STRATEGIC RISK ANALYSIS LIMITED

*Your business risk management partner*

**RODNEY'S RAVINGS** take an open-minded and at times irreverent look at topical economic issues. Unlike our pay-to-view reports, that are for the eyes of subscribers only, the **RAVINGS** are free and you may forward them to other people. You can signup to the **RAVINGS** and **Property Insights** reports, and for notification about forthcoming **Property Research** reports on our website – http://www.sra.co.nz/lists/.

# RODNEY'S RAVINGS

A rift between housing market and economic growth prospects

## EXECUTIVE SUMMARY


The RBNZ and the 10 forecasters surveyed by NZIER in June are predicting robust economic growth over the next two years and robust growth in residential building activity (and, by implication, robust housing market activity more generally). Unfortunately, as this Raving shows, the economists' residential building predictions are dubious. Bizarrely, the forecasters are predicting both significant increases in interest rates and robust growth in residential building activity. The housing market is the most interest rate sensitive part of the economy and there is no basis for expecting robust housing market activity to coexist with significant interest rate increases. It doesn't and won't happen (i.e. the forecasters are off with the fairies).

There are good reasons why the leading indicators of housing market activity are starting to diverge from the leading indicators of economic growth, as canvassed in this Raving and covered in detail in our pay-to-view reports and in the educational workshops we are running. See http://www.sra.co.nz/workshops.html for information on the Auckland workshops, while we are planning workshops for Christchurch in late September.

I get no perverse gratification from warning people about negative risks, like the one currently facing the housing market. My aim in setting up Strategic Risk Analysis in 2006 was to provide valuable insights to firms and individuals exposed to the housing market and the economy so they can make more informed and more profitable operational, strategic and/or investment decisions. The workshop programme we recently launched is an extension of this objective. The inexpensive workshops deliver insights that any firms exposed to the housing market, the economy or the NZD/USD shouldn't be without.



Rodney Dickens
Managing Director and Chief Research Officer
Strategic Risk Analysis Limited
09 426 4122 (Orewa) 027 2882209
rodney@sra.co.nz
www.sra.co.nz

