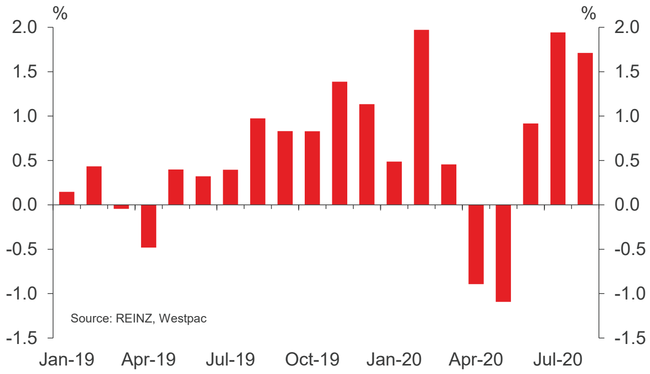
Home Truths.

14 September 2020

House price forecasts upgraded... again.

When Covid-19 first broke out in New Zealand, we predicted a 7% decline in house prices between March and December. Other major banks, the Treasury and the Reserve Bank forecast even greater declines. But our collective predictions of house price decline have been proven wrong. Between March and August house prices have actually risen 2.6%, on a like-for-like, seasonally adjusted basis. Data released today showed that August was the third consecutive month of house price increase, so this is no statistical quirk or brief period of catch-up.

Monthly seasonally adjusted change in House Price Index



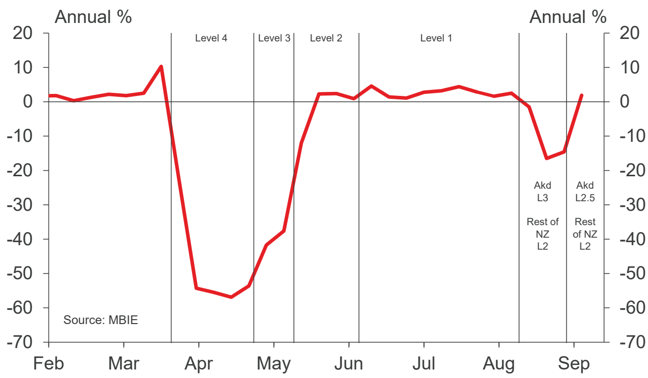
Back in July we upgraded our house price forecasts. We shifted to forecasting a fall of 2.5% over the second half of 2020, and an increase of 8% over 2021. However, even this is looking too pessimistic. Today we are upgrading our house price forecast again. We now expect an *increase* of 3.5% between March and December 2020, and we are sticking with an annual increase of 8% for 2021.

This month *Home Truths* takes a good look at how the housing market has so thoroughly defied a global pandemic.

First and foremost, Covid-19 and the associated lockdowns have proven less economically damaging than originally anticipated. We had expected that economic losses and rising unemployment would dent the housing market. And they did – there was a dip in house prices during Alert Level 4, and prices have probably been weaker than they otherwise would have been. But the surprising resilience of the economy has meant less of an impact on house prices than anticipated.

We were stunned when we saw that, outside of activities related to international travel, the economy quickly rebounded after the first lockdown. For example, employment fell by 34,000 people in April, but had regained the entire loss by June. Early data is showing that the second lockdown is following much the same trajectory as the first – a hit to activity followed by a rapid rebound. For example, weekly electronic card data suggests that consumer spending snapped back to previous levels almost as soon as Auckland dropped from Level 3 to Level 2.5.

Weekly retail spending on electronic cards, New Zealand

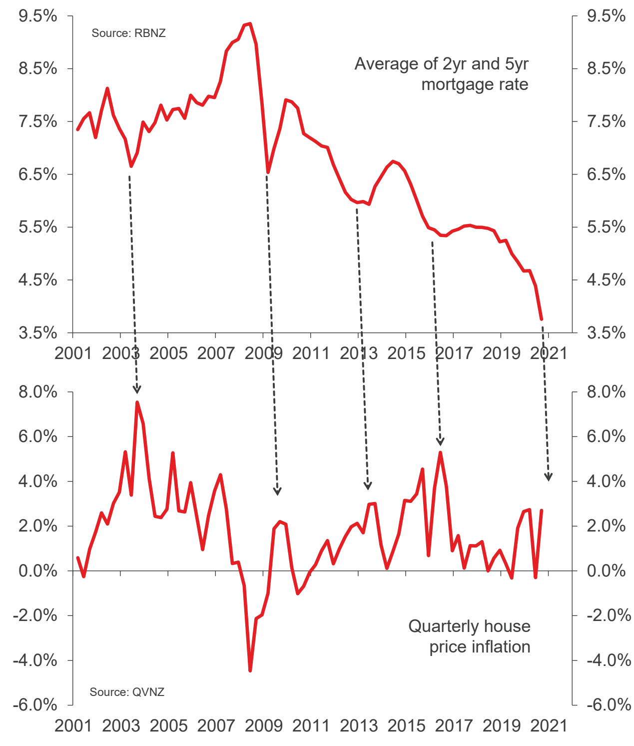


Our original GDP forecast was that the economy would shrink 3.6% between March 2020 and December 2020. As the facts have revealed the surprising resilience of the economy, we have upgraded that to a 0.6% decline in GDP over those nine months. Similarly, our forecast for peak unemployment has dropped from 9.5% to 7%. To be clear, this still amounts to a severe recession, but it is not as bad as we first feared.

