15 November 2007

House of sticks or bricks?

Outlook for New Zealand house prices

- **New Zealand's housing market has slowed dramatically.**
- **Interest rates are hurting the market, and there is no relief in sight.**
- **Houses are now grossly overvalued, but the strong economy and relative shortage of housing supply will prevent significant price declines.**
- **We expect house price inflation to wallow a few points either side of zero, with prices in five years' time similar to today.**

There is no doubt about it. New Zealand's house price boom is over. The long-anticipated housing downturn is underway.

House sales have collapsed by a third, and are running at half of 2003 levels. Plummeting sales are a classic early warning signal of a price downturn. True to form, house price inflation has screeched to a halt, with zero price movement for the past seven months. The turnaround was as spectacular as it was abrupt – prices were rising by $8,000 per month in the early part of the year, before stopping dead in April. In this article we will explain why we expect more price weakness to come – prices could be flat for half a decade.

Figure 1: Median house price

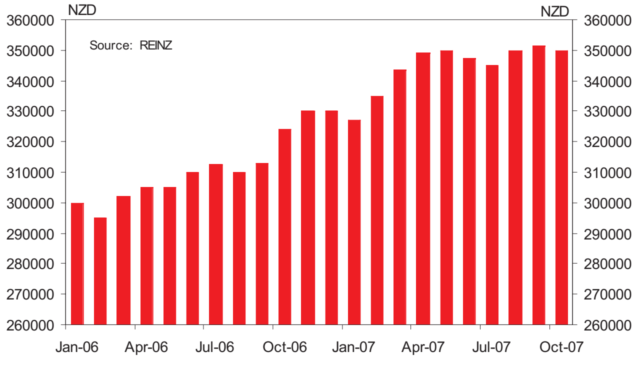
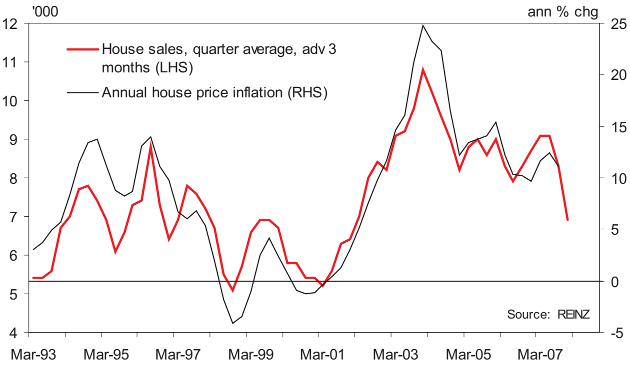


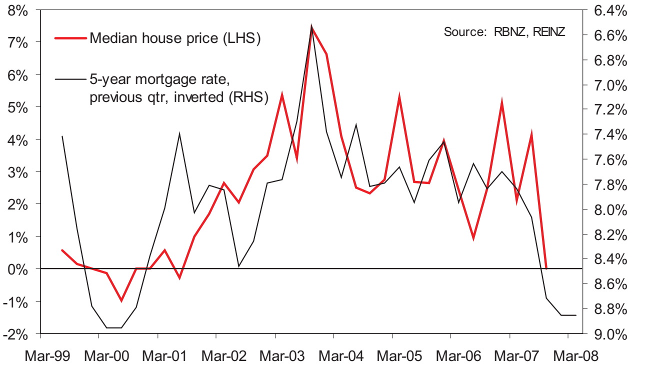
Figure 2: NZ house sales and annual price inflation



Why house prices have stagnated

The reason for the housing market's malaise is higher interest rates. The Reserve Bank of New Zealand finally engineered higher fixed-term retail mortgage rates in March 2007. The RBNZ had been persistently hiking the OCR since 2004, but the earlier hikes had little effect. Homebuyers could always migrate to longer fixed terms, where interest rates were lower. The quarter after fixed rate mortgages went up, house prices stopped rising (refer Figure 3).

Figure 3: House price response to interest rates
Quarterly house price inflation charted against the previous quarter's 5-year mortgage rate, inverted



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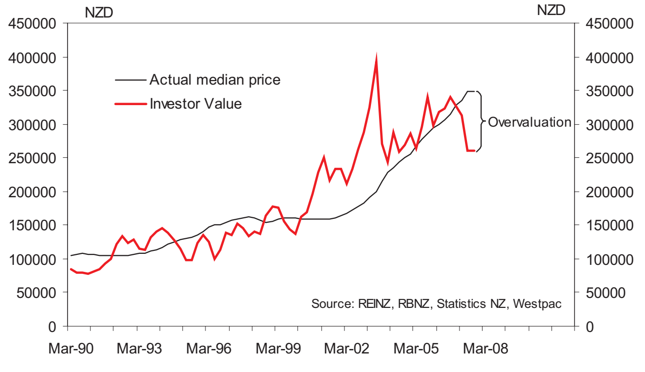
With rental yields at 4% and mortgage rates at 9%, property investment is looking less attractive. The Westpac "investor value of housing" measures the value of property as an investment asset, according to prevailing long-run interest rates, marginal tax rates, rents, and expected capital growth. The investor value was $328,000 in December 2006 – similar to the actual selling price of property at the time. Since then, rising mortgage rates have dragged the investor value down to $260,000. Meanwhile, the median selling price has risen to $350,000. Prices have drifted away from fundamentals, leaving houses grossly overvalued today.

