4 June 2009

Westpac InstitutionalBank

Flash in the pan

New Zealand's housing market pickup will prove unsustainable

- **New Zealand house sales are rising rapidly. Prices are probably rising too.**
- **Low mortgage rates were the main factor stimulating the market. But long-term mortgage rates have since risen sharply, undermining the pickup.**
- **Housing data in the immediate future may be strong, but we predict a return to low sales and gentle price declines in H2 2009.**

Current situation

Considering the environment of global economic carnage, it is extraordinary that the New Zealand housing market is picking up. But picking up it is. Seasonally adjusted house sales have jumped 74% in five months, from rock-bottom to roughly average. The number of days to sell a house has fallen back to 2007 levels. And the number of available listings in Auckland has started to fall. We don't have any reliable price data for 2009 yet, but market activity is an excellent indicator. When houses are selling at this clip, chances are that prices are rising, not falling. The Real Estate Institute reports that the median sale price has risen from $325,000 to $340,000 in the past three months. We doubt that house prices have risen that much on a like-for-like basis (medians can be skewed by the composition of sales). We would put the house price increase for the second quarter of 2009 at more like 1%.

The main factor behind the price pickup is falling mortgage rates. In March 2008 the average two-year fixed mortgage rate offered to new customers was 9.6%. By February this year it had fallen to 5.9% – a 40% decline in the cost of finance. The five-year fixed rate fell from 9.5% to 6.6% over a similar period, allowing buyers to lock in cheap financing. Long-term mortgage rates have a huge influence on house price inflation in New Zealand, so the market reaction is in fact unsurprising, despite the recession. Indeed, in our last housing update six months ago we predicted lower mortgage rates would create a market thaw in 2009. Monetary policy is definitely working in New Zealand.

The market pickup has been concentrated at the bottom end of the market, which is more interest rate sensitive due to the dominance of investors and first home buyers.

Figure 1: House sales and house prices

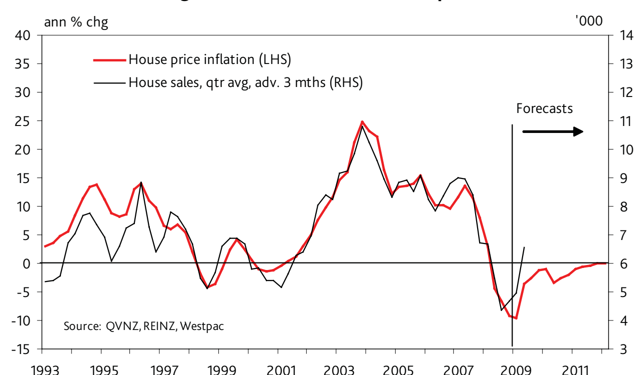
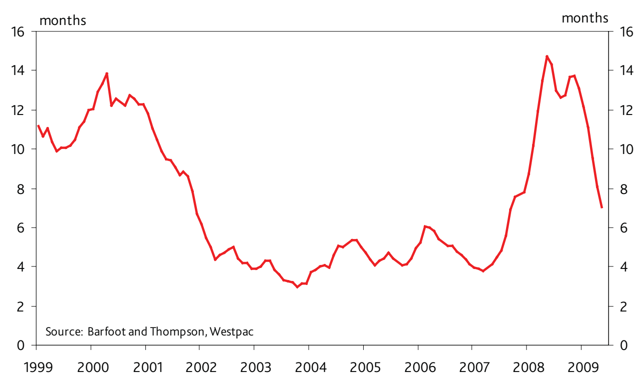


Figure 2: REINZ days to sell

Figure 3: Available listings in Auckland – months' supply



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The second cause of this housing market pickup is rising net migration. In 2007 and 2008 hoards of New Zealanders moved to Australia, almost negating arrivals of foreign migrants. Net migration (arrivals less departures) was just 3,800 in 2008, the lowest annual total since 2000. But in the past few months the number of Kiwis crossing the Tasman has plunged, pushing the net migration figures up sharply. There were 5,500 net migrants in the first four months of this year. We expect 2009 net migration to total 20,000 people, or 0.5% of the population.

Combine this faster population growth with the ultra-low level of building activity, and we quickly arrive at the conclusion that New Zealand is about to suffer a housing shortage. Housing shortages do not necessarily create house price increases if other fundamentals are working against the market. But they certainly help support prices, in the short run at least.

