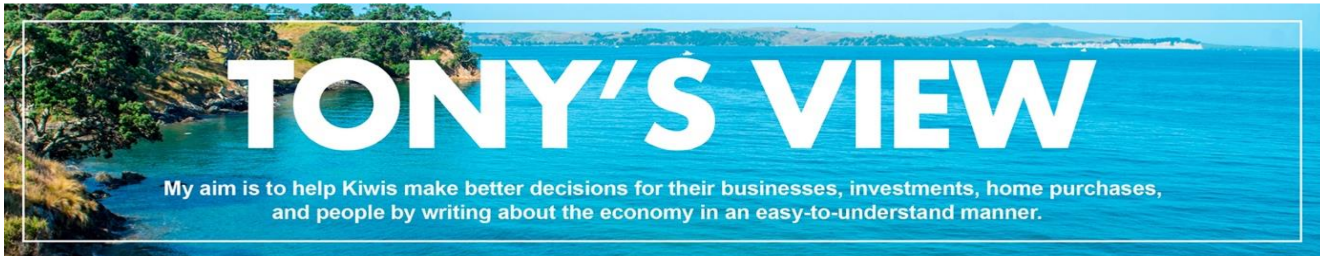

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The layer cake gets thinner

Last year and for much of this year I have spoken about the factors which have caused average prices to jump 39% since March 2020 as forming a layer cake. The bottom layer is the normal volume of buyers you would expect to see in a housing market at any time. The other layers are special additions to the cake brought about by the global pandemic and the response to it.

This week I shall have a look at what has happened with each of the layers to see again which have gone completely, which are partially eaten, and which are untouched.

Untouched layers

Shortage of property

There is not a fundamental shortage of property in most parts of the country. Instead, there is a belief that the best way to stop prices rising and maybe get them down is to boost supply. These are different things and at some stage next year or in 2023 talk of shortages will disappear. For now, the belief that there are shortages persists. One or two people are starting to wonder who will occupy the many townhouses being built in Auckland. This layer has been poked but not consumed in any way yet.

Parents helping

There is no official regular measure of this. But if we go by the continuing stream of articles discussing the apparently growing gap between those who get help from their parents to buy a house and those who don't, then it seems safe to assume this factor is still strongly in play and not much diminished if at all.

For amusement, consider this. A first home buyer in March 2020 buying a property with a 20% deposit has seen their net worth increase almost 200%.

That is, imagine they bought a $1mn house with a $200,000 deposit. That house now is worth $1,390,000. If they sold it and paid off the mortgage (let's assume unchanged at $800,000 for simplicity), then they now have $590,000 to their name, up from $200,000 20 months ago. They have grown their wealth by 195%.

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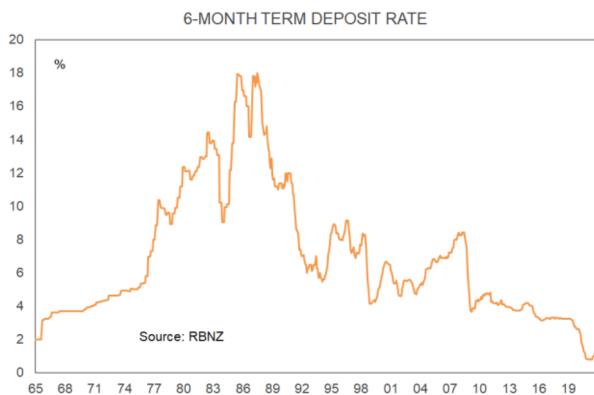
In truth, over 40% of first home buyers do not have a 20% deposit. If we assume a 10% deposit in this case, then their net worth has gone from $100,000 to $490,000 – an increase of 390%.

Will these people be criticised to the same extent as the Baby Boomers for profiting from the desperation of others to buy a home?

