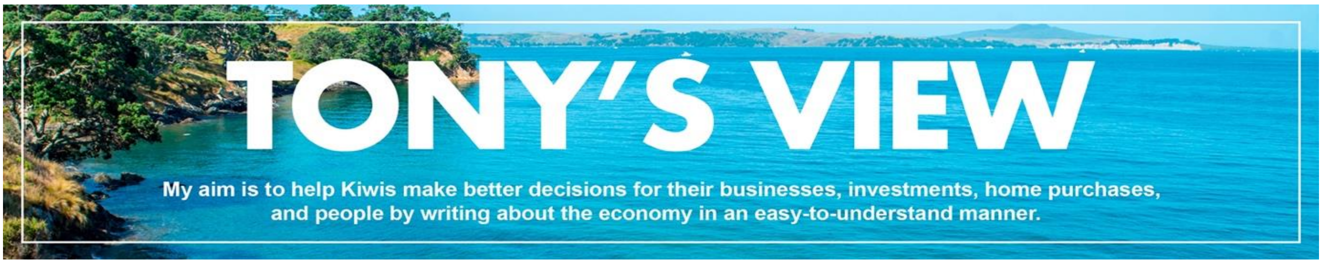

Input to your Strategy for Adapting to Challenges

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A reminder on house repricing

Average house prices have fallen 7.7% so far nationwide, though with Auckland peaking in November and the rest of the country mainly February. We are probably about half-way through the pullback from absurdly high prices reached last year when a FOMO-gripped public bought anything they could get their hands on.

As house prices fall further we are going to see some optimistic predictions that affordability will go back to levels of earlier years. We might even see the old view that house prices should be three times incomes because that is where they were in the modern dark ages up to the late-1980s.

Prices are not going to go back so far that we get anywhere near close to that ratio and forces are already in play to strongly limit the extent to which prices fall this cycle and the duration of the period over which these declines will occur. As noted here recently, we are seeing an acceleration of many things currently as central banks scramble to unwind the effects of their incompetent implementation of monetary policy last year.

The period of falling prices is likely to be over quite quickly.

But why is it not reasonable to expect a reversion to the three ratio of prices to incomes? To help understand this here is a run-through of factors I have been discussing since 2008 which explain why we have seen a permanent change in this ratio. There are others, but this list should suffice to curb the enthusiasm of those yet to buy.

Planning rules

The rise in the urban planning profession from four decades ago, and the derision attached to development of new suburbs on city fringes encapsulated in the term “urban sprawl” has meant soaring prices for land to build on. Councils have restricted urban boundaries to try and create better “planned” urban environments.

But at the same time as new land supply was restricted, intensification on existing already developed land was made near impossible. The government has now wiped away those restrictions through some rule changes so the impact of this factor will diminish over time.

Falling interest rates

Around the world interest rates were structurally falling for over three and a half decades from the late-1980s. As mortgage rates went down more people qualified for debt funding of a house purchase.

Lower mortgage rates have been factored into higher house prices, share prices, commercial property prices and so on. Lower deposit rates and returns on other assets meant investors were incentivised to purchase houses for their yield.

Save for retirement

From the late-1980s we saw government campaigns aimed at encouraging Kiwis to save. The message was that retirement would be a miserable affair if one did not have assets from which to supplement superannuation, especially as the pension might disappear because of tight fiscal circumstances.

These scare tactics have encouraged people to save and with the 1987 sharemarket crash fresh in the minds of many they naturally looked towards an asset that did not fall 60% in prices as shares did back then. Many investors opted for housing, purchasing properties and renting them to people who missed out at the auctions.