The final factor influencing prices may be the changing news regarding tax cuts. Property is a very effective income tax shelter. When the new Government was elected there was an expectation that income tax rates would start falling. The value of property as a tax shelter would wane if tax rates fell just as umbrellas are less useful in drier climates. As it turns out, events have overtaken us and tax cuts are now less certain. So the value of property as a tax shelter is holding up after all.

Will it last?

To put it bluntly, this period of rising house prices is unlikely to last. We expect prices to start falling again soon, for the simple reason that longer-term mortgage rates have risen sharply since March. Lower mortgage rates sparked the market revival, and higher rates will extinguish it. The mortgage rate reversal will have affected buying decisions made in April and May, and so could start showing up as subdued prices from June.

Mortgage rates are likely to continue weighing on the market for the next few years. Short-term rates might fall, but only temporarily, and long-term rates are more likely to rise. There are many factors keeping New Zealand mortgage rates above the March lows. (1) International term rates have risen as deflation fears have subsided. (2) The credit crunch is forcing banks to pay more to secure funds for on-lending. (3) The Reserve Bank of New Zealand is close to the end of its OCR easing cycle.

There are a couple of other reasons to doubt the longevity of this housing market pickup. Unemployment is set to rise further in 2009, forcing more sales and creating greater uncertainty for potential buyers. And credit conditions remain tight.

The only positive factor for house prices in late 2009 is expected to be continuing strong net migration. This serves to keep our prediction of price declines modest, but is not yet strong enough to have us calling sustained price increases.

Figure 4: Mortgage rates and house prices

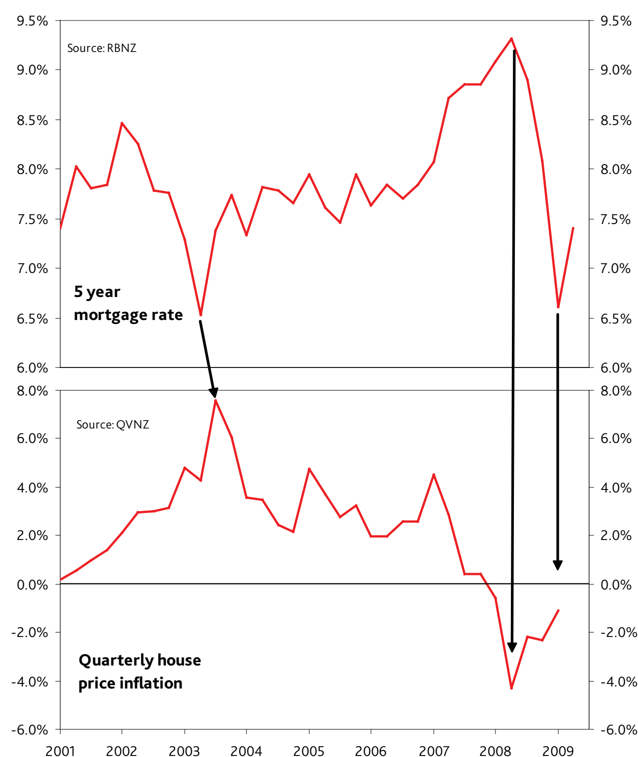


Figure 5: Net migration

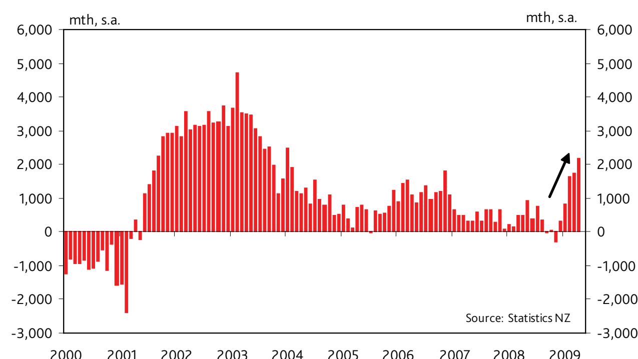
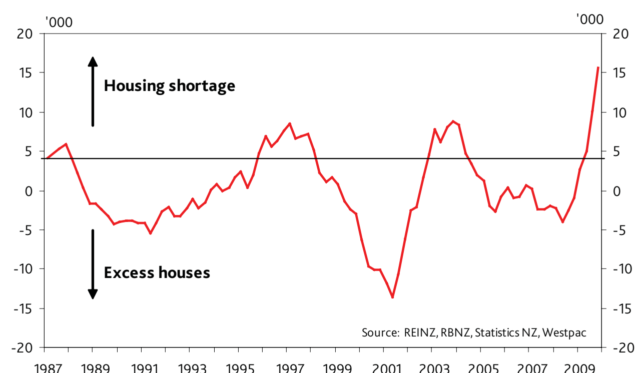


