

Time for a cool change

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Summary

- Our monthly Property Focus publication is aimed at providing investors and prospective homeowners with an independent appraisal of recent developments in the property market, as well as our favoured mortgage borrowing strategy.

The month in review (page 2)

- The latest REINZ data continues to depict weakness. Higher fixed lending rates, affordability measures at extreme levels and receding net migration inflows continue to weigh on momentum. There are widespread stories and evidence of greater numbers of properties for sale, which implies continued downward pressure on prices if they are indeed to be sold.

Property gauges (page 3)

- Higher mortgage rates could be the knock out blow to hit an already punch-drunk housing market. How long will it be before the Reserve Bank decides to throw in the towel? The answer is not until the property market is sufficiently weak and filters into the general economy and dampens inflation. Our property gauges continue to warn of a corrective phase as the market retreats from overvalued levels.

Economic backdrop (page 5)

- We've pencilled in a meagre 1 percent growth in 2008. The housing market (a pro-cyclical sector) is expected to under-perform the economy in general. A negative turn in the credit cycle skews the risk profile downwards. The strategy in this environment is to keep your powder dry and remain cautious. Many will have seen this before, looking for buy-on-dips opportunities. Be patient. We suspect the dip has a way to go.

Mortgage borrowing strategy (page 6)

- We're standing by our expectation that wholesale interest rates are set to fall in 2008. Yet given market (credit) conditions, this may not flow through into lower retail lending rates. We remain inclined towards the 2-year part of the curve at present. We have previously discounted 5-year borrowing as too expensive relative to history. We are now more inclined to having a proportion of debt on longer terms as insurance against an un-orderly current account adjustment.

Feature article – supply-demand balance (page 7)

- We have updated our demand-supply housing balance measures for data to December. Despite the valiant attempts of Auckland and Nelson-Marlborough, the supply-demand scales are tipped in the supply direction.

Key forecasts (page 12)



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The month in review

The latest REINZ data continues to depict weakness. Higher fixed lending rates, affordability measures at extreme levels, and receding net migration inflows are weighing on momentum. There are widespread stories and evidence of greater numbers of properties for sale, which implies continued downward pressure on prices if they are indeed to be sold.

The end of the golden weather.

A weak cold construction front lies over the North Island whilst a ridge lies over the South Island.

Everywhere you go, always take the weather with you.

- > **REINZ housing data – February.** Housing market activity continued to soften in February as seasonally adjusted house sales fell 2.5 percent from the previous month. It is taking longer to sell a house, with the median days to sell jumping from 40 days in January to 45 days in February (seasonally adjusted). The median house price fell for the third consecutive month to \$337,500, the first time it has done so since late 1997. Compared to a year ago, house prices are effectively flat, up 0.7 percent. However, looking at the movement over six months shows the median sale price to be down 4 percent. The gap between the median list price and actual sale price widened to \$11,500 (the widest we have seen for a number of years) reinforcing that buyers are being more circumspect with bids, and sellers are having to adjust their expectations given market conditions.
- > **Barfoot and Thompson figures for Auckland – February.** Barfoot and Thompson's figures generally mirrored the aggregate REINZ report. One focal point in this data is on actual listings. The number of listings continue to increase at a time buyer demand is waning. Based on Barfoot and Thompson data, there is now 10.5 months worth of housing supply - a sign that further downward pressure on house prices is coming. The last time the housing supply exceeded 10 months was in early 2001, a period when the housing market was last subdued.
- > **Building Consents – January.** Residential dwelling consent issuance rose 3.3 percent in January rebounding from a 3.9 percent fall in December. As this data is notoriously volatile on a monthly basis, we are not reading too much into the rebound, especially as it comes after a large fall in December. The trend for both total residential and ex-apartment consent issuance continues to be down. As has been the theme over recent months, construction prices (which we proxy as the value of dwelling consent issuance per square metre) has softened. Annual growth in this measure (on a three month basis) looks to have found a base at around 4 percent. This is after being at over 10 percent over the first half of last year.
- > **External Migration – January.** The 12 month total for net migration continues to ease and is currently sitting at 4,799 people. This is well down from a net 14,000 at the start of 2007 and is at its lowest level since the end of 2001. The last few months have shown a fall in the number of permanent and long-term arrivals into the country. Net migration over the past two months has totalled a meagre 70 people after averaging 460/mth over 2007.
- > **Mortgage lending - January.** Lending to households was up only 0.7 percent in the first month of 2008, the same monthly rate of increase it finished last year on. Annual lending growth to households has slowed to a 5½ year low of 12.4 percent. The 3-month annualised rate is below 10 percent.

Assessment

Higher mortgage rates, particularly as 2 and 3 year fixed rates roll-off, rising supply and easing migration are collectively ominous signals for the property market, which is clearly showing a weakening trend. However, amongst all the pending pessimism that is starting to pervade commentary, we need to be mindful that we have been here before. There is a standard 9 year pattern in the property market, five years of boom, a dip, and then sideways. We are entering the dip, with prices expected to ease further over the year.

Property gauges

Higher mortgage rates could be the knock out blow to hit an already punch-drunk housing market. How long will it be before the Reserve Bank decides to throw in the towel? The answer is not until the property market is sufficiently weak and filters into the general economy and dampens inflation. Our property gauges continue to warn of a corrective phase as the market retreats from overvalued levels.

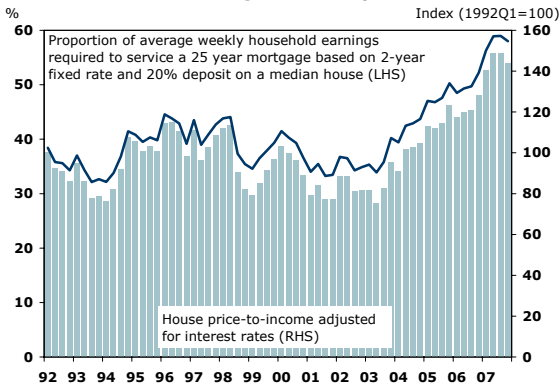
We use eight gauges to assess the state of the property market, and whether warning signs are emerging.

- > **Affordability.** For new entrants into the housing market, we measure affordability using the ratio of house prices-to-income (augmented for interest rates), and mortgage payments as a proportion of income.
- > **Serviceability / indebtedness.** For existing homeowners, serviceability relates interest payments to income while indebtedness is measured as the level of debt relative to income.
- > **Interest rates.** Interest rates affect both the affordability of new houses and the serviceability of existing mortgage payments.
- > **Migration.** A key source of demand for new housing.
- > **Supply-demand balance.** We use dwelling consents issuance to proxy supply. Demand is derived via the natural growth rate in the population, net migration, and the average household size.
- > **Consents and house sales.** These are both key gauges of activity in the property market.
- > **Liquidity.** We look at growth in Private Sector Credit relative to GDP to assess the availability of credit in supporting the property market.
- > **Globalisation.** We look at relative property price movements between New Zealand, the US, UK and Australia in recognition of the important role that globalisation is playing in NZ's property cycle.

