Home Economics

August 2021

Upcycling

- We've upped the amount of 'cycle' in our house price inflation forecasts: more this year, less next.
- The recent COVID outbreak means a chunk of activity will get postponed, rather than cancelled. But we don't think this will have a lasting impact on the house price outlook, assuming the lockdown is brief.
- Higher mortgage rates are a gamechanger. But most of the house price impact will occur next year. We haven't materially changed our mortgage rate forecasts despite the RBNZ's August pause.

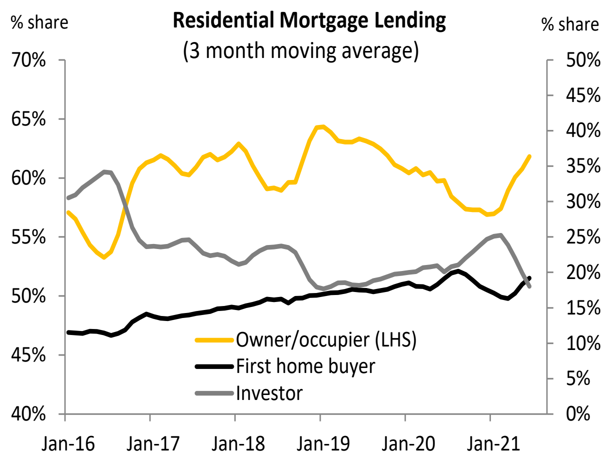
Welcome to Home Economics, our regular wrap on all things NZ housing. If you're interested in signing up for future publications, you can do so here.

Our view

We've lifted our house price inflation forecasts for this year and dropped them for next (forecast table below). A bit more 'cycle', in other words. The upwards revision for this year probably won't surprise and reflects still-tight demand/supply conditions, despite the policy-related speedbumps laid out this year. For next year, the coming together of three separate braking factors should flip momentum to the downside. Mortgage rates are expected to keep rising, the long-vaunted supply response will make an impact, and the RBNZ is standing by with extra 'macro-pru'. We've assumed minimal COVID impacts, at this stage. The lockdown means a chunk of activity will get postponed, but we don't think this will have a lasting impact on house prices, assuming the lockdown is brief.

Chart 'o' the Month

Owner-occupiers fill the investor void



Source: ASB, RBNZ

Forecasts

ASB House Price Forecasts (QV, annual % change)			
	Dec 2021	**Jun 2022**	**Dec 2022**
Auckland	16%	8%	2%
Christchurch	23%	11%	3%
Wellington	20%	6%	2%
Other Regions	23%	9%	3%
National	**22%**	**9%**	**3%**

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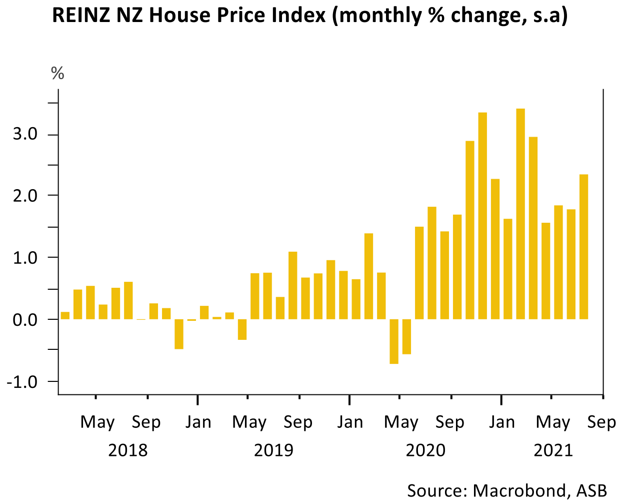
What happened to the slowdown?

What happened to the slowdown?

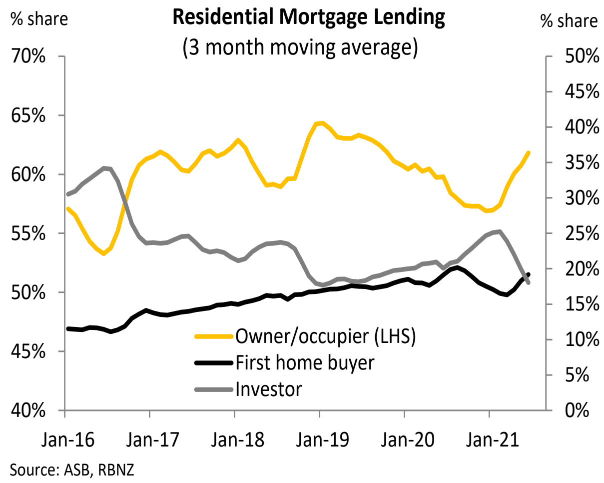
The first seven months of the year are gone and, despite all manner of predictions to the counter, we're yet to see any material slowdown in the housing market.

