Westpac Institutional Bank

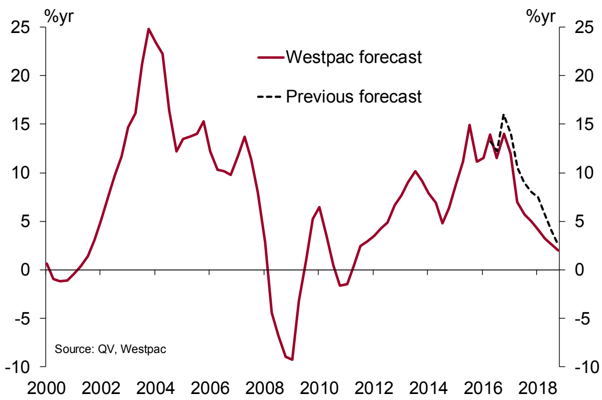
Home Truths

15 December 2016

There's been growing discussion recently about whether the housing market has reached a turning point. For our own part, in our latest quarterly *Economic Overview* we revised down our forecast of house price growth to just 5% in 2017, a more subdued outlook after two years of double-digit gains.

There are at least three competing arguments for a softer housing market over 2017. One is that the latest round of loan-to-value ratio (LVR) restrictions has finally broken the back of the market. Another is that mortgage rates are now rising instead of falling. Lastly, some have argued that the housing market is simply a bubble ready to burst. While all three stories point in the same direction, it's important to distinguish between them – not just in terms of coming up with a sensible forecast, but to guide any policy decisions about housing over the coming year.

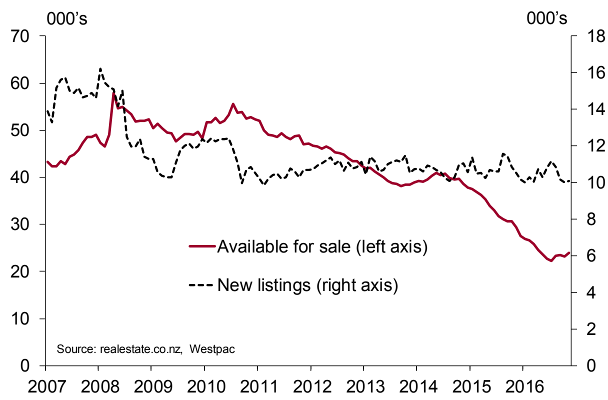
Annual house price growth



Hypothesis 1: Lending restrictions

The third round of LVR restrictions that was announced in July has clearly had an impact on activity in the housing market. The figures from REINZ up to November show that house sales are down more than 16% from their peak in April this year. Separately, realestate.co.nz reports that the number of homes available for sale has been edging up in recent months, though that's largely a consequence of the slowdown in sales. The number of new listings remains near its lows, indicating that homeowners are under no pressure to sell into a softening market.

Realestate.co.nz listings, seasonally adjusted



It's less clear whether the restrictions have been effective in cooling house prices. At a national level, prices have continued to rise since July, albeit at a slower pace than before. The rate of increase has clearly slowed in some previous hot spots such as Auckland and Hamilton. But an even greater number of regions have actually seen prices accelerate since July. What's more, this doesn't seem to accord with the regions that are more affordable – for instance, one of the hottest regions is Queenstown, where the average house price now tops the $1m mark.

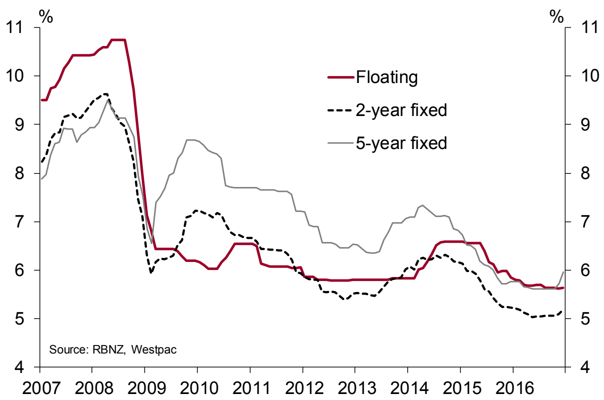
These results are consistent with our long-running 'investment value' analytical framework for housing. As we've discussed in previous issues of *Home Truths*, we would expect lending restrictions to limit the number of potential house buyers, but to have little impact on the maximum that bidders are willing to pay. The latter is driven by factors such as rental yields, borrowing costs and the tax treatment of investment property – none of which are affected by LVR restrictions. We suspect that debt-to-income (DTI) restrictions, were they to be added to the Reserve Bank's macroprudential toolkit, would suffer the same drawback.