Another upward shift in fixed rate mortgages and ever increasing listings suggest housing demand will remain under pressure over the coming months.

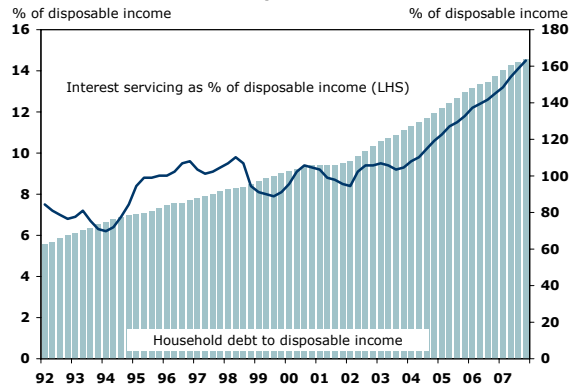
Indicator	Level	Direction for prices	Comment
Affordability	Expensive	↓	Affordability, while at extremely expensive levels, may have peaked.
Serviceability / indebtedness	High	↓	Household indebtedness and the debt servicing burden keep hitting new highs and show no signs of consolidating yet.
Interest rates	High	↔/↓	Fixed-term mortgage rates took another lift up.
Migration	Medium	↔/↓	Migration inflows still heading South.
Supply-demand balance	Neutral	↔	Close to balance.
Consents and house sales	Consents easing, sales softening	↓	Ex-apartment consent issuance has been easing. Sales volumes are in free-fall.
Liquidity	High	↓	Changes in risk appetites as the flow-on from a turn in the credit cycle and global unease unfold.
Globalisation	Not that cheap	↔	Median house prices in New Zealand are correcting but remain more expensive than the US (based on current exchange rates), but cheaper than in Australia.
On balance		↓	Batten down the hatches

Housing Affordability



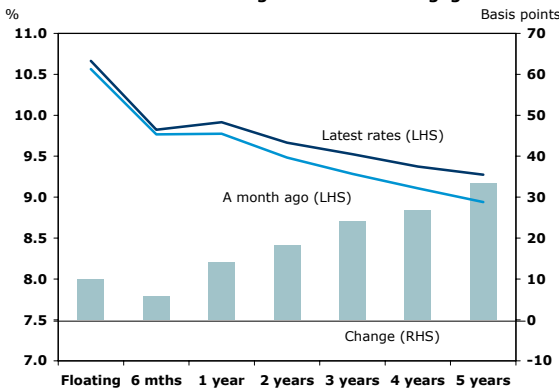
Sources: ANZ National Bank, Statistics NZ, REINZ, Reserve Bank

Serviceability and indebtedness



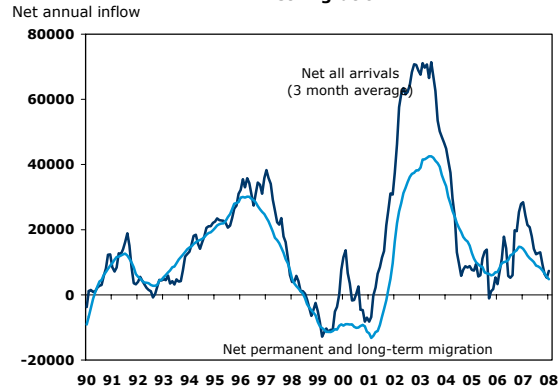
Sources: ANZ National Bank, Reserve Bank

New customer average residential mortgage rate



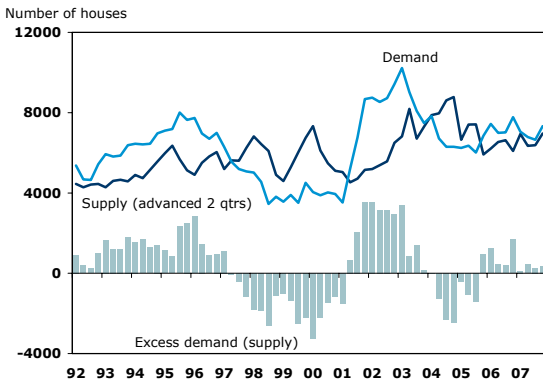
Sources: ANZ National Bank, Reserve Bank, www.interest.co.nz

Net migration



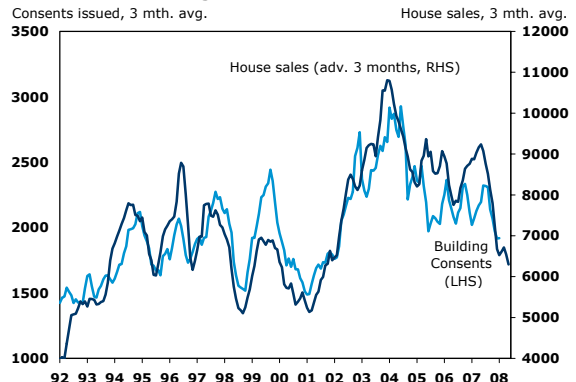
Sources: ANZ National Bank, Statistics NZ

Housing supply-demand balance



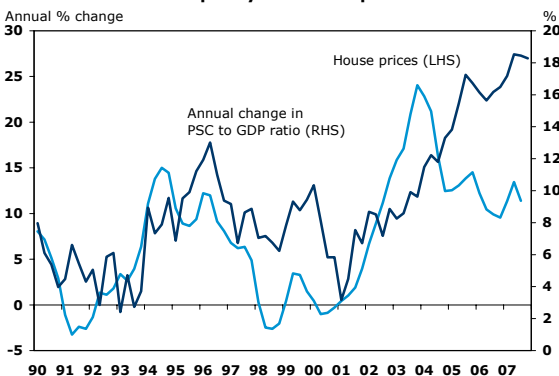
Sources: ANZ National Bank, Statistics NZ

Building consents and house sales



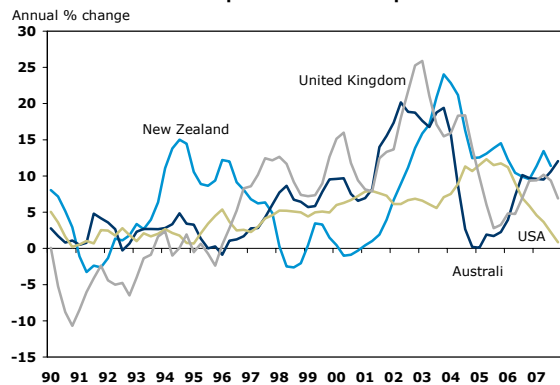
Sources: ANZ National Bank, Statistics NZ, REINZ

Liquidity and house prices



Sources: ANZ National Bank, QV, Reserve Bank

House price inflation comparison



Sources: ANZ National Bank, QV, Nationwide, Bloomberg

Economic Backdrop

We've pencilled in a meagre 1 percent growth in 2008. The housing market (a pro-cyclical sector) is expected to under-perform the economy in general. A negative turn in the credit cycle skews the risk profile downwards. The strategy in this environment is to keep your powder dry and remain cautious. Many will have seen this before, looking for buy-on-dips opportunities. Be patient. The dip has a way to go.

