



**RODNEY'S RAVINGS** take an open-minded and at times irreverent look at topical economic issues. Unlike our pay-to-view reports that are for the eyes of subscribers only, the **RAVINGS** are free and you may forward them to other people. You can sign up to the **RAVINGS** on our website – <http://www.sra.co.nz/lists/>. The same distribution listed is used for the **Property Insights** reports and for notification of forthcoming seminars and property market reports.

## RODNEY'S RAVINGS

### Is a house price bubble brewing?

#### EXECUTIVE SUMMARY

The title of the latest blog on <http://www.landlords.co.nz/blog/> is, “[Is there a property bubble brewing?](#)” The blog starts by stating: “For all those property bears out there I have some disconcerting news. The property market is starting to stir and it’s only going to go one way – up.” Blogs, like Ravings, should be considered in the proper context. At times they are designed to be controversial and in pursuit of stirring up interest in a topic may be skimpy on quality analysis. I believe the LandLords’ blog should be viewed in this context as should to some extent my response in this Raving that puts the sword to some of the claims made in the blog. But this is an important topic that warrants quality and independent analysis of the sort we offer in our pay-to-view reports and as contained in this Raving.

Having warned that a tumble in house prices was coming in the original **Housing Hell** Raving in 2007 (see <http://sra.co.nz/pdf/housinghell.pdf>), some have labelled me a property bear (i.e. a doomsayer on property). But clients of our **Housing Prospects** reports know that I provided advance warning of the temporary upside in house prices in 2009 and again last year. We provide clients with a well-founded, balanced and comprehensive assessment of house price prospects nationally and for 24 cities/districts. The **Housing Prospects** reports also provide a five point assessment of how housing stacks up as a medium-term investment option. For info on these report visit <http://www.sra.co.nz/housing.html> or contact me.



Rodney Dickens  
Managing Director and Chief Research Officer  
Strategic Risk Analysis Limited  
[rodney@sra.co.nz](mailto:rodney@sra.co.nz)  
[www.sra.co.nz](http://www.sra.co.nz)



### Are we on the verge of the next house price boom?

The Landlords' blog suggests that "right now the housing market is perky" and that "most of the ingredients [for a bubble in prices] are there", including:

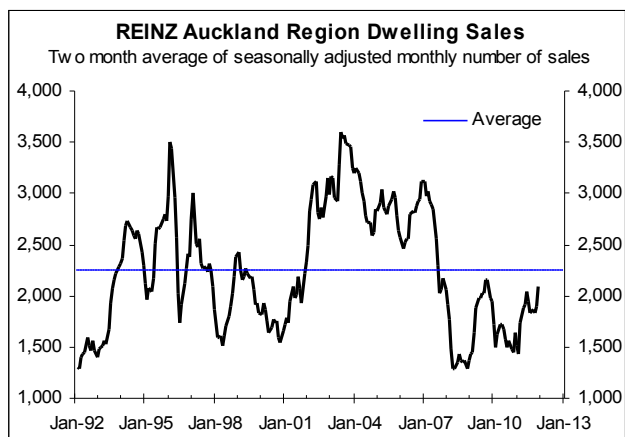
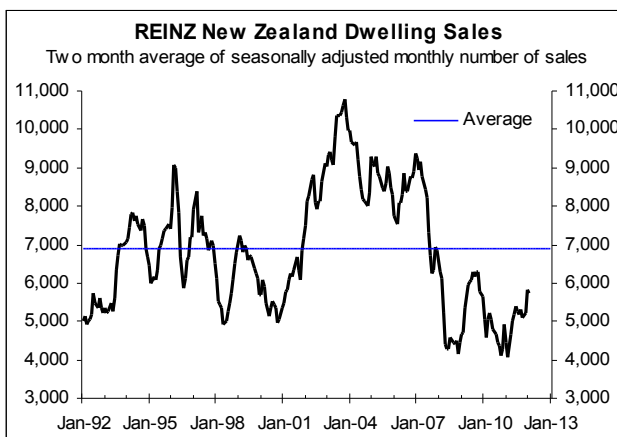
- "Money is cheap."
- "Banks have now eased this [lending] requirement and will often lend up to 90-95% of a house's value."
- "Then there is the supply and demand equation. ... We aren't building enough houses fast enough to house our growing population."
- "The other sign that things are happening is the news about rents in central Auckland. ... History tells us that the first place a housing bubble starts is central Auckland then it moves outwards into the suburbs. ... Over time these waves reach the provincial centres like Rotorua and house prices increase."
- "We hear all this news that houses in New Zealand are unaffordable. One thing that I am sure about is that they are not likely to suddenly become more affordable (unless of course our incomes suddenly rise rapidly)."

