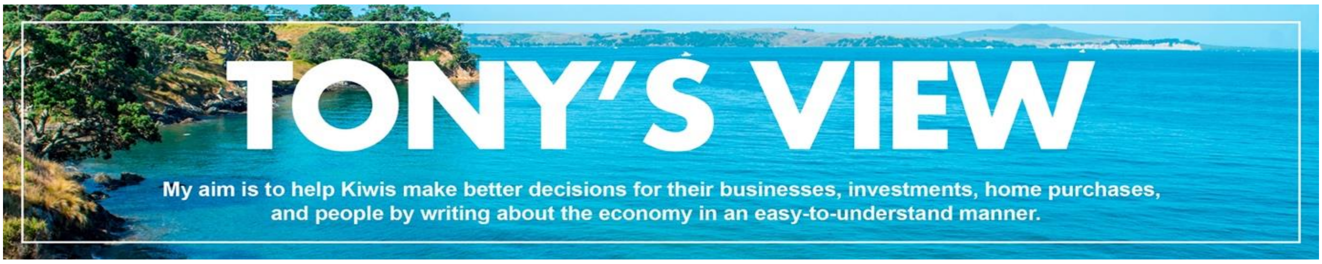

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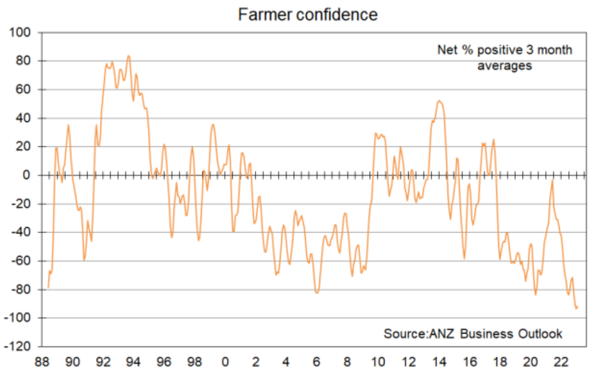
China weakness & NZ city house prices

Having been in this business of analysing the New Zealand economy for a few years now there are a few key things I have learnt. One is that it is unwise to lightly dismiss the economic hit which can come from a crunch in the rural sector. The other is that it is equally unwise to think a rural or even wider economically weak period will naturally translate through to weakness in house prices.

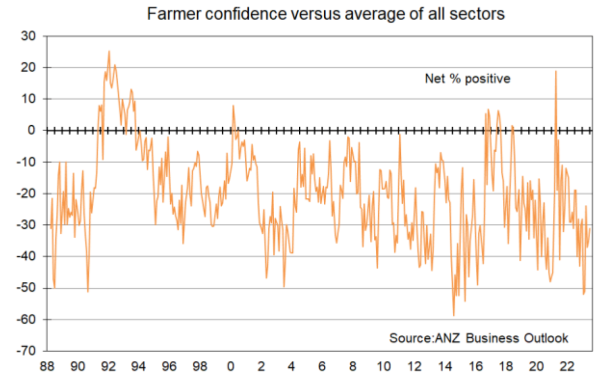
Over the past couple of years costs have risen sharply for farmers throughout the country and their regulatory burden has intensified with more to come related to climate change. Interest rates are at high levels and now product prices are falling away, most notably for dairying.

Having said that, before anyone starts thinking farming its on its knees, it pays to remember the 1980s when farmers were hit by at least four huge shocks. The removal of SMPs (subsidies), borrowing costs above 20%, a high NZ dollar as inflation was fought, and banks repossessing then selling off farms after some years of irresponsible lending.

This graph shows the three month rolling average level of farmer sentiment from the ANZ's long running Business Outlook Survey. Farmers currently are saying that things are worse than back then. I invite you to form your own view on the extent to which sentiment measures this century are affected by the new focus in social and mainstream media on things in crisis.



