Economic Weekly

06 April 2021

Housing policies bring modest forecast tweaks

We have crunched the numbers in the wake of the Government's recent housing policy announcement. Perhaps it won't be too much of a surprise that we have essentially flat-lined our house price outlook for the rest of 2021, made slight trims to our consumer spending and construction forecasts, and nudged up our rent outlook. Aside from the house price changes, the shifts aren't dramatic – you can read more on the next page.

Much of NZ's housing challenges lie with the high cost and sluggish response of NZ's housing supply. We simply haven't been building enough homes to adequately house our population. Key long-term solutions lie with improving that supply response, particularly successful RMA replacement. Anything that speeds up the planning/construction phases and provides greater certainty of time and cost to those taking the risk of developing will help. As we have seen with KiwiBuild, it is not that easy to build homes. The Government is working hard on policies to permanently improve the supply response, but it will take time for those efforts to impact.

Meanwhile, we run the risk of a housing whack-a-mole game. To whack the house price 'mole' in the interim, the Government has materially increased the cost structure of private-sector landlords – collectively the biggest rental provider – through eliminating the tax deductibility of interest expenses. As we pointed out in our Note, private-sector investor appetite to hold rental property is likely to fall and rents are at risk of going up – at a time when rental properties are in hot demand and social housing waiting lists are growing. As yet there is no official advice on the rental market impact of the policy change, though the actual impacts will become clearer with time.

The next housing 'mole' that is popping up is rents: the new class of property 'speculator' is people musing about rent controls. Rent controls do give a benefit to the incumbent renters (regardless of their financial circumstances) of properties brought into the rent control web. But pretty much everyone else bears costs. Future would-be renters tend to face shortages of (rent-controlled) properties, as few incumbents want to give up their windfall gain and private landlords shy away from providing rental stock. Properties tend to either be undermaintained (New York's post-war experience) or can be over-renovated in order to boost the rent if such adjustments are permitted (which impacts rental affordability). Berlin's year-old rent controls on pre-2014 dwellings have created a shortage of rent-controlled properties while sharply boosting the rents of exempt new builds, as new renters have little alternative. Stockholm has an average 11-year wait to officially rent a rent-controlled dwelling. A thriving black market has developed for sub-leases of rent-controlled dwellings, which has attracted criminal gang involvement and even sparked homicides. In summary, a policy that distributes the benefits irrespective of need, and potentially constricts rental housing supply in the midst of a housing shortage, may not help resolve NZ's problem of an expensive and undersupplied housing stock – for both would-be owners and renters.

Anyway, that's enough commentary on NZ's ongoing obsession. The rest of the week brings another insight into the durability of dairy prices' recent jump, and an early read on ANZ's business confidence survey. Across the ditch the Reserve Bank of Australia makes its latest policy pronouncement. nick.tuffley@asb.co.nz

Our forecast tweaks

Where the housing policy rubber hits the road for the economic outlook will mainly come down to:

- How house prices get affected;
- The flow-on impact on future construction;
- And how house price wealth impacts and shifts in housing completion affect consumer spending.

As our Note suggested, the price an investor would now be willing to pay to buy a typical property could drop by up around 30% if seeking the pre-existing after-tax cashflow. In reality, rents are likely to bear some of the adjustment and it is also probable that a return to pre-existing cashflows is unlikely. Nevertheless, the price an investor would now be willing to pay for a property will clearly be less. At the lower end of the market, where investors are most active, first-home buyers are now likely to be the group setting the price at the margin. But they will be doing that in a market that remains undersupplied.

For that reason, we expect house prices will still get a degree of support: from this month onwards, we expect house prices will be roughly flat through the middle half of 2021. That would still mean annual growth in 2021 of around 9-10%, compared to our view of 15% before the housing announcement. Beyond that we see 3-5% annual growth. Essentially, we expect the heat to sharply come out of the housing market over the next six months, rather than the gradual moderation we previously expected. Slight month-on-month price falls may be possible if investor demand changes abruptly over the next couple of months, much as happened last year after the initial lockdown was imposed.

The weak price signal for developers, plus uncertainty over whether/exactly how new builds will be exempt from the loss of interest expense deductibility, will be a drag on construction activity this year. We have pulled back our housing construction forecast by 8% (by the end of 2021). Yet the fundamental issue of needing new construction remains acute. We have also revised up our net migration forecast on the basis that trans-Tasman people movement will soon become freer. Our estimate is that the housing shortage will now be resolved more gradually, reinforcing that lack of supply will continue to give house prices some degree of support.

