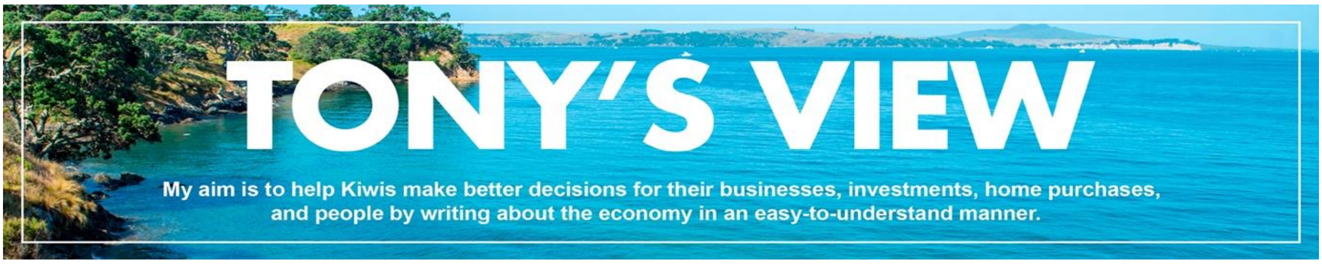

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Reasons for inaction

Housing markets move in cycles. Over a year ago I said that NZ's housing market had entered the endgame for the cycle regardless of whether you started the boom from 1992, 2012, or June 2020.

The end has come about six months earlier than the June quarter 2022 timing I was expecting and that is largely because of the credit crunch. This involves the tightening of LVR restrictions from November 2021 and the crushing effect on bank willingness (not ability) to lend of the Credit Contracts and Consumer Finance Act.

In the mix also are

- the new tax rules for investors,
- diversion of spending back to travelling overseas,
- failing of some builders scaring away new orders for houses to be built,
- near total loss of FOMO (fear of missing out) around all the country, and
- an especially rapid increase in fixed mortgage interest rates.

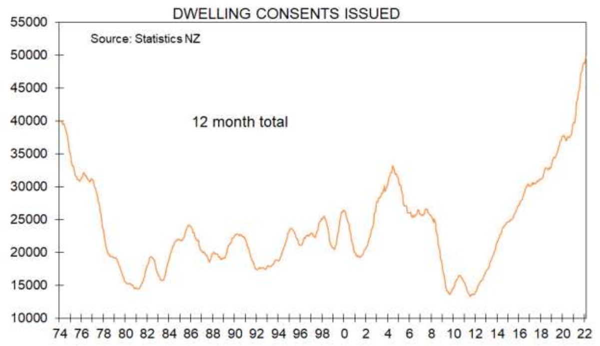
Failing construction

I have written a lot about the coming cleanout in the home building sector as over-optimistic, inexperienced, and under-capitalised developers fail. The speed with which these failures will roll through is being accelerated by the unprecedented shortages of materials and ongoing difficulties getting staff.

Staffing problems have been made worse by the reopening of the border with Australia encouraging many skilled tradespeople to easily boost their incomes and lower their living costs by going across into one of the many strong sectors there.

Right this moment there will be many developers, builders, contractors, bankers, and end buyers holding meetings to discuss their projects in light of what seems to be the straw set to break the sector's back. Plasterboard supplies look like remaining tight to non-existent for new developments until at least the middle of next year when the new factory producing Gib Board is likely to be open in Tauranga.

It's not that chickens have necessarily come home to roost. Its more that just as luck would have it the removal of many factors which caused a lift in dwelling consent numbers to record highs is happening at the same time as new constraints appear.



My comment to builders for over a year has been that while they face a long queue of buyers and we all like to raise our outputs to meet customer demand, the time had come to start taking some risk off the table. We know from every building cycle in the past that while some will do that (and I saw some stepping back in action late in 2020), many will not.

The large operators will place faith in their long-lasting relationships with their bankers. The others will feel the opportunity provided by strong demand is too good to pass up and assume their financiers will carry them through – unless they've been through at least one other cycle in which case they will know such an assumption is very unwise.

Failure impact on buyer willingness

So, now we are in the downward leg of the construction cycle. We openly express the view that many of the consents issued for near 51,000 houses, apartments, townhouses and retirement units in the past year will not be acted on.