Our core economic view

Riders on the storm

The economy finished 2007 on a reasonable note. However, most of the partial indicators for the first half of 2008 are suggesting that the economy may have sunk into quicksand. Housing market activity is weak, retailing (excluding price increases) is the same, and business confidence – a key leading gauge – has collapsed. Why has the economy turned so rapidly? It is easy to identify reasons. Drought conditions, credit market dislocation (which has necessitated higher fixed lending rates), a declining equity market, a higher NZ dollar and continued housing woes are all candidates, both individually and collectively. There is still an emergency rescue rope – by way of tax cuts and higher commodity prices – although the strength of the fibres is being tested.

We've shaved our growth expectations for 2008 to a meagre 1 percent. With a sticky and persistent inflationary undertone, softening growth was always the endgame, although 1 percent growth is a realisation that the pace of momentum has slowed rapidly. The housing market and durable goods are expected to under-perform the economy. Being heavily pro-cyclical areas of the economy they naturally outperform at the top but under-perform at the bottom.

While there is support emanating from a tight labour market, jobs always lag the cycle. When we look at employment across the economy, around 60 percent of the growth in employment in the past five years has been in construction, distribution (retail) and business/finance services, all leveraged plays off the property market. We struggle to see employment growth remaining robust in the current environment, despite capacity constraints persisting in some areas.

The long-range forecast, valid until midnight tomorrow.

All credit (channel) to the opposition

Why are we more downbeat or conservative than the consensus, which continue to expect growth of around 2 percent plus in 2008? We are placing far greater weight on the role that the credit channel of monetary policy will play in dampening growth over the coming year. Interest rates are moving up as international credit dislocation widens credit spreads. It's a cost borrowers will have to face. There will of course be the typical sour grapes. But borrowers need to appreciate that narrow credit spreads, when international credit markets were healthy, flowed on to borrowers via attractive fixed lending rates. Remember the so-called mortgage wars? Well, the ability of financial institutions to engage in such pricing was determined by favourable global conditions. Times have changed. Credit costs to the nation have increased (reflecting the nation's risk margin in the eyes of overseas investors) and so too have retail borrowing rates. Retail lending rates are determined by both the cost of credit, and what the RBNZ does. The former channel is not well understood. The real "problem" is our current account deficit. Fix that, and we can borrow cheaper.

Raindrops keep fallin' on my head

Rising borrowing costs and the rollover of existing mortgages onto higher rates are hitting at a time the property market is already weak. Throw in the potential for a turn in the credit cycle to move beyond price and into an outright restriction of credit to some pockets, and the outlook for the property market and economy has a clear asymmetric and downward risk profile. The investment strategy in this environment is to keep your powder dry, stay conservative and cautious. There will be buying opportunities that appear to savvy investors, but we would be inclined to wait for a bigger dip. Be patient.

Mortgage borrowing strategy

We're standing by our expectation that wholesale interest rates are set to fall in 2008. Yet given market (credit) conditions, this may not flow through into lower retail lending rates. We remain inclined towards the 2 year part of the curve at present. We have previously discounted 5-year borrowing as too expensive relative to history. We are now inclined to having a proportion of debt on longer terms as an insurance policy against an un-orderly current account adjustment.

Our view

The Reserve Bank noted in their March *Statement* that interest rates would remain high for a significant time. What defines significant is probably as uncertain as the outlook in general. While we agree with the spirit of the Reserve Bank's March synopsis, which noted strong inflation pressure and a sustained period of weak growth, we beg to differ in two key areas.

- We expect growth to be far weaker in 2008, removing capacity constraints much quicker, and hence easing core inflation pressure. Don't get us wrong, we don't expect inflation to come crashing down given the prevalence of high oil prices, emissions costs, rates etc. We simply expect to see inflation emanating from contestable demand driven areas of the economy ease quickly in a weak growth environment.
- We believe the Reserve Bank is understating the significance of the turn in the global credit cycle, which has taken monetary conditions from being restrictive, to bordering on severe levels. Just as the credit cycle "leaned against" the Reserve Bank's attempts to slow the economy on the way up, the danger is that the Reserve Bank fails to recognise the significance of the credit channel as a driver of slower momentum as the credit cycle flows through.

We've pencilled in rate cuts from the September quarter (an assertive call relative to the consensus), and believe the real risk at this juncture is that the easing cycle is very aggressive, with movements down in 50 basis point clips. However, borrowers need to be aware that this is likely to be slow to filter through to fixed lending rates. Monetary policy accommodation is likely to be an offset to credit market restriction as international credit spreads remain wide. (Remember, the retail borrowing rate is determined by both the cost of credit internationally, and what the Reserve Bank does). Our retail borrowing rate forecasts include a wider margin over swap as an implicit recognition of the role wider credit spreads and funding costs are set to play.

Themes we favour in the current environment

The two year part of the curve remains the "sweet" spot in our view. However, this month we are also drawn towards cementing a piece of borrowing security in the 5-year. While historically unattractive, we need to be cognisant of some of the risks NZ is facing. Internationally, inflation pressures remain disconcerting, largely courtesy of sky-rocketing commodity prices. Moreover, the "adjustment" New Zealand is facing over the coming years is effectively being determined by our massive current account deficit. While a weaker currency is the endgame, this could add to inflation (thereby tying the Reserve Bank's hands) and there is a risk the longer part of the curve starts to see a higher risk premium built in.

- > **Borrowers should continue to have a degree of diversification.**
- > **We remain inclined to a term of 2 years given recent developments,** and the growing risk that this cycle is likely to unfold sharply.
- > **While historically expensive, we now recommend a portion of borrowing be locked for five years** as an insurance policy against inflation, or current account adjustment dislocation.

