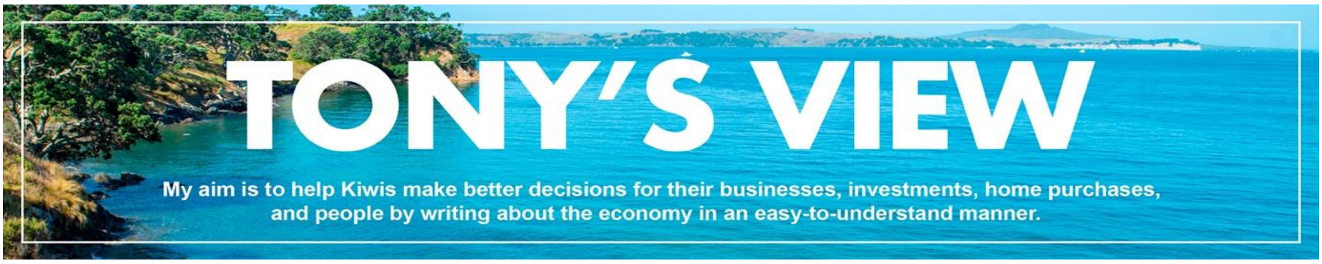


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# Catching the falling ball of house prices in 2023

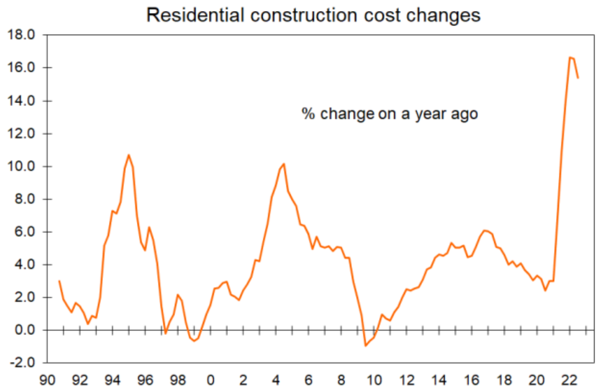
Last week brought the first true statistical sign of the long overdue correction in the volume of house building around New Zealand. The past few years has been a period in which people have become convinced that there is a shortage of housing not just in the cities but everywhere else as well.

This belief in a universal shortage has been encouraged in public commentary regarding the difficulties young people have making their first property purchase, with the mistaken belief that affordability will be strongly improved by simply boosting house supply.

## 1. Rising construction costs

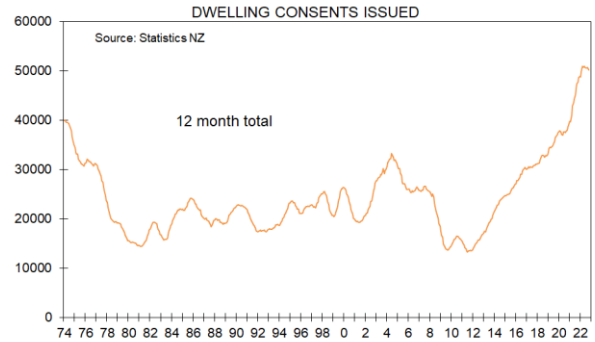
It sounds good from an Eco 101 point of view but fails to recognise that construction costs have been on a strong path upward for a long period of time with assistance from central and local government adding layer upon layer of extra costs to developers looking to supply extra housing.

Rising construction costs provide a natural floor to overall house price levels and are one of at least seven factors coming together to change the house price outlook from some point probably in the first half of next year – but not now. The negatives dominate currently, and it would be premature to argue that the downward phase of the house price cycle has reached its natural end.



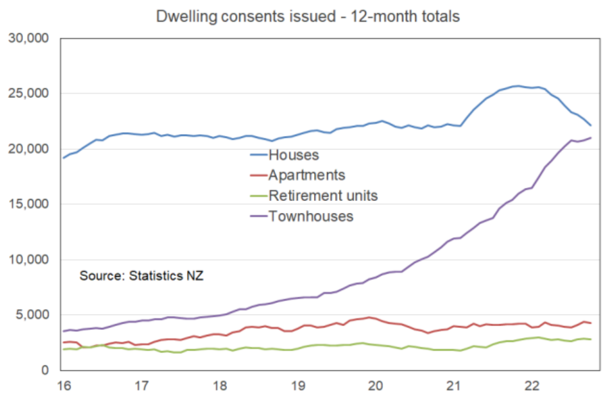

In Australia there is emerging evidence of construction cost inflation easing and we are likely to see the same in New Zealand now that the pipeline of construction is starting to be cleaned out.

Statistics NZ last week announced that in seasonally adjusted terms the number of consents issued for the construction of new dwellings fell in October by almost 11% from September's total. This is the greatest monthly decline since February 2021 and means the annual number of consents issued has fallen slightly to 50,252 from 50,732 in September and a peak of 51,015 in May. We are probably headed down towards 35,000 or thereabouts – not that any of us has a model which can actually predict these things. We proved that in 2020.




The number of consents issued has held up surprisingly well in spite of rising interest rates, only 0.6% nationwide population growth in the past two years, falling house prices since November, and depressed consumer sentiment.