Higher net immigration

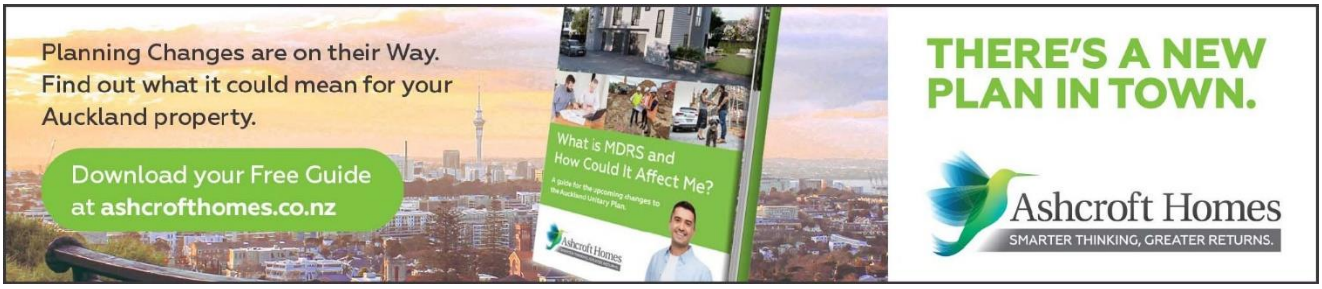
Migration rules were changed in the late-1980s away from a focus on source country towards skills. This has led to many people coming from countries with a far greater focus on building lifetime wealth through property ownership than those who tended to come here under the previous rules.

Rising construction costs

Governments and local council have piled more and more costs on anyone building a new house through the likes of more frequent inspections, consent fees, developers levies on sections, and much higher standards for materials and construction methods. The latter includes tougher rules on earthquake resilience and energy efficiency. Extra costs come from the likes of stringent health and safety rules.

More "luxurious" houses

The average size of a newly built house is far greater these days than in earlier decades, toilets are on the inside and there is usually more than one of them, and fittings tend to be of higher quality.



Credit supply

The availability of mortgages was often constrained for extended periods up until financial deregulation of the mid-1980s.

Aging population

As a population ages the average number of people per house goes down. You need more houses for the same population as more people live alone.

Higher divorce rate

Marriage breakdowns have meant more households with just one parent instead of two. Similarly for the rise in solo parenting.

Tourism growth

Many houses have been taken out of the rental and owner-occupancy pool by investors making them solely available for tourists to use through the likes of Airbnb.

No new cities

People like to live where other people live, where jobs and business customers are, and where cultural and recreational activities are located. There has been an absence for many decades of a new town sprouting up in a new location where land prices are low and people are happy to live, perhaps embracing a pioneering spirit. Twizel maybe.

In the early-1970s most of the three million Kiwis living here wanted to live not far from CBDs and in or close to suburbs long considered desirable. Now there are 5.1 million of us trying to do the same thing.

Lack of productivity growth

Growth in output per person in the construction sector (productivity growth) has lagged well behind virtually every other sector. Houses are still to a large extent hand-crafted. Lack of scale limits the widespread use of off-site construction techniques in New Zealand.

The current period of house price declines is likely to end sooner than many people are thinking. I'll be able to see when through my monthly surveys. My latest survey of real estate agents undertaken with REINZ will be released next week and I can note here that we are nowhere near that turning point yet.

When the turning point in the cycle comes it will not remotely involve a massive correction in the ratio of average house prices to average household incomes. But things will be more sane than they were last year.

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.

The inflation battle

We should expect to see continuing high volatility in wholesale interest rates for the rest of the year as a major battle continues between two forces. On the side of pushing interest rates higher and higher is the surge in inflation attributable to last year's excessively loose monetary conditions plus the effects of China's covid policy on supply chains and Russia's war against Ukraine impact on food and energy prices.

High printed inflation rates and concerns that they will feed into fast wages growth argue strongly for higher interest rates in order to do three things.

1. Make it hard for businesses to pass on higher costs because customer demand is being crunched.
2. Send a warning to wage negotiators that demanding and giving high wage rises to explicitly compensate for high cost of living increases will guarantee even higher interest rats and almost certainly recession.
3. Push asset prices lower and via creating pessimism and reducing wealth cause additional weakness in business and consumer spending.

