Property Pulse

30 November 2023

Slow Build

- **The housing market upturn is here but, with apologies to The Beastie Boys, slow and low is the tempo**
- **The market's key macro drivers are evolving roughly as expected (table below) and we haven't changed our forecast for a ~7% lift in house prices through 2024**
- **The housing policies of the new government will add to the upward momentum, at the margin**
- **Mortgage rates are peaking but we can't see a downtrend taking hold until the latter stages of next year**

The view, in brief

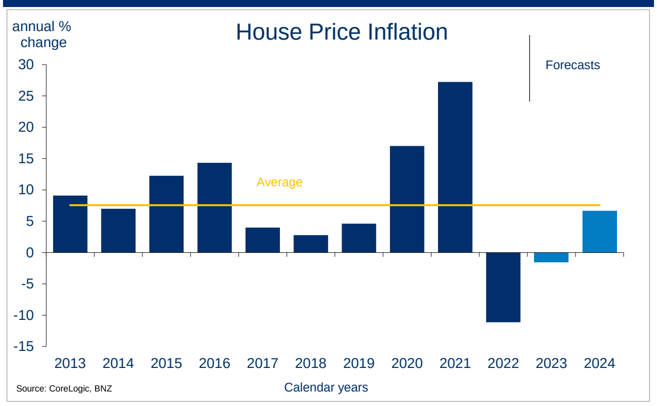
NZ house prices have rounded the turn and are now rising again. Expectations of a hot summer are wide of the mark though. High mortgage rates will stick around for most of next year and the economy is stuck in low gear. We see little reason to change our short-term house price inflation forecasts of around 1% per quarter. It's more grind than boom.

'Tis the season to think about next year though, and we expect momentum to pick up through 2024. First, we don't think the supply side will keep pace with rising housing demand. Second, the mortgage rate uptrend is expected to flatten and eventually turn. We see annual house price inflation rising to +7% over calendar 2024 (chart opposite).

Welcome to our final *Property Pulse* for the year. Supporting our more regular EcoPulse updates, the idea here is to take a more detailed look at all things housing. We also dip into mortgage rate dynamics.

Included in report:

BNZ house price forecasts



Impact of macro drivers of our house price view

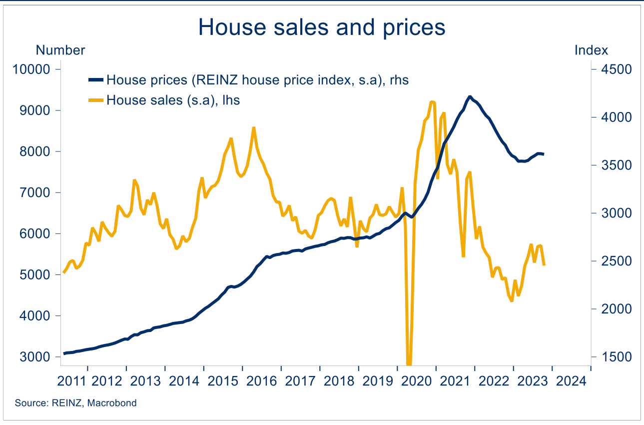
The table below summarises the various drivers of house price inflation and their impact on our view.

	Short-term	Further ahead	View summary
Mortgage rates			Mortgage rates are peaking and will tip lower (late) next year. The Reserve Bank's shot across the bows yesterday is a risk to this view
Housing supply			We're not building enough houses. The need is there but the macro-level maths doesn't add up given high build costs and interest rates
Labour market			Prior labour market strength is rapidly reversing. Rising unemployment and reduced job security next year will test the strength of the house price upturn
Housing policy			The impacts are second order compared to the big fish above, but the new government's policy changes will boost investor participation
House price inflation			The upswing will gather momentum in 2024

Spring brake

Having exited the downtrend in autumn, the housing market has spent the subsequent six months in a grinding sort of recovery. Prices are about 2% above the April low (REINZ House Price Index, seasonally adjusted). Monthly house sales are tracking higher (chart below) – but are still more than 10% below average levels.

Sales in slow lane, prices revert to trend



All of this is in keeping with our view of a creaking recovery, as laid out in our last Property Pulse. We've been forecasting rates of house price inflation of 1-1½% per quarter through to early 2024. We see little reason to change this view.

There's been a couple of things holding the market's horses. First, the pre-election pause came through as expected and was as clear as day in the just-released October REINZ housing figures. Second, mortgage interest rates remain at activity-stifling levels, and have nudged a little higher in recent weeks.