But reality is probably now settling in and the part of construction likely to feel the decline most intensely is multi-unit properties. The issuance of consents for standalone houses peaked on an annual basis late in 2021. But townhouses kept rising and rising.



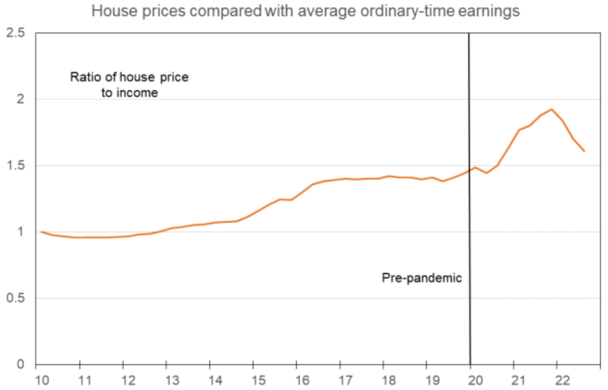

Changing the rules to allow intensification is all well and good. But people have paid too much for the development land and not allowed for soaring construction costs and delays which now make their project no longer financially viable.

Presales required by banks for financing are very hard to secure outside of the most favoured suburbs, and the newspapers abound now with stories of failing developers and people losing their savings. There is worse to come.

### 2. Rising incomes

Returning to a comment I made above, the second factor which will act to catch house prices as they fall is rising household incomes. I discussed this a few weeks ago but a reminder might be needed for those still focusing only on house price changes since the pandemic started.

Average house prices are 26% higher than pre-pandemic levels. But average hourly earnings have increased by 8.6% in the past year and 3.6% the year before, making for a 14% gain from before the pandemic.

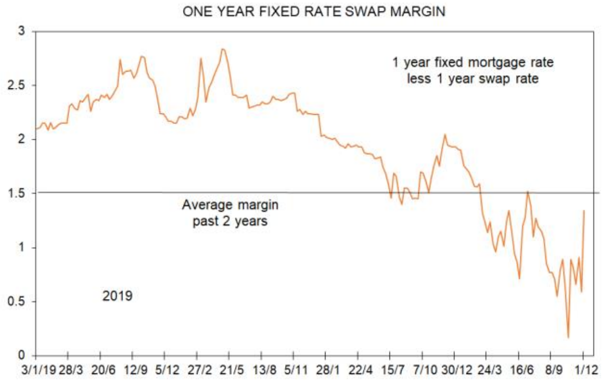



The ratio of house prices to this income measure was 30% above pre-pandemic levels at the end of last year. Now the gap is only 8% and falling fast. We may be able to say that by the end of this year this ratio will have retreated back to pre-pandemic levels.

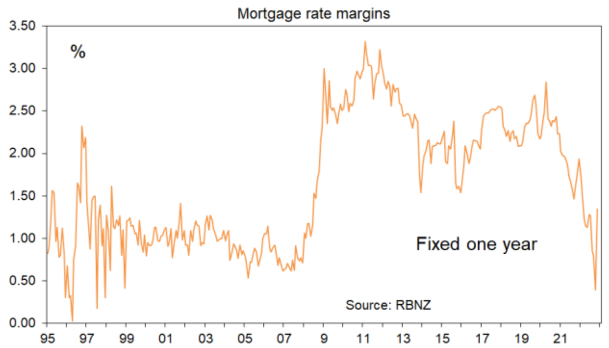
This does not mean affordability is back to those levels because of the rise in interest rates. But that is where the third underlying trend factor relevant to the house price cycle comes into play. Interest rates.

### 3. Peaking interest rates

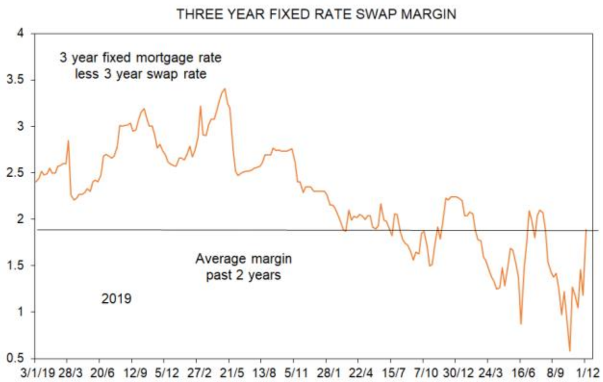
Fixed mortgage rates are probably now at their cyclical peaks This may not be accepted for a while, and we cannot completely rule out banks increasing their lending margins further. This next graph shows the margin between the cost to a bank of borrowing money at a one year fixed rate and the rate they lend to you and I fixed for one year. Note how the margin is only just below the two year average.




Of course, who is to say that the two year average margin is the most relevant? The margin since 1995 has averaged slightly higher at 1.65% but was about 1% from 1995 to 2007.


The graph mainly just tells us that pressure on banks to raise the one year fixed mortgage rate to rebuild margin has substantially dissipated now. This graph shows the three year fixed rate margin.




