Wednesday 14 December 2022

focus

House prices are tumbling... **and that's okay**

New Zealand's extreme house prices have been exposed by rising mortgage rates, tightened bank lending, and a building boom that's finally delivering enough houses. House prices have already experienced the largest nominal decline on record, down an average of -14% across the country. We suspect there is more to come. While the adjustment will be painful — and we do have sympathy for those who bought near the peak — a correction is needed and should benefit the economy longer-term.

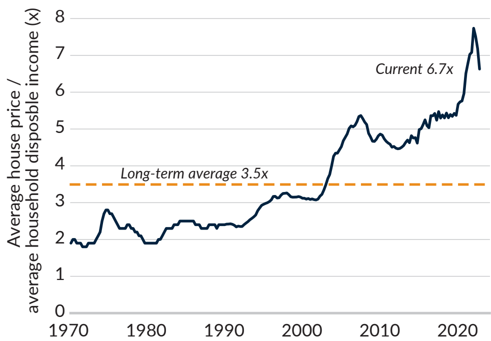
FORSYTH BARR

...The average house price costs around 6.7 times the average household disposable income...

How did we get here?

Last year Bloomberg described New Zealand as the "frothiest" housing market in the world. On any measure our house prices are extreme. The average house price costs around 6.7 times the average household disposable income. At their peak late last year that figure was nearly 8. To put that in perspective the long-term average is about 3.5 times, and in the United States this year there was a lot of talk about a housing affordability crisis because they'd just touched 4 times. They have nothing on us.

EXTREME HOUSE PRICE UNAFFORDABILITY: HOUSE PRICES VS. HOUSEHOLD DISPOSABLE INCOME



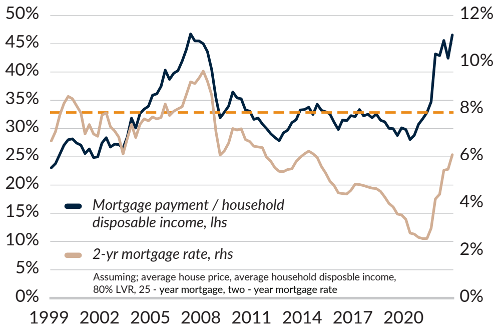
Source: REINZ, RBNZ, Forsyth Barr analysis

New Zealand house prices reached eye-watering levels through the perfect storm of low interest rates...cheap money, a post-Global Financial Crisis construction slump...not enough supply, followed by a boom in migration...soaring demand. As any student who studied 5th form (or for younger readers, year 11) economics knows when demand exceeds supply prices rise. And when the cost of borrowing is super low, prices can rise by a lot.

The wind has turned

The backdrop for house prices has turned 180 degrees. For the first time in nearly a decade and a half mortgage rates have jumped meaningfully ...debt servicing costs have soared, housing construction is booming...supply is growing, while migration is roughly flat...demand growth is modest.

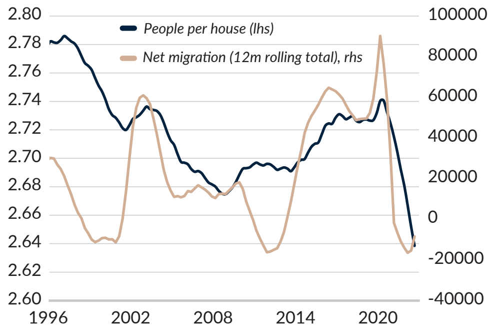
MORTGAGE SERVICING COSTS HAVE SOARED: MORTGAGE PAYMENTS VS. HOUSEHOLD INCOME



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

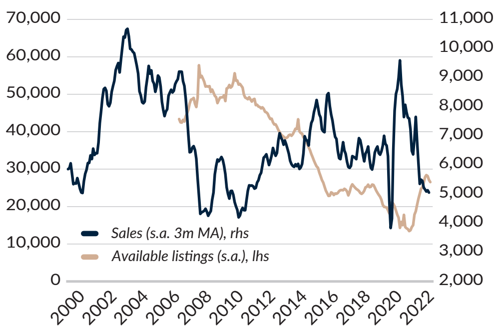
...House price corrections, however, tend to be long dated, typically taking years rather than months...

WE'VE FINALLY BEEN BUILDING ENOUGH HOUSES: PEOPLE PER HOUSE VS. NET MIGRATION



Source: Stats NZ, Forsyth Barr analysis

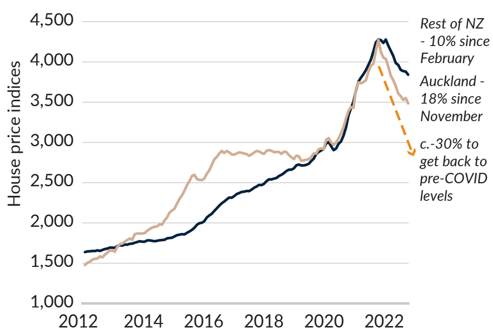
HOUSING INVENTORY IS STEADILY BUILDING: HOUSE SALES VS. INVENTORY AVAILABLE FOR SALE



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

So far national house prices are back -14% from their late 2021 peak, with Wellington and Auckland leading the pack down -21% and -18% respectively. This is already the largest nominal fall on record. House price corrections, however, tend to be long dated, typically taking years rather than months. A further -20% drop would only get us back to pre-COVID levels. In our view, this is definitely not out of the question.