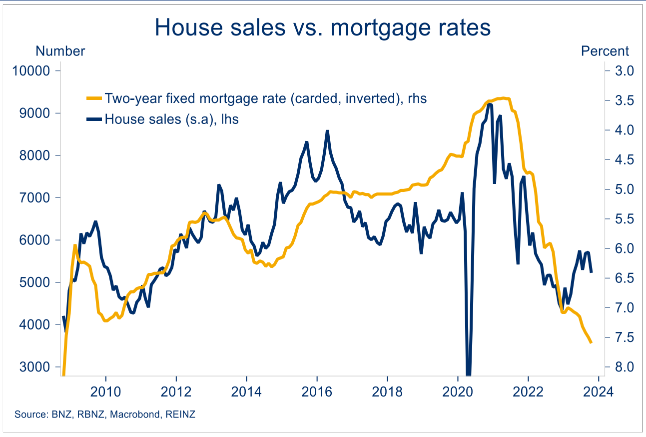
Election impacts look to be passing. New listings in October were the highest since January, even adjusting for the usual spring flush. Anecdote points to more of the same in November. Auction clearance rates are trending higher too.

Still, contrary to some of the commentary, we don't think it's all off to the races from here. Yes, the intended changes to housing policy by the new government (see below) will add a sprinkling of support, but they'll also take time to work through. In the meantime, the broader economy is increasingly doing it tough, and cracks are appearing in the labour market.

Most importantly, high mortgage rates – banks are now testing new borrowers on 8½ to 9% rates (see mortgage rate section) – are expected to stick around for most of next year. The restraining effects on demand are powerful. Indeed, the recent nudge higher in fixed rates represents a modest threat to the tentative recovery underway in housing market activity (chart opposite).

Still patchy demand, coupled with a lift in available listings, suggests the current slow and low environment for house price appreciation will continue in the short-term.

Mortgage rates keeping a lid on activity



Looking into 2024

'Tis the season to think about next year though, and we expect momentum to pick up through 2024. Below we outline the key factors expected to drive the upturn.

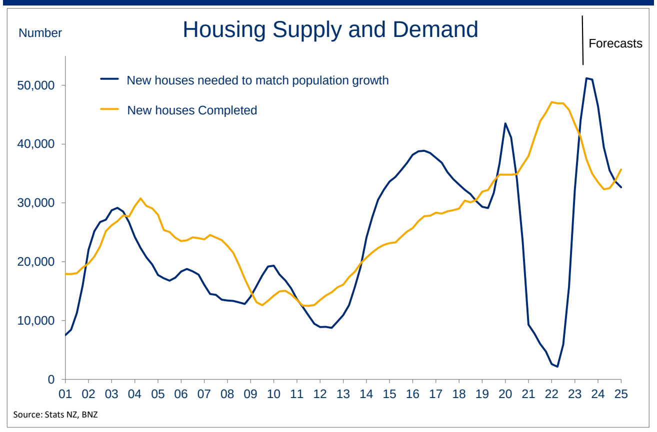
Not enough supply

First, we don't think the supply side will keep pace with rising housing demand. Prices will be forced higher as a result. Residential construction activity looks set to slow dramatically even as booming population growth increases the need for additional housing.

A big part of this potential under-build relates to record high build costs and the large gap to the cost of purchasing an existing home (see our recent note). Basically, the economics of building are stretched, meaning the financial incentive to build – at a macro level – is low.

Our rough estimates suggest the number of new houses completed could undershoot the number required to match population growth by 5k or so a quarter through 2024.

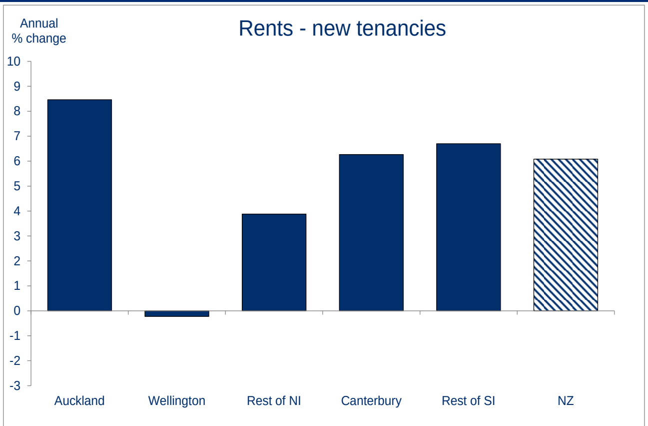
Growing imbalance



Evidence of this demand/supply imbalance can already be seen in the rental market. Auckland rents have jumped 9% in a year. That's unsurprising given Auckland has enjoyed the strongest population growth in the country. The latest figures show 55% of all international migrants coming into NZ in the 12 months to June settled in Auckland.