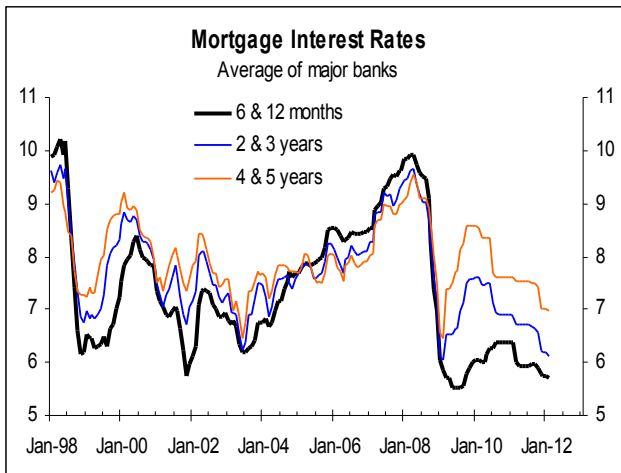
Source: <http://www.landlords.co.nz/blog/>

### How do Landlords' claims stack up?

Is the market "perky"? Most recently the national number of dwelling sales reported by REINZ is 16% below the historical average number (left chart), while in Auckland the number is 7% below the historical average (right chart). I suppose to some people something below average might seem "perky", but to me it reflects a somewhat subdued market. The charts use two month averages of the numbers of sales reported by REINZ to smooth out some of the monthly volatility, while I have adjusted the monthly numbers to remove the seasonal pattern (visit <http://sra.co.nz/pdf/SeasonalAdjustment.pdf> for a discussion of seasonally adjusted data and how to interpret it).

From the perspective of the depths of despair in late 2010 and early 2011 things might well be described as being perky (e.g. the number of sales most recent are up 41% nationally and 43% in the Auckland region from the respective recent trough levels). But in the context of a housing boom the recent numbers are disappointing rather than perky (e.g. the national number is 46% below the average number during the boom that lasted from 2003 to 2007, while the number in the Auckland region is 29% down). "Perky" might be in the eyes of the beholder and it certainly differs depending on what the current situation is compared with. But a balanced assessment should conclude that the market is still somewhat lackadaisical by historical standards and slumming it compared to the conditions that reflect a boom. This is not to say that the number of sales will not head higher on the back of the small falls in mortgage interest rates in October-November and in the last couple of weeks. But I agree with the Landlords' comment that money is "as cheap as it ever will be" (i.e. there isn't scope for a further significant fall in mortgage interest rates of the sort needed to drive up the number of sales into the "bubble" ballpark).



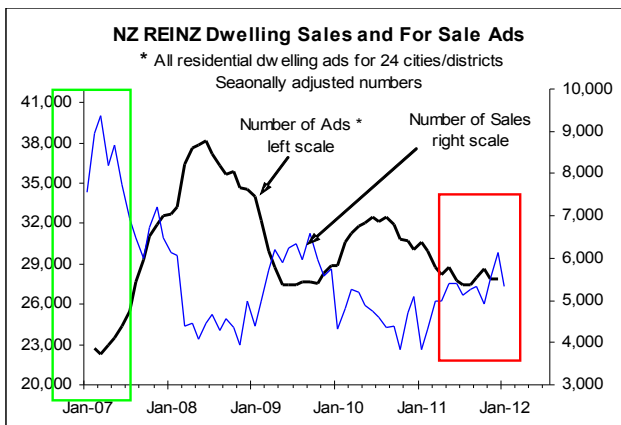


Is money “cheap”? By historical standards mortgage interest rates are low, as shown in the adjacent chart. The chart also shows the falls since October that will drive some further increase in the number of house sales. But floating and short-term fixed rate (e.g. the average of the 6-month and 1-year fixed rates shown in the chart) are the lowest rates and haven’t fallen much. If cheap money was going to drive a “bubble” in the housing market the number of sales should already be well above historical average levels rather than somewhat below. And a housing bubble needs significant participation by investors. The most recent BNZ-REINZ survey shows that investors are not playing a significant part in the market (to access this visit <http://tonyalexander.co.nz/bnz-reinz-survey/>). Money

is cheap but investors are not playing a major part because the financial incentives don’t stack up for them, as discussed in detail in our **Housing Prospects** reports. This is because of the housing affordability challenge that the Landlords’ blog only offers glib comments on. Viewed from an investor’s perspective unaffordable housing equals the prospect of at best mediocre medium-term returns. Great returns are to be had when there is blood on the street and assets are so cheap they are screaming out to be bought, albeit that in such circumstances most would-be investors are frightened by the blood and interpret the creams as reason for caution. Great returns are not achieved by buying unaffordable assets and housing market bubbles don’t start from a platform of unaffordable prices!!!