Partially eaten layers

Low term deposit rates

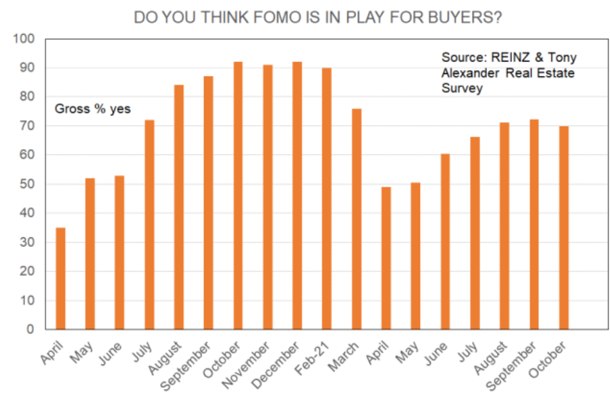
Rates are off their lows but remain well down from levels of early-2019. Back then the average six-month term deposit rate was 3.25%. Currently it is about 1.4%. Compare that with the situation for fixed mortgage rates below and you'll see that banks for the moment are largely rebuilding margins on the deposit side.



Interest rates for simple and safe bank deposits remain at levels which actively encourage people to seek alternatives such as property, shares, or just playing in the crypto market. Note, if we adjust for inflation to get the real bank deposit rates, at the moment that real return is about negative 3.5% versus +1.75% in early-2019. This layer of the cake has been licked only.

FOMO

I can measure this each month from the survey I undertake of licensed real estate agents around the country each month with REINZ. Between August last year and February this year FOMO was very high and the frenzy to buy housing was at peak levels. Now, FOMO is strong, but lower than back then. This layer is partially eaten, and my expectation is that over 2022 it will strongly diminish in size.



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Expats returning

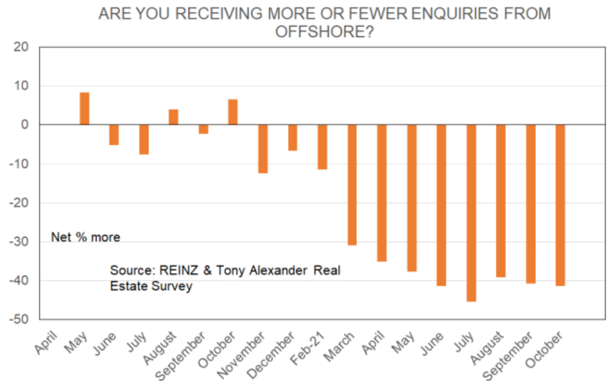
We Kiwis suffer some particular cultural cringes and one of them is an ongoing belief that everyone offshore wants to live here. However, we have the second biggest proportion of our population living outside our country after Ireland. There are about one million of us offshore including over 600,000 in Australia.

We have convinced ourselves through the pandemic that these one million people want to come back and that the other billions of people on the planet would also like to get in. So, we have been buying houses before these hordes arrive in a manner similar to past years when we have blamed soaring Auckland house prices on Chinese offshore and sought to buy property before they do.

But by the standards of the countries Kiwis have shifted to we are quiet, suffer from over-priced houses and a high cost of living, and pay very low wages and salaries. Those of us here have self-selected to be so, favouring some aspect of the country's lifestyle over the opportunities and experiences available elsewhere. This self-selection process gives a bias to our views – and in the case of the housing market, our actions.

With labour demand soaring offshore, especially in Australia, wages rising, and freedoms being allowed in Australia still denied us here, the expat-buying factor is likely to be very weak currently. When the borders open and thousands of young Kiwis go offshore – especially to Australia – the talk will shift from brain gain to brain drain.

But we are not quite there yet, and we seize the data on how many people are bidding for MIQ spaces to justify a view that we are wonderful and house prices will continue to rise. In truth, the survey I run of real estate agents with REINZ shows a very high net proportion of agents reporting decreasing enquiry from offshore.



This layer is partly eaten but there is still a lot of ground to go before it disappears.

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Space to work from home

There are still many people seeking to buy a property well away from their usual workplace, and if not that, something which is more suited for working from home. The drive to do this has however eased as vaccination rates have risen strongly around the country, and we are moving away from an environment of constant lockdown risk.

This layer is thinner, but it is still there.

Layer gone

Low mortgage rates

The following table shows fixed mortgage rates before the Reserve Bank cut the official cash rate by 0.75% between May and August of 2019. The second column shows current best available fixed rates for the lenders I track, and the third column shows the difference. We can see that if you want to fix for the current most popular terms of two and three years then the cost is about what it was in April 2019. Reflecting the OCR being at 0.5% rather than the 1.75% back then, the one-year term is still cheaper. The four- and five-year terms – which people only lock themselves into in great numbers when the yield curve is inverse and they shouldn't touch them with a bargepole -are also still below April 2019 levels.

