently lifted our expectation for how high the OCR will need to go. See our Market Overview.

Mortgage borrowing strategy

Fixed mortgage rates have either increased or stayed the same since our last edition of the Property Focus. The biggest change has come in the 1-year part of the curve, with most banks unwinding earlier cuts as sharp rises in wholesale interest rates made those specials unsustainable. Although this turnaround has taken the average 1-year fixed rate to a fresh high for the cycle, 3 to 5-year rates are unchanged or slightly lower, reducing the step-up to fix for longer. We have recently upgraded our OCR forecasts and now expect more RBNZ hikes. Global interest rate markets have also become much more volatile, and sovereign bond yields continue to trend higher across the world. Upside risks around inflation in turn speak to the odds of more OCR hikes, and also imply limited scope for the OCR to fall even if the economy sours. Floating rates have not changed, but for most banks, this is the most expensive rate on offer. See our Mortgage Borrowing Strategy.

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Summary

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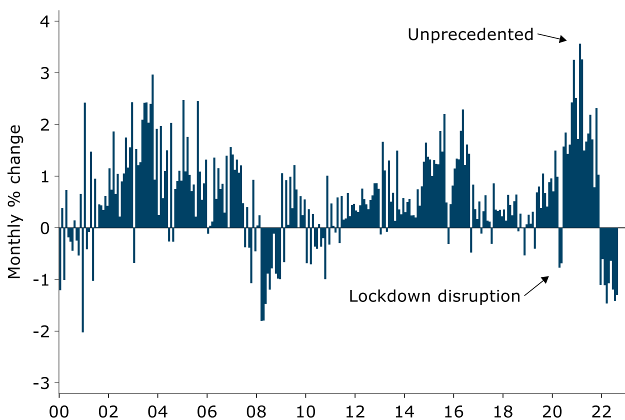
An orderly retreat, but still unaffordable

August's 1.3% m/m fall (ANZ seasonal adjustment) in the REINZ House Price Index (HPI) saw this measure of house prices 9.5% below its November 2021 peak. As figure 1 shows, prices have been slipping a little more than 1% per month on average since late last year. Our forecast is for monthly declines to continue at roughly this pace for the remainder of the year, before gradually finding a floor over the first half of 2023. All up, price declines to date leave prices about two thirds of the way through the 15% peak to trough decline we have pencilled in. That might sound drastic, but given the exceptionally high starting point, it's very much "soft landing" stuff.

Figure 1. Monthly house price inflation (sa)

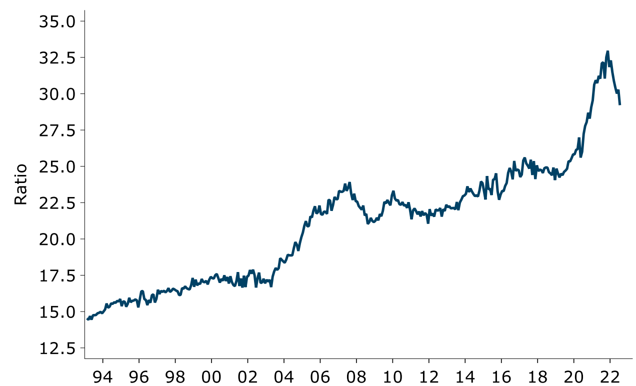


Source: REINZ, Macrobond, ANZ Research

Indeed, following the 45% house price surge in the wake of the pandemic, a 15% retracement is hardly a big correction. But it's important to note that while house prices are falling, other prices (not just CPI, but also rents and wages) are rising, further reducing the relative price of houses. So while the post-pandemic surge took the housing market to the next level in terms of unaffordability (typically defined as house prices relative to incomes and rents), affordability metrics are now improving from both sides of the ratio. The numerator (house prices) is doing more of the work, but a 7% increase in average hourly earnings isn't exactly chump change when it comes to improving the affordability of houses either.