Feature article – Housing supply vs demand balance

We have updated our demand-supply housing balance measures for data to December. Despite the valiant attempts of Auckland and Nelson-Marlborough, the supply-demand scales are tipped in the supply direction.

We monitor two simple gauges to highlight supply-demand balance within the property market and across the regions. Firstly, on the supply side, we monitor the ratio of building consents to economic growth within a region. If consents are growing faster than baseline demand within the region, it is indicative of excess supply, and of course the converse applies. Secondly, we analyse the ratio of house sales to consents. This is another supply-demand balance measure with an up-tick in the ratio indicating excess demand, and a fall below trend suggesting a supply glut pending.

Is the rain-gauge half full or half empty?

Forecasts for the main centres.

So what do the gauges show?

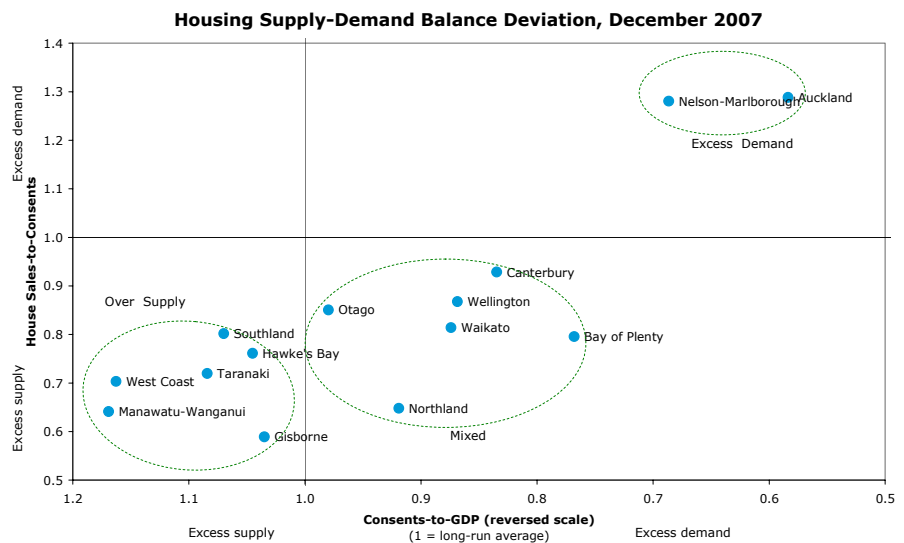
As the chart below depicts, the housing supply-demand balance across the regions can be broadly grouped into three distinct clusters:

- > Nelson-Marlborough has joined Auckland with both measures indicating an excess of housing demand. The ratio of consents to GDP remains below trend (too little supply). The ratio of sales to consents fell, but it still remains indicative of excess demand.
- > The demand-to-supply conditions are mixed in Northland, Waikato, Bay of Plenty, Wellington, Canterbury and Otago.
- > There is a marked excess of housing supply in Gisborne, Hawke’s Bay, Taranaki, Manawatu-Wanganui, West Coast and Southland.

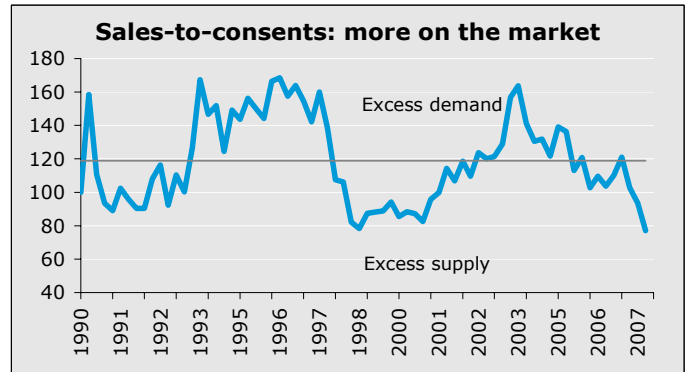
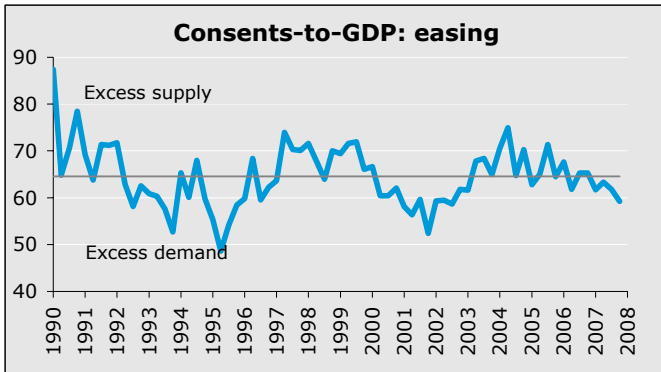
The upshot

Despite the valiant attempt of Auckland and Nelson-Marlborough, the supply-demand scales are gradually tipping in one direction. Two regions remain in the strong demand quadrant. Seven regions are in the rather grey neutral area getting an excess demand signal from one indicator but excess supply from another. Six regions are in the excess supply category. Our gauges are calculated on a quarterly frequency and thus aren’t available past December, when house sales have since eased further and sale times lengthened.

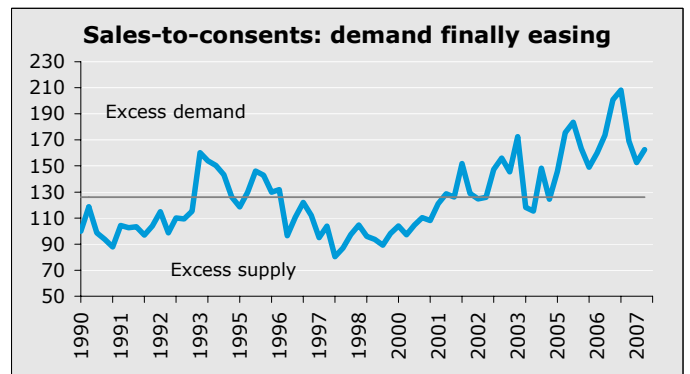
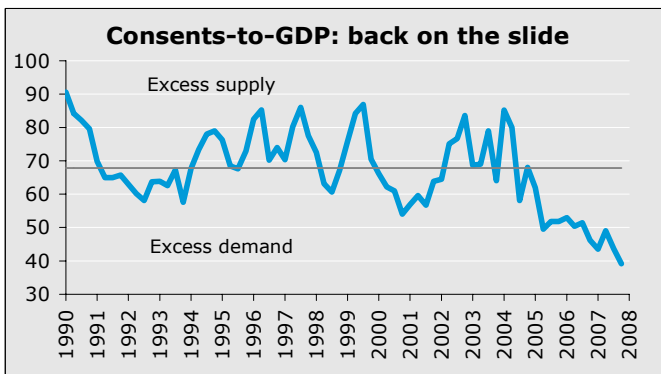
The closer the isobars, the stronger the winds.