It's proven remarkably resilient to the various policy speedbumps laid out in front of it: LVR restrictions have been returned, and tightened for investors; mortgage rates have plateaued or lifted a little; house prices have been formally written into the Reserve Bank's remit, and the Government has rolled out a string of measures targeting more sustainable house prices, including the removal of tax deductibility for investors.



Having soared 18% in 2020, house prices have risen a further 16% in the first seven months of 2021 according to the REINZ House Price Index (HPI). For a while it looked as if things were starting to throttle back. The pace of monthly HPI increases slowed to around 1.5%/month in the three months to June, down from a heady 2.5%/month pace over summer. But, if anything, the market re-accelerated in July (chart above).

We've tended to lean against some of the more dire predictions for house price inflation this year, stressing the importance of the fundamentals at play. The market remains desperately short of supply and our view has been that it would probably be next year before the massive residential construction effort underway restores some balance to the market (see here and here).



We've nonetheless been surprised at the sheer robustness of housing demand.

Owner-occupiers fill the investor void

So, what's going on?

For a start, it appears owner-occupiers have readily filled the void left by a pull-back in investor demand. This wasn't expected.

Average monthly lending volumes to investors have tailed off by around 20% following the tax changes and tightening in LVR restrictions. But loan demand from owner/occupiers has held steady, or even lifted a little. No wonder high-LVR lending to owner-occupiers is now in the RBNZ's crosshairs (see below). The chart above shows that first home buyers have also picked up some of the slack.

All of this speaks to continued excess demand, and a long line of unsatisfied bidders. Such is the reality of a persistent housing shortage. Instead of the market easing off as investors pulled back, owner-occupiers have seized the opportunity and rushed in.

Regional housing variation linked to economic variation

Post COVID, the NZ economic landscape has become much more regionally diverse. To a lesser extent, the same is true of the housing market. The national house price average we usually talk about masks some big regional differences.

As can be seen from our regional heatmap below, those regions with strong rural ties – Taranaki, Gisborne/Hawke's Bay, Bay of Plenty, and Manawatu/Whanganui – have tended to outperform as the extra export revenue from the commodities boom has provided a welcome income boost. And then there's Wellington.

In contrast, those that have been dealt a tough hand by COVID – primarily as a result of international tourism exposures – haven't experienced (quite) the same level of extraordinary gains. These areas are almost entirely in the South Island.

Still, the fact that Otago's 25% annual house price inflation amounts to the "weakest" in the country is testament to the strength of the boom. And also to how powerful both the supply shortage – check out the *inventory* column below – and low mortgage rates have been in 'floating all boats'.

ASB Housing Market Heatmap

	Sales (s.a)	Prices	Days to Sell	Rents	Inventory
	%3m/3m	%yoy	Dev from avg	Yield (%)	Dev from avg
Auckland	-10.2	27.7	-5	2.5	-68%
Canterbury	-6.7	28.7	-9	3.6	-82%
Wellington	-5.6	39.9	-4	3.2	-68%
Northland	-10.1	25.1	-19	3.3	-89%
Waikato	-13.0	32.4	-21	3.0	-87%
Hawke's Bay	-9.7	35.1	-14	3.5	-76%
Bay of Plenty	-5.5	34.0	-22	3.1	-86%
Gisborne	10.0	35.1	-8	3.6	-74%
Manawatu-Whanganui	-10.0	48.5	-15	3.5	-80%
Taranaki	-5.0	35.0	-19	3.6	-72%
Nelson/Tasman	-11.7	27.0	-12	3.4	-79%
Marlborough	13.0	27.0	-19	3.2	-67%
West Coast S.I.	-15.2	27.0	-49	8.9	-94%
Otago	-9.6	24.5	-9	3.3	-52%
Southland	-1.7	25.6	-5	4.4	-79%

Brrr

Sizzling

Sources: ASB, Corelogic, REINZ, MBIE, realestate.co.nz

Upcycling our forecasts

The one aspect of recent housing figures we have seen cool its jets has been activity, or sales volumes. Average monthly house sales are running about 10% below the spring/summer peak. Lockdown disruptions will also suppress house sales in August and possibly beyond. On past form, this would suggest house price growth will soon follow sales growth southwards.

