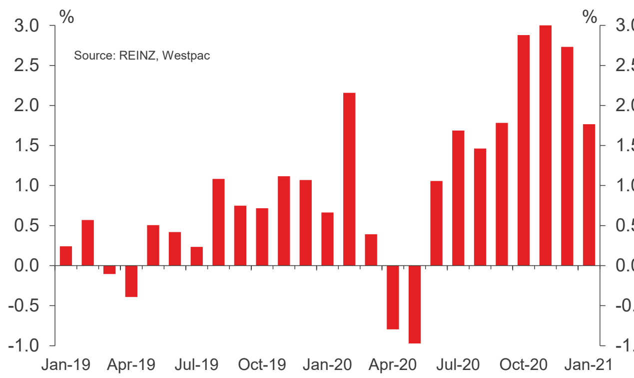
Home Truths.

3 March 2021

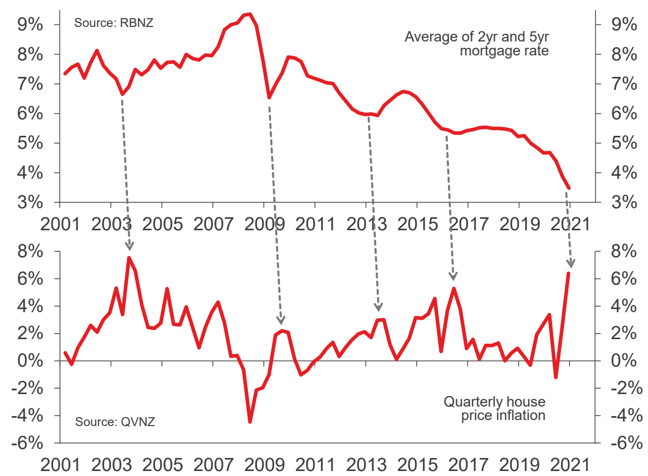
House prices are now rising more rapidly than in 2003, and the boom has a way to run yet. But Home Truths argues that the market will slow in time. That's because mortgage rates will rise and the shortage of housing is being rapidly reduced.

On the official quarterly measure, house prices rose about 12% in 2020. But the market accelerated wildly at the very end of the year, and the REINZ's monthly House Price Index rose by an astounding 9% in just three months – the sharpest increase on record.

Monthly seasonally adjusted change in House Price Index



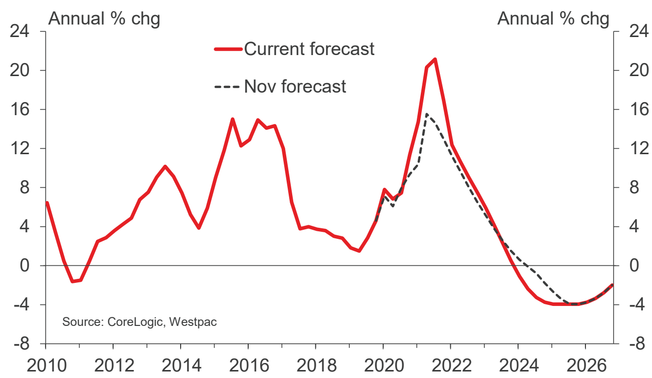
Interest rates and house prices



Home Truths has consistently argued that low mortgage rates would drive house prices higher, and that is exactly what is happening. In June 2019 Home Truths first predicted that "the cancellation of capital gains tax combined with sharply lower mortgage rates will be game changing," and forecast that annual house price inflation would accelerate from 2% at the time to 7% over 2020. We have consistently maintained that view ever since (although there was a brief period when we thought Covid-19 would temporarily interrupt the trend).

Over the past few months mortgage rates have fallen even further than originally anticipated, so our house price forecasts have been revised up accordingly. We now expect a 17% increase in house prices for 2021, on top of the 12% increase from last year.

Westpac house price forecasts



That said, we think the current boom has, in one sense, already passed its peak. We expect the monthly pace of price increases will trend down from here. This gradual slowdown in the market will see house prices rise at a slower 7.5% pace in 2022, and zero in 2023. And eventually, we expect house prices to fall. Far-future forecasts are always indicative at best, but we are pencilling in -4% annual house price inflation over 2024 and 2025.

There are two key reasons we expect the housing market to gradually slow from now.

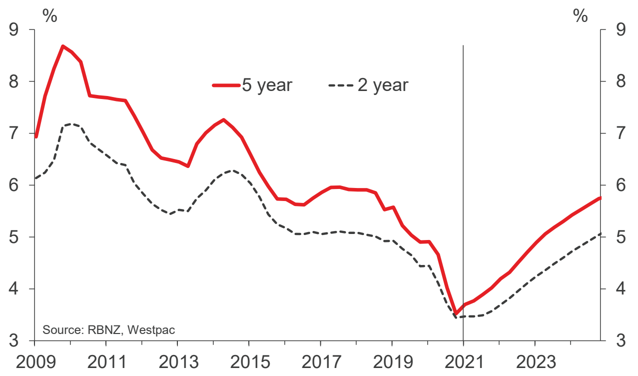
First and foremost, we expect mortgage rates to trend higher. To be clear, we anticipate no change in the OCR until 2024, but there are still good reasons to expect fixed mortgage rates will rise:

- Financial markets are forward-looking, and will incorporate expected future OCR hikes into wholesale fixed interest rates ahead of time – in fact, they already are.