The good interpretation of this is that many of the projects will be shifted out a couple of years. But that effect will be minor. The bigger effect will be to magnify the caution which buyers have and their willingness and in fact determination to step back, to take their personal financial and family risk off the table, and not get a house built.

Which is where I was going to start this article but got distracted by the need to give a reminder that the spreading woe in the building sector was predicted and inevitable despite the overblown talk of property shortages everywhere around the country.

When cycles are rising, we swap stories about shortages of the asset in the question, big price gains by Deirdre down the road, the ease of getting exposure to the asset, and the societal inevitability of prices having to rise. We gee each other up to buy the thing, be it property, crypto "assets" of no intrinsic worth (at least you could plant tulip bulbs), negative cash flow tech shares, or toilet paper.

Markets in the short to medium term get driven by psychology and the way we think – not the underlying analysis of fundamentals.

On the way up people looked for reasons to buy property even though it was already highly priced. In particular people bought on the basis that prices would keep rising, that other people would pay a greater price either to get the house to live in or to treat it as an investment.

People tend to think that this sort of thinking is associated only with investors being greedy. It is not. It is the great unwashed engaging in thoughts that they are idiots not to buy and that others will keep buying which really gets a market soaring upward. Crypto shows this in spades.

Actively seeking excuses not to buy

If people looked for excuses to buy on the way up, now they will look for excuses not to buy or even to sell on the way down. That was my original starting point for this article.

My intention here is to give a warning that no matter what fundamentals you may throw out there regarding

- the likely coming smallness of net migration outflows,
- the low levels interest rates will rise to by historical standards,
- the underlying dire need for more social housing, and
- the low probability of a housing over-supply,

it won't matter. People will actively look for stories about woe in the construction sector and people losing their houses because the project is stuffed. The media will respond accordingly.

People will actively swap stories about so and so smartass down the road who were so up themselves talking about the $300,000 they made on paper by buying a rotting building a year ago, now facing bankruptcy.

People will swap stories about banks backing out of deals and of property developers no longer able to get finance. We will read about new bank restrictions on lending to developers on top of the restrictions already put in place by the Reserve Bank, the government, and the banks on lending to end buyers of houses.

But the underlying demand will remain, and grow

We will look for reasons to sit on our hands and do nothing even though we fundamentally want to buy a house. We want something better than what we are living in. We need an extra bedroom for the growing number of kids, or fewer bedrooms because they are leaving home. We want to sell then buy because there is a good career opportunity in another part of the country.

All of the usual reasons for shifting house will remain. But we will put moving/buying plans on hold because of all the negative things we will hear and because we will actively seek out such negative things.

What does this mean?

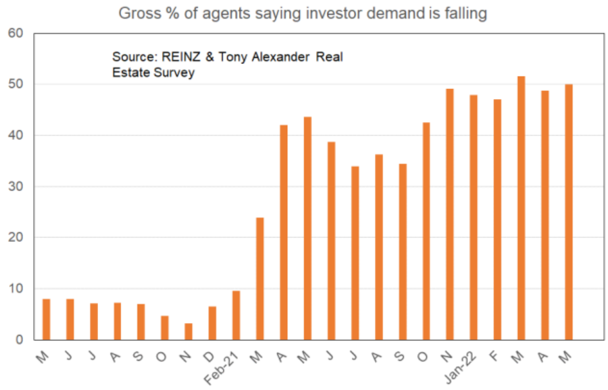
A backlog of buyers will build and build. And it will grow especially large over the next 18-24 months because of some specific factors which make this downward leg of the housing cycle unique. This time around we are unlikely to see any big waves of distressed and unwilling sellers.

Only a handful of people will end up having to pay an interest rate higher than what the bank used as a test rate when they took out their loan.

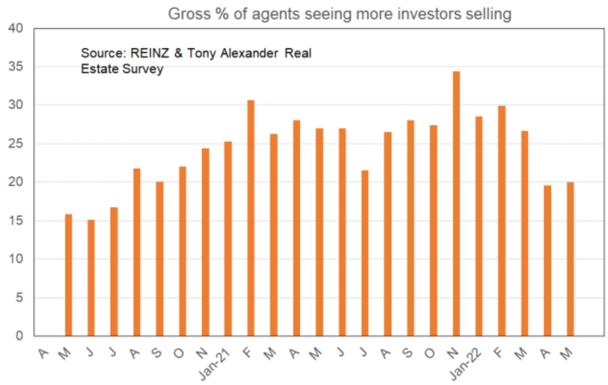
The labour market is very strong and although we will see a surge in layoffs from the construction sector next year, most people will rightly feel their job is safe. Or they will feel that if they get laid off they can easily find another position elsewhere in a short period of time.