Of course, there's a lot more to household income than just hourly wages, and it's a complicated dataset for Stats NZ to gather. Accordingly, we'll have to wait a while longer for the next proper read on household income. But rents data is pretty timely, and it shows that the house-price-to-rent ratio has fallen from a recent peak of just under 33 times annual rents to slightly above 29 times as at July 2022. That's still "stretched", but a considerable improvement – about a 12% improvement, in fact. Broadly, however, it would certainly be a push to look at current affordability indicators and conclude New Zealand housing is now affordable. It's just a little less dire.

Figure 2. Median sale price to annualised median rents

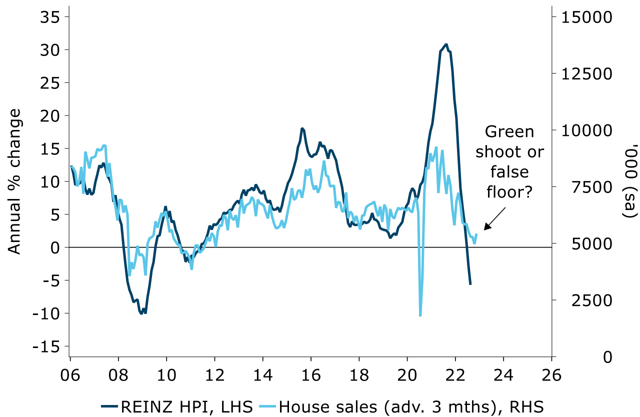


Source: REINZ, Macrobond, ANZ Research

Green shoots or false floor?

House price momentum remains southbound, and the number of days it is taking to sell a house is still increasing (up 2 in August to 46 – which is very much in cool-market territory). However, there was a sharp rise in seasonally adjusted sales in August, which made our ears prick up a little. That's because sales tend to be a decent leading indicator for price momentum, and the 9.4% bounce in sales in August was solid. That said, as figure 3 (over) clearly shows, house sales can be volatile month-to-month, so it may prove to be little more than a blip. One data point certainly does not make (or in this case, break) a trend.

Figure 3. House prices vs house sales

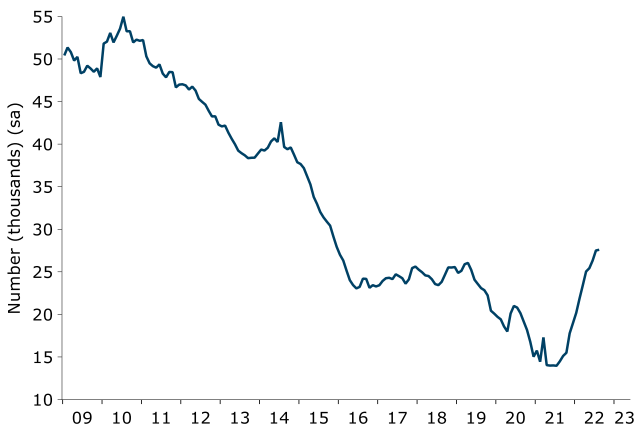


Source: REINZ, Macrobond, ANZ Research

Market fundamentals remain consistent with ongoing downwards price pressure:

- Based on our forecast for a peak OCR of 4.75%, mortgage rates are likely to continue rising (see our Mortgage Borrowing Strategy). And while household incomes are certainly growing at pace on the back of the exceptionally tight labour market, rising mortgage rates will be a drag for anyone looking to borrow (or currently indebted) – particularly at a reasonably high debt-to-income ratio (more on this later).
- The number of properties available for sale held steady at a 6-year high in August (figure 4), despite strong sales. Spring typically brings a surge in listings as well as sales. All else equal, relatively elevated inventories (if maintained) should limit how nutty the market is able to get when it does eventually find a floor.