It pays to remember that farmers almost always express greater pessimism than businesses overall.



Cynicism aside, the recent declines in export prices largely reflect new weakness in China's economy where a lot of chickens are coming home to roost. Economic activity in China has been boosted for the past few decades by hefty investment in new apartments and infrastructure. But such periods of nation-building activity never persist and with millions of apartments sitting empty the residential construction sector is falling away. It used to account for up to 25% of economic activity. In our economy something closer to 6% or so is more normal.

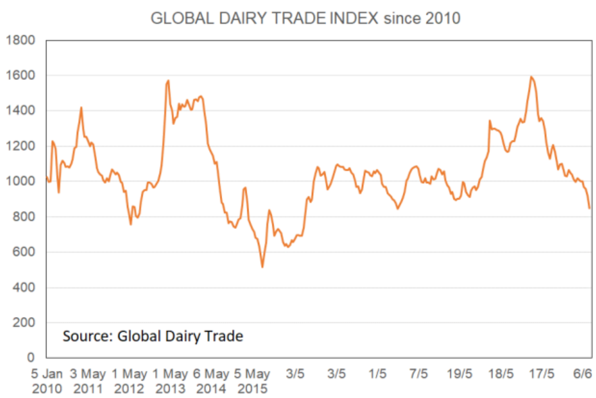
Property development businesses are carrying large debts and so too are regional governments who have driven growth and revenues through leasing land to those developers. Those cash flows have now dried up and costs related to maintenance of infrastructure are building. The flow of people from the countryside into cities has ended.

China initially exited its overly long pandemic lockdown with good sentiment. But spending associated with good feelings of freedom (in an authoritarian state) did not last long and virtually all of the monthly indicators economists have tracked for decades are now painting a picture of shrinking or minimally growing economic activity. Households ran down their savings during the pandemic and are now looking to rebuild them. Weakness in consumer spending comes on top of reduced demand for China's goods internationally, reduced capital inflows into China, increasing state intervention, crackdowns stifling innovation in numerous sectors, and shrinking credit availability.

As noted previously, the situation has become so concerning for the CCP that they have suspended publication of youth unemployment data and instructed local economists to refrain from negative commentary on the Chinese economy. China's consumer confidence measure ceased being reported early this year. Data on land sales are apparently now being withheld, and police have warned citizens not to stage protests about financial sector losses.

Consumers traditionally have few areas to invest their savings in China outside of banks. So, many of the hundreds of millions of people brought into the middle class have purchased investment properties – many of which either have not been completed or sit empty. Wealth worries alongside high youth unemployment are leading people to cut back their spending and that includes on the things we send to China which are largely commodities.

Falling dairy prices means weak dairy incomes here and that means cessation of spending where possible by NZ farmers. This applies not just in dairying but for red meat producers also who are being affected by falling prices.



We have seen this before. Farmers know what to do. As long-time rural accountant Pita Alexander has said over the years to farmers, when times are good take photos. You'll one day need them to remind you that the bad times pass, and better conditions will one day return.

Plus they serve (hopefully) to curb excess spending when times are good. Bad times always return. Bankers know this and that is why there is no parallel between upcoming bank treatment of farmers in cash flow difficulties now as compared with late last century.

The challenge for banks is not well handling problems when times are weak, it's doing responsible lending and not advancing all the funds farmers (and other businesses and home buyers) want when times are good. Such is life. Bankers get booted on the way up for not doing enough to support families and growing businesses, then they get booted on the way down for lending too much.

We are just at the start of a cash-flow challenged time for farmers, and while much focus for the moment is on the subject of mental health – not to be under-estimated – the reality which matters here is that farmers will do what they have done before and slash spending.

The regions are set for a period of weak growth and deeper recession than the cities. In the cities we may see the news reports, but we won't feel what the farmers are feeling. We will focus on our own lives which involve good levels of job security, a strong view that mortgage rates have peaked, and an upturn in the housing market.