The attention people have on interest rates for the moment is all around how much higher they will go. Then it will shift to where they peak, then how quickly they will fall. I reckon the fall will be slow because the recession – if one occurs – will be shallow. But my view that fixed rates have now probably peaked means the next shift in focus will be to accepting the worst case scenario for debt servicing costs. As soon as people start doing that and we throw in some mild consideration of rates declining over 2023, buyers will step forward.

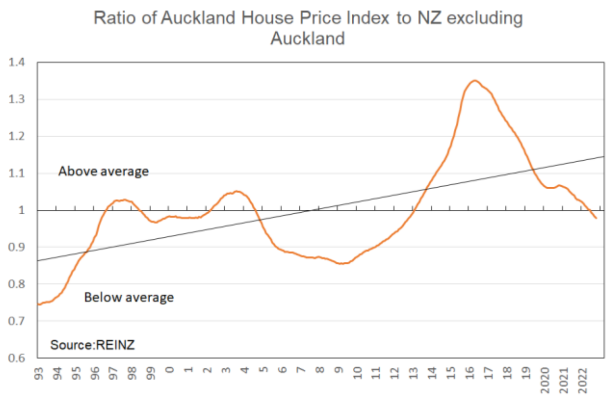
Best guess for this to happen? Before the end of the March quarter. But do keep in mind that no-one has developed a record for good interest rate forecasting for a long time here in New Zealand and overseas.

#### 4. Rising net immigration

The migration flows into New Zealand are turning upward faster than any of us were assuming and I note that last week one commentator was predicting a net gain a year from now of about 36,000 people. The latest flow is a net loss of just over 8,000.

Migrants go where migrants have gone and that means discussions of Auckland's 1.2% population shrinkage in the past two years will switch over 2023 towards the city being the main beneficiary of the strengthening gross inflow of people. The gross outflow in contrast will be sourced from all over the country.

There is no established tendency for Auckland's housing market to lead the country. But in a long-term relative pricing sense, the city is actually set to do so in the recovery part of the cycle.



### 5. House supply

At some stage next year attention will turn towards the pricing implications of a substantial falling away of dwelling consent numbers and the already large gap between consent issuance and the much smaller level of code of compliance certificate issuance.

Until then talk will focus on perceptions of an over-supply in Auckland, incorrect as that may be given the backlog of young buyers and the backstop of Homes & Communities building up the state housing stock on a distributed basis.

### 6. Property listings

I discuss this factor on the following page in Tview Premium. Suffice to say, the stock of property listings is now falling and is 6.6% off its peak in August. At some stage next year people will wonder if the long-term downward trend in the stock of properties listed for sale is re-establishing itself. (Yes.)

### 7. Change in government

The government's attempt to prevent future parliaments from unwinding their legislation shows they are shifting to a view that they will lose next year's general election. That means there will probably be a loosening of fiscal policy in the May 2023 Budget and that is one reason the decline in interest rates from the second half of next year will be a gradual affair. Having said that, don't be surprised if 3-5 year fixed rates start falling much earlier than that.

Anticipation of the return of National and restoration to property investors of the same legal right accorded to all other businesses – deducting interest expenses from gross incomes for tax purposes – will see investors re-enter the market. They will also move in once they accept interest rates are headed lower.

None of us have models giving accurate predictions of house price movements. The best we can do is try to figure out where the important factors are trending and get a feel for how the psychology of the market is changing.

For the moment that psychology is negative courtesy of the Reserve Bank's scary words and rate rise two weeks ago. But the negative sentiment will pass, and I would expect the larger investors with good cash reserves built up after selling their crap last year to now be actively looking to capitalise on the pessimism and make some good long-term purchases. For first home buyers this may be their best opportunity in a generation to secure a good home to raise their family in – as long as they can get the finance.

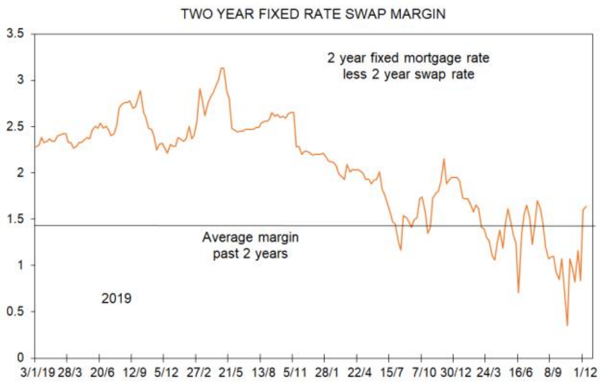
These conditions of good listings, increasingly compliant vendors, and minimal competition from investors will dissipate through 2023.

## If I were a borrower, what would I do?

In this week's Tview Premium I run through a list of reasons why current fixed mortgage rates are probably the peaks for this cycle. Suffice to say, the chances are growing that the Reserve Bank has over-cooked policy restraint after keeping things too easy last year.



Bank margins are now at above average levels so internal pressure to hit customers some more is minor. Offshore inflation is easing, NZ business and consumer confidence is newly falling, the NZ dollar is rising, and the labour market is weakening.




If I were borrowing anew at the moment or rolling off an older fixed rate, I would be inclined to fix just for one year – two years at most.

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

**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.**