However, we're a little wary that the cooling in activity may just be the market burning itself out. There's just not enough listings. Unsold inventory is sitting at the lowest level since realestate.co.nz began collecting records in 2007. Some of the better indicators of market tightness we look at – like days to sell a house and the sales/listings ratio – point to a market that is still exceptionally tight. It will take time for rising mortgage rates to tamp down demand, and we continue to hold the view that the supply response won't kick in proper until next year.

For these reasons, we've extended the length of the house price inflation upcycle in our forecasts. We've lifted our year-end house price inflation forecast to 22%. But we've also lowered our forecasts for next year, to 3% (see below).

What about COVID?

Our assumption at this early stage, is that the current COVID outbreak is relatively inconsequential for the house price outlook. We know from past lockdown experience that housing activity and demand tends to get postponed rather than cancelled. There will be a chunk of *activity* in August and likely September that won't be able to take place, but this isn't expected to have a lasting impact on house *prices*.

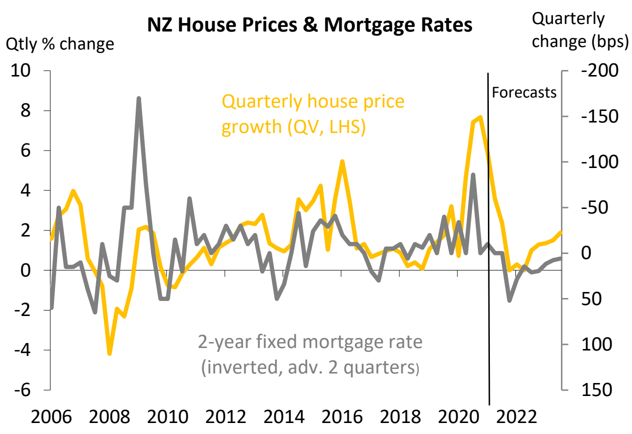
The reality when it comes to COVID of course is that no one knows. We'd be remiss not to also flag the risk that the current outbreak worsens, necessitating a lengthier lockdown. Any negative feed through to the labour market would be the thing to watch for housing demand. But let's hope it doesn't come to that. It's also important to note that, even if things did take a turn for the worse, there would be some important offsets for the housing market. Interest rates would stay lower for longer, and fiscal support such as the wage subsidy would likely continue.

Mortgage rates are already lower than otherwise, after the RBNZ decided to sit pat on the Official Cash Rate last week rather than start to lift it. And so, while COVID tail risks now loom a little larger, if anything, current housing market supports are a little stronger than they were last week.

Higher mortgage rates are a game changer…in time

Next year is a different story. Two of the biggest supports for house prices of the past two years will flip into restraints.

First, the upward adjustment in mortgage rates we've been calling has begun and, in time, will tilt momentum. The RBNZ delayed the start of its tightening cycle last week, but has been quick to assert it will kick-off if/when the COVID fog clears a little. Around ¾ of mortgages are due to re-fix over the coming 12 months and the Bank clearly doesn't want the mortgage curve to droop.



Source: QV, ASB

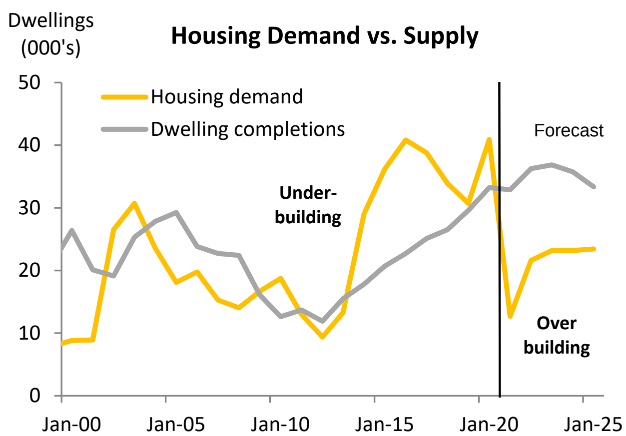
Uncertainty abounds but, for now, we've simply tabbed down our mortgage rate forecasts a touch, with the broad uptrend remaining intact. This is consistent with the RBNZ's (so far) unwavering intention to lift the OCR back towards 'neutral' levels over the coming few years. Allowing for the usual lags, this turning in the mortgage rate cycle points to a clear change in house price momentum over the first half of 2022 (chart above).

