

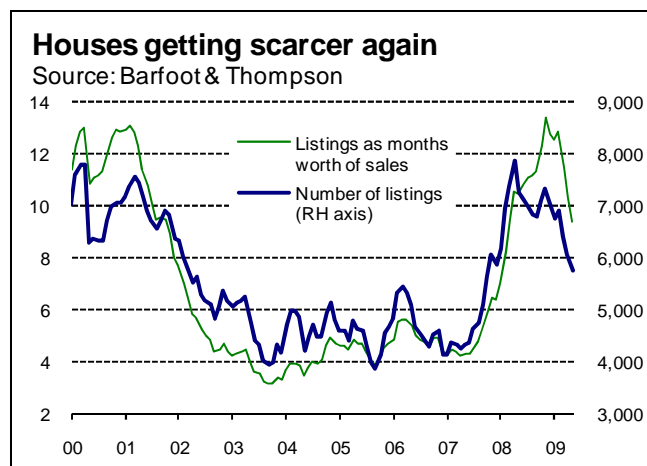
RESIDENTIAL PROPERTY MARKET

Through the worst

House sales have picked up over the last few months, prices appear to have stabilised, and real estate agents are reporting a shortage of listings in some areas. Although the housing market may be through the worst of the downturn, the soft domestic economy and labour market will dominate the effects of low mortgage rates over the next 18 months, stalling the current pick-up in sales. However, a prolonged lack of new residential building activity threatens to push house prices back up further above their long-term trend – after adjusting for inflation, we predict prices could rise by as much as 4.6%pa over the next five years.

Our prediction that the housing market would stabilise by the middle of this year appears to have come true. In terms of house sales volumes, the improvement has been stronger than we expected, with turnover in April and May the strongest for any months since activity collapsed in March 2008. Sales volumes over the three months to May 2009 were up 38% on a year earlier.

After getting up towards an average of 60 days last year, the median length of time that houses are taking to sell has dipped back towards 40 days. The level of competition among buyers has increased as financing costs have fallen and the number of properties on the market has dropped away. Listings with Barfoot & Thompson, Auckland's largest real estate company, are now at their lowest level since December 2007.



Graph 3.1

But the recovery in turnover has been patchy. There are two broad types of property that have underpinned the pick-up.

- Very low mortgage rates have significantly improved the affordability of property for investors and first-home buyers. Although tougher deposit requirements will have prevented some first-home buyers from entering the market, anecdotal evidence suggests that some buyers are taking the plunge given the significant drop in financing costs



compared to a year ago. The cash flow position of investors has also improved due to lower interest rates. Both types of buyers, however, are being relatively choosy about properties and paying particular attention to price, location, and presentation.

- Turnover in well-presented mid-priced properties in popular suburbs is strong as existing homeowners take advantage of low interest rates to trade up. This segment of buyer demand is a flow-on effect, in part, from the lift in demand for low-end properties as outlined above.

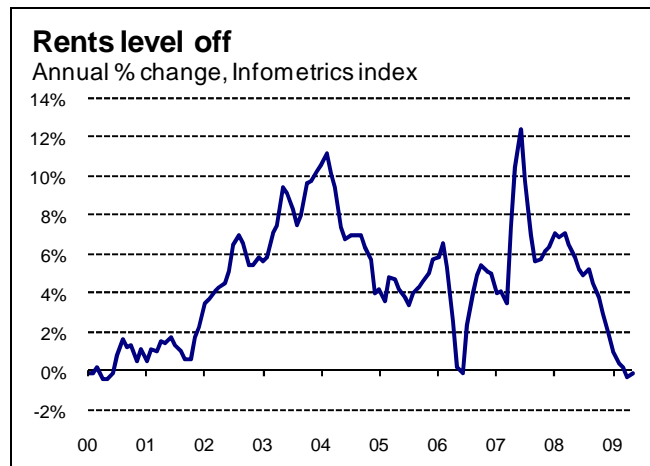
As a result of these trends, there now seems to be a relative shortage of property fitting the price, location, and presentation requirements of buyers. In contrast, vendors in less desirable suburbs, with excessive price expectations, or with poorly presented houses are struggling to attract buyers and their properties are remaining unsold. There will be a ripple effect on activity in less desirable locations as the shortage of suitable properties encourages some buyers to look further afield, but having realistic price expectations will remain crucial for sellers. Given that buyers have little or no expectations of capital gains in the near future, potential purchasers feel under no rush to buy and are only likely to be interested in reasonably priced property.