Since we emerged blinking last year from our bunkers into the post-lockdown sunshine, we have channelled spending into some form of nesting while we contemplated that we could be spending a lot more time in our homes and within NZ. Part of that spending has been driven by those buying their first home, upgrading to a larger home, buying holiday houses (and, yes, more rental properties). The pace of housing turnover and construction influences durable goods spending, as does the feel-good wealth factor of rising house prices. A quicker cooling of these drivers will take the edge of what was already set to be a pretty muted consumer spending outlook.

And what of those rents? These latest changes simply reinforce that rents will continue to go up – just faster now. Property investors on a 33% marginal tax rate will effectively face a 50% increase in the debt servicing costs. It is inevitable that some landlords will attempt to pass some of that cost on. We have factored in an extra 15% in rents through to mid-2025 that will add roughly 0.3 percentage points to annual CPI inflation.

All up, the steam is set to come out of the housing market, but it unlikely to resemble a deflated soufflé given other underlying factors. The housing measures announced are mainly intended to curb housing demand, but with that comes some flow-on effect to broader economic demand.

The risks are that the RBNZ doesn't lift the OCR as early as the August 2022 start date we have pencilled in. But there is a lot of water yet to flow under the bridge, including the potential for the border closure to be pried open a crack before too much longer. Any developments that prompt a greater flow of people into NZ and greater freedom of moment within countries that have continued to resort to restrictions will all bring global economic recovery closer.

Foreign Exchange Market

FX Rates	Current*	Week ago	Month ago	Year ago	ST Bias	Support^	Resistance^
NZD/USD	0.7058	0.7023	0.7169	0.5873	FLAT/UP	0.6940	0.7300
NZD/AUD	0.9224	0.9178	0.9298	0.9761	DOWN	0.9120	0.9280
NZD/JPY	77.76	77.22	77.44	63.96	FLAT/UP	76.20	79.20
NZD/EUR	0.5975	0.5970	0.5994	0.5429	FLAT	0.5890	0.6130
NZD/GBP	0.5076	0.5098	0.5159	0.4801	FLAT	0.5040	0.5205
TWI	74.5	73.9	74.7	67.78	FLAT/UP	N/A	N/A

*^ Weekly support and resistance levels * Current as at 9.30am today; week ago as at Monday 5pm*

NZD Recap and Outlook

After its losses a fortnight ago, the NZD continued to trade in a lower range last week. While the NZD edged upward slightly against most of its peers over the week, it remained well south of its levels in much of March and changes were relatively muted. The NZD/USD has begun the week pushing just north of 0.7000 again. NZD/USD direction continues to be heavily impacted by the two themes we highlighted last week.

Most obviously, the government's housing policy changes are continuing to play a substantial role in the direction of the NZD. Markets continue to take the view that the government's housing policy changes will somewhat lessen house price inflation, reducing the urgency of any tightening in monetary policy and pushing back the likely timing of the RBNZ's first post-COVID rate hike. We still have August 2022 pencilled in as our prediction for the first move in the OCR, but the risk of a later move is now heightened, signalling reduced interest rate support for the NZD.

Second, recent USD strength remained in force. The trend hasn't just been evident in the NZD/USD, with the AUD/USD, EUR/USD and GBP/USD all finished the month trading in a lower range than at the beginning. The US vaccine rollout is well underway, and economic data out on Friday continued to confirm the US recovery is proceeding at pace, with non-farm payrolls surprising on the upside. While stronger growth prospects would normally be a detriment for a counter-cyclical currency like the USD, the divergence between the growth outlook in the US and the rest of the world is supporting the greenback. The contrast is particularly marked in Europe, where growth forecasts have actually been cut, and controversy over the slow vaccine rollout is escalating.

Still, we emphasise that the broader fundamentals remain supportive of the NZD. Commodity prices remain strong. The *ASB Commodities Index* – an index of commodities weighted by share of NZ's exports – is nudging highs not seen since 2014 in SDR terms. We'll get another clue on the direction of commodity prices after the next GlobalDairyTrade auction, on Wednesday morning. After two very strong auctions, we suspect more easing is on the cards, but prices should remain well supported, limiting any currency impact.