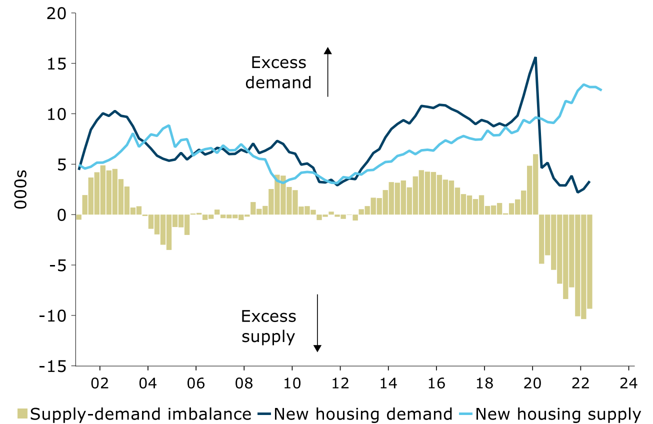
Figure 4. Number of properties available for sale



Source: Realestate.co.nz, Macrobond, ANZ Research

- New housing supply continues to play catch-up with new demand (figure 5), meaning the **"housing deficit" is rapidly eroding** – by our estimates to the tune of 65,000 houses since the border was closed. This is particularly the case in Auckland. The housing market may not always follow fundamental supply-demand imbalance in the short run, but it is a significant anchor for the longer-run picture, and it suggests limited scope for significant price rises when the mood does finally turn.

Figure 5. Housing supply-demand imbalance



Source: Stats NZ, Macrobond, ANZ Research

But broadly, **it's** this **"mood" that** we need to keep an eye on, as it will likely have a lot to say over the **coming months. We've spoken about the animal spirits** component of housing outcomes many times before, highlighting that FOMO (fear of missing out) and FOOP (fear of overpaying) are merely characterisations of the extremes of this. And with recent anecdote suggesting buyer interest has been picking up lately in some regions (from very low levels), the strong lift in house sales in August may well represent a portion of buyers who think this is a good time to get ahead of the market before it tightens again over summer.

But just because buyer interest picked up a little early **this year, that doesn't necessarily mean the** overall market is tightening. As mentioned, listings also tend to rise over the spring, meaning the true test for the market still lies ahead. Higher trading volumes over spring and summer will certainly hasten the pace at which the market clearing price is discovered, but at **this stage we're not** at all convinced this is pointing to a change in direction. But we are watching very closely for green shoots that might suggest to the Reserve Bank that more broad-spectrum herbicide is required.

Further mortgage rate increases to maintain downwards pressure on prices

As we've been outlining for a while now, it's hard to get too optimistic on the housing outlook when broad economic conditions are such that CPI inflation is way too high, and the RBNZ needs to do everything within its power to guide the economy towards a more sustainable trajectory. Indeed, a persistently

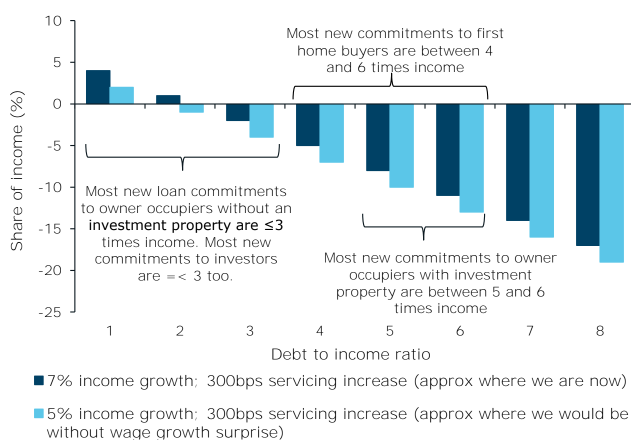
overstretched labour market and too-high core inflation pressures represent a significant upside risk to the OCR. That is, while strong wage/income growth means households might be able to afford a higher-than-otherwise mortgage payment, all else equal, the OCR will need to more than keep pace to ensure households are squeezed enough for monetary tightening to get traction. In other words, the OCR will go as high as it needs to go to get the job done. The hard part is gauging the likely net impacts of rate hikes, as the situation will vary significantly from household to household.

