focus

New Zealand's housing market: **Built of bricks or built of cards?**

On any measure New Zealand house prices are extreme. Even before we'd ever heard of COVID-19 there was much consternation about the country's "housing crisis". Since COVID hit, house prices have soared and unaffordability has gotten worse. Much worse. So where to from here?

New Zealand housing is seen by many to be "as safe as houses". We disagree. Headwinds are mounting — more supply, higher mortgage rates, a brake on credit, and unappealing returns for investors. We would not be shocked to see a meaningful drop in prices through 2022.

FORSYTH BARR

Conditions could not have been more perfect

If you Google 'New Zealand housing bubble' you can find articles dating back to the mid 2000s predicting the market's imminent collapse. Through today's lens, however, prices back then look restrained.

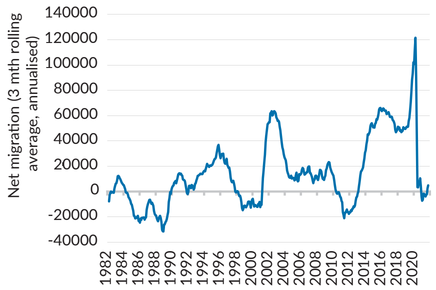
There was a threat of a significant correction in 2008/09 following a boom-bust in migration and the Global Financial Crisis. The market stabilised after a very helpful (i.e. massive!) 575bps interest rate cut by the Reserve Bank of New Zealand (RBNZ).

House price growth really kicked off again in 2012 fuelled by the perfect storm of surging migration, the inability of housing supply to keep pace with demand, and record low mortgage rates.

Today the construction industry is booming. A decade ago it couldn't have been more different. New Zealand was a net exporter of people. Population growth was modest. And New Zealand was building the fewest houses since World War II.

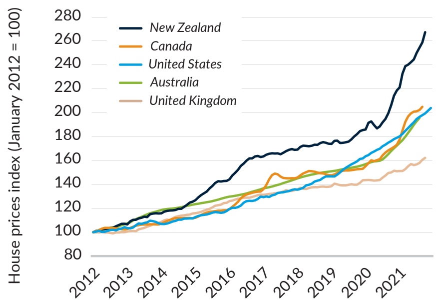
Then migration took off soaring to record levels. New migrants need somewhere to live and a boom in housing construction followed. Supplying new houses, however, is sticky — meaning it's difficult to lift quickly. Supply has not kept pace with demand.

NET MIGRATION: PRE-COVID BOOM, BUT THE DOOR IS NOW SHUT



Source: Statistics New Zealand, Forsyth Barr analysis

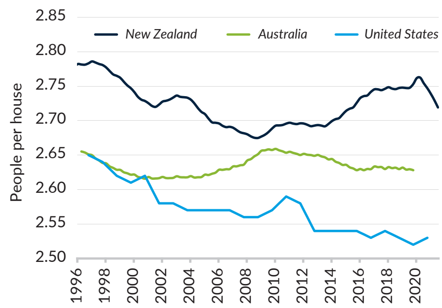
GLOBAL HOUSE PRICES: NEW ZEALAND TOPS THE 'LEADER BOARD'



Source: Refinitiv, REINZ, CREA, Forsyth Barr analysis

One way to highlight our housing underbuild is people per house. In most developed countries people per house has been falling due to demographic reasons — smaller family sizes, ageing populations, more single-parent households. In New Zealand (until recently) it has been rising.

PEOPLE PER HOUSE: NEW ZEALAND HASN'T BEEN BUILDING ENOUGH HOUSES

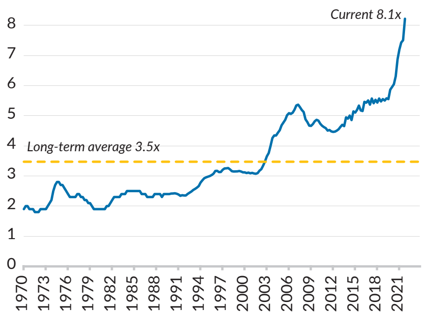


Source: Statistics New Zealand, realestate.co.nz, ABS, Refinitiv, Forsyth Barr analysis

The first thing any economics student learns is that when demand exceeds supply prices typically rise. And when interest rates fall the price people can afford to pay for houses climbs. The result is house prices have soared.

New Zealand now ranks as one of the most expensive housing markets globally. Mid last year Bloomberg named us the 'frothiest' housing market in the world. And the latest Demographia International Housing Affordability Survey ranked Auckland as the fourth least affordable city in the world (and prices have surged 31% since that report!).

NEW ZEALAND HOUSE PRICES VS. INCOME: ONE OF THE MOST EXPENSIVE MARKETS IN THE WORLD



Source: REINZ, RBNZ, Forsyth Barr analysis

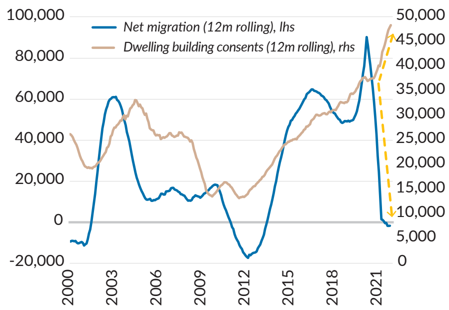
The wind has now turned

Successive governments have tried to address the 'housing crisis'. Housing Accords, Special Housing Areas, and KiwiBuild were intended to boost supply. The removal of depreciation and interest tax deductibility on investment properties, plus the introduction (and extension) of the 'bright-line' rule for capital gains tax, aimed to dampen investor demand.