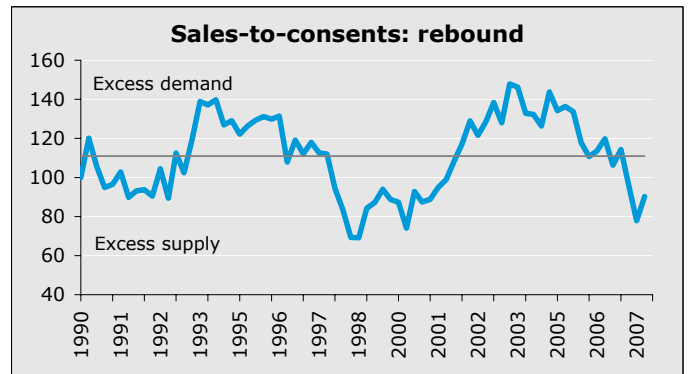
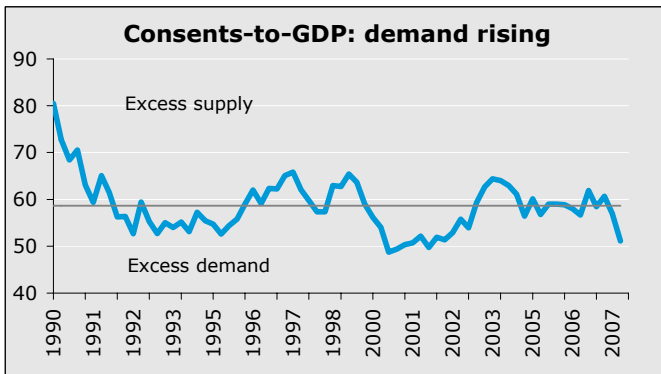
Northland



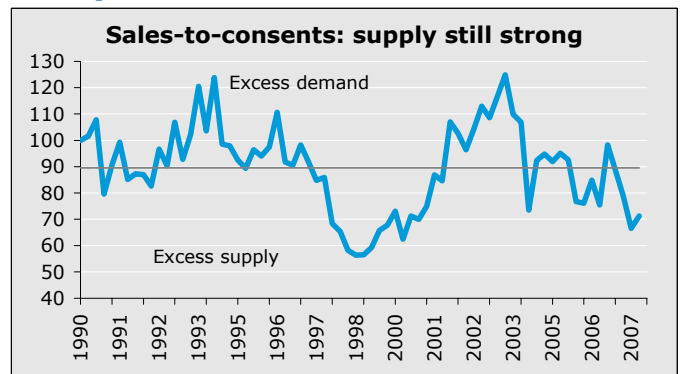
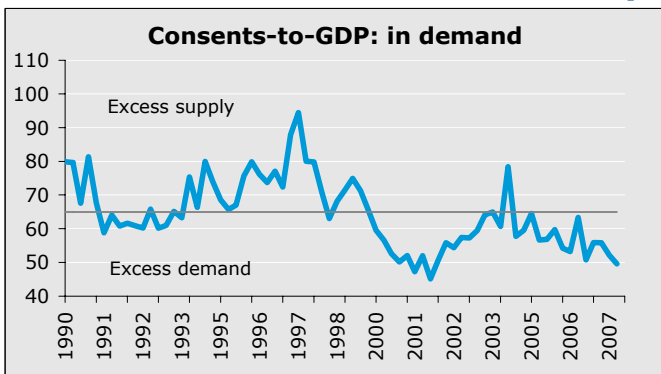
Auckland



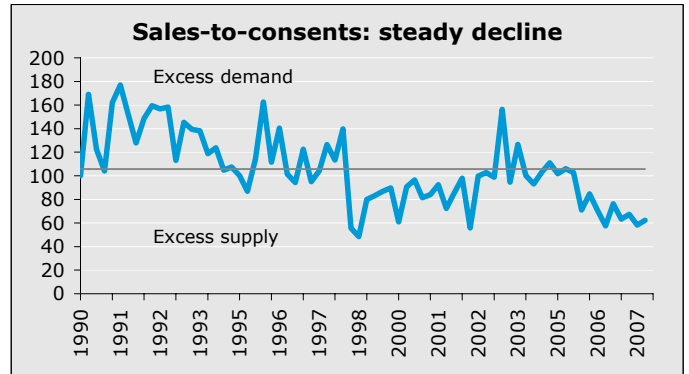
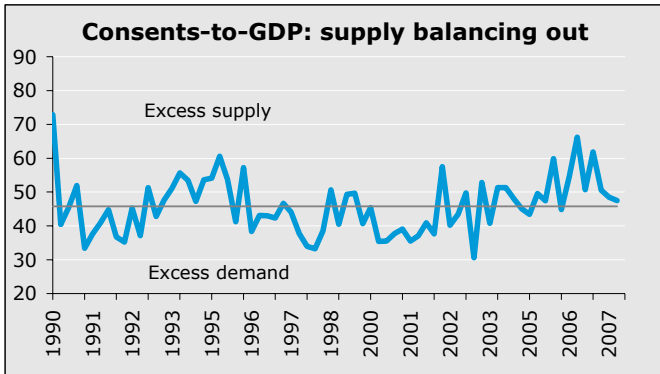
Waikato



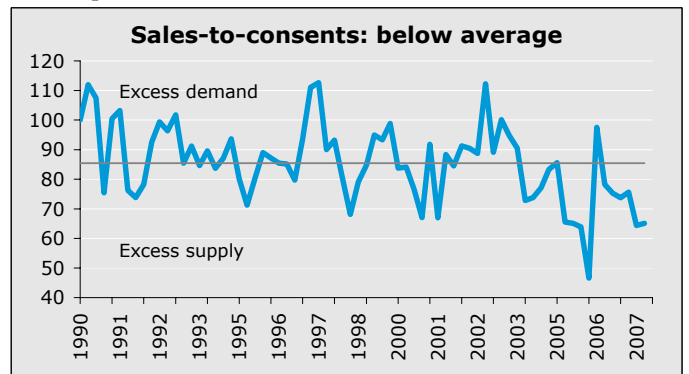
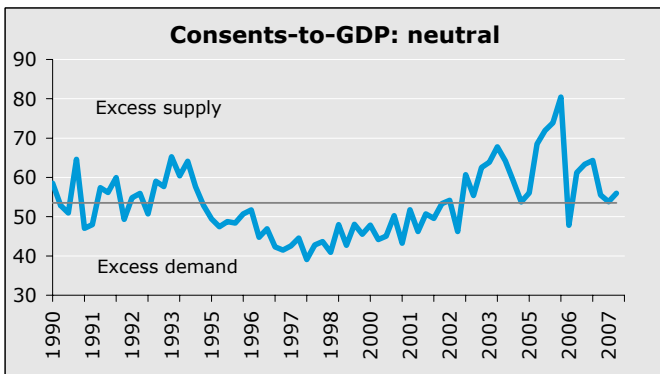
Bay of Plenty