Rents and land prices hit by downturn

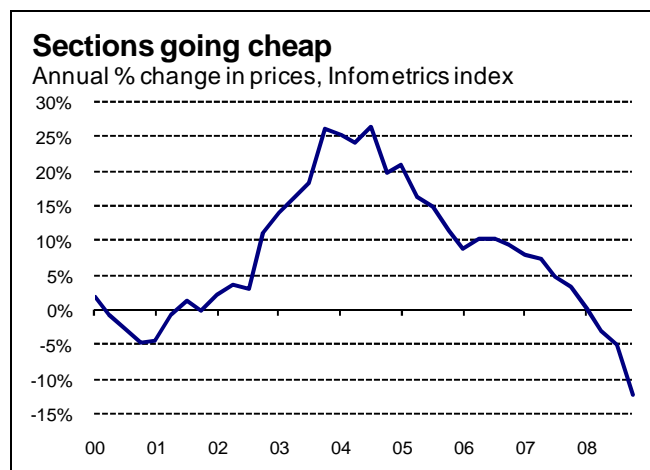
House price data for the March quarter will be released by Quotable Value later this month. However, mapping changes in QV's monthly numbers to their quarterly index suggests that house prices actually rose 0.3% over the March quarter. This quarterly increase was the first since the end of 2007, and represents an earlier stabilisation in property values than even we were expecting.

Growth in rents, however, has been easing. Since peaking at 7.1%pa in March last year, rental growth has steadily slowed, and it turned negative in April. This trend lines up with an increased supply of rental accommodation (due to the accidental landlord phenomenon), as well as the broader economic environment reducing people's ability to pay higher rents. With employment and incomes under pressure, some people are being forced to downsize their accommodation requirements or live in more crowded situations. Property managers have been encouraging landlords to set rents relatively low to ensure they attract and maintain tenants, rather than run the risk of suffering vacancies.

The effect of the housing downturn is being clearly seen in section prices and sales activity. The number of section sales over the 2008 calendar year was down 63% on the previous 12 months, and our section price index estimates that land prices plunged 7.6% over the December 2008 quarter to be 12% lower than a year earlier. We estimate that almost 80% of the country's local authorities currently have falling section prices, and of the largest development areas, only North Shore has avoided annual price falls.



Graph 3.2



Graph 3.3

Make the most of now

The stabilisation in the housing market was one of the key factors that dissuaded the Reserve Bank from lowering the official cash rate below 2.5% at its most recent monetary policy review. The Bank has previously had a more pessimistic forecast of house prices, so will still be conscious that property is overvalued by most measures. The Reserve Bank is likely to have some concerns that low mortgage rates could fuel a renewed housing boom, and if homeowners fix debt for two or more years, the effectiveness of any tightening in monetary settings could be severely reduced or delayed (as was the case between 2003 and 2008).

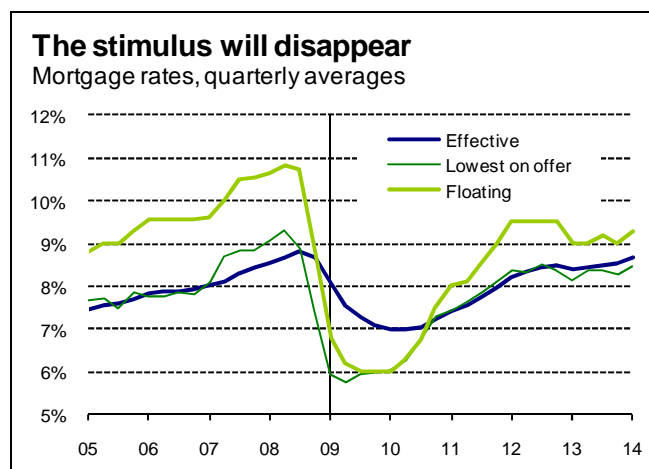
There has been plenty of rhetoric from politicians criticising trading banks for not passing official cash rate cuts through into floating mortgage rates (a criticism that has not been adequately refuted by the Reserve Bank). But we suspect the Reserve Bank is not too worried about where mortgage rates have got to, particularly when you take into account that one-year fixed rates were as low as 5.5% – providing significant stimulus for people whose previous fixed-rate terms were expiring.