But it's not just Auckland experiencing strong demand for rental accommodation. With the rather glaring exception of Wellington, rents in most other parts of the country are growing strongly as well.

Auckland out in front

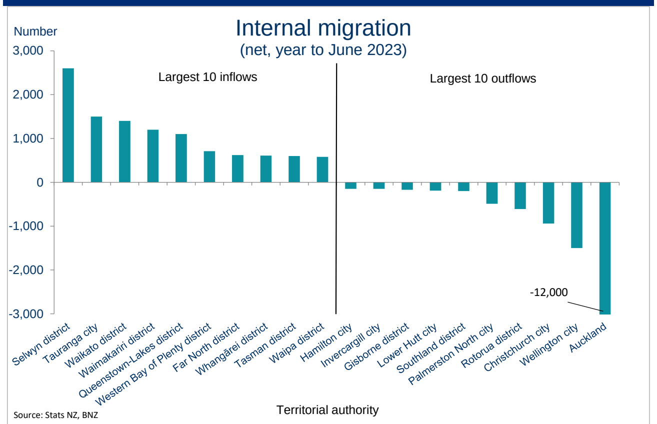


Source: BNZ, Stats NZ

In time, some of the pressure in the rental market will likely spill out into the broader housing market. Those renters that have saved a deposit may choose to exit the market and buy, and there's also likely to be demand from non-NZ citizens that become eligible to purchase a house, for example by having been here for 12 months.

Auckland won't necessarily be at the centre of this extra housing demand. High housing costs are dampening the appeal of the cities and internal migration flows show (on net) folk fleeing to the regions and city fringe areas (see our recent note and chart below). House prices in these areas have outperformed in recent years.

Flee the cities



Source: Stats NZ, BNZ

Mortgage rate uptrend flattens

A flattening in the mortgage rate uptrend is another key factor underlying our 2024 house price outlook.

We continue to hold the view that the Reserve Bank doesn't need to increase the cash rate again. We also continue to believe that cash rate cuts will ultimately come earlier than the Bank's projections (which imply an early 2025 start to the cutting cycle).

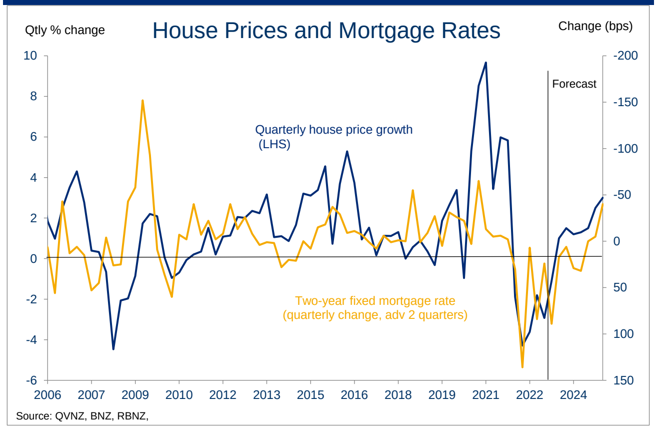
What we have changed following yesterday's strident higher-for-longer messaging from the RBNZ is the timing of the first expected rate cut. This has been pushed back from May to August 2024.

Market pricing, for now, is roughly in line with our view. Should this broad state of affairs remain in play we'd expect to see the mortgage rate uptrend soon flatten off, with rates beginning to tip lower over the second half of next year.

On past form, this sort of picture would be consistent with about an 'average' (~7%) lift in house prices next year, as is our current forecast (chart below).

Clearly the calculus would change should the RBNZ ultimately deliver the additional tightening it now says is a higher chance. But, for now, we're sticking with our view that inflation, the labour market, and economic growth will all slow up more rapidly than the Reserve Bank expects.