To illustrate that point, figure 6 provides a couple of scenarios showing how a household's debt servicing burden might change after household income growth has been subtracted from the impact of rising interest rates (we don't examine here the impact of other cost of living pressures, such as high CPI inflation). What the scenarios really demonstrates is that the potency of monetary tightening on an individual household is very much dependent on their-debt to-income (DTI) ratio, and how fast their income is growing.

We examine the impact of a 300 basis point increase to a household's debt-servicing cost. That is very roughly how much things changed (in aggregate) a year on from when fixed mortgage rates troughed in mid-2021. Then we have two income growth scenarios:

- Income lifts 5%. That is roughly our mid-2021 expectation of where we thought income growth would sit over the following year.
- Income lifts 7%. That is roughly what actually happened over the year to June 2022.

Figure 6. Change in income-adjusted debt servicing cost



Source: ANZ Research

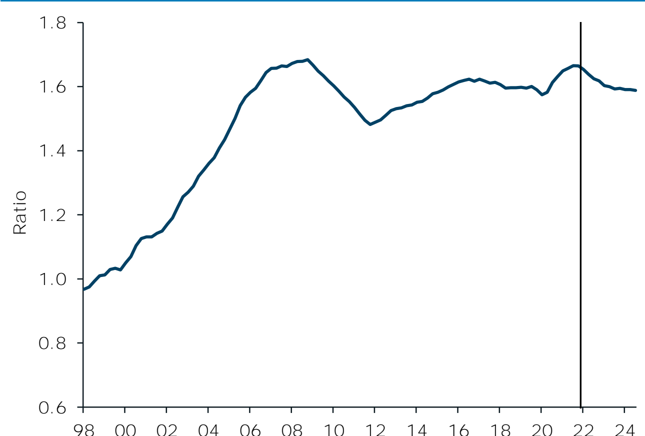
The results are very intuitive. Households with a debt to income (DTI) ratio of 1 or below will still be better off in net terms when income is growing faster than their debt servicing burden (abstracting from other living costs). A household with a DTI of 2 will stand still when income grows at exactly double the pace their debt-servicing burden does. A ratio of 3 requires triple-pace income growth to hold steady, and so on. It's a linear relationship and it's simple to calculate any combination. For example, a recent first-home buyer with a DTI of 6, a 300bp increase to their servicing burden over the past year, and income growth of 7% will experience more than a 10% erosion of their net income from higher debt-servicing costs.

Figure 6 provides two key insights:

1. For households with a debt-to-income ratio of 2, the recent upside surprise on wage growth (7% vs 5%) is the difference between a household being squeezed or not in a net sense through the mortgage servicing channel. At a DTI ratio of 3 or higher, the change in servicing costs more than offsets income growth.
2. High-DTI ratio households are very unlikely to be able to hide from rising rates, and will therefore bear the brunt of monetary tightening. But even within this group, income growth will have been highly variable, with the squeeze also therefore unevenly distributed.

NZ-wide (ie using aggregated data), household debt relative to income is currently just under 1.7 times (figure 7). Plugging in our expectation for household credit growth and household income growth suggests the ratio will slip slightly to around 1.6 times over the next year or two.[1]

Figure 7. NZ-wide debt to income ratio



Source: Stats NZ, RBNZ, ANZ Research

[1] We assume household net disposable income grows 6% y/y on average, with household credit growth averaging around 4% y/y (on the back of the slowing housing market).