FURTHER TO FALL?
NEW ZEALAND HOUSE PRICES



Source: REINZ, Forsyth Barr analysis

...Developers and buyers are less willing to invest when it's less clear where prices and margins will be in 12 months or so...

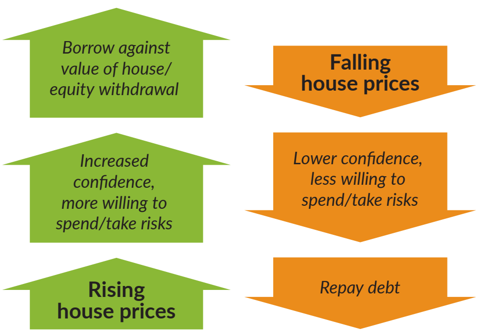
A correction is painful

A drop in house prices theoretically doesn't leave the country any worse off. We still have the same number of houses, it's just that they're worth less on paper.

In practice, however, a house price adjustment is typically painful. New Zealand households have a significant share of their net worth tied up in housing. The wealth effect of rising or falling asset prices effects consumer confidence, spending, and willingness to take on financial risk.

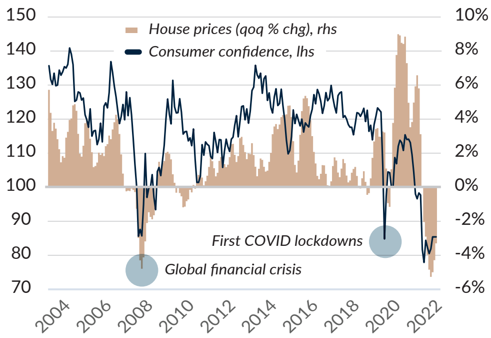
Lower house prices mean people feel poorer and spend less, particularly on large ticket items (exacerbated in the current environment by higher interest rates and increased debt servicing costs).

WEALTH EFFECT OF ASSET PRICES



Source: Forsyth Barr

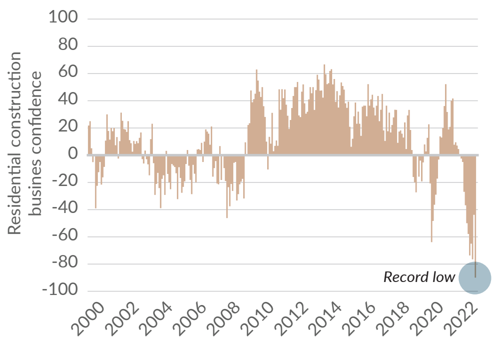
CONSUMERS ARE FEELING GLUM: CONSUMER CONFIDENCE VS. HOUSE PRICES



Source: Roy Morgan, ANZ, REINZ, Forsyth Barr analysis

This reluctance to spend unsurprisingly extends to building new houses. Developers and buyers are less willing to invest when it's unclear where prices and margins will be in 12 months or so.

RECORD LOW CONSTRUCTION CONFIDENCE



Source: ANZ, Forsyth Barr analysis

But a reset is sorely needed

While a house price correction is painful in the near-term, it is necessary. Lower prices will be beneficial to the New Zealand economy over the longer term.

Extreme house prices hurt the economy in numerous ways.

1. Exacerbates inequity

Despite what you read in some parts of our media, income inequality in New Zealand hasn't significantly changed over recent decades. That is not to say there aren't people suffering from poverty — there clearly are. But the data suggests the distribution across the country hasn't really shifted.

What has changed though is housing costs. High house prices and rents means people have less to spend on other goods and services. This disproportionately impacts lower wage earners who spend a higher portion of their income on housing.

Misunderstanding about the cause of inequality can lead to misdirected policies that may reduce productivity and economic growth.

2. Misallocation of capital

Rapid house price growth can distort the allocation of capital. The often associated credit booms and busts can damage the economy. In New Zealand during the early/mid 2000s soaring house prices fuelled a surge in borrowing and construction. A chunk was funded by low quality lending from non-bank finance companies. In the subsequent bust 67 finance companies collapsed. A government inquiry estimated between 150,000 and 200,000 investors collectively lost over NZ$3 billion. Recessions associated with credit crunches and house price busts are usually deeper and last longer.

3. Reduces labour market mobility

Typically the most important resource is human capital. In a global marketplace New Zealand's high house prices (coupled with relatively low wages) makes attracting and retaining talent substantially more difficult.

Furthermore, elevated house prices also reduces labour mobility within New Zealand. An efficient economy allocates resources to its most productive use. Productivity and wages are considerably higher in cities than in regional areas. Unaffordable housing, however, makes more people reluctant to move to expensive cities. They remain in less productive jobs with lower wages, while businesses find it harder to attract the skilled labour they need to innovate and grow.