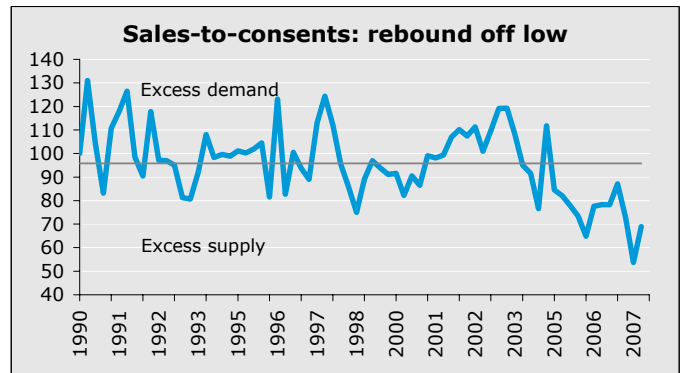
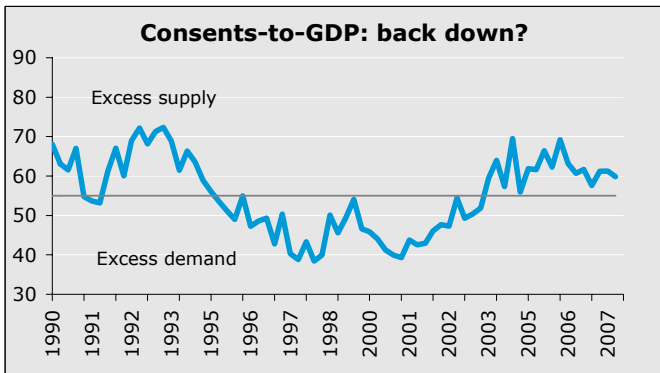
Gisborne



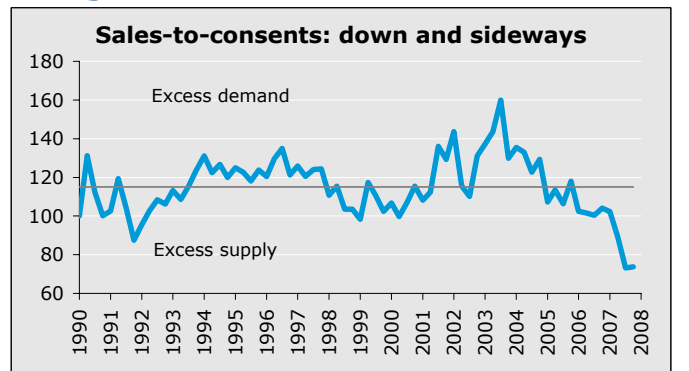
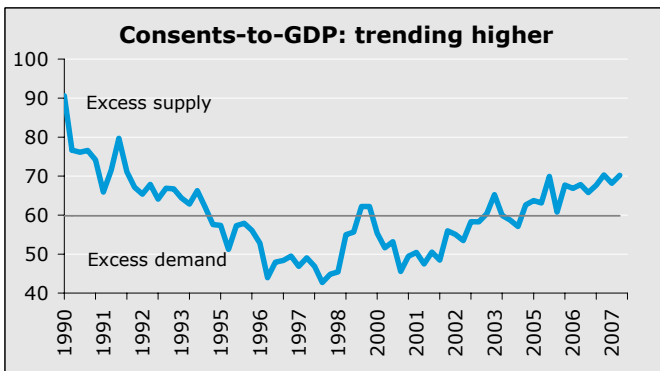
Hawke's Bay



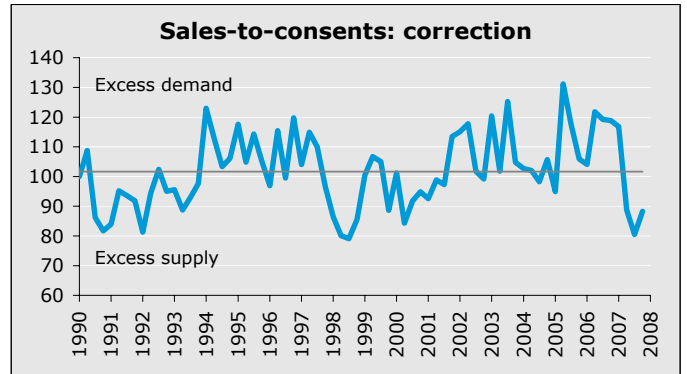
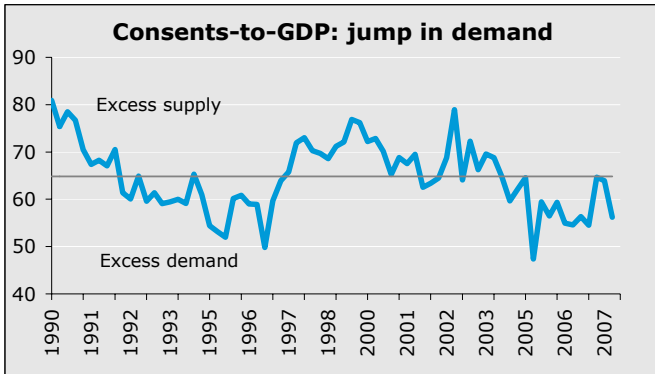
Taranaki