The number of sales largely reflects the level of demand, while prices are driven by the combination of demand and supply. If supply is greatly restricted there could be a boom in prices even with demand being below average. In the context of the demand-supply balance the Landlords’ blog focuses on the level of new house building and claims that “We aren’t building enough houses fast enough to house our growing population”. By inference this is supposed to mean existing house prices could boom. This is a red herring that a number of bank economists have also abused.

A moment of thought is all that is required to conclude that the low level of building doesn’t represent unsatisfied demand for housing. If there is unsatisfied demand for new housing who or what is stopping people from building? The Landlords’ blog correctly points out that interest rates are low and banks are lending. In both our **Housing Prospects** and **Building Barometer** reports we analysis the national and regional section markets and there is no shortage of sections to build on. The low level of building is because demand is low (i.e. the inference in the Landlords’ blog that the low level of new building should be viewed as an ingredient for a bubble in existing house prices is a red herring). Low building reflects a rational response by people to new housing and especially section prices being unaffordable. As explained in detail in our pay-to-view reports, people are rationally economising on housing because it is expensive. This has broken the link between population growth and new house building that the Landlords’ blog is relying on. The traditional link between population growth and new house building can remain broken while new housing (i.e. section prices) remains unaffordable, which the Landlords’ blog suggests will be forever.



The demand-supply balance in the existing housing market can be looked at directly rather than indirectly using a red herring. The adjacent chart compares the number of dwelling sales reported by REINZ and the number of for-sale listings on the real estate website [www.reinz.co.nz](http://www.reinz.co.nz). The green boxed area shows what the market looks like when the demand-supply balance supports booming house prices. The number of sales is high (blue/thin line, right scale) while the number of listings is low (black/thick line, left scale). The red boxed area highlights the current demand-supply balance in the national existing housing market. The demand-supply balance isn’t even close to the

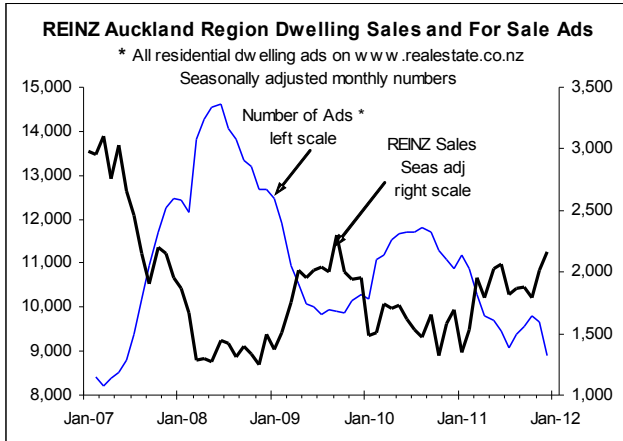


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state the would justify talk of an imminent bubble in prices. The number of listings is probably below the historical average – I can't be sure because we have only been collecting data on listings back to early 2007. But it is certainly not low enough in the context of the number of sales to suggest there is a significant undersupply or to predict a pending bubble in prices.

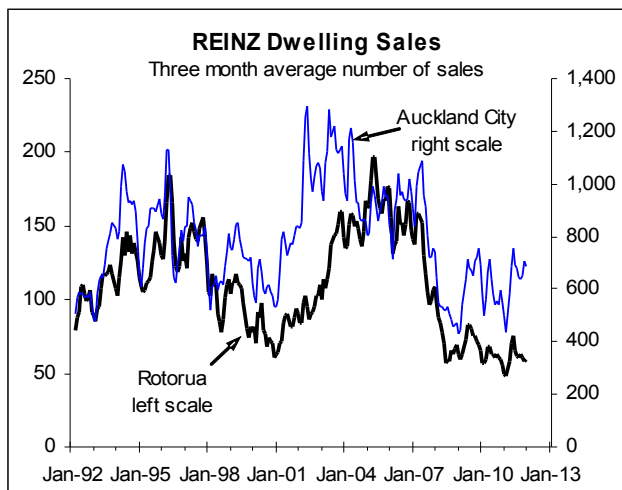
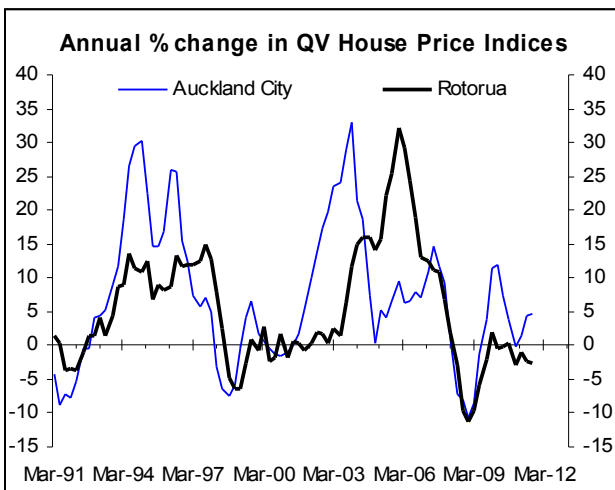


