WESTPAC WEEKLY ECONOMIC COMMENTARY

Taking stock of housing.

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Mānuka

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RBNZ Chief Economist Paul Conway delivered a speech last week on the New Zealand housing market, accompanied by several research articles. While the conclusions themselves weren't new, this work provided a useful stocktake on the current state of thinking on housing.

We should start by noting that the speech did not provide any pointers on RBNZ policy, monetary or otherwise. Under its current Remit, the RBNZ is required to assess the effect of its decisions on the Government's policy to support more sustainable house prices. And as we've long shown, interest rates are the single biggest driver of swings in house prices. But as the RBNZ's work makes clear, monetary policy can only operate against the backdrop of what broader institutional and policy settings mean for the housing market.

In simple terms, house prices are determined by demand and supply factors and the interactions between them. Starting with the demand side, the RBNZ showed how to assess the sustainable level of house prices through a 'user cost' model. This model works by equating the expected returns from owning versus renting, and emphasises the importance of financial factors such as interest rates and tax settings.

As we mentioned, this approach isn't new. The Westpac economics team has been using this model to analyse house prices since 2007, and the original literature on it dates back to 1984. The RBNZ's version of this model, which it introduced last year, makes a useful distinction between short-term interest rates and expected interest rates over the long run. The latter has played the biggest role in the upward trend in house prices over the last few decades, not just in New Zealand but globally.

The user cost model highlights another factor in the high level of house prices in New Zealand: tax settings. It has long been recognised that investors face a lower effective marginal tax rate on rental property than on financial assets such as bank deposits and equities. Correcting for this distortion has always been politically difficult – a capital gains tax on property seems to be a no-go area. However, the tax changes last year to limit interest deductibility for property investors go some way in this direction.

The user cost model addresses the supply of housing only indirectly. The key insight is that if interest rates fall, then rental yields should adjust lower as well (and vice versa). If the supply of housing is very responsive, then more of the adjustment will happen through rents. But if supply is unresponsive, the adjustment will happen through the value of houses instead.

The latter has been the better description of the New Zealand housing market in recent decades. As recent work by the Infrastructure Commission shows, land use restrictions and urban planning rules have been an increasing handbrake on the supply of housing in the last 50 years. These rules have pushed cities towards low-density housing, sprawl, and insufficient supply in the places that people want to live and work.

Strong financially-incentivised demand for housing, combined with limited responsiveness in supply, accounts for a great deal of the relatively high level of house prices in New Zealand. That doesn't detract from the role that interest rates play in house price cycles. Indeed, New Zealand has just experienced one of its most intense house price booms in history – prices rose almost 50% between mid-2020 and the end of 2021 – at a time when net migration slowed sharply, homebuilding was running at multi-decade highs, and tax settings were made less favourable for property investors.

As mortgage rates have risen from their lows, the user cost approach has pointed to a sharp drop in what buyers should be willing to pay – houses have rapidly flipped from being 'undervalued' to 'overvalued'. And sale prices have quickly followed, falling about 6% from their peak in the last six months according to the REINZ house price index.

Conway's speech made an important point that house price 'affordability' and 'sustainability' are quite different concepts. Distortions in the housing market mean that prices can be sustained for a long time at levels that are 'unaffordable' for the average household. Forecasters – including the RBNZ – have often made the mistake of conflating the two, declaring that house prices can't possibly rise further and are due for a fall because they've reached 'unaffordable' levels. The track record of such predictions speaks for itself.

With that in mind, what does the RBNZ's work suggest for house prices going forward? Conway suggests that "the tide may well have turned against housing being a one-way bet for a generation of Kiwis." But there are reasons to be cautious around that conclusion.

Higher interest rates will clearly play their role in the short term at least. Both we and the RBNZ are forecasting a 15% peak-to-trough fall in house prices over this year and the next. In the RBNZ's view, this would bring prices back to a 'sustainable' level. But it would still only take them back to where they were at the start of 2021, hardly making a dent in the long-running issue of affordability.