The investor value is not a price forecast. We are not saying that the median house price will fall to $260,000. Rather, the investor value tends to exert slow and steady pressure on market prices. It took four years for prices to fully reflect the large increase in the investor value earlier this decade. Today's price overvaluation could persist for a similar period.

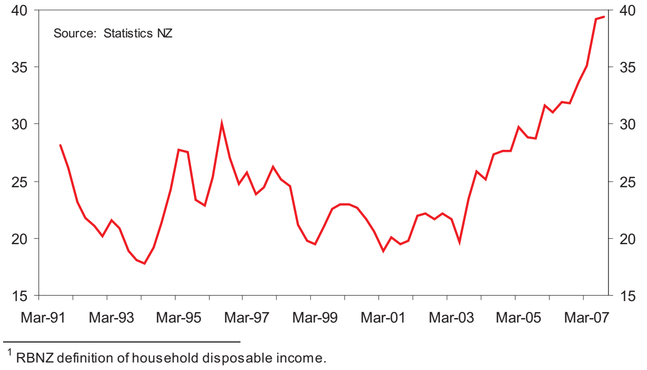
Figure 4: Investor value versus median house price



Interest rates were also behind a sharp deterioration in housing affordability this year. The cost of servicing an 80% mortgage on a median house, at prevailing 5-year interest rates, has risen from 34% of average household disposable income to 39% this year, mostly due to higher interest rates.

Figure 5: Housing affordability

Cost of servicing 80% mortgage on median house at 5-year interest rates, as % of average household disposable income[1]



[1] RBNZ definition of household disposable income.

How will the imbalances correct?

In New Zealand, house price corrections have tended to play out as protracted periods of flat or slightly declining prices. While prices meander, the fundamentals play catch-up. The current overvaluation is most likely to resolve itself in a similar fashion.

The key reason for eschewing a more pessimistic price forecast, in which house prices fall earlier and more aggressively, is the strong economy. New Zealand is enjoying a massive income boost thanks to global food price inflation. Unemployment is at 20-year lows, job security is excellent, and wage growth is good. It is unlikely that redundancies will cause mortgage defaults and forced sales in any great numbers. Established homeowners who have built up equity and have secure jobs will not be forced to sell into the weak market.

Another supporting factor is a relative lack of housing supply. The shortage of housing supply that prevailed in 2002 may have resolved itself to some extent, but there is no evidence of a massive overhang to put immediate downward pressure on prices.

And finally, New Zealand banks did not indulge in the super-lax lending standards that have since backfired spectacularly and gotten the US, UK, and Irish housing markets into such trouble. By New Zealand standards, 100% mortgages are extreme. 110% mortgages, sub-prime mortgages, no-doc loans, and negative amortisation are all thankfully absent.

If house prices do stagnate or fall slightly, it will be a very long time before the fundamentals catch up to resolve the overvaluation – at least four years and possibly longer. There is little prospect of a quick fix from lower interest rates. We actually expect mortgage rates to go higher next year, putting even more pressure on the housing market. Even if mortgage rates returned to average levels, the investor value would be $300,000, still leaving a gaping overvaluation. (5-year mortgage rates have averaged 8.3% since 1996).

From an investor perspective, higher rents would improve the situation. We are forecasting 6% per annum rent increases, which is very strong. Even at that pace, it will take four years to restore equilibrium between rents and house prices, and that is *assuming* an eventual normalisation of mortgage rates. If mortgage rates instead remain at current levels, it will take 5½ years to restore equilibrium.

From the owner-occupier perspective, rising incomes and stagnant prices will eventually restore affordability. But again, it will take a long time. If household disposable income rises at 5% per annum, and interest rates eventually return to average levels, it will be eight years before affordability returns to “normal” (arbitrarily defined as the historical average since 1991 – 25% of disposable income required to service an 80% mortgage over the median house).

House price predictions

Our central forecast is for house price inflation to wallow a few points either side of zero, with prices in five years' time similar to today. What happens in the short term is uncertain, since swings in sentiment could go either way, but the risks seem oriented more towards price declines than significant increases. We need not look far for a precedent. House prices fell in 1998, and were unchanged for four years between 1997 and 2001. Today's overvaluation is larger than the late-90s episode.

Our forecast is something of a middle ground between the looming overvaluation and the strong economy. The opposing forces will affect each region, suburb, and house differently. We are already witnessing rural house prices outperform urban – Southland's house prices are up over 30% in a year! Rural regions, especially the dairying ones, are more likely to experience ongoing price increases over the next few years. Urban areas are more likely to experience price declines.

The lower end of the market will be weakest, since the most vulnerable owners are highly leveraged property investors and recent entrants. If tax cuts eventuate, they will tend to depress lower-end prices further, since lower tax rates reduce the incentive for holding rental property as a tax shelter. Conversely, tax cuts would benefit the top end of the market, thus generating greater price dispersion. There is not one single housing market at any time, and we expect divergences between market segments and regions to become more pronounced in the next few years. All up, housing will remain a good long-term investment, but the next few years will be challenging.

The current housing downturn is peculiar because is it is occurring in the midst of a strong economy – other house price downturns have coincided with weak economic times. Next week we will publish a bulletin detailing the Reserve Bank's likely response to the weak housing market. The upshot is that the strong economy and pervasive inflation pressures will leave no scope for interest cuts in the foreseeable future.

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