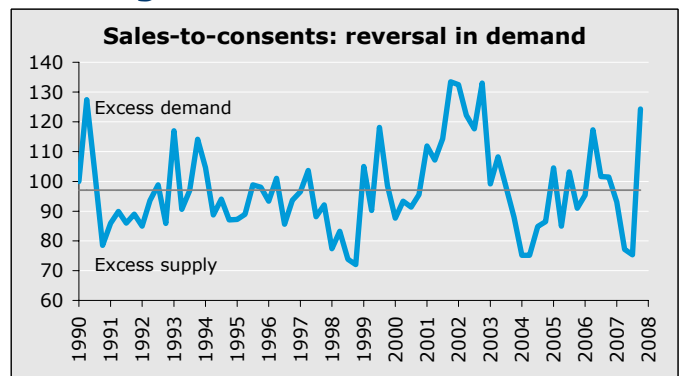
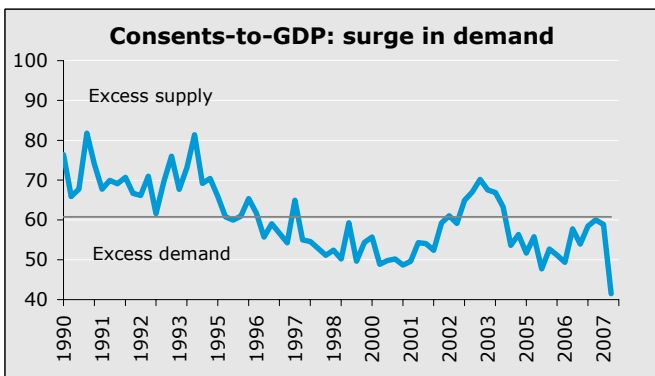
Manawatu-Wanganui



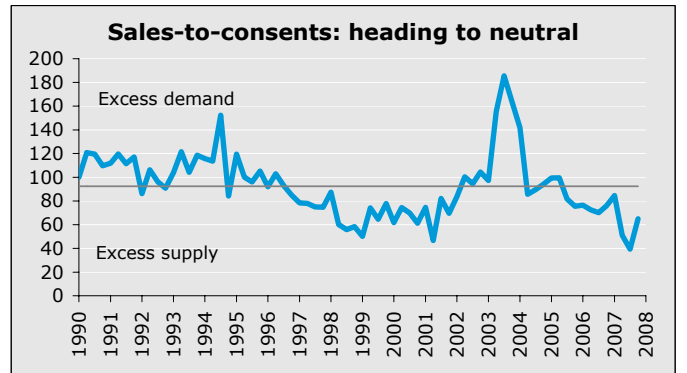
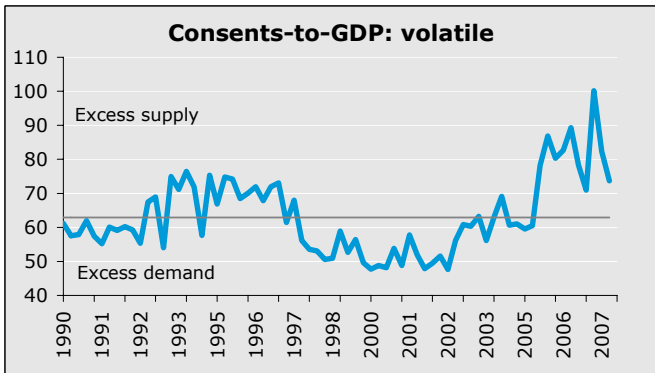
Wellington



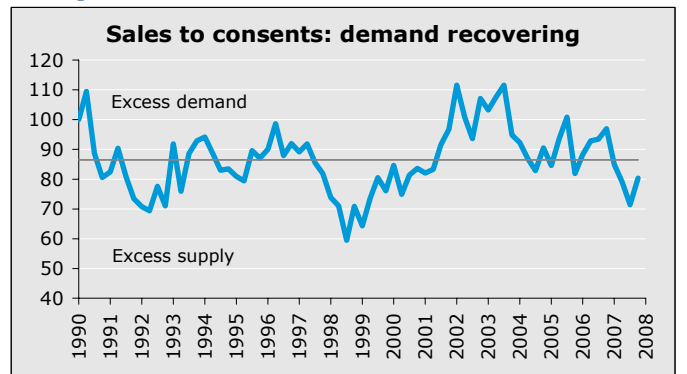
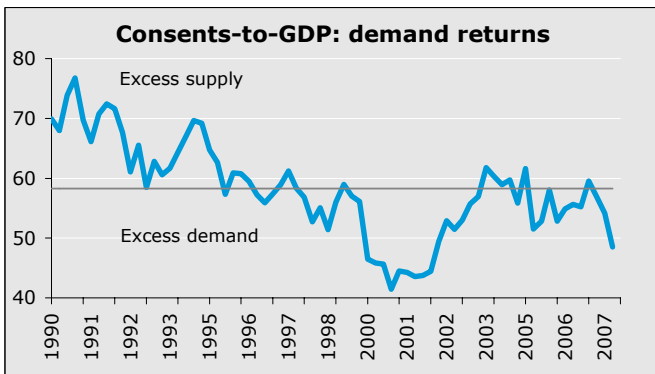
Nelson/Marlborough



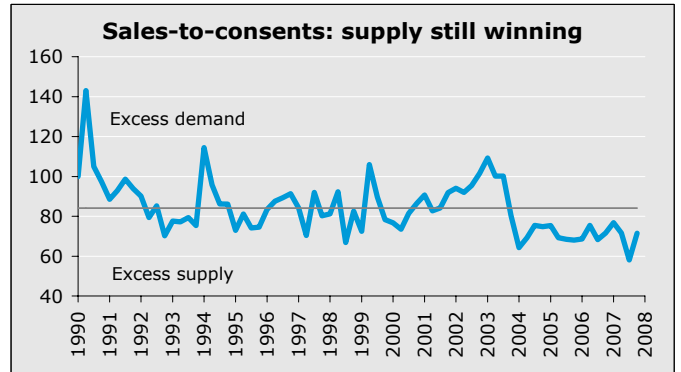
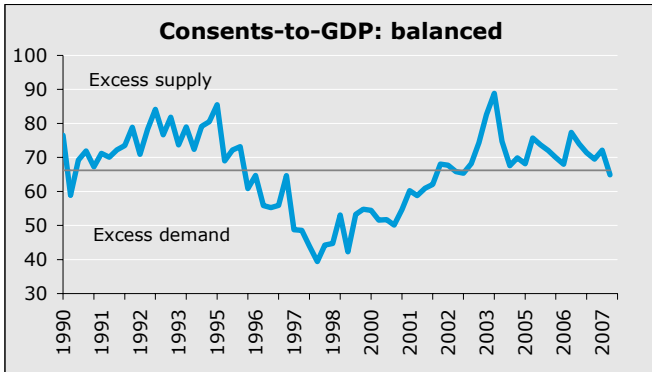
West Coast