Housing market overview

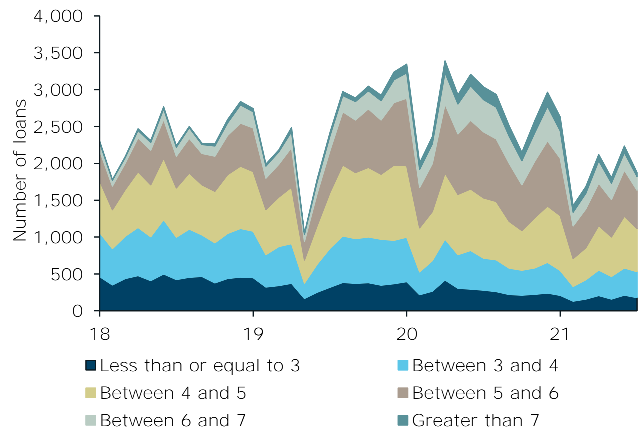
At 1.7 times, the aggregated DTI ratio suggests income growth at around 7% combined with a 300 basis point increase in the servicing burden over the past year hasn't been net drag on the overall household sector. But that's not to say monetary tightening isn't working. Monetary tightening has certainly been a net drag for some households, and higher rates are at least a partial offset to income growth for anyone with a mortgage, while also imposing a larger cost on new borrowers than previously. And there are other channels too, such as encouraging households to save more than otherwise (ie consume less). But what is clear, is that monetary tightening is having less impact than if income growth had come in at a still-solid 5%. And the small positive offset from stronger wage growth (not to mention strong job security) could make a big difference at a psychological level if it means the difference between keeping up with a rising debt servicing burden or not. The latter scenario would likely see a sharper pace of belt tightening, and if that's what the RBNZ need to see, then this is a good argument to front-load OCR hikes (ie get in before wage growth erodes the potency).

But importantly, the aggregated data hides the uneven nature of monetary tightening: it'll always be households with high debt-to-income ratios that feel the sting of monetary tightening, and unfortunately after an episode of such rapid house price inflation, that's likely to put recent first-home buyers under pressure.

The RBNZ publishes DTI data for new mortgage commitments, and while things move around a bit, new loan commitments to first-home buyers are most likely to be at a DTI ratio between 4 and 6, with a relatively small share above 6 times. However, as figure 8 shows, there was some increase in the number of loans at a DTI ratio above 6 when the housing market started taking off like a rocket in 2020. Given the relatively short time frame for these households to chip away at principal, that suggests there will be a lot of interest rate pain being felt for some. The other published borrower categories are:

- New loan commitments to owner occupiers that also have an investment property (most common DTI is 5 to 6 times).
- New loan commitments to owner occupiers that do not have an investment property (3 or below is most common).
- New loan commitments to investors (3 or below is also most common).

Figure 8. Debt-to-income ratio for new commitments to first-home buyers



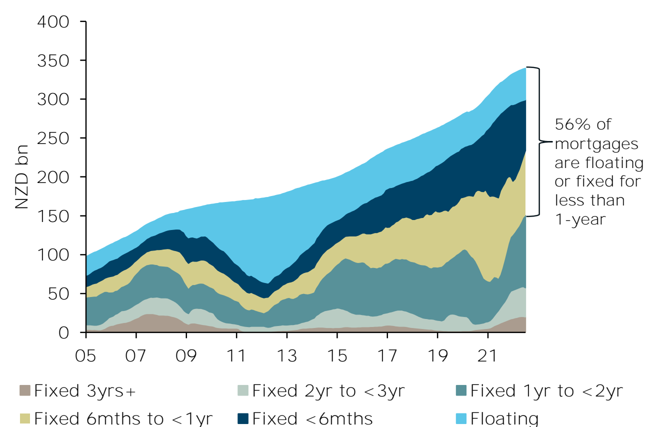
Source: RBNZ, ANZ research

So what does it all mean for getting monetary policy settings just right (ie not too painful, but packing enough punch to slow the aggregate inflation impulse?). This is actually a much harder question to answer than it first appears.

First, the RBNZ doesn't actually need to target a net-worse-off situation for the "*average*" household. They need to target the *marginal* household that tips the broader balance between economic supply and demand. But unfortunately, the degree of unmeasurable variables required to make this calculation means there will always be a bit of a feel-your-way approach required:

- Past and future fixing behaviour matters, as this will affect the (variable) lags with which higher rates bite (figure 9).