Supply dynamics will also swing into play

A change in the supply picture will also remove some of the support for house price increases next year. The combination of slowing population growth thanks to the closed border and the recent frenzied pace of residential construction should, finally, put paid to the supply air-pocket that's been a feature of the market this year.

The fact we are now 'overbuilding' relative to population growth has wrong-footed a few market watchers into expecting an imminent change in the housing cycle. We've tended to emphasise the lags involved.

In our view, 2022 will be the year that these shifting dynamics are reflected in a slower rate of house price inflation. This is ultimately a good news story to the extent the long-running housing shortage is materially

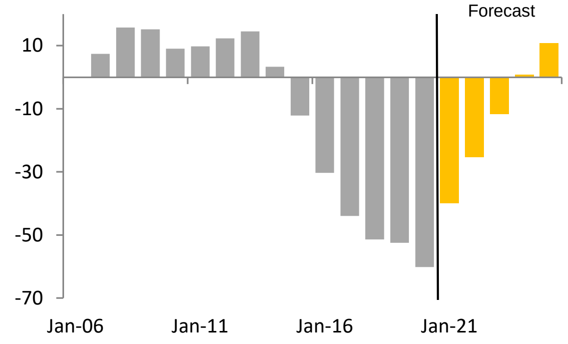


Source: Stats NZ, ASB estimates

reduced (chart opposite).

RBNZ not gonna take it anymore

Recent Reserve Bank rhetoric has betrayed increasing frustration at the stubborn strength of housing demand and, in particular, continued "risky" lending. Current levels of house prices have now been officially blasted as "unsustainable". The Bank looks set to soon walk the talk and introduce additional macro-prudential tools.



Source: Stats NZ, ASB estimates

First cab off the rank will be a reduction in the speed limit on high LVR lending to owner-occupiers, to 10% of new lending from 20%. The effect here won't necessarily be material as new lending to this group is already tracking at around 10-11% of the total.

The Bank is also looking closely at debt-to-income (DTI) restrictions. These are a potentially more powerful tool, but it all depends on where the DTI limit is set. The RBNZ has been charged with avoiding negative impacts on first home buyers, the group that tend to have the highest DTI. So setting DTIs at a level that avoids such impacts while still getting some "bite" will be a challenge.

Whatever the exact policy mix, the take-home message is that the RBNZ is serious about changing the momentum in the housing market. And if the fundamentals – rising mortgage rates and increasing supply – don't do it, then the RBNZ will take increasingly aggressive action.

In summary

The 2022 confluence of the above three house price restraints has raised our conviction that the end of the cycle is nigh, and we'll see house price inflation fall back to single-digit levels next year. Our central expectation is that we won't see outright falls in house prices. We think the RBNZ will be sensitive to the higher debt load of the economy and thus adopt a 'softly softly' approach to policy tightening. But valuations are extreme and uncertainty is high. We certainly wouldn't rule out prices falling for a few quarters.

The table below summarises the various drivers of house price inflation and their impact on our view.

House Price Driver	Current	Next 12 months	Comment
Mortgage Rates	green	red	We find mortgage rates to be a strong driver of house prices, with around a six-month lead. The mortgage cycle has turned. Further increases are expected, and this willl slow house price inflation appreciably next year.
Population Growth	yellow	yellow	Population growth will continue to slow. We've assumed very little net inward migration for most of next year. We're not expecting net outflows though, meaning it's a neutral rather than negative driver.
Housing Supply	green	red	Booming construction/slowing poulation growth is helping to reduce NZ's housing shortage, but it's taking time.
Labour market	green	green	NZ's labour market is extremely tight. We expect further falls in unemployment and for wage inflation to accelerate further. The current COVID outbreak is a risk.
Housing Policies	yellow	red	A lot's been thrown at the housing market, but the the net effect has been limited thanks to extreme excess demand. The RBNZ is re-loading, and will fire off a few more shots later this year/early next.

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