The key things to watch on this side of the battle are wage rises and indicators of consumer spending strength.

On the other side we have potential for recession which may or may not already be locked in. The more we see talk about recession and the greater the weakness coming through in leading and early partial indicators of output growth, resource demand, and therefore cost pressures and pricing ability, the less the chance that interest rates will be pushed to extreme levels.

We don't know how long this battle will rage but it could last until the end of the year and as it rages we will see some big ups and downs in asset prices and market interest rates.

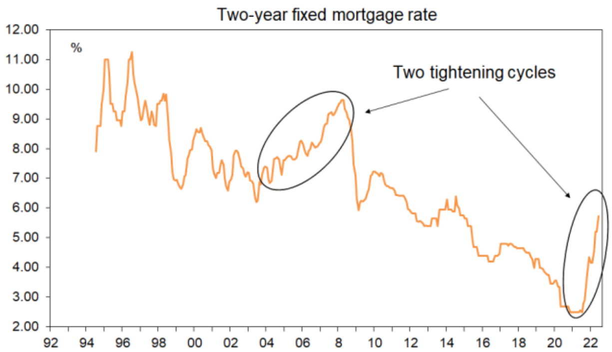
At the heart of the issue however is this. All we are really talking about is how soon weakness in economic activity arrives and whether it involves flat output growth or recessionary shrinkage of 1-2%.

The sooner weakness arrives the better. The longer it takes for central banks to see widespread woe then the higher they will feel they need to take their interest rates.

"They only hit until you cry, after that you don't ask why."

Here in New Zealand we already have fixed mortgage rates 3% - 3.5% above their levels of just over a year ago. The last time monetary policy was in a proper tightening cycle from 2004 - 2008 it took over three years for this to happen.

The tightening this time around is running at triple the pace of the last one.



Because central banks have credibility to rebuild after poor policy implementation last year, and because they see themselves as saviours, they also see themselves as rightful punishers – and that is the story for 2022. The risk is they overshoot and unnecessarily depress their economies, including our own. But we'll just have to wait and see if the Reserve Bank truly stuffs things up again or not. The record so far is quite bad.

This week wholesale interest rates in New Zealand have edged down slightly in response to weak economic data in the United States.

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 averages	
2022	5.19		5.19	1 yr
2023	5.75	5.47	5.69	2 yr
2024	5	5.31	5.89	3 yr
2025	4.25	5.05	6.05	4 yr
2026	4.00	4.84	6.19	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 5.47%, three years 5.31%, four years 5.05%, and five years 4.84%.

If I were a borrower, what would I do?

Following the latest round of increases in banks' fixed mortgage rates there is probably not much upside left for the 2-5 year terms. The one year rate may have another 0.5% left in it.

Looking at the table above in which I show the best 1-5 year rates offered by the five large lenders I track, I could fix one year at 5.19% and that is the cheapest rate available across the terms. But if I did that for two years the cost will average 5.47% (if the forecasts are right – laughable really) versus simply fixing for two years at a known 5.69%.

What would I do right now if I were borrowing again? After comparing the rates on offer with the 18.5% I paid back in 1987 I'd contain my ecstasy by noting the house price I'd just paid would probably be eight times average income versus three back then.

I'd consider my view that the tightening cycle has been accelerated and that means easing will appear sooner than "usual". That would lead me to take the pain of fixing for just the one year. I might fix some for two years if I were a tad more conservative.

I would like to write here that I would not touch the five year rate with a bargepole. But when I wrote exactly that in 1998 and 2008 the yield curve was inverse and that is not what we have now. The one year rate is still the lowest on offer.

My bargepole comment refers to an environment where people wanting whatever rate is the lowest gravitate towards five years. But we are not in that situation yet so the comment is not yet justified.

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

Links to publications

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