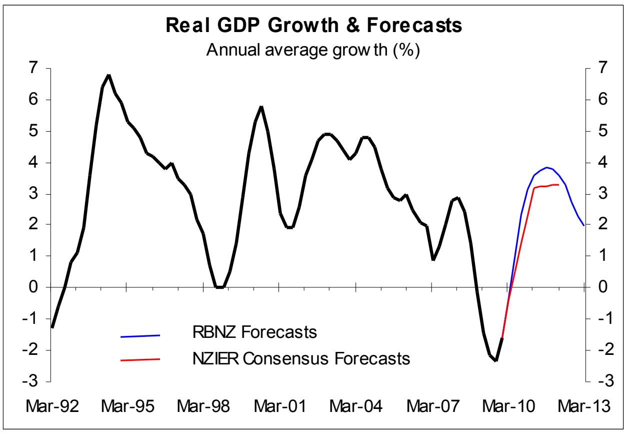


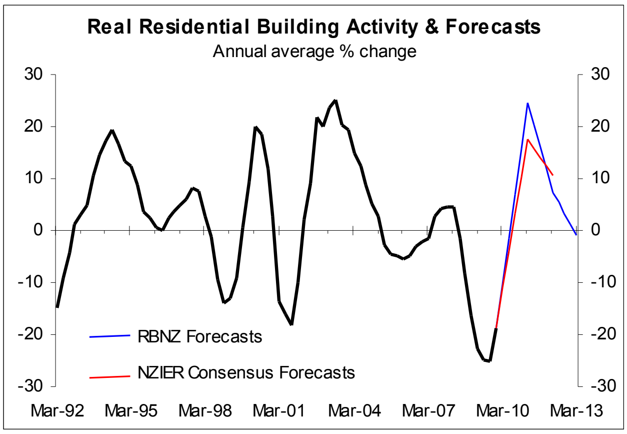

**June 2010**

### The conventional view on the outlook for housing activity and economic growth

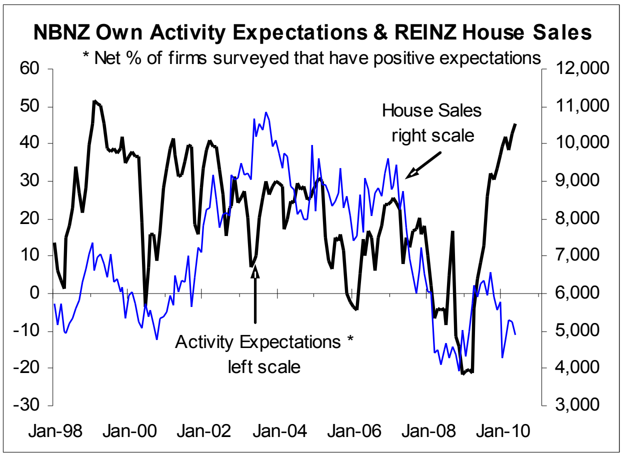
The RBNZ released its latest forecasts on 10 June and NZIER yesterday released the consensus economic forecasts based on a survey of 10 forecasters. The RBNZ is predicting that the economy will grow 3.5% in the 2010/11 March year, 3.6% in 2011/12 and 2% in 2012/13 (blue line, left chart). Seemingly consistent with its view on economic growth, the RBNZ is predicting solid growth in residential building activity over the next two March years (24.6% and 7.4%, respectively), followed by a tiny fall of 0.8% in 2012/13 (blue line, right chart). The average or consensus predictions of the 10 forecasters surveyed by NZIER in June are reasonably close to the RBNZ's forecasts for 2010/11 and 2011/12 on both counts (the respective red lines). Most economic forecasters exhibit flocking tendencies.

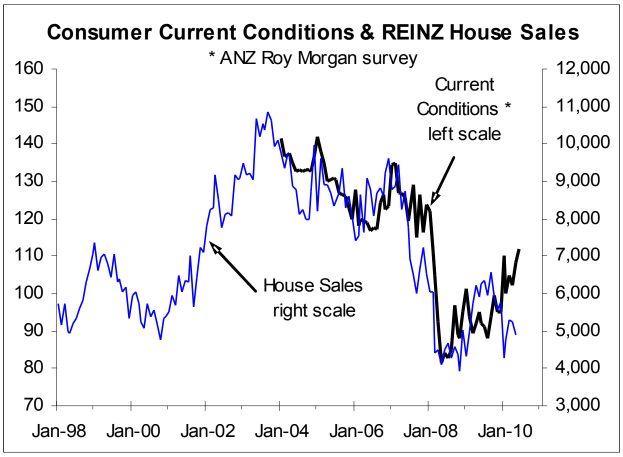
The RBNZ and the consensus view of the forecasts is for a favourable outcome for both economic growth and housing market activity over the next two of years, which is the sort of thing one would like to see after a recession (i.e. wishful thinking could be involved). The performance of the existing housing market is closely tied to the performance of residential building, so based on what the economic forecasters are predicting for residential building the existing housing market (i.e. the number of sales and house prices) should also participate in the fairytale outcome.




If I was in the business of granting wishes I would give the forecasters the thumbs up. I would like nothing more than to see economic growth and housing market activity behave in line with the predictions in the charts above. However, I have a nagging suspicion, which already has some empirical backing, that the economic forecasters are off with the fairies.



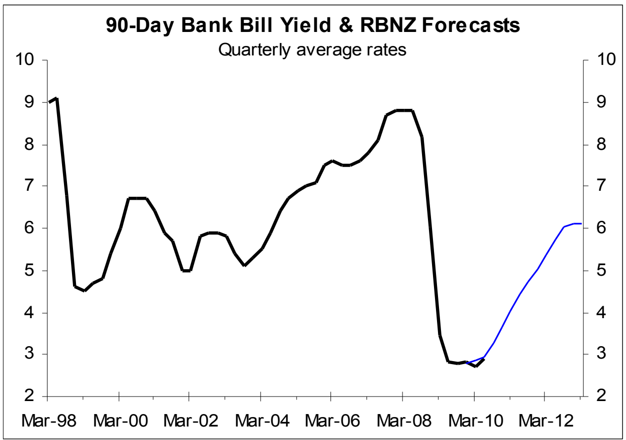