Determination to keep servicing one's mortgage and keep the house will remain firm.

I have already repeatedly shown for over a year now that there is no wave of investors selling in response to the tax changes. Real estate agents swapped stories of such, but I can't see it in any figures. Instead, investors have simply stood back as buyers. Their demand has definitely fallen.



But as the graph below from my monthly survey of real estate agents shows, the percent who are seeing more investors selling is falling.



But as potential sellers the challenge is this. What do you then do with your investable capital? Put it in a bank and go backwards immediately? Sacrifice an asset delivering on average 7% tax free capital gain per annum since 1992?

Property investors are in it for the long haul and apart from the most inexperienced late-cycle buyers who felt they had to buy in order not to miss out (FOMO) will hold the course through storms of rising interest rates, tenant legislation, and tax rule changes.

In particular consider this. The National Party have repeatedly stated that when elected (2023 or 2026) they will reverse Labour's investor tax changes. As each month goes by, we will get closer to that happening and the incentive to hold on facing an investor owner will grow.

We also have the coming lift in housing demand from returning tourists and eventually returning foreign students. (Is this the counter-cyclically best time ever to buy an apartment in Auckland's decrepit, crime-ridden, empty shop infested home to street people known as the CBD?)

In summary, what are some of the factors which people will seize on and swap stories about to justify doing nothing even though they know they eventually will make a shift?

1. An over-supply of housing due to excess construction.
2. Brain drain of young home buyers and existing owners to Australia.
3. An upcoming recession.
4. Developers failing and a potential rush of distressed properties being placed on the market

Why did I write this article? What would you rather be? The buyer who moves with the herd and buys whatever piece of is available when they do, even though it does not meet your family's needs? Or the buyer who takes advantage of the biggest jump in listing numbers in many years and highest willingness of vendors to negotiate to secure exactly what you need?

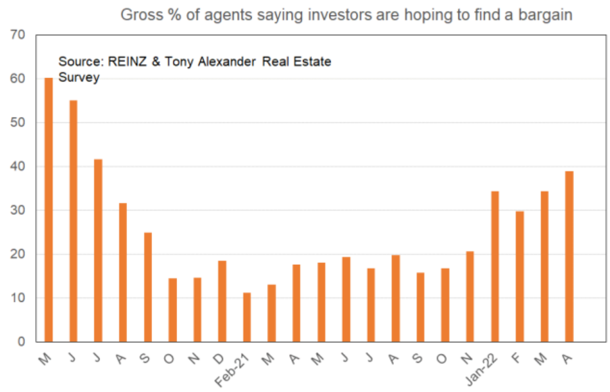
You have to ask yourself. Are you trying to pick the bottom of the cycle? If you are, you're an idiot. If you get it, that's pure dumb luck – like Lotto. None of us with decades in this business can accurately pick cyclical tops and bottoms.

Remember the rule which skilled operators in any sector know on the way up to a peak. Be prepared to sacrifice the final cream on the top to ensure you survive the inevitable decline. For you as a buyer the rule is this. Be prepared to miss the lowest price you could get a property at in order to lock in place the most suitable accommodation for you and your loved ones over the next 10 – 20 years.

Few people will do this and most of you currently and in the coming year looking for a reason not to buy will end up joining the rush to purchase when the cycle turns.

So, to finish off where I started. Housing markets move in cycles. Is the endgame for this downturn in play yet? No. This ball of psychology driving people to step back has only just got rolling. My best pick is we will be in that endgame from some point next year. From here we will actively be looking for the negative housing headlines. Happy hunting.

- Oh, and just be aware of one thing. Skilled investors know all of this and know what their incentive is at these times. Either shut up or scare the bejeebers out of you with scary stories. That way they get better buying opportunities down the line from panicked owners, small investors, developers, and especially bankers looking to protect their loan. It is in the development sector that the best bargains will appear – for partly-completed projects, and land for which stupid prices were paid over 2020-21.



If I were a borrower, what would I do?

Nothing I write here or anywhere else in this publication is intended to be personal advice. You should discuss your financing options with a professional.