The RBNZ sees hope for a sea-change on the supply side due to changes in land use regulations. The National Policy Statement on Urban Development (NPS-UD) directs local councils to remove overly-restrictive planning rules and enable higher housing density. But the need for the NPS itself points to deeper-rooted issues: why are councils not incentivised to provide more housing in the first place? This may be a question around who bears the costs of development; it may be concerns around liability for shoddily-built homes. Again, these are not new insights – if there's been little progress on dealing with these problems, it has not been from a lack of people pointing them out.

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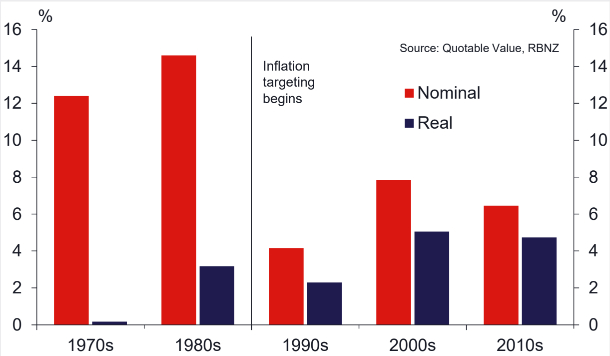
Chart of the week

In a 1998 speech RBNZ Governor Don Brash warned that, in a low-inflation environment, property investors could no longer rely on double-digit house price gains each year. While that has been broadly true, house prices have still seen some substantial gains: since the start of inflation targeting in 1990, they have risen by about 7% a year on average. And in inflation-adjusted terms, house prices have generally risen faster since 1990 than they did in the two decades beforehand.

Annual house price growth by decade

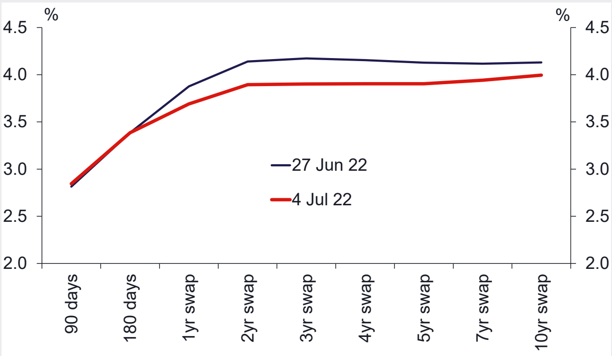


Fixed vs floating for mortgages

Wholesale interest rates have fallen sharply in the last couple of weeks, as markets have reassessed the prospects for the global economy. If these moves are sustained, we could see some falls in fixed-term mortgage rates in the coming weeks.

Even so, market pricing remains higher than what would be consistent with our forecast of a 3.5% peak in the Official Cash Rate this year. This suggests to us that fixing for a short period and rolling it is still likely to produce a lower borrowing cost on average over the next few years. Fixing for a longer term could prove more expensive, but may suit those who want more certainty in their repayments.

NZ interest rates



The week ahead

NZ Q2 NZIER Quarterly Survey of Business Opinion

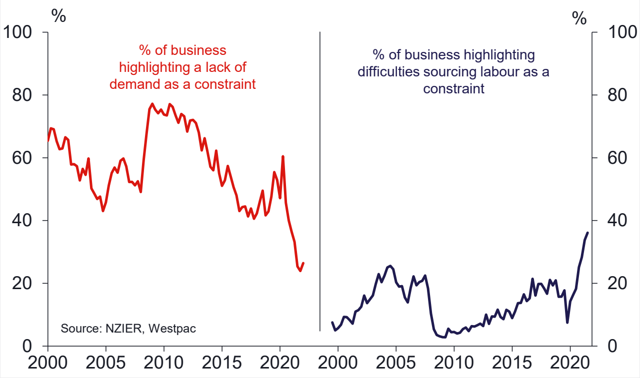
Jul 5, Domestic Trading Activity (past 3mths) last: –9.3

The NZIER's March quarter survey of business opinion highlighted the rocky start to the year for many New Zealand businesses. Trading activity remained weak. Shortages of staff and materials were acute. And profit margins were being squeezed as operating costs continued to push higher.

As we've moved into the middle part of the year, earlier Covid related disruptions have eased. However, the other challenges that businesses have been grappling with have remained acute, particularly the pressures on costs. That signals an ongoing squeeze on profit margins.