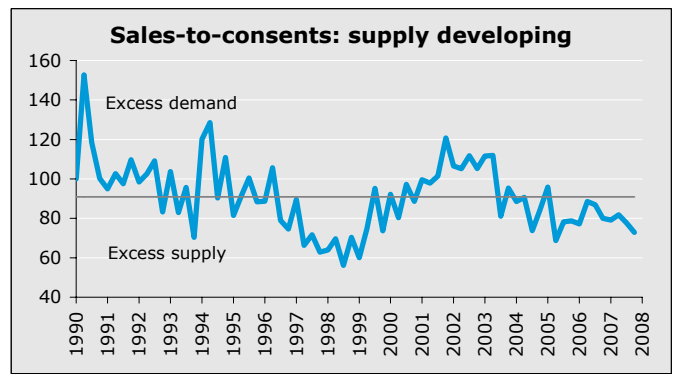
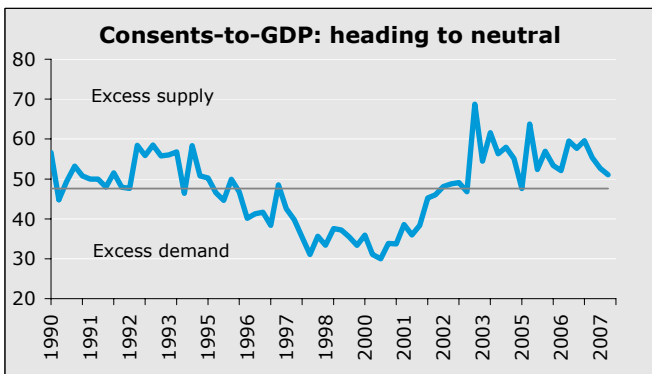
Canterbury



Otago



Southland



Statistical Annex

Weekly mortgage repayments table (based on 25 year term)

Mortgage Size (\$'000)	Mortgage Rate (%)													
	7.50	7.75	8.00	8.25	8.50	8.75	9.00	9.25	9.50	9.75	10.00	10.25	10.50	10.75
100	170	174	178	182	186	190	194	197	201	205	210	214	218	222
150	256	261	267	273	279	284	290	296	302	308	314	320	327	333
200	341	348	356	364	371	379	387	395	403	411	419	427	435	444
250	426	435	445	455	464	474	484	494	504	514	524	534	544	555
300	511	522	534	545	557	569	581	592	604	616	629	641	653	666
350	596	610	623	636	650	664	677	691	705	719	733	748	762	777
400	682	697	712	727	743	758	774	790	806	822	838	855	871	887
450	767	784	801	818	836	853	871	889	907	925	943	961	980	998
500	852	871	890	909	928	948	968	987	1007	1027	1048	1068	1089	1109
550	937	958	979	1000	1021	1043	1064	1086	1108	1130	1153	1175	1198	1220
600	1022	1045	1068	1091	1114	1137	1161	1185	1209	1233	1257	1282	1306	1331
650	1108	1132	1157	1182	1207	1232	1258	1284	1310	1336	1362	1389	1415	1442
700	1193	1219	1246	1273	1300	1327	1355	1382	1410	1438	1467	1495	1524	1553
750	1278	1306	1335	1364	1393	1422	1451	1481	1511	1541	1572	1602	1633	1664
800	1363	1393	1424	1454	1485	1517	1548	1580	1612	1644	1676	1709	1742	1775
850	1448	1480	1513	1545	1578	1611	1645	1679	1713	1747	1781	1816	1851	1886
900	1534	1567	1602	1636	1671	1706	1742	1777	1813	1849	1886	1923	1960	1997
950	1619	1655	1691	1727	1764	1801	1838	1876	1914	1952	1991	2029	2069	2108
1000	1704	1742	1780	1818	1857	1896	1935	1975	2015	2055	2095	2136	2177	2219

Housing market indicators for February 2008 (based on REINZ data)

	House prices (Ann % change)	3mth % chng	No of sales (s.a.)	Mthly % chng	Avg days to sell (s.a.)	Comment
Northland	-8.4	1.0	176	(+7%)	53	A torrential downpour in annual house price growth
Auckland	-0.7	-1.3	1,827	(-5%)	42	A wintry blast as the mercury dips into the negatives
Waikato/BOP/Gisborne	7.4	0.9	890	(-2%)	54	House prices have enjoyed an Indian Summer
Hawke's Bay	-0.7	0.2	268	(+7%)	58	Drought conditions linger as average days-to-sell dry up
Taranaki	0.0	-1.8	177	(-5%)	45	A steady Easterly has cooled annual prices in this region
Manawatu-Wanganui	1.6	-0.3	347	(+7%)	51	Days-to-sell barometric pressure hits a 6-year high
Wellington	1.4	-2.4	691	(-6%)	41	Afternoon breezes develop on monthly sale numbers
Nelson-Marlborough	13.5	1.9	226	(-15%)	45	A deep depression moved over house sale numbers
Canterbury/Westland	7.7	0.6	899	(-2%)	43	A little ray of sunshine, as property prices hit a new high
Otago	0.7	1.5	286	(-5%)	44	House sales prices brighten after a cloudy start
Central Otago Lakes	16.8	-2.9	92	(-13%)	56	A frosty nip in the air was recorded in this district
Southland	21.8	4.6	215	(0%)	33	The place to be, with a large high not wanting to budge
NEW ZEALAND	0.7	-2.9	6,182	(-2%)	45	Weather Warning: A polar blast is rapidly approaching

Key forecasts

Economic indicators	Actual			Forecast						
	Jun 07	Sep 07	Dec 07	Mar 08	Jun 08	Sep 08	Dec 08	Mar 09	Jun 09	Sep 09
GDP (ann avg % chg)	2.1	2.7	3.0e	2.9	2.4	1.8	1.0	0.8	0.9	1.2
CPI inflation (%)	2.0	1.8	3.2	3.5	3.2	3.6	3.2	2.9	2.8	2.7
Unemployment rate (%)	3.6	3.5	3.4	3.6	3.7	3.8	4.0	4.1	4.3	4.4
Interest rates	Actual			Forecast (end month)						
	Jan 08	Feb 08	Current	Jun 08	Sep 08	Dec 08	Mar 09	Jun 09	Sep 09	Dec 09
Call rate	8.38	8.40	8.25	8.25	8.00	7.50	7.00	6.8	6.75	6.75
90-day bank bill rate	8.7	8.8	8.8	8.8	8.2	7.6	7.0	7.0	7.0	7.0
Floating mortgage rate	10.5	10.6	10.7	10.7	10.5	10.0	9.5	9.2	9.2	9.2
1-yr fixed mortgage rate	9.8	9.8	9.9	9.9	9.6	9.0	8.5	8.3	8.3	8.3
2-yr fixed mortgage rate	9.5	9.5	9.7	9.7	9.4	8.9	8.5	8.3	8.3	8.3
5-yr fixed mortgage rate	9.1	8.9	9.3	9.3	9.1	8.8	8.2	8.0	8.0	7.9

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