Specifically, it can take 12-18 months for a farming downturn to much affect the cities. But before that happens and then as it does interest rates go down. The level of interest rates currently is preventing many people from being able to make a house purchase which they desperately want to.

Many people have built up good deposits and have secure incomes. But with stress test interest rates near 9% they cannot qualify for a mortgage. They are sitting there watching house prices rise and increasingly feeling they are missing out. Most will in fact miss out on both making a purchase only just after house prices have bottomed and on being able to select from a good number and range of properties on offer.

By the time interest rates come down enough to bring mortgage supply into their grasp house prices will be probably at least 10% higher and listings over another 15% lower than they already are – 15% down since the end of 2022.

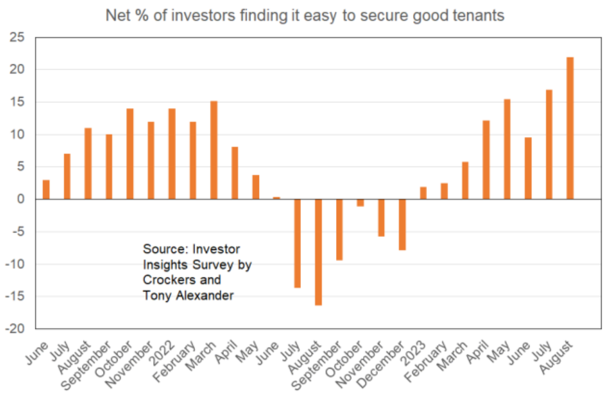
As weakness in China and evidence of farmers slashing spending feeds through into the Reserve Bank's inflation outlook and into the cities, the interest rates outlook will improve. This is largely a story for next year because for the moment, if I were running the central bank, I'd not feel it is yet safe to assume the inflation genie is back in the bottle.

2024 then will be a story of falling interest rates which will bring many financially firm buyers into the market. But what about rising unemployment? Surely as the rate heads from the current 3.6% to 5% this will cap the housing market. No.

Already the unemployment rate has risen from 3.2% to 3.6% and the housing market is turning upward. This partly reflects the effects of booming net migration now at 87,000 or a 1.8% boost to our population. This flow is likely to ease off over 2024, but maybe only towards the average from 2014-19 of 55,000 rather than back to something very low.

Jobs growth is likely to continue in New Zealand, concentrated in the cities. In fact, with the rural sector turning down we can expect some migration of people from the regions back to the cities looking for work. This will place extra pressure on city rental markets beyond that already in place from booming immigration.

In fact, my latest survey of residential property investors undertaken with Crockers Property Management has just revealed a rise in the net proportion of landlords saying it is easy to find good tenants to a record 22% from 17% last month and -8% in December.

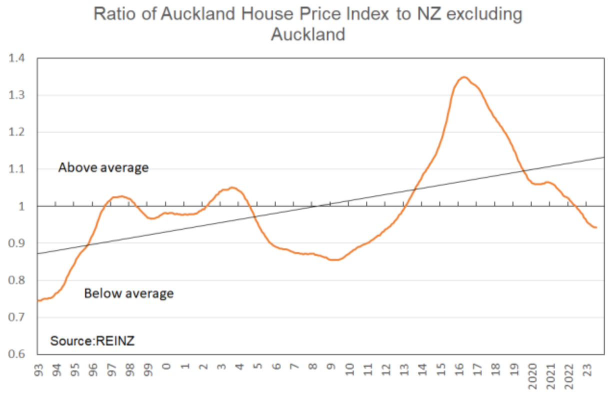


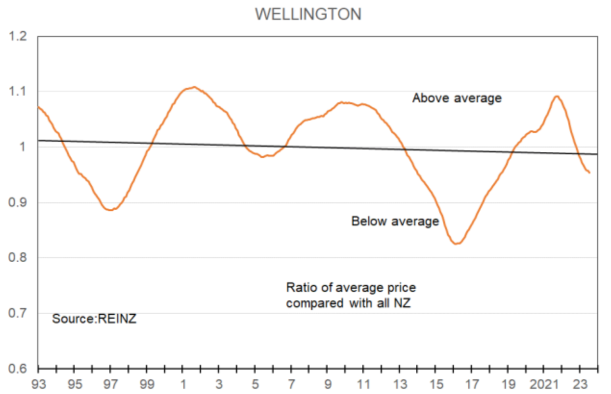
What can we reasonably expect will be the impact on property demand from investors next year as