The survey's various price and cost gauges are all expected to point to continued strong and widespread inflation pressures. That will be of interest for the RBNZ ahead of the July policy decision.

Factors constraining business activity



NZ GlobalDairyTrade auction, whole milk powder prices

July 6, Last: –0.6%, Westpac: +1%

We expect whole milk powder prices (WMP) to post a modest rise of around 1% at the upcoming auction.

In the absence of fresh market-moving news, we expect prices to largely head sideways in the short term.

Further out, we anticipate that very weak global supply combined with rebounding Chinese demand should help keep prices at very elevated levels.

Whole milk powder prices

Aus May housing finance

Jul 4, Last: –6.4%, WBC f/c: –5.0%
Mkt f/c: –2.5%, Range: –5.0% to 2.0%

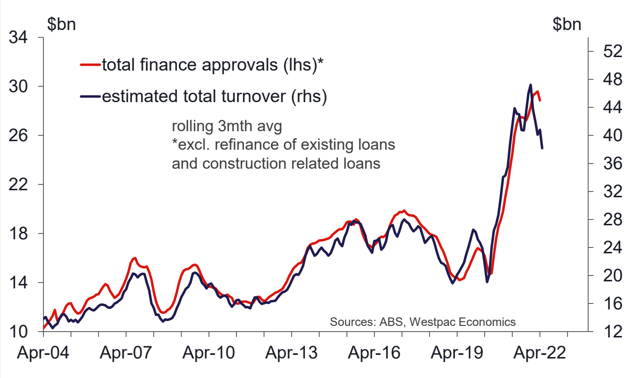
Housing finance approvals weakened sharply in April, recording a 6.4% fall, the biggest monthly decline since the first COVID lockdown, and prior to that, since the tightening in prudential conditions in 2015.

The April fall brings finance approvals more into line with turnover, which has shown a big nominal decline since the start of the year, falling by 20–25%.

That pull-back – which is now coming from a combination of falling sales volumes and declining prices – will continue to show through in the May finance approvals which are expected to see another significant 5% fall.

Owner occupier loans are again likely to see a slightly larger decline than investor loans.

New finance approvls*



The week ahead

Aus May dwelling approvals

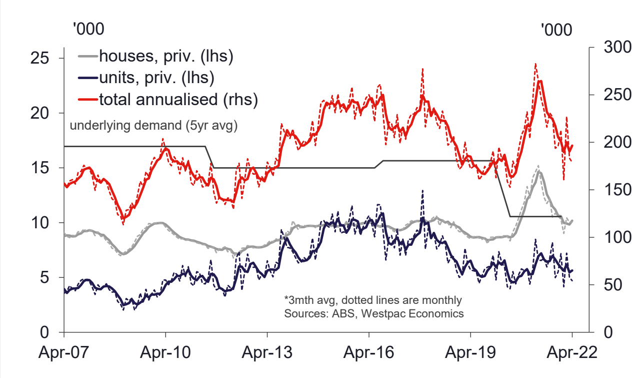
Jul 4, Last: –2.4%, WBC f/c: –5.0%
Mkt f/c: –2.0%, Range: –8.0% to 5.0%

Early 2022 saw an incredibly volatile profile for dwelling approvals: a –27% plunge in January, followed by a +42% rebound in February and a steep –18.5% drop in March.

The easing of disruptions led to a moderation in April, declining by just –2.4%. However, the, detail showed a notable broad-based surge in the average value of dwelling approvals for detached houses – a 22%yr rise the strongest annual pace since the mid-1970s.