4. Dampens the entrepreneurial spirit

Healthy entrepreneurialism is critical to a productive economy — it creates new companies, products and services, and jobs. Elevated house prices and resulting high debt levels can dampen people's entrepreneurial ambitions — they need to maintain a steady income to service the mortgage and can less afford to take the risk of starting a new venture.

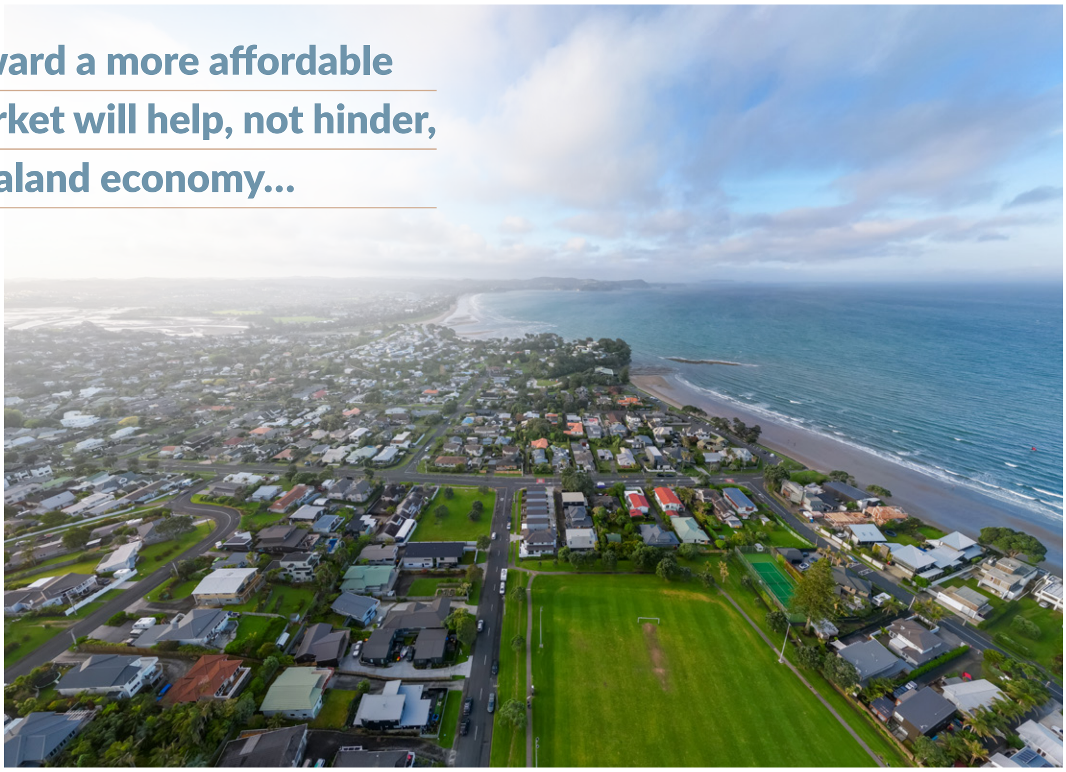
5. Dominates the government agenda

New Zealand has a notoriously poor track record of productivity improvement (which is the biggest determinant of the country's long-run wages and living standards). Governments, like any organisation, have limited time and resources. If alleviating overinflated house prices is near the top of the government's agenda it reduces its capacity to address other issues which may boost productivity.

6. Promotes uneconomic spending

At best, high house prices is a wealth transfer from first home buyers to existing owners, particularly those with more than one property. But if then the sellers use their additional wealth (funded by first home buyer debt) for more extravagant spend on non-productive assets — the nicer car, the bigger boat — then the country as a whole is less economically well off.

...a shift toward a more affordable housing market will help, not hinder, the New Zealand economy...



A painful but necessary adjustment

New Zealand is in the midst of a meaningful house price correction. In the near-term this will be painful. In the long-term it should be beneficial.

Over the past two decades or so New Zealand house prices soared. The boom attracted capital — people funnelled more and more money into housing. Households felt wealthier and spent more (largely funded by debt). In recent years construction boomed.

The "punch bowl" metaphor is sometimes used to describe the role of central banks — their job is to tighten monetary policy (or "remove the punch bowl") before the economy ("the party") gets out of control. When COVID hit our Reserve Bank spiked the punch bowl, and the housing market party roared.

Now we're suffering the hangover. House prices were (and still are) unsustainably high. Businesses and consumers are left feeling pretty glum. There's an expectation that housing construction will fall sharply and consumer spending will slow. Investors are realising that buying property isn't a one-way bet. While this is all a bit painful, unfortunately, this is a necessary adjustment we have to go through — eventually all parties have to end. The good news is, though, that longer-term, a shift toward a more affordable housing market will help, not hinder, the New Zealand economy.

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If at any time you want to discuss investment options and opportunities, your Forsyth Barr Investment Adviser is available to provide you advice and assistance.

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