None of these achieved the primary long-term issue — building enough houses.

That is slowly starting to be remedied. With our borders shut, net migration has fallen to effectively zero but construction has continued to boom. We are slowly making a dent in the undersupply.

MIGRATION VS. DWELLING CONSENTS: WE'RE FINALLY BUILDING ENOUGH HOUSES

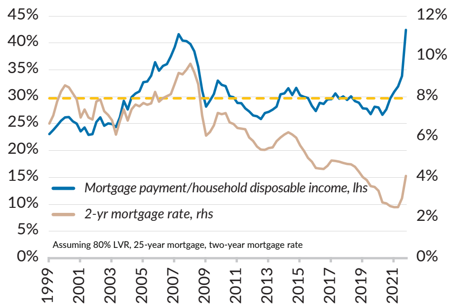


Source: Statistics New Zealand, Forsyth Barr analysis

Probably more significant in the near-term is the largest jump in mortgage rates in nearly 15 years.

The following chart highlights the share of income required by the average household to service a mortgage on the average house. Until recently, lower and lower mortgage rates offset higher and higher house prices meaning the share of income required to service a mortgage had been broadly stable ... until recently. The recent surge in mortgage rates means debt servicing will now consume a lot more of household incomes. Unaffordability is really starting to bite.

COST OF SERVICING A MORTGAGE (% OF INCOME): THE BURDEN HAS SOARED

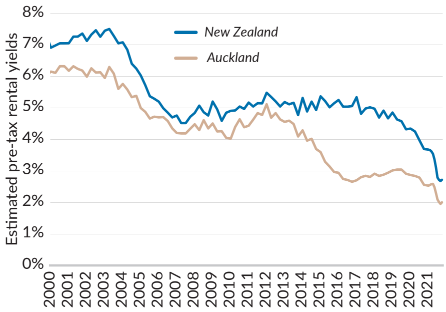


Source: REINZ, RBNZ, interest.co.nz, Forsyth Barr analysis

Unaffordability is also being compounded by a brake on credit. Following the RBNZ's revised restrictions on high loan-to-value (LVR) mortgages banks have reportedly restricted (or even canned) lending to home buyers with less than 20% deposit. Additionally, the recently introduced Credit Contracts and Consumer Finance Act (CCCFA), designed to protect the vulnerable from predatory lending, is also having the unintended result of raising onerous barriers for borrowers.

And while affordability has become more difficult for owner-occupiers, it's gotten even tougher for investors. Rising mortgage rates adds to the challenges of tax changes, RBNZ imposed lending restrictions, tenancy law changes, and poor cash returns. Investors own around 38% of New Zealand's housing stock. You could understand if a few were reconsidering their investments.

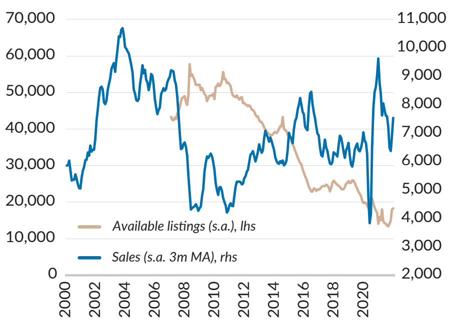
RENTAL YIELDS: INVESTORS ARE BEING OFFERED ANAEMIC CASH RETURNS



Source: RBNZ, REINZ, Statistics New Zealand, Forsyth Barr analysis

Signs and anecdotes suggest the market is already slowing. Over the last two years limited houses available for sale has heightened buyer FOMO (fear of missing out). Recently sales have fallen, inventory has started to tick up, and auction clearance rates have dropped. We will be watching available listings over coming months with interest.

HOUSING INVENTORY HAS STARTED TO TICK HIGHER: HOUSE SALES VS. AVAILABLE LISTINGS



Source: REINZ, realestate.co.nz, Forsyth Barr analysis

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Will we see a house price correction?

Debates on New Zealand house prices can evoke a reasonable amount of passion.

It is always interesting how quickly, after the fact, people accept past extreme events as entirely rational. Back when COVID first hit in early 2020 most economists were predicting house price declines of 10-15%. If you'd suggested they were actually going to rise by more than 40% most people would have said "you're crazy!". But now we're at those levels and the median price has passed $900,000, many struggle to envisage a scenario where prices may fall by $100,000 – to levels we saw only back in April – or, heaven forbid, $200,000 – where they were as recently as November 2020.

History tells you predicting where house prices will land is challenging. Within Forsyth Barr some of us think declines are highly likely and that these could be significant; others are more sanguine. What there is agreement on is that the market does look more vulnerable today than it has for a long time. Moreover, the trajectory of prices (particularly if it's sharply downward) will influence the path of the broader economy, likely impacting consumer and business sentiment, household spending, construction, and interest rates. The housing market is definitely worth keeping an eye on.

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Understanding that sudden changes in financial markets can cause concern or indicate opportunity, your Forsyth Barr Investment Adviser is available to provide you with advice and assistance at any time.

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