There is some chance of a further reduction in the OCR if the Reserve Bank becomes nervous about the strength of the New Zealand dollar and its negative effect on the export sector. However, our core view is that the Bank will leave the OCR at 2.5% until the second quarter of 2010, by which stage the world economy will be clearly in recovery mode and the New Zealand economy will have emerged from recession. We have incorporated a forecast OCR of 4.5% by the end of 2010, lifting to 6% by early 2012. The need for an earlier or more rapid tightening will be alleviated by the amount of spare capacity and resultant lack of domestic inflation pressures over the next 18-24 months, along with the limiting effect of the relatively high exchange rate on the export sector.

The OCR has currently taken a back seat anyway in terms of setting retail interest rates. Offshore investors are demanding a higher risk premium than before the financial crisis, and those higher wholesale rates are flowing through into higher deposit rates in the battle for domestic savings as well. Add in the surge in longer-term bond rates over the first half of this year, and it is unsurprising that the outlook for mortgage rates is less rosy than it was back in February and March.

We expect mortgage rates to steadily climb over the next 18 months, with nothing available below 7.5% by early 2011, and nothing below 8% by the end of that year. The effective mortgage rate will reach its low point early next year, and climb throughout most of the rest of the forecast period.

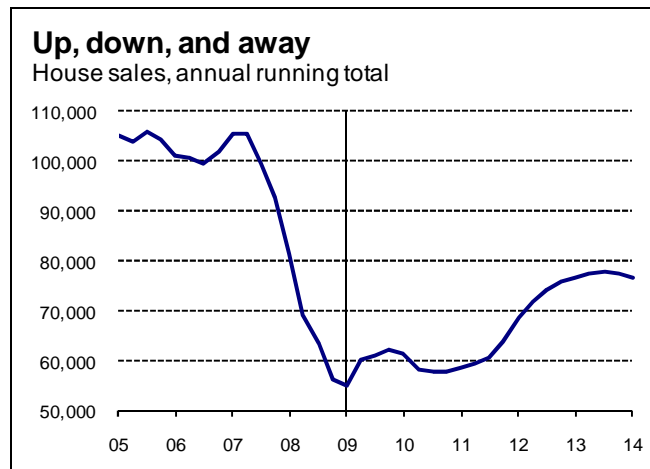


Graph 3.4

Sales stutter, prices don't

We believe the current surge in house sales reflects pent-up demand of the last 12-18 months, and are looking for turnover levels to ebb over the second half of this year. The supply of property on the market will continue to ease as property owners generally choose to maintain their holdings rather than sell at the low point of the cycle. We forecast a more sustained rebound in housing turnover in 2011/12 as strong economic growth and a turnaround in unemployment increase people's willingness to take on debt again. By this time, credit conditions are likely to have eased and banks may be less stringent in their deposit requirements.

Increasing capital gains could also fuel another round of “bubble behaviour” as people try to get their share of rising property prices.



Graph 3.5

Despite a relatively soft outlook for house sales, we have taken a bullish view on house prices. The lack of new residential building activity has put a definite floor under property values, and strengthening population growth will maintain buyer competition across what we expect to be a constrained supply of housing available for purchase. We estimate that inflation-adjusted house prices are currently about 15% above their long-term trend line (down from 36% in mid-2007), but could climb back towards 30% overvalued towards the end of the forecast period.



Graph 3.6

The continuation of overvalued house prices is one of the New Zealand economy's imbalances that we do not believe has been adequately rectified by the current financial crisis. Along with the large current account deficit, high debt levels, and poor national savings rate, the imbalance in the housing market is one of the factors that threaten to lead to a downgrade in our creditworthiness by the middle of next decade.