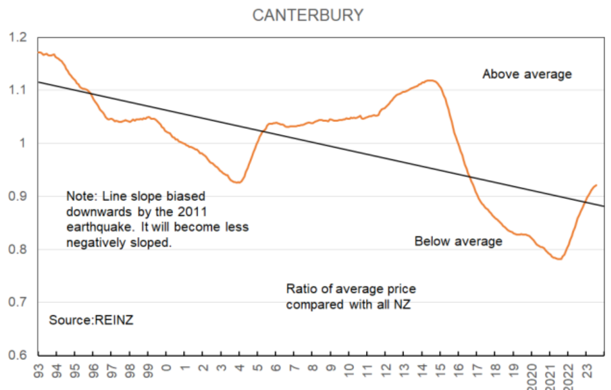
- interest rates fall,
- interest expense deduction rules potentially change,
- CCCFA rules potentially get eased,
- house prices reveal upward momentum for all to see,
- FOMO climbs well above average,
- listings stocks fall,
- population growth remains strong,
- the number of new houses completed falls, and
- discussion centres around the cities well out-performing the regions this cycle?

House prices will rise at an accelerating pace. We can see now that the common view on likely changes in house prices has switched in the direction what I have been saying since early this year – prices up 10% or thereabouts over 2024. The year after will likely be stronger because interest rates will keep edging lower through 2025 into 2026 – best guess at this stage in these still very uncertain times we live and work through.

As noted, since last year, Auckland and the two other main cities in NZ will lead this cycle.







In case you missed it

On Monday I released results from my monthly survey of businesses undertaken with sponsorship from Mint Design digital agency.

This month some 230 businesses reported that they are still deeply concerned by the state of the economy and interest rates, with frequent mention of desire for change in the political and policy arenas. Areas of strongest planned spending increases are retention of customers, development of strategy, and staff training. But there are now five areas in which more businesses plan cutbacks than increases, compared with just two last month.

Weaker business spending itself begets weaker levels of economic activity and this alongside some clear factors such as falling export prices, rising oil prices, and falling consumer spending help illustrate why recession may return later this year.

[Mint Business Insights - May 2023 - Mint Design]

Yesterday I released results from my monthly survey of residential property investors with Crockers Property Management. Key results included these.

- Investors looking at buying a new dwelling are increasingly favouring apartments, though standalone houses and townhouses remain highly preferred.
- A record net 22% say it is easy to find good tenants whereas in December a net 8% said this was hard. The market has shifted substantially this year – probably due to the migration boom.

[08-crockers-tony-alexander-investor-insight-august-2023.pdf]

If I were a borrower, what would I do?

The picture is now getting very cloudy. There is upward pressure on interest rates from the better than expected performance of the US economy which is leading to reduced expectations of easing monetary policy there over 2024. That has caused US medium to long term interest rates to rise and generated upward pressure here as well.

This upward pressure is for now comfortably offsetting any downward pressure coming from the deteriorating outlook for China's economy. The worse China looks the greater the weakness in our exports and our economy. But that weakness hits with a lag and it won't be until very late this year that the Reserve Bank will likely explicitly factor in the downward pressure on our inflation now expected to come from China's weakness and its falling prices.

For now NZ bank wholesale funding costs continue to rise and there is a round of increases underway (again) in fixed mortgage rates for 2 years and beyond.

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.