Figure 6: Housing demand/supply balance



Predictions

The next batch of housing data, released next week, will probably show that May was still strong. However, we expect a return to low sales volumes and falling prices in the second half of 2009. The second half of 2009 will likely be slower than the first half, but will be better than 2008. Our price forecast is for a 5% decline over the next 18 months, with the risks on either side of that mostly determined by the evolution of interest rates.

Our house price forecast remains less pessimistic than others. The more pessimistic forecasters out there seem influenced by the fact that New Zealand's house price to income ratio is much higher than it was in the 1990s. However, there is a deep flaw in assuming that the old house price to income ratio will reassert itself: changes in taxes, interest rates, and inflation have made property ownership more attractive relative to the 1990s. Restricted land supply might also have pushed up prices. So the house price to income ratio *should* be higher now than it was in the 1990s. Our own investor value model takes account of changing taxes, interest rates and inflation. It suggests house prices are about 8% overvalued at present. That overvaluation can be corrected by a combination of gentle price declines, and time.

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Figure 7: Labour market outlook

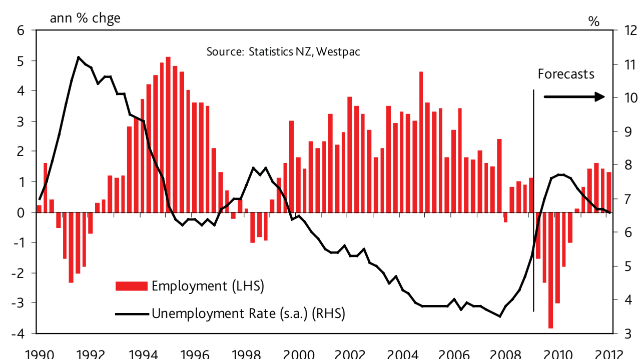
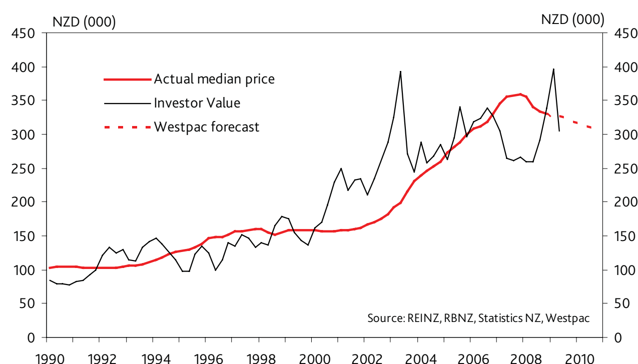


Figure 8: Investor value of housing and actual house prices



Technical Appendix: Investor value of housing

The investor value of housing model notes that the rental market will be in equilibrium if rental income plus expected capital gains are equal to mortgage interest and expenses, after allowing for tax and a risk premium. Under New Zealand's tax system the equilibrium condition is:

$$\text{Rent}(1-t) + P\pi^e = P(i+f)(1-t) + Pe,$$

where t is the marginal tax rate, P is the house price, π^e is the long run expected rate of capital gain on property, i is the mortgage interest rate, f is tax-deductible maintenance costs as a proportion of the house's value, and e is a risk premium. Rearranging, the investor value is given by:

$$P = \text{Rent}(1-t) \,/\, \left((i+f)(1-t) - (\pi^e - e) \right)$$

The $313,000 current investor value is based on the following assumptions:

- Rent = $11,500, based on June 2008 Household Economic Survey adjusted for inflation and allowing two weeks vacant per year.
- Tax = 38%.
- i = 7.4%, current 5-year mortgage rate.
- f = 3.2% (based on conversations with property investors).
- π^e = 5.6%, composed of 2.3% expected inflation plus the mean real capital gain from 1971 to 2006 of 3.3% per annum.
- e = 1.3%, calibrated to make investor value mean approximately equal to actual house price mean during 1990s.

These figures are meant to represent the average investor's long run expectations.

WEB: 34/09