	Apr-19	Current	Difference
1 year	4.05	3.49	-0.56
2 years	4.29	4.15	-0.14
3 years	4.49	4.39	-0.1
4 years	5.19	4.69	-0.5
5 years	5.39	4.79	-0.6

Basically, the stimulus layer from monetary policy as represented by the levels of fixed mortgage rates has been completely eaten.

Delayed travel

When we learnt that we could not travel overseas and come back we diverted about half of the near $10bn we would normally spend travelling offshore towards spending on things in New Zealand. These things included houses to live in and investment properties.

Now, we can see light at the end of the border tunnel and people will be starting to put funds aside for travel offshore. For all intents and purposes, this layer of demand has gone and soon it will outright reverse.

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LVRs

These restrictions on lending were removed. They cam back officially from February 1 but were being applied by banks from late-2020. They got strengthened on May 1 and have recently been strengthened again.

This layer is not just gone, it has become something of a black hole, sucking away at other sources of property demand as people are unable to access the finance they want or need to purchase the property they want or need.

Re-joining the fray

This referred to people in lockdown sitting initially like stunned mullet, but then jumping back into the house-search world once we were able to move about again. Very quickly this layer got used up.

One might run an argument that it is there to a very small degree again. But with knowledge of what happens once a lockdown ends, this time around from August 18 we have remained engaged with the property market.

There will be very few people only now choosing to restart their property search simply because the situation in Auckland is becoming less restrictive. I consider this layer to be gone, with nothing left bar a few crumbs.

Lockdown savings

During last year's seven weeks of savings but minimal spending we emerged with higher bank balances and some people decided to put that money to good use buying a property.

This time around we know better how to keep spending online than we did back then, and it is doubtful that any meaningful boost to household bank deposits has occurred as a result of this most recent lockdown as was the case for last year's.

There are of course many other factors in play, and nowadays most of them are acting to restrict further gains in house prices. They include, or will include,

- population loss to Australia,
- CCCFA-related restrictions on bank lending,
- DTIs being applied,
- investors slowly adjusting their portfolios to reflect the increasingly relevant change in the tax status of debt-funded investment property,
- rising new build supply and so on.

But this section was simply a signing off of the old layer cake analysis.

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The Consumers Price Index

I have found over the years that people often don't fully understand what the details are behind calculation of the rate of inflation in New Zealand and how their own experience of some items changing in price may not represent what is happening generally. So here is some information.

Inflation is measured as the change in the Consumers Price Index (CPI) from one period to the next – in this case over a one-year period. The CPI is a basket of 649 items and services which households typically consume over a quarter, but it excludes prices for sections and existing houses. That is because these are better classified as assets (which deliver a flow of services) and are traded between households rather than sold to the household sector.

If petrol prices go up all households suffer. If house prices rise, then those buying for the first time pay more, but those selling and not buying again get more.

But housing costs do still make it into the CPI in the form of rents, local authority rates, insurance, and the cost of building a new house. So, over the past year the CPI received a boost from a 12% rise in the cost of getting a new house built. Our rates went up by 7.1% and rents by 3.2%.

People often say that the things they buy are rising in price a heck of a lot more than the general rate of inflation (currently 4.9% versus an average of 2% since 1992). But there are always some things jumping a lot in price and some things getting cheaper.

For instance, during the September quarter 384 things went up in price, 97 stayed the same, and 166 went down.

Compared with a year earlier, the prices for games, toys & hobbies went up by 30%, petrol 22%, used cars 14%, real estate services 13% (higher house price impact), pets & pet products 9%. The prices for telecommunications equipment went down by 15%, AV gear 13%, computers 13%, books 8%, motorbikes 1.4% and so on.

Every three years at least Statistics NZ will review the items for which it gathers about 100,000 prices each quarter. Recently they have dropped cordless telephones, CDs, and computer paper. They have added e-cigarette devices and juices along with exercise equipment and surgeon fees (this item only just added because it can now be measured properly).

While we often say that inflation is a measure of the change in our cost of living, this is not completely accurate because the CPI excludes interest rates. This is because in the context of the Reserve Bank trying to keep inflation near 2%, it makes no sense including mortgage rates. If the RB raises interest rates to suppress the pace of economic growth, business pricing power, and eventually inflation, higher interest rates would actually lift the inflation rate. Higher inflation would lead to higher wages growth which would lead to higher business price rises and so on.