Slow climb

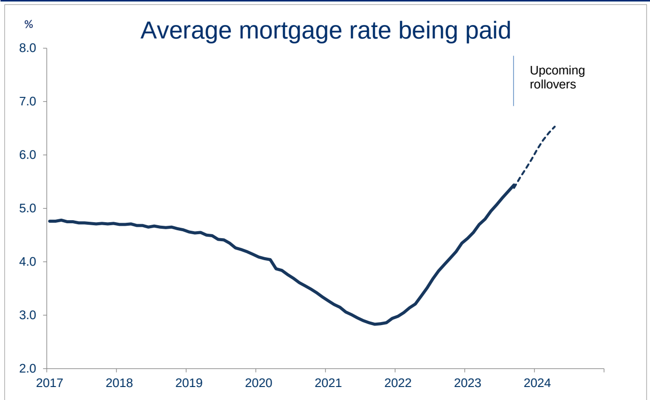


Source: QVNZ, BNZ, RBNZ,

Meanwhile, existing mortgage borrowers continue to be buffeted by past interest rate hikes working their way through the system.

The average mortgage interest rate being paid is still "only" 5.4% according to the latest RBNZ data. This will rise another 100bps or so next year as older, lower fixed rate mortgages roll onto higher rates. It's an extra cost that will, all else equal, dampen housing market participation amongst existing owner-occupiers.

Pipeline tightening



Source: BNZ, RBNZ

Housing policy playing a supporting role

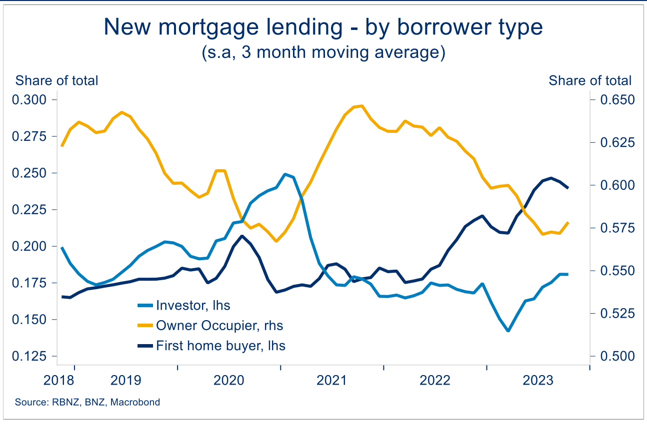
Change is afoot on the housing policy front. There are changes, and changes to the changes, arising from the change in government, and the Reserve Bank may also try out a new policy tool next year.

Our view is that the policy changes[1] recently agreed by the new coalition government are mildly supportive for housing market activity and prices overall but probably not construction.

The changes to interest deductibility in particular will boost prospective returns for investors and help reverse the downtrend in investor participation we've seen over the past few years (chart below). There are signs of this occurring already.

Given the high cost of construction noted earlier, relatively more of this extra investor demand is expected to turn up in the market for existing houses rather than new builds. Supporting this view is the fact that any preference for new builds arising from the interest deductibility carve out will soon depart as full deductibility is (progressively) restored. In short, the boost to housing demand looks set to trump any lift in housing supply.

Investor share lifting



Nonetheless, the changes to the policy landscape haven't given us sufficient cause to upgrade our house price forecasts. For one thing we already had a firm view. Recent events have simply crystalised some of the upside risks we'd allowed for. Bear in mind also that, alongside higher prospective returns, costs for investors are also rising rapidly, particularly those for rates and insurance.

Finally, there's a potential wildcard next year in the form of the implementation and impact of restrictions on debt-to-income ratios (DTIs). We provide our take in the box opposite.

[1] The "brightline test" looks set to be wound back from ten years to two years, and the proposed, staged restoration of full interest deductibility (new builds are currently exempted) will be fast-tracked by a year under a coalition agreement with the ACT party. National's proposed lifting of the ban on foreign property purchases for properties over $2 million has been shelved under a coalition deal with NZ First.

Overall, our view is that housing policy will shift from a mild handbraking effect to one of modest support over the course of next year.

What about DTIs?

Alongside LVRs and the OCR, there's a new housing policy tool and acronym to get your head around – DTIs.

The Reserve Bank has said that restrictions on high debt-to-income mortgage lending could be ready by April, with mid-2024 being the earliest possible implementation date. The details will be hashed out during consultation in early 2024.

Importantly, getting a shiny new tool doesn't mean you have to immediately use it. This will depend on how market conditions evolve. We suspect the RBNZ won't be in a rush. It's also hinted that any initial DTI setting may not be "binding" right off the bat.