Figure 9. Residential mortgages by fixed term



Source: RBNZ, ANZ research

Housing market overview

- Income growth can vary a lot by region, sector, skill level and experience.
- Every household will have a different share of discretionary spending in their budget (things you can cut back on), depending on both income level and household structure (eg having children may increase the non-discretionary share).
- The economic backdrop also matters. Households might be going backwards in a real net income sense (ie after inflation and higher debt-servicing burdens), but if they feel this is temporary, that they are still saving by paying down debt, and that they have high job security, they may behave very differently than the counterfactual. That is, the same degree of policy tightening for the same economic outcomes may (for a time at least) yield different macroeconomic outturns, depending on the 'fear factor'.
- And let's not forget the fact that some households opted to maintain their mortgage payments as rates fell, meaning less adjustment and more wiggle room as rates rise.

So while the recent surge in house prices (and the debt burden that sits behind that) suggests some households will be feeling very uncomfortable as rates rise, it's not a guarantee that their financial squeeze will be enough to get the inflation-taming job done. And the more insulated households are to the impacts of rising interest rates, the more work the RBNZ will probably need to do in order to take the heat out of demand and inflation. It's not pretty, and it certainly isn't 'fair' across the DTI spectrum, but the alternative of letting high inflation get entrenched is much worse. Our updated, higher OCR forecast is based heavily on this premise: high income growth is a partial but significant offset to the monetary tightening delivered so far. To our minds, that rates outlook keeps our forecast for a 15% peak to trough decline in house prices firmly in play, despite some recent evidence of potentially premature green shoots.

Housing market indicators for August 2022 (based on REINZ data seasonally adjusted by ANZ Research)

	Median house price			House price index		# of monthly sales	Monthly % change	Average days to sell
	Level	Annual % change	3-mth % change	Annual % change	3-mth % change			
Northland	$680,807	-1.1	-5.5	7.8	-1.5	154	+3%	53
Auckland	$1,114,484	-8.2	-1.7	-9.5	-4.3	1,640	+7%	47
Waikato	$787,479	0.1	-1.3	1.2	-2.1	483	+5%	46
Bay of Plenty	$920,001	6.6	-0.2	-2.9	-3.6	347	+5%	57
Gisborne	$615,961	14.5	-6.5	-7.6	-3.5	41	-4%	43
Hawke's Bay	$720,329	1.1	-4.6	-7.6	-3.5	200	+17%	56
Manawatu-Whanganui	$576,250	-6.3	-2.6	-7.8	-4.0	244	+8%	56
Taranaki	$647,681	12.6	-1.0	6.1	-1.0	161	+14%	41
Wellington	$817,605	-8.7	-6.9	-17.0	-6.4	560	+1%	58
Tasman, Nelson & Marlborough	$753,303	1.9	-0.7			167	-5%	51
Canterbury	$663,327	4.7	-0.6	6.0	-1.3	826	+3%	35
Otago	$704,911	1.8	2.5	0.3	-1.6	371	+9%	52
West Coast	$342,183	25.8	-6.9	0.6	-2.8	36	+31%	39
Southland	$448,383	10.0	-1.0	5.5	-1.6	129	+1%	39
New Zealand	**$815,870**	**-5.9**	**-2.8**	**-5.7**	**-3.3**	**5,430**	**+9%**	**46**

Mortgage borrowing strategy

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Summary

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The biggest changes seen in the mortgage market over the last month have been the rebound in 6-month to 4-year fixed rates, which are generally higher. Floating rates are unchanged, but the average 1-year rate now stands at 5.38%, which is a new high for the cycle.

That isn't much higher than where we recorded it in July (on average across the big-4 banks), but as noted, it is a new high. It comes after an offshore-led breather in wholesale rates saw mortgage rates drop for a time, as markets contemplated global recession risks and concluded that central banks accordingly might 'blink' and stop hiking policy rates.

However, inflation has proven to be stickier than many expected, and central banks across the global have made it clear that they will be guided by where inflation is heading, rather than where growth is heading. Among other things, that suggests that policy rates will remain elevated, even if growth slows.