Interest rates have to be excluded, but because households are net borrowers, rising interest rates do boost the average household cost of living.

If I were a borrower, what would I do?

Nothing I write here or anywhere else in this publication is intended to be personal advice. You should discuss your financing options with a professional.

Reserve Bank tip-toes

The Reserve Bank largely met market expectations for timidity yesterday afternoon by raising their official cash rate from 0.5% to 0.75%. There had been about a 40% pricing in of the rate lifting instead to 1.0%, therefore the news generated some small declines in swap rates (bank wholesale borrowing costs for fixed terms). Rates are basically back where they were two weeks ago except for long rates which are higher.

The one-year swap rate has ended near 1.59% from 1.7% last week while the three-year rate is now near 2.52% from 2.6%.

Three months ago the Reserve Bank was projecting that the peak for the cash rate would be 2.1%. Now they predict 2.6%. Back in August they figured they would reach 2.1% at the start of 2024. Now they plan a more accelerated period of rate rises with that level hit by the end of next year.

Personally, I feel they will have to go to 3% for the OCR, but there is a lot of water to go under the bridge as yet.

The Reserve Bank noted that household and business balance sheets are in good shape, fiscal policy is stimulatory, and export returns for the country are good.

They also said that the economy is growing at above its potential rate and employment in particular is above the maximum able to be sustained without inflation becoming a problem.

Three months ago they predicted that come the end of 2022 inflation would be 2.2%, now they predict 3.3%. But they still feel the rate will be back at 2.1% come the end of 2021 and one of the things they seem to be relying on to stop things running away on them is the spread of Covid.

Specifically, after noting the expected spread of Covid-19 as restrictions ease, they wrote the following.

"**However, household spending and business investment will be dampened in the near-term by these ongoing health uncertainties."**

I'm not so sure. Personally, listening to the announcement on Kiwis returning from early next year not having to go through the MIQ horror, and hearing the open date for foreigners, I felt inclined to spend more – frankly, to seize summer.

The other important point I took from their comments is that after noting that inflation currently is being boosted partly by oil prices, transport costs, and supply shortfalls, they wrote this.

"These immediate relative price shocks risk generating more generalised price rises given the current domestic capacity constraints."

That's the warning people need to take heed of. They are saying that they believe the current period of high inflation can be contained with the OCR moving up just 2.25% in total from 0.25% to 2.5%. But there are risks and that is why we need to keep an eye on the second-round impact of the current jump in our cost of living.

My view is that the tight labour market will produce a strong wages response over 2022 and 2023. Also, because supply chain disruptions are delivering businesses some pricing power they have not had for over a decade, a version of an old wage-price spiral will appear.

Therefore, while their predictions imply a peak for the one-year fixed mortgage rate just below 5%, I expect the peak instead will be above 5.5%.

My current expectation for the one-year rate in November each year is shown in the first column of the table below. I focus on that rate because there are many people who have fixed one-year repeatedly since 2009 and the strategy has worked very well.

The second column shows what the one-year rate will average over the next 2-, 3-, 4-, and 5-year periods. The last column shows the current minimum 2 – 5-year fixed rates charged by the lenders I track.

	Forecast 1 year rate	Rolling average rates	Current fixed	
2021	3.49		3.49	1 yr
2022	4.5	4.00	4.15	2 yr
2023	5.25	4.41	4.49	3 yr
2024	4.65	4.47	4.69	4 yr
2025	4.25	4.43	4.85	5 yr

If these forecasts prove correct (I'd give that a 10% probability), rolling one-year fixed will deliver an average rate for the next two years of 4.0%, three years 4.41%, four years 4.47%, and five years 4.43%.

The last column shows what the current best fixed rates are for those time periods. Given that there is a rate premium one should be prepared for rate certainty, rolling one-year fixed will deliver a cost higher than one could get by fixing at the moment – if the forecasts are right.

A number of people have asked why I have rates projected to fall from 2024. Simple. The Reserve Bank will take rates to levels which will cause growth in our economy to slow and inflation to settle back near 2%. As they see that happening, they will take away some of the monetary policy restraint and that means lower interest rates.

If I were a borrower, what would I do?

Personally, I would fix three years where rates currently are just below 4.5%.

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