Will Auckland lead the rest of the country to housing heaven? There is no doubt that the demand-supply balance is tighter in the Auckland market than nationally, as shown in the adjacent chart. However, at the moment the gap between the number of sales and the number of listings is around half what it was in 2007. This suggests that Auckland is heading for solid increases in house prices as distinct from a “bubble” or a “boom”. And these increases are likely to halt when mortgage interest rates are eventually and inevitably increased. See our **Monetary Policy Briefing** reports for the best insights into what the RBNZ will do with the OCR. We were the only forecasters I am aware of who were advising clients that the next

move in the OCR would be down even before the first major earthquake in Canterbury in 2010. For info on these reports visit <http://www.sra.co.nz/monetary.html> or contact me.

Part of the reason we can supply superior insights into house price prospects is because we are better at picking the outlook for interest rates. Our regular pay-to-view housing-related reports also offer valuable insights into the outlook for net external migration. Strongly positive net external migration, low interest rates, affordable housing and a generation of gullible would-be investors are the critical ingredients for a house price bubble of the sort that the Landlords' blog is hinting at. In the blog there is no mention of net external migration, which is currently negative. This is probably because it doesn't fit with the optimistic view presented on house price prospects (i.e. never let the facts get in the way of a good story).

Will “waves” from Auckland reach “provincial centres like Rotorua” and drive up house prices? There is certainly some support for this idea in that historically house prices in places like Rotorua and Whangarei have increased with a lag on house prices in Auckland City. The left chart shows the relationship between annual house price inflation in Auckland City (the old Auckland City not the supercity) and Rotorua. The best fit, based on correlations, is with Auckland prices leading Rotorua prices by one quarter. The same one quarter lag exists between Auckland City prices and Whangarei prices, although in both cases the lag can vary. Upper and central North Island centres often follow in the footsteps of Auckland, but house prices in the provincial centres don't go up by magic. In Rotorua the number of sales remains depressingly low (right chart below), with Whangarei not much better. A number of North Island provincial centres are still recovering from prices having been driven well above what locals could afford by investors during the 2003 to 2007 boom years. This makes them unlikely candidates for booming house prices any time soon.



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As an aside, Rotorua is one of the 24 cities/districts we assess near-term house prices prospects for in the **Housing Prospects** reports, as is Whangarei.

Is it right that “We have been through the bottom of the housing market cycle and the only way is up”? In terms of actual prices this might be the case, but a number of NZ provincial centres remain vulnerable if or when mortgage interest rates head higher (e.g. if the number of sales is still near rock bottom in Rotorua despite mortgage interest rates being low, what will happen when mortgage interest rates increase?!). But as covered in chapter one of **The Real Housing Market Story** booklet, what matters is real house prices (visit <http://sra.co.nz/pdf/RealHousingChapterOne.pdf> to access the booklet, while the other chapters of the booklet are stored on our website - <http://www.sra.co.nz/pdf/Ravings.pdf>). Real house prices measure the purchasing power of house prices (i.e. how many pounds of butter and pork sausages your investment in housing will convert to when you need to use the equity in it to survive during retirement or in terms of what it will be worth to your children in their inheritance).

The critical issue is what will happen to house prices relative to what will happen to prices in general and in this context it is highly likely that we haven't seen the bottom yet. Just as the rise in house prices in 2009 was transitory and followed by falling prices, especially in real terms, I believe the unfolding increases in national and Auckland house prices will prove to be transitory rather than being the start of a sustained boom or “bubble”. And I expect the increases to be followed by falling real prices.

Some commentators have made much of the fact that house prices nationally are now back to around the peak level. Based on the REINZ stratified median national house price of \$371,900 in December this is largely the case, with the peak level being \$380,900 in November 2007 (i.e. the latest price is only 2.4% below the 2007 peak level). But since November 2007 prices in general have increased 10% based on the CPI and excluding the impact of the increase in GST in 2010. This means that in terms of pounds of butter and pork sausages the purchasing power of housing is still around 12% below the peak level.

The issue of real house prices is at the heart of the analysis presented in the first and subsequent **Housing Hell** reports, with these being worth recapping. Use the following link to access the original report - <http://sra.co.nz/pdf/housinghell.pdf>, <http://sra.co.nz/pdf/housinghellrevisited.pdf> for the second instalment and <http://sra.co.nz/pdf/housinghellupdate.pdf> for a subsequent update.