- The Reserve Bank's quantitative easing programme (LSAP) and Funding for Lending Programme (FLP) have been supressing longer-term interest rates, but both will wind down over the coming year or so.
- The Reserve Bank will require banks to hold more capital from mid-2022 onwards. This will drive mortgage rates higher independent of wholesale interest rates.

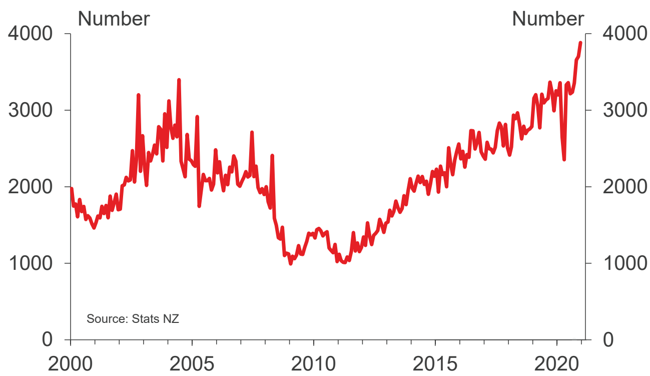
We expect that the longest-term fixed mortgage rates, such as five-year fixed, will start increasing quite soon. Two-year fixed mortgage rates are expected to start rising late this year or early next.

Mortgage rate forecasts (averages for five main banks)

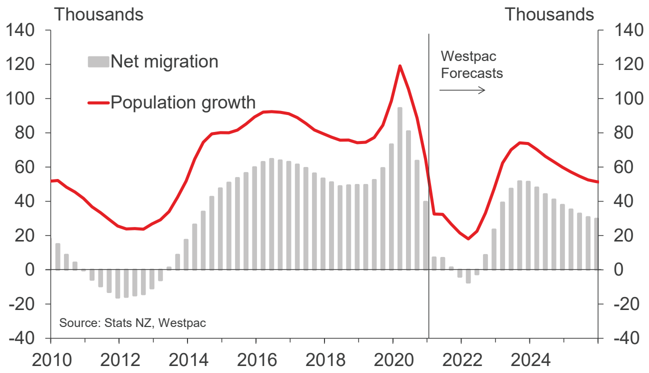


Second, changes in the balance between physical supply and demand will soon become a drag on house prices. Residential construction is currently booming at the same time as the population growth rate has crashed. Since last September the number of consents to build residential dwellings has increased 16%. Meanwhile, annual population growth is on track to slow from 2.4% last year to a low of 0.4% per annum, due to the closed border. Even after the borders reopen we expect population growth will be slower than before the pandemic, due to tighter government migration policy. And we expect construction to remain strong.

Residential building consents (monthly)

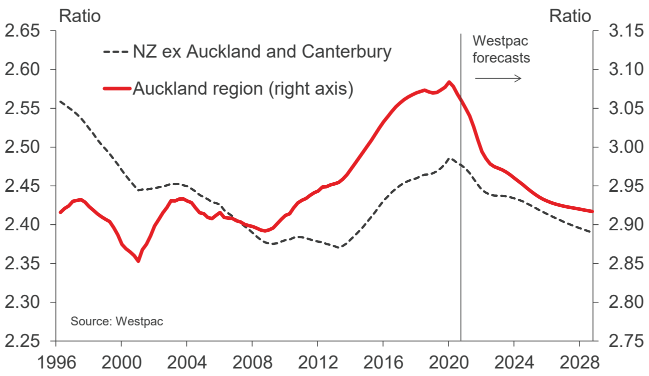


Annual population growth



What all of this means is that the housing shortages that have long dogged New Zealand are now receding quickly. The number of people per dwelling (PPD) is a good gauge of New Zealand's housing shortage, and indicates whether we are overbuilding or underbuilding. PPD rose sharply last decade, especially in Auckland, indicating that people were squeezing into houses. But PPD is now falling very rapidly and in Auckland it will be back to 2014 levels by the end of next year.

People per dwelling – a measure of housing shortages



At the peak, Auckland's "housing shortage" was 32,000 dwellings (where housing shortage is defined as the number of additional dwellings required to return PPD to the 2010 level). By the end of next year the shortage will be 12,000, and on our forecasts, it will be zero by 2028.

For the whole of New Zealand excluding Auckland and Canterbury, the estimated shortage peaked at 48,000, will be 25,000 by the end of next year, and will be zero by 2027 (using the same 2010 benchmark for PPD).

Home Truths has long argued that physical supply and demand factors played only a supporting role in the run-up in New Zealand house prices over the past thirty years. Even so, physical factors do have some influence, so the fact that housing shortages are rapidly receding is one supporting reason to expect house price inflation to gradually slow over the coming couple of years.

The impact of diminishing housing shortages will be more clear-cut in the rental market – over the coming few years we expect to see a slowdown in the pace of increase in rents.

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