A few other key points to note:

- DTIs will be used in conjunction with loan-to-value ratios (LVRs), but are a more direct way of limiting housing credit in the name of financial stability. Linking how much you can borrow to a property's value, as LVRs do, means allowable loan size booms along with house values in an upswing. That won't occur if loan size is linked to income.
- Property investors are likely to be the most affected given they tend to operate with the highest DTIs. Around 20% of current investor lending is on a DTI > 6, for example, compared to owner-occupiers at around 10% and first home buyers at 6%.
- The impact of DTIs will depend on where the limit is set (e.g. DTI < 7), as well as any exemptions and speed limits. Some have drawn parallels to the UK and Ireland's limits that sit between 3.0 and 5.0. However, 'debt' is measured differently there, limiting comparability in our view.
- In any case, house price fundamentals like interest rates, population growth, new supply, and incomes will remain the bigger drivers of the market. DTIs are not a monetary policy tool – interest rates will remain front and centre. It's also worth noting that banks already do a range of serviceability tests on new borrowers, including DTI assessments.

Mortgage rate outlook

Our view at a glance*

	Short-term	Further ahead	Comment
Floating rates	➡	↘	If our cash rate forecasts are correct, we wouldn't expect any change until late 2024
Short-term (1-2 year) fixed	➡	⬇	Likely peaking, but a sustained downtrend is unlikely until the latter part of next year
Longer term fixed	➡	↘	A period of stability beckons before the downdrift resumes
Fix or float?	More value in shorter fixed terms		

*Based on our forecasts for wholesale interest rates

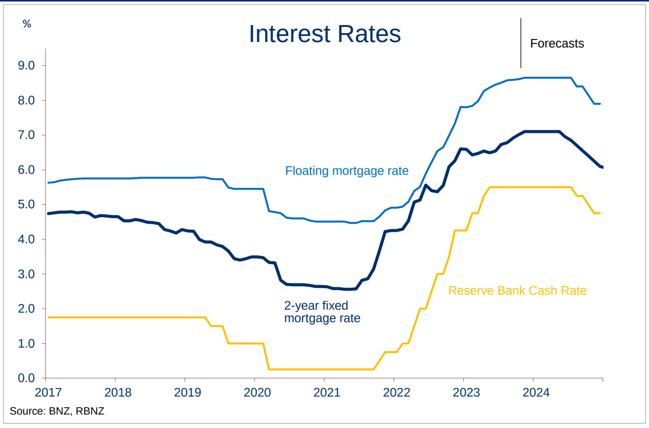
Floating rates

Since May, we've been of the view that the Reserve Bank's cash rate, and hence floating mortgage rates, were unlikely to move higher. Speculation of additional rate hikes still exists but, at least up until yesterday's "hawkish" Reserve Bank (RBNZ) meeting, had generally been fading.

The RBNZ is now placing greater odds on another cash rate increase being needed to quell inflation pressures. We still don't think it will be necessary. The economy is out for the count. Inflation and labour trends are all going the right way for the RBNZ and will continue to do so in our view.

But we have taken at least some of the RBNZ's messaging on board and pushed the timing of the expected first cash rate cut out to August 2024. We'd previously expected May. Should this scenario pan out, we might expect floating mortgage rates to end 2024 a little lower than currently. However, these forecasts are now sufficiently uncertain and far into the future that it's probably best to bank on floating rates sticking around where they are now for some time.

Plateau rather than peak



Fixed rates

In our last missive we said: "while the OCR has likely peaked, we could still see some upward tweaks to some mortgage rates given recent lifts in wholesale rates and bank funding costs." These upward tweaks came through and if anything were a little larger than we'd expected. This was largely thanks to strong lifts in (particularly offshore) wholesale rates. These lifts are now in the process of reversing, leading to some speculation of imminent falls in mortgage rates.

At this point, it's worth reiterating the two main drivers of movements in fixed mortgage rates:

1) Wholesale interest rates ("swap" rates), which embody expectations for where the Reserve Bank's cash rate will go, and also draw influence from offshore wholesale rates.