The most pertinent event his week is today's RBA meeting. Our CBA colleagues expect the bank to leave policy settings unchanged and stick to its dovish tone. Fed meeting minutes are also out in the US on Thursday, though they are likely to generate few headlines, merely confirming the recent line that most Fed members expect a short-term uptick in inflation but doubt it will be sustained Nathaniel.keall@asb.co.nz

ASB foreign exchange forecasts	Dec-20	Mar-21	Jun-21	Sep-21	Dec-21	Mar-22	Mar-23
(end of quarter)	<< actual	forecast >>					
NZD/USD	0.72	0.72	0.73	0.74	0.74	0.74	0.73
NZD/AUD	0.94	0.95	0.91	0.89	0.91	0.94	0.95
NZD/JPY	75	78	80	83	84	85	88
NZD/EUR	0.59	0.59	0.59	0.59	0.58	0.57	0.54
NZD/GBP	0.53	0.51	0.51	0.51	0.51	0.50	0.48
NZD/CNY	4.7	4.6	4.7	4.7	4.7	4.7	4.5
NZD TWI	75.1	75.1	75.2	75.4	75.5	75.5	74.6

Interest Rate Market

Wholesale interest rates	Current	Week ago	Month ago	Year ago	ST Bias	MT Bias
Cash rate	0.25	0.25	0.25	0.25	UNCH	UP
90-day bank bill	0.34	0.35	0.32	0.47	UNCH	UP
2-year swap	0.44	0.47	0.56	0.48	UNCH	UP
5-year swap	1.10	1.10	1.27	0.60	UNCH	UP
10-year swap	1.93	1.92	2.07	0.93	UNCH	UP
10-year govt bond yield	1.82	1.76	1.93	1.03	UNCH	UP
Curve Slope (2s10s swaps)	1.49	1.45	1.51	0.45	UNCH	DOWN

** Current as at 9.30am today; week ago as at Monday 5pm. Key UNCH = Broadly unchanged*

Market Recap

Local and global yields have remained volatile over the past week. Higher short-term and broadly unchanged longer-term US and Australian yields contrasted with continued curve steepening of NZ yields. There was little market reaction to local data, with the move in local yields responding to the March 23 announcement on housing by the NZ Government. During last week longer-term local and global yields had pushed higher on improving economic optimism, given the strong pace of vaccine rollouts in the US and UK and on the USD2.25tr infrastructure package proposed by President Biden. US economic data (US non-farm payrolls (+916k) and the manufacturing ISM (64.7) topped market expectations and helped push the S&P500 to fresh record highs. US 10-year Treasury yields touched 14-month highs (1.77%) last week but fell to 1.70% at the start of this week, with markets more confident that strong momentum could be maintained without economic overheating. NZ longer-term yields held onto gains from last week, despite $430m of RBNZ purchases.

Near-term interest rate outlook

We expect continued volatility in local rates market, with our near-term bias for a mild retracement in longer-term local yields given the moves offshore. The move up in longer-term yields have been massive - up around 80bps since the start of the year for US, Australian and NZ 10-year yields – and a period of consolidation may be looming as markets assess whether the moves have been justified. The low NZ bond issuance profile by NZDM this week ($300m) has remained comfortably below the $430m weekly LSAP programme, and should dampen bond yields at the margin.

The direction of interest rates over the next few months will depend on how quickly economic life can return to pre-COVID-19 norms. Today's announcement by PM Ardern on the timetable for a trans-Tasman bubble will have a bearing on how quickly short-term yields will move up. However, we expect the tone from central banks – including the RBA (today) and the RBNZ (next Wednesday) – to be one in which they will justify the need for ultra-low interest rates. We expect that RBA Governor Lowe will reaffirm the RBA will not hike the cash rate until 2024 at the earliest, with the RBA to continue to pin the 3-year 0.1% target to the April 2024 bond. We expect little market reaction from the FOMC meeting minutes or Chinese inflation data this week.