This surprising economic resilience is actually a global phenomenon – in recent months we have also revised up our GDP forecasts for China, Australia and the United States.

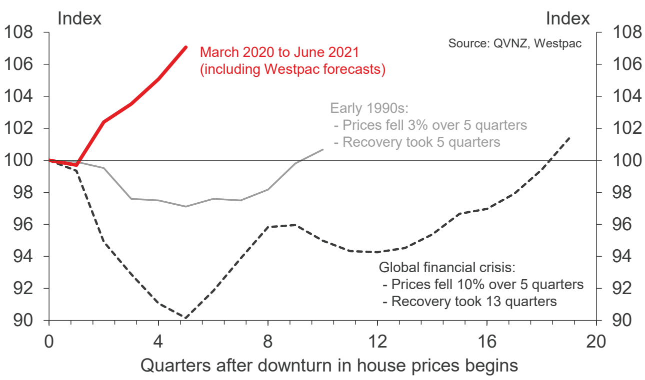
The second reason for rising house prices is low mortgage rates. Low interest rates push savers out of bank deposits and into more active investment classes, such as investment housing and shares. This tends to push asset prices up in general. Low mortgage rates also make large mortgages more affordable for owner occupiers, allowing them to bid more for houses. And New Zealand's tax system, where income is taxed but capital gains is not, tends to exaggerate the attractiveness of land-based assets even further when interest rates fall.

House prices and mortgage rates



Our original expectation for a fall in New Zealand house prices was based on the fact that prices fell during the recessions of the early 1990s, 1998, and 2009. This created an association between rising unemployment and falling house prices in the data, and we expected that association to repeat. But all of those past recessions were preceded by a rapid increase in interest rates, whereas the current recession was not. This unusual feature of the current recession may be teaching us that interest rates play an even more powerful role in determining house prices than previously appreciated.

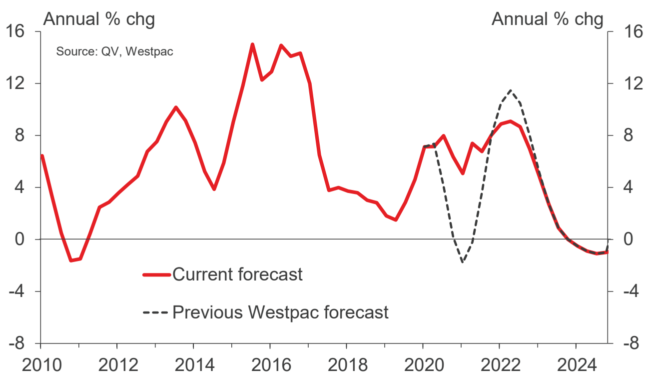
New Zealand house prices during economic downturns



With this lesson in mind, we are upgrading our house price forecasts today. We now expect a small 3.5% rise in house prices from March to December this year. There was a very strong increase in prices in March quarter, so this would put annual house price inflation for 2020 at 6.3%. Our forecast still attempts to balance low interest rates against the weak economy. We expect unemployment will continue to rise this year, and that will hold the house price horses back to some extent – if interest rates fell this far in a strong economic environment, the house price increase would be much larger.

Next year, we expect the economy to be beginning its post-Covid recovery journey. At the same time, we are actually expecting another decline in mortgage rates, as the RBNZ drops the OCR into negative territory in response to low inflation. Therefore, we are forecasting an 8% increase in house prices for 2021.

Westpac house price forecasts



When will house prices stop rising?

Over the past decade *Home Truths* has repeatedly identified episodes of falling interest rates that beget rising house prices. This cannot continue forever, so the big question is when will it all end?

The answer is when inflation rises enough to concern the Reserve Bank. Only at that point will the Reserve Bank see fit to increase interest rates. When interest rates eventually do rise, the forces that have driven New Zealand house prices ever higher over the past decade will go into reverse. Investors will be attracted back into bank deposits rather than riskier investments. Aspiring owner occupiers will face higher mortgage payments, meaning they can't bid as high. Existing homeowners will find their mortgage payments become less affordable, forcing some to sell. All of this could see house prices decline, as they have after other periods of rising interest rates. We are pencilling in a period of declining house prices from 2024, but such long-range forecasts are subject to extreme uncertainty, so the timing is perhaps less important than the principle – when interest rates rise, house prices will fall.

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