Hypothesis 2: Interest rates

That leads us to a factor that does have a significant bearing on our 'investment value' framework. Over the past couple of years, mortgage rates have been steadily declining, on the back of cuts to the OCR (and anticipation of the same). This has steadily underpinned the price that investors are willing to pay for properties.

But the situation is changing. Global interest rates have turned higher in the last few months, and New Zealand has been taken along for the ride. This began before the US election, but the surprise election of Donald Trump, and speculation about a surge in infrastructure spending in the US, has certainly accelerated the trend. In addition, a slowdown in deposit growth means that local lenders are now having to seek more expensive sources of funding. Consequently, mortgage rates have risen by around 20 basis points from their lows for a two-year fixed term, and around 40 basis points for a five-year term.

Average new mortgage rates



While we expect the Official Cash Rate to remain unchanged over 2017, we suspect that longer-term interest rates will face further upward pressure over the coming year. That will mark a clear break from what the housing market has experienced over the last couple of years, and it's the key reason why we're forecasting a much more subdued pace of house price growth next year. In our view, higher mortgage rates will have a more meaningful – and sustained – impact on house prices than lending restrictions alone ever could.

Hypothesis 3: Bubble trouble

The final story revolves around the degree of 'stretch' in the housing market. Metrics such as house prices to disposable income, or prices to rents, have risen strongly in recent years, and are very high by world standards. Some argue that house prices must eventually fall back to levels that are more 'affordable'.

As we discussed in the last issue of *Home Truths*, the terminology here can obscure the issue. When we talk about house prices, we're really talking about property prices – that is, the value of the land plus dwellings. And the value of land will reflect not just its current use, but its potential for future development.

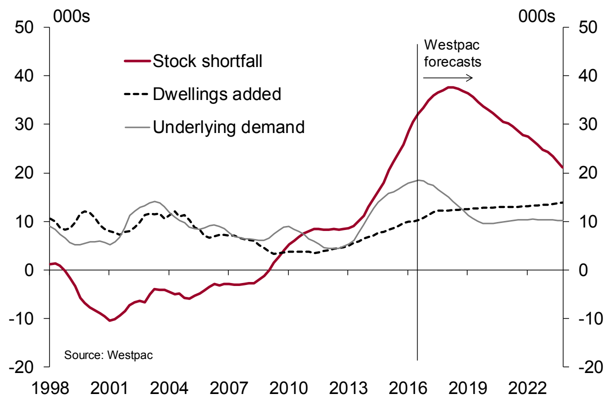
We can say that there is a speculative element to property prices, in the sense that today's land prices reflect that value of houses not yet built, and that there's some uncertainty around the future value of those houses. But that speculative element still has a basis in the fundamentals of demand and supply. New Zealand's burgeoning population, especially in Auckland, has created a demand for new homes that the market is struggling to deliver. Ultimately, the solution will include more intensive use of existing land, particularly in the main centres.

With that in mind, the main things that could trigger a collapse in land prices are:

- Failing to realise the full value of the land, either through renewed restrictions on building or by building the wrong kind of homes, or
- Demand for housing falling short of expectations, for instance if migration turned sharply back towards a net outflow of people.

Even so, these forces are unlikely to come to bear quickly. The accumulated shortage of housing (we estimate this at around 35,000 dwellings, concentrated in Auckland) and the building industry's limited capacity suggest that there's little risk of an oversupply of homes any time soon.

Auckland's housing shortfall



Michael Gordon
Acting Chief Economist

Contact the Westpac economics team

Michael Gordon, Acting Chief Economist +64 9 336 5670
Satish Ranchhod, Senior Economist +64 9 336 5668
Anne Boniface, Senior Economist +64 9 336 5669
Sarah Drought, Economist +64 9 336 5696
Any questions email: economics@westpac.co.nz

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