A 'perfect storm' looks to be hitting Australia's dwelling construction sector. Profits are being squeezed by rising costs and a large backlog of projects on fixed price terms; compounded by an aggressive RBA tightening cycle and a sharp slowdown in housing markets. Therefore, we expect dwelling approvals to move another leg lower in May, declining by 5%

Dwelling approvals



Aus RBA policy decision

Jul 5, Last: 0.85%, WBC f/c: 1.35%
Mkt f/c: 1.35%, Range: 1.35% to 1.60%

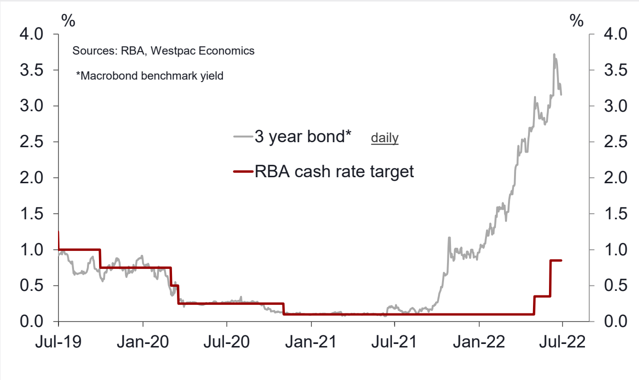
The RBA is, in our view, likely to deliver a back-to-back 50bp interest rate hike at the July board meeting, lifting the cash rate from 0.85% to 1.35%.

Globally and domestically, the inflation outlook is challenging, with risks that inflation expectations ratchet higher. In Australia, headline inflation is expected to approach around 7% by year end, well above the RBA's 2–3% target band. The labour market is the tightest in 50 years and wages growth is accelerating, albeit from modest levels.

In this environment, official interest rates need to promptly move back towards neutral levels, followed by a measured shift into contractionary territory.

In May, the RBA lifted rates from the record low of 0.1%, up by 25bps, the first hike since 2010, followed by a 50bp hike in June. After July's 50bp hike, Westpac expects the cash rate to rise to 1.85% by August. Moves thereafter are likely to be more gradual, with the cash rate forecast to peak at 2.6% in February 2023

RBA cash rate and 3 year bonds



Aus May trade balance, AUDbn

Jul 7, Last: 10.5, WBC f/c: 10.6
Mkt f/c: 10.9, Range: 10.0 to 11.5

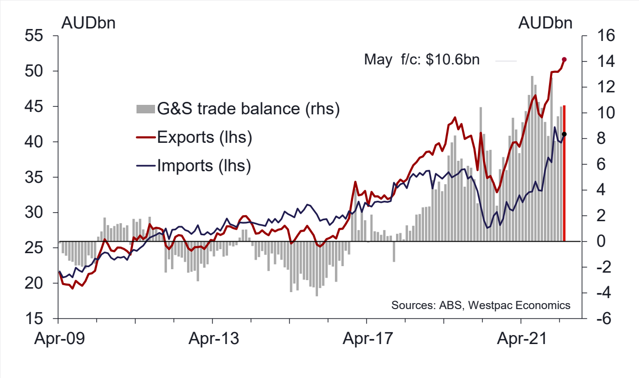
Australia's monthly trade surplus averaged $10.5bn over the past twelve months, including a $10.5bn outcome for April.

For May, exports and imports are both expected to post solid gains, such that the trade balance remains little changed, at a forecast $10.6bn.

Export earnings grew by a forecast 2.5%, a rise of $1.3bn. Coal likely led the way, on higher prices and volumes. Gold potentially made a partial rebound off a weak base (demand from China having been dented by lockdowns) and prices in general are up on the lower AUD (–5% against the USD). Service exports may have extended their 9.6% rally in April on the national border reopening. Against that, global prices weakened for iron ore and base metals.

Imports rose by a forecast 3%, up by $1.2bn. This likely reflected both higher volumes, to meet rising domestic demand, and higher prices, on a lower AUD and the surge in global energy costs.

Ausrtralia's trade balance



The week ahead

US Jun employment report

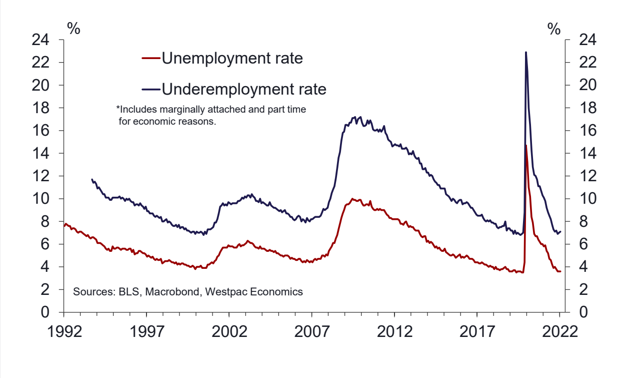
Jul 8, payrolls, Last: 390k, WBC f/c: 300k, Mkt f/c: 250k
Jul 8, unemployment rate, Last: 3.6%, WBC f/c: 3.6%, Mkt f/c: 3.6%

The pace of employment growth is definitely slowing in the US. But, given the mismatch between demand and supply and the high starting point, it is likely to be a number of months before employment growth can be characterised as soft or weak.