Acknowledging increased inflation risks, we lifted our OCR forecast earlier in September, adding a further three 25bp hikes to our forecasts. We now expect the OCR to peak at 4.75% in mid-2023. If we are right, it is likely that many shorter-term fixed rates will start to push above 6%, which is clearly higher than where they are now. Of course, inflation may decline more quickly, making these extra hikes unnecessary. But even having upgraded our OCR forecasts, there are risks to the upside too. For example, the lower NZD exchange rate is making imported goods and services more expensive, and our exports more competitive.

And another risk to mortgage rates is what's happening offshore, with sovereign bond yields and credit spreads widening as markets push back on spendthrift government spending plans, and as global bond markets react to the unwind of COVID-era quantitative easing programmes. Although this movement started in the UK (where 10-year government bond yields have surged from 2¾% at the end of August to around 4½% as we go to print), the ripple effects have been (and are likely to continue to be) felt in New Zealand.

Given the risks around inflation, the ominous global interest rate backdrop and the now-lower step-up from a 1-year fixed rate (typically the cheapest) to longer fixed rates out to around 3 years, we think it makes sense to at least consider fixing a portion of debt for longer. Fixing for 4 or 5 years may also appeal, but in some cases, those rates are much less attractive as banks compete more aggressively in the 1 to 3-year part of the curve.

Regular readers will be familiar with break-evens. Right now, they show that the 1-year rate only needs to rise to 5.90% in a year's time before it'd end up being cheaper being fixed for 2 years at 5.64%. Yet if we are right and the OCR needs to go to 4.75% (or beyond), it's easy to envisage the 1-year going above 6%. The step-up to 3 years is also pretty small (at 5.81% vs 5.38% and 5.64% for 1 and 2-years respectively). The extra certainty longer fixes offer may appeal to some borrowers, especially if those rates are still affordable, and capacity to withstand a surprise upward jump in interest rates is limited.

Figure 1. Carded special mortgage rates^

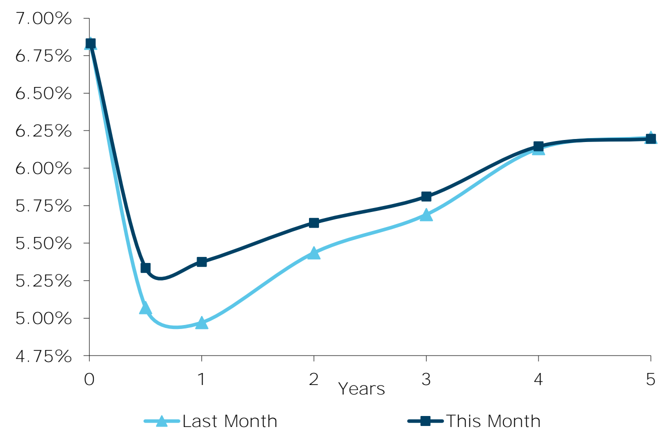

Table 1. Special Mortgage Rates

		Breakevens for 20%+ equity borrowers			
Term	Current	in 6mths	in 1yr	in 18mths	in 2 yrs
Floating	6.83%				
6 months	5.34%	5.42%	6.01%	5.79%	6.07%
1 year	5.38%	5.71%	5.90%	5.93%	6.16%
2 years	5.64%	5.82%	6.03%	6.27%	6.66%
3 years	5.81%	6.08%	6.40%	6.46%	6.57%
4 years	6.15%	6.27%	6.40%		
5 years	6.20%	#Average of "big four" banks			

^ Average of carded rates from ANZ, ASB, BNZ and Westpac.