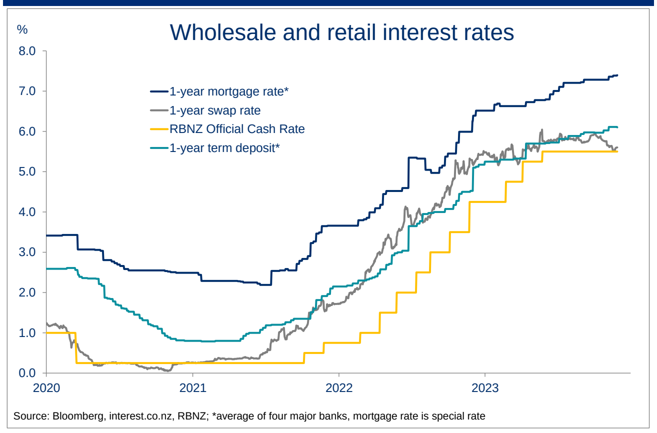
   These have gone down recently. The two-year swap rate, for example, has declined to about 5.20% from an average of closer to 5.60% over the previous four months.

2) Bank funding costs, such as term deposit rates and the cost of issuing debt in wholesale markets.

   These have gone up. Term deposit rates are still rising, and the cheap funding provided to banks by the Reserve Bank during 2020/21 is rolling off.

Both of the above need to be taken into account when assessing the outlook for mortgage rates.

Term deposit rates still rising

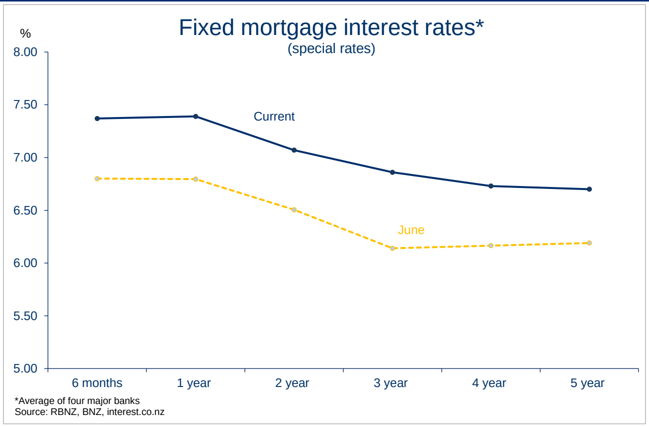


We expect wholesale rates to continue to drift southwards over 2024, as inflation comes down and eventual Reserve Bank cash rate cuts slowly draw into view. But rising bank funding costs may blunt some of the impact of this on mortgage rates.

The overall picture is one where we think mortgage rates are broadly peaking. But we could do still an upward tweak here and there given higher funding costs. Moreover, we don't expect to see fixed rates trend lower on a sustained basis until late next year.

When the downtrend does come, we'd expect short-term rates to fall the fastest as the "inverted" curve (shorter-term rates above longer-term rates) "un-inverts". Longer-term fixed rates (3-years plus) already factor in a good chunk of the cutting cycle so would be expected to move by a relatively smaller amount.

A higher inversion



Fix or float?

Before diving into the rate fixing debate, it's worth reiterating that getting a mortgage strategy "right" is more about meeting a borrower's financial needs and requirements for certainty, rather than trying to pick the next rate move. The latter is fraught with difficulty.

The broad mechanics of the mortgage rate fixing decision haven't changed much this year. The mortgage curve has been "inverted" most of the year and still is (chart above). Shorter-term rates are higher than long-term.

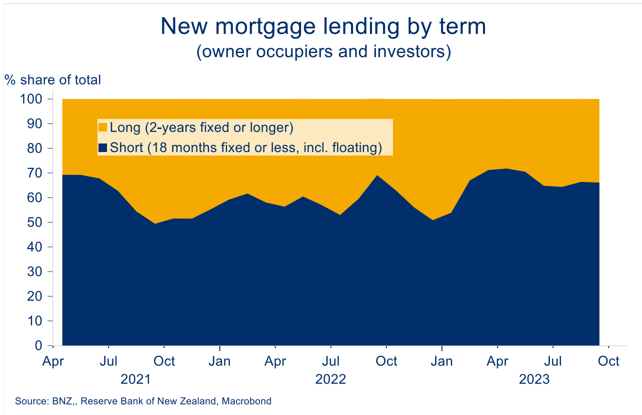
This means that a desire to fix for shorter-terms, and hence obtain the optionality to roll onto lower mortgage rates in future (should they occur), brings with it a cost. The alternative is to fix for a longer, say three-year, term. It costs less now (around 6.9% vs. a 7.4% one-year rate) and brings with it additional interest rate certainty. But you could end up 'stuck' paying a higher rate if rates fall over the next few years.