Even though we expect growth to remain below trend through 2022 and 2023, our base remains only a modest rise in the unemployment rate to end-2023 circa 1ppt. It is important to note however that, to this baseline view, the risks are heavily skewed towards weaker outcomes for activity and hence higher unemployment.

As balance returns to the labour market, wage growth is likely to moderate further, limiting support for inflation

US labour market near peak strength

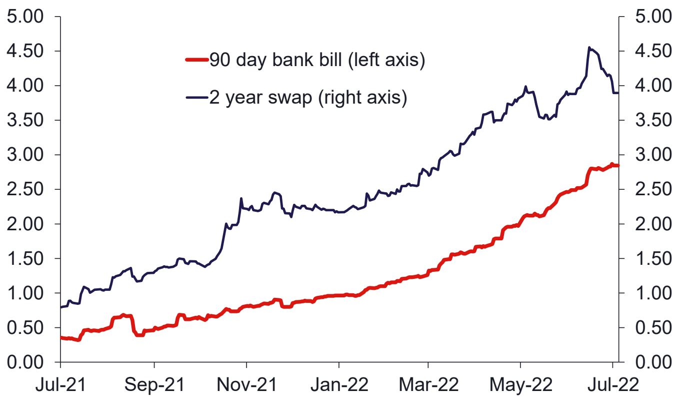


New Zealand forecasts

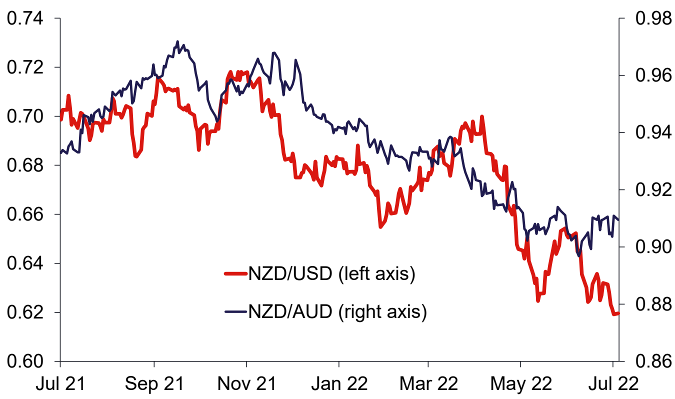
Economic forecasts	Quarterly				Annual			
	2021	2022						
% change	Mar (a)	Jun	Sep	Dec	2020	2021	2022f	2023f
GDP (Production)	-0.2	1.0	0.7	1.2	-2.1	5.6	2.1	3.3
Employment	0.1	0.2	0.2	0.2	0.6	3.5	0.8	0.9
Unemployment Rate % s.a.	3.2	3.1	3.0	3.0	4.9	3.2	3.0	3.3
CPI	1.8	1.1	1.2	0.4	1.4	5.9	4.5	2.7
Current Account Balance % of GDP	-6.5	-7.5	-7.8	-7.5	-0.8	-5.8	-7.5	-6.1

Financial forecasts	Sep-22	Dec-22	Mar-23	Jun-23	Sep-23	Dec-23	Mar-24
Cash	3.00	3.50	3.50	3.50	3.50	3.50	3.50
90 Day bill	3.40	3.60	3.60	3.60	3.60	3.60	3.60
2 Year Swap	4.30	4.10	4.00	3.80	3.50	3.20	2.90
5 Year Swap	4.30	4.10	3.95	3.75	3.50	3.30	3.05
10 Year Bond	4.00	3.80	3.60	3.40	3.20	3.00	2.90
NZD/USD	0.65	0.68	0.70	0.71	0.72	0.72	0.72
NZD/AUD	0.90	0.91	0.91	0.91	0.91	0.90	0.90
NZD/JPY	85.8	87.7	88.9	88.0	87.2	87.1	86.4
NZD/EUR	0.61	0.62	0.63	0.63	0.63	0.63	0.62
NZD/GBP	0.52	0.54	0.55	0.55	0.54	0.54	0.53
TWI	71.6	73.3	74.4	74.7	74.5	74.7	74.5