Source: interest.co.nz, ANZ Research

Key forecasts

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

Mortgage Size ($000)	4.50	4.75	5.00	5.25	5.50	5.75	6.00	6.25	6.50	6.75	7.00	7.25	7.50	7.75
	Mortgage Rate (%)													
200	256	263	270	276	283	290	297	304	311	319	326	333	341	348
250	320	329	337	345	354	363	371	380	389	398	407	417	426	435
300	385	394	404	415	425	435	446	456	467	478	489	500	511	522
350	449	460	472	484	496	508	520	532	545	558	570	583	596	610
400	513	526	539	553	566	580	594	608	623	637	652	667	682	697
450	577	592	607	622	637	653	669	684	701	717	733	750	767	784
500	641	657	674	691	708	725	743	761	778	797	815	833	852	871
550	705	723	741	760	779	798	817	837	856	876	896	917	937	958
600	769	789	809	829	850	870	891	913	934	956	978	1,000	1,022	1,045
650	833	854	876	898	920	943	966	989	1,012	1,036	1,059	1,083	1,108	1,132
700	897	920	944	967	991	1,015	1,040	1,065	1,090	1,115	1,141	1,167	1,193	1,219
750	961	986	1,011	1,036	1,062	1,088	1,114	1,141	1,168	1,195	1,222	1,250	1,278	1,306
800	1,025	1,052	1,078	1,105	1,133	1,160	1,188	1,217	1,246	1,274	1,304	1,333	1,363	1,393
850	1,089	1,117	1,146	1,174	1,204	1,233	1,263	1,293	1,323	1,354	1,385	1,417	1,448	1,480
900	1,154	1,183	1,213	1,244	1,274	1,306	1,337	1,369	1,401	1,434	1,467	1,500	1,534	1,567
950	1,218	1,249	1,281	1,313	1,345	1,378	1,411	1,445	1,479	1,513	1,548	1,583	1,619	1,655
1000	1,282	1,315	1,348	1,382	1,416	1,451	1,486	1,521	1,557	1,593	1,630	1,667	1,704	1,742

Mortgage rate projections (historic rates are special rates; projections based on ANZ's wholesale rate forecasts)

	Actual			Projections						
Interest rates	Dec-21	Mar-22	Jun-22	Sep-22	Dec-22	Mar-23	Jun-23	Sep-23	Dec-23	Mar-24
Floating Mortgage Rate	4.9	5.1	5.9	6.8	7.9	8.2	8.7	8.7	8.7	8.7
1-Yr Fixed Mortgage Rate	3.6	3.9	5.1	5.4	5.9	6.2	6.2	6.2	6.2	6.2
2-Yr Fixed Mortgage Rate	4.3	4.5	5.6	5.6	6.1	6.5	6.5	6.5	6.5	6.4
5-Yr Fixed Mortgage Rate	4.9	5.1	6.3	6.2	6.7	7.1	7.1	7.1	7.1	6.9

Source: RBNZ, ANZ Research

Economic forecasts

	Actual			Forecasts						
Economic indicators	Dec-21	Mar-22	Jun-22	Sep-22	Dec-22	Mar-23	Jun-23	Sep-23	Dec-23	Mar-24
GDP (Annual % Chg)	3.0	1.0	0.4	5.0	2.1	2.6	1.6	1.4	1.4	1.4
CPI Inflation (Annual % Chg)	5.9	6.9	7.3	6.7	6.1	5.0	3.9	3.1	2.5	2.3
Unemployment Rate (%)	3.2	3.2	3.3	3.3	3.4	3.4	3.6	4.0	4.5	4.8
House Prices (Quarter % Chg)	3.8	-2.2	-3.2	-3.6	-3.1	-2.2	-0.9	0.1	0.2	0.4
House Prices (Annual % Chg)	26.2	14.1	3.5	-5.4	-11.6	-11.6	-9.4	-5.9	-2.7	-0.1

Interest rates	Dec-21	Mar-22	Jun-22	Sep-22	Dec-22	Mar-23	Jun-23	Sep-23	Dec-23	Mar-24
Official Cash Rate	0.75	1.00	2.00	3.00	4.00	4.25	4.75	4.75	4.75	4.75
90-Day Bank Bill Rate	0.97	1.61	2.86	3.81	4.27	4.77	4.85	4.85	4.85	4.85
10-Year Bond	2.39	3.22	3.86	4.29	4.50	4.75	4.75	4.75	4.75	4.50

Source: ANZ Research, Statistics NZ, RBNZ, REINZ

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