In essence, to make it economic to fix for a shorter-term now, interest rates *need* to fall over the next few years. The question is, by how much?

At face value, our interest rate view implies there's a good chance future falls in mortgage rates would justify fixing for shorter-terms at higher rates now. That option entails more risk though and, as of yesterday, the Reserve Bank is now flagging rates staying higher for longer. Those that value certainty more highly may still prefer a longer term (e.g. 3-year) rate, which offers protection from a scenario in which the cash rate does not come down next year.

If we look at what people are actually doing, the latest data show the popularity of fixing for shorter-terms has been slowing increasing, presumably on an expectation we're around the top of the interest rate cycle.

Shorter terms increasingly preferred



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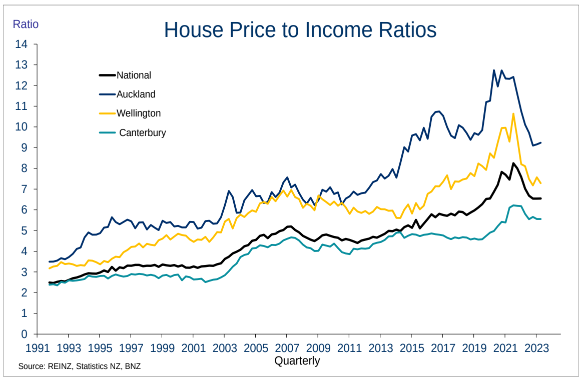
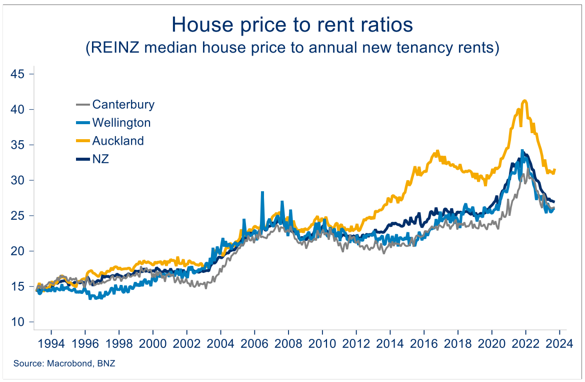
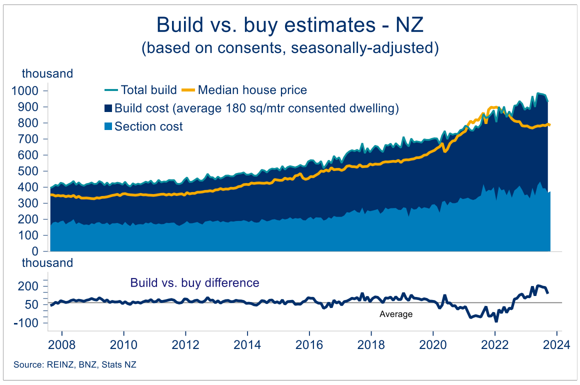
Appendix 1: Valuation chart-pack

Valuations: degree of stretch easing but still elevated

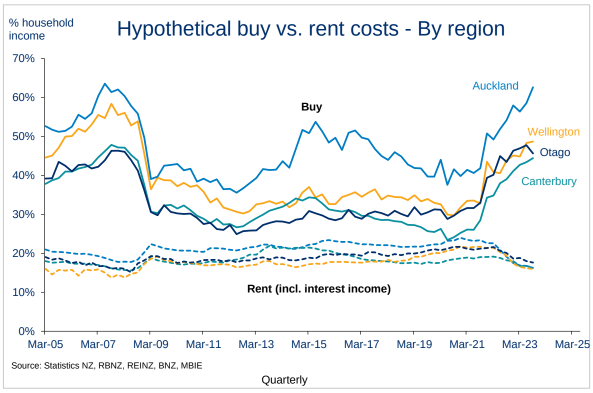




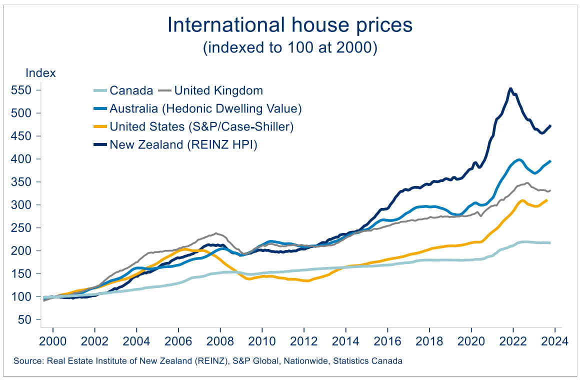
Buy or build?