Wholesale borrowing costs rise

The Reserve Bank have predicted that the cash rate will need to be pushed from the current 2% to almost 4% come the middle of next year in order for them to feel confident that inflation will settle back within the 1% - 3% target range.

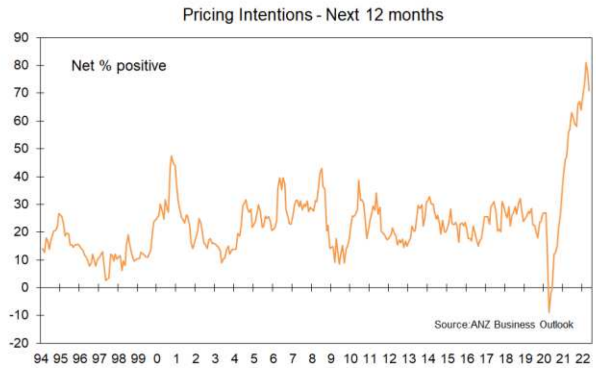
But they probably won't need to take rates that high because the crunch in the economy they need to make businesses push back against high wage claims and not raise prices as much as needed to easily recoup cost increases is well underway.

I discussed some readings showing the crunch in my lead article this week. There are more available from my latest survey of real estate agents around the country which will be released next week.

The net proportion of agents seeing prices as falling in their location has increased, we are in more of a buyer's market than perceived a month ago, FOMO is more dead than a month back, fears of prices falling after making a purchase (FOOP) are greater, and even fewer people are attending auctions and open homes.

Then there are the specific inflation gauges from the ANZ's monthly Business Outlook Survey. For

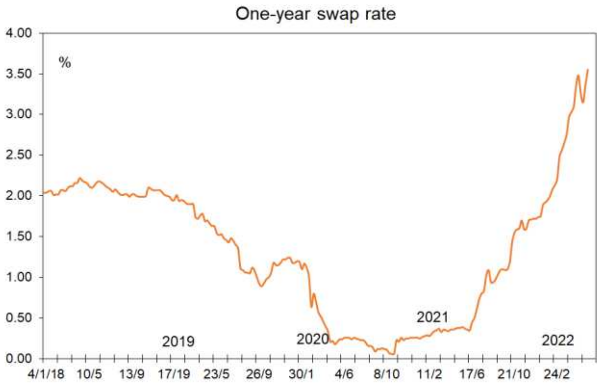
the second month in a row the proportion of businesses planning to raise their selling prices has gone down. At a net 71% the proportion is still very high and above the 30% ten year average for May. But the April reading was 77% and March 81%. So, this is a good thing.



Recently we learned that retail spending fell in the March quarter and business sentiment continues to deteriorate.

But with a new rise in global interest rates this week assisted by recoveries in share prices and China reopening Shanghai, wholesale borrowing costs in New Zealand have stepped up.

The one-year swap rate at which NZ banks borrow to lend fixed for one year has risen to about 3.55% from 3.35% last week.



The three year swap rate has climbed to near 3.9% from 3.7% and the five year rate has done about the same.

My current expectation for the one-year fixed mortgage rate in June each year is shown in the first column of the table below. I focus on that rate because there are many people who have fixed one-year repeatedly since 2009 and the strategy has worked very well.

The second column shows what the one-year rate will average over the next 2-, 3-, 4-, and 5-year periods. The last column shows the current best 2 – 5 year fixed rates charged by the lenders I track.

	Forecast 1 year rate	Rolling average rates	Current fixed	
2022	4.49		4.49	1 yr
2023	5.75	5.12	5.19	2 yr
2024	5	5.08	5.39	3 yr
2025	4.25	4.87	5.55	4 yr
2026	4.00	4.70	5.79	5 yr

If these forecasts prove correct (I'd give that a 10% probability), rolling one-year fixed will deliver an average rate for the next two years of 5.12%, three years 5.08%, four years 4.87%, and five years 4.70%.

If I were a borrower, what would I do?

No change. I would still fix two years at the longest. I see scope for mortgage rates to start coming down towards the end of 2023, first half of 2024. Soon only fixing one year will be the optimal move.

To see the interest rates currently charged by major lenders go to www.mortgages.co.nz

Tview Premium contains more interest rates discussion and graphs than included in Tony's View.

Links to publications

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