2 year swap and 90 day bank bills



NZD/USD and NZD/AUD



NZ interest rates as at market open on 4 July 2022

Interest rates	Current	Two weeks ago	One month ago
Cash	2.00%	2.00%	2.00%
30 Days	2.38%	2.25%	2.03%
60 Days	2.62%	2.52%	2.26%
90 Days	2.85%	2.79%	2.49%
2 Year Swap	3.90%	4.47%	3.88%
5 Year Swap	3.91%	4.47%	3.94%

NZ foreign currency mid-rates as at 4 July 2022

Exchange rates	Current	Two weeks ago	One month ago
NZD/USD	0.6196	0.6357	0.6523
NZD/EUR	0.5943	0.6035	0.6080
NZD/GBP	0.5117	0.5189	0.5195
NZD/JPY	83.80	85.74	85.21
NZD/AUD	0.9095	0.9095	0.9039
TWI	70.29	71.62	72.36

Data calendar

		Last	Market median	Westpac forecast	Risk/Comment
Mon 04					
Aus	Jun MI inflation gauge	4.8%	–	–	Inflation well above the RBA's target band.
	Jun ANZ job ads	0.4%	–	–	Job vacancies a plenty - limited labour supply.
	May housing finance	–6.4%	–2.5%	–5.0%	More sharp falls likely as market enters correction phase...
	May investor finance	–4.8%	–	–4.5%	... both turnover and prices now moving lower...
	May owner occupier finance	–7.3%	–	–5.5%	... owner occupier loans to lead the way.
	May dwelling approvals	–2.4%	–2.0%	–5.0%	Heading for another leg lower.
Eur	Jul Sentix investor confidence	–15.8	–20.0	–	Growth outlook remains very weak.
US	Independence Day, 4th of July	–	–	–	Public holiday; markets closed.
Tue 05					
Aus	RBA policy decision	0.85%	1.35%	1.35%	Back-to-back 50bp moves - a prompt return towards neutral.
NZ	Q2 QSBO business opinion	–9.3	–	–	Cost pressures continuing to squeeze margins.
	Jun ANZ commodity prices	–2.8%	–	–	Prices softened on the back of China's Covid lockdown.
Jpn	Jun Nikkei services PMI	54.2	–	–	Final estimate for the month.
Chn	Jun Caixin services PMI	41.4	49.0	–	Official PMI indicates services recovery is underway.
Eur	Jun S&P Global services PMI	52.8	52.8	–	Final estimate for the month.
UK	Jun S&P Global services PMI	53.4	–	–	Final estimate for the month.
US	May factory orders	0.3%	0.5%	–	Capital investment moderately positive so far in Q2.
Wed 06					
NZ	GlobalDairyTrade auction prices (WMP)	–0.6%	–	1.0%	Futures market pointing to small price gain.
Eur	May retail sales	–1.3%	0.6%	–	Cost of living pressures are weighing on retail trade.
US	Jun S&P Global services PMI	51.6	51.6	–	Inflation is stripping some momentum out of services...
	Jun ISM non-manufacturing	55.9	54.3	–	... but the sector generally remains in robust health.
	May JOLTS job openings	11400k	–	–	Continues to point to extraordinary labour demand.
	FOMC June meeting minutes	–	–	–	Focus is on discussions of the path for policy in 2022.
Thu 07					
Aus	May trade balance $bn	10.5	10.9	10.6	Imports f/c +3% (vol's & prices). Exports f/c +2.5% (led by coal).
Chn	Jun foreign reserves US$bn	3127.78	3127.78	–	Little need for authorities to be active in the market in 2022.
US	May trade balance $bn	–87.1	–84.9	–	Deficit to remain wide.
	Initial jobless claims	231k	–	–	To remain at a low level.
	Fedspeak	–	–	–	Waller and Bullard.
Fri 08					
Jpn	May household spending	–1.7%	2.1%	–	Pent-up demand outweighs purchasing power concerns.
	May current account balance ¥bn	501.1	162.0	–	Import value lifts on weaker Yen and higher energy costs.
US	Jun non-farm payrolls	390k	250k	300k	Jobs growth moderating but still healthy...
	Jun unemployment rate	3.6%	3.6%	3.6%	... keeping pressure on the unemployment rate...
	Jun average hourly earnings %mth	0.3%	0.3%	0.3%	... and aiding wages growth.
	May wholesale inventories	2.0%	–	–	Final estimate; restocking continuing at robust pace
	May consumer credit $bn	38.07	30.00	–	Aggressive monetary tightening cooling credit growth.
	Fedspeak	–	–	–	Williams.
Sat 09					
Chn	Jun PPI %yr	6.4%	5.9%	–	Producer inflation easing but elevated.
	Jun CPI %yr	2.1%	2.4%	–	Pass through to consumer inflation still limited.
	Jun new loans, CNYbn	1890.0	2200.0	–	Credit momentum is building...
	Jun M2 money supply %yr	11.1%	11.1%	–	... thanks to support from authorities.