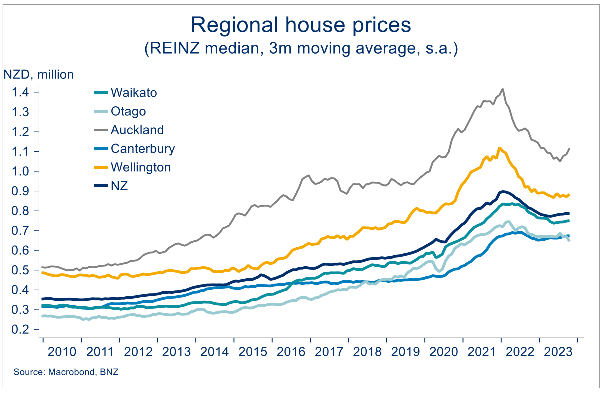


Rent or buy?

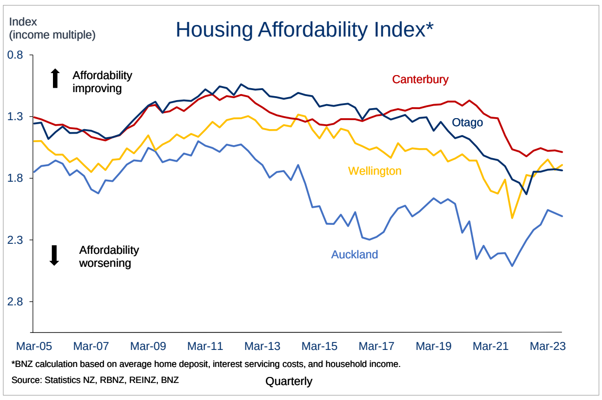


International and regional comparisons





(Un)affordability not improving, but mixed around the grounds



Appendix 2: Regional Heatmap

Our housing market heatmap provides a snapshot of the *relative* strength of housing markets around the country.

- Broadly speaking, things are a little warmer in the southern parts of the country. Not only did house prices not fall as heavily in the likes of Otago, Southland, and Canterbury but the recovery in those regions appears to be on a slightly firmer footing too.
- Conversely, Wellington appears to be on the cusp of a cold snap. House sales – a good lead indicator for prices – have slumped. Some of this is no doubt a temporary election effect, but some will be sustained given the implications for the public service from the new government. Rent inflation is also clearly lagging in the capital (see chart earlier).
- Auckland is roughly middling as far as relative housing heat goes. Everything else is a bit mixed.

Regional Housing Market Heatmap - October data*

	House prices[1]			House sales	Days to sell	Rents[2]	
	Median price	*3m/3m %*	*Annual %*	*3m/3m %*	*Deviation from av*	*Annual %*	Relative strength
Northland	$675,000	-1.0	-7.3	11.1	6%	7.2	
Auckland	$1,103,833	1.6	-2.6	3.6	3%	8.5	
Waikato	$750,561	0.8	-4.6	-2.6	-10%	7.9	
Bay of Plenty	$822,299	0.3	-1.7	-9.4	-17%	7.1	
Gisborne	$584,812	1.1	-3.4	10.6	31%	14.8	
Hawke's Bay	$679,702	1.1	-3.4	1.8	-3%	9.8	
Manawatu-Whanganui	$525,698	1.3	-3.4	7.9	-6%	9.1	
Taranaki	$569,969	0.0	-1.9	9.7	4%	14.2	
Wellington	$872,253	2.0	-3.4	-12.6	11%	2.8	
Nelson, Tasman, Malborough	$723,899	-0.4	-3.7	4.9	31%	4.7	
Canterbury	$676,402	1.3	0.2	0.5	-5%	10.7	
West Coast	$330,000	0.5	-3.3	-3.9	-33%	-4.8	
Otago	$657,245	2.3	0.2	1.0	1%	8.7	
Southland	$433,291	2.1	-1.6	7.1	32%	NA	Relative
New Zealand	$785,596	1.2	-2.6	0.9	2%	7.6	Weakness

*Notes: All data seasonally adjusted by BNZ; (1) House price data (other than Median Price) based on REINZ HPI; (2)Sep data, based on new bonds lodged.

Sources: REINZ, Statistics NZ, BNZ, realestate.co.nz, NZ tenancy service, Macrobond.

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