Medium-term outlook

We expect the RBNZ to continue to trim LSAP programme and to halt purchases altogether from 2022, prior to raising the OCR from August 2022 - with risks of a slightly later start to RBNZ tightening. The OCR is expected to reach 1.25% in March 2024, slightly below neutral levels. Our bias is for shorter-term yields to edge up over the next few years and for the yield curve to flatten, with longer-term NZ yields to peak at historically-low levels. mark.smith4@asb.co.nz

ASB interest rate forecasts	Dec-20	Mar-21	Jun-21	Sep-21	Dec-21	Mar-22	Mar-23
(end of quarter)	<<actual	forecast >>					
NZ OCR	0.25	0.25	0.25	0.25	0.25	0.25	0.75
NZ 90-day bank bill	0.27	0.30	0.30	0.30	0.30	0.35	0.90
NZ 2-year swap rate	0.28	0.40	0.50	0.60	0.70	0.80	1.20
NZ 5-year swap rate	0.54	1.00	1.10	1.20	1.30	1.40	1.80
NZ 10-year swap rate	0.98	1.80	1.85	1.90	1.95	2.00	2.20
NZ 10-year Bond	0.99	1.65	1.70	1.75	1.80	1.85	2.05

Major International Events for the week ahead

Data	Date	Time (NZT)	ASB
RBA Interest Rate Announcement	06/04	4:30 pm	-
US Federal Reserve Meeting Minutes	08/04	9:00 pm	-
RBA Financial Stability Review	09/04	4:30 pm	-
China CPI, March, %yoy	09/04	4:30 pm	0.4

** Forecasts and commentary originally published by CBA Global Markets Research Thursday 1 April at 5:25 pm*

There were extensive communications from the Reserve Bank of Australia (RBA) in March pushing back against the idea of any premature policy tightening. The RBA made it clear it does not think economic conditions will warrant a lift in the cash rate until 2024 at the earliest. The RBA believes wages growth will need to be at least 3% before actual inflation will sustainably return to the 2-3% target and this will require a material tightening in the labour market. They may be wrong of course and wages and inflation pressures may lift before they anticipate. The labour market did tighten after the March Board meeting with the unemployment rate falling from 6.3% to 5.8% in February. Uncertainty around the end of JobKeeper and the lockdown in Brisbane will be enough for the RBA to maintain its dovish position. The other piece of detail worth watching this month will be any further commentary about the 3-year yield target. The RBA will need to decide in coming months if it will continue to target the April 2024 bond or switch to the November 2024 bond. We expect the RBA to keep the target pegged to the April 2024 bond.

Australia's semi-annual Financial Stability Review will be released Friday. The RBA is expected to outline its view of Australia's financial system and the risks associated with this. The most attention will likely be on the household sector and the view on recent lifts in new lending for housing and prospects for macro-prudential measures. At this stage we think these are unlikely to be implemented this year as the stock of housing credit is lifting only modestly.

We expect **China's CPI** rebounded to 0.4%yoy after contracting for the previous two months. Nevertheless, base effects will keep inflation muted on an annual basis because of the surge in prices (particularly food prices) in early 2020. We expect PPI inflation increased to 3.3%yoy in March. Fading base effects, the global roll-out of vaccines, large savings buffers and US fiscal stimulus are expected to underpin PPI inflation over the coming few months.

The **US Federal Reserve's meeting minutes** are unlikely to unveil any new information. Nevertheless, market participants will no doubt pay close attention to the Committee's discussions around the inflation outlook. We expect the minutes to confirm that policy makers expect a short-term rise in inflation, but that sustained inflation increases remain some way off.

Key Forecasts

ASB NZ economic forecasts	Dec-20	Mar-21	Jun-21	Sep-21	Dec-21	Mar-22	Mar-23
	<< actual	forecast >>					
GDP real - Q%	-1.0	-0.2	1.1	1.0	-0.8	-0.6	0.5
GDP real - A%	-0.9	0.2	13.8	0.9	1.2	0.7	4.5
GDP real - AA%	-3.0	-3.0	3.0	3.2	3.7	3.9	2.7
NZ House Prices (QV Index) - A%	14.9	20.0	20.2	15.7	9.4	2.6	5.3
CPI - Q%	0.5	1.0	0.6	0.5	0.4	0.5	0.7
CPI - A%	1.4	1.6	2.7	2.5	2.5	2.0	2.5
HLFS employment growth - Q%	0.6	-0.1	0.1	0.3	0.3	0.4	0.5
HLFS employment growth - A%	0.7	-0.4	-0.1	1.0	0.6	1.1	2.0
Unemployment rate - %sa	4.9	4.9	5.1	5.3	5.4	5.3	4.7

Q% = percentage change on previous quarter
A% = percentage change since same quarter the previous year
AA% = percentage change for year ending quarter since the previous year

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NZ 10-year swap rate	0.98	1.80	1.85	1.90	1.95	2.00	2.20
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