International forecasts

Economic Forecasts (Calendar Years)	2018	2019	2020	2021f	2022f	2023f
Australia						
Real GDP %yr	2.8	2.0	-2.1	4.8	4.5	2.7
CPI inflation %yr	1.8	1.8	0.9	3.5	6.6	3.0
Unemployment rate %	5.0	5.2	6.8	4.7	3.2	3.5
Current account % of GDP	-2.1	0.7	2.6	3.5	1.4	-1.3
United States						
Real GDP %yr	3.0	2.2	-3.4	5.7	2.5	1.6
CPI inflation %yr	2.4	1.9	1.2	5.1	7.1	2.5
Unemployment rate %	3.9	3.7	8.1	5.4	3.6	4.0
Current account % of GDP	-2.3	-2.6	-2.5	-2.4	-2.4	-2.4
Japan						
Real GDP %yr	0.6	0.3	-4.8	1.8	1.7	1.8
Euro zone						
Real GDP %yr	1.9	1.3	-6.6	4.9	2.2	1.5
United Kingdom						
Real GDP %yr	1.3	1.4	-9.9	7.2	3.7	0.0
China						
Real GDP %yr	6.7	5.8	2.3	8.1	5.3	5.5
East Asia ex China						
Real GDP %yr	4.4	3.7	-2.4	4.2	4.5	4.6
World						
Real GDP %yr	3.6	2.8	-3.3	5.5	3.4	3.3

Forecasts finalised 10 June 2022

Interest rate forecasts	Latest	Sep-22	Dec-22	Mar-23	Jun-23	Sep-23	Dec-23	Mar-24
Australia								
Cash	0.85	1.85	2.35	2.60	2.60	2.60	2.60	2.60
90 Day BBSW	1.81	2.30	2.72	2.80	2.80	2.80	2.80	2.80
10 Year Bond	3.54	3.90	3.60	3.30	3.00	2.70	2.50	2.35
International								
Fed Funds	1.625	2.875	3.375	3.375	3.375	3.375	3.125	2.875
US 10 Year Bond	2.96	3.30	3.10	2.90	2.70	2.50	2.30	2.20

Exchange rate forecasts	Latest	Sep-22	Dec-22	Mar-23	Jun-23	Sep-23	Dec-23	Mar-24
AUD/USD	0.6833	0.72	0.75	0.77	0.78	0.79	0.80	0.80
USD/JPY	135.12	133	131	129	127	125	123	121
EUR/USD	1.0455	1.08	1.10	1.12	1.13	1.14	1.15	1.16
GBP/USD	1.2124	1.25	1.27	1.28	1.30	1.32	1.34	1.35
USD/CNY	6.7051	6.50	6.35	6.25	6.20	6.15	6.15	6.10
AUD/NZD	1.1045	1.11	1.10	1.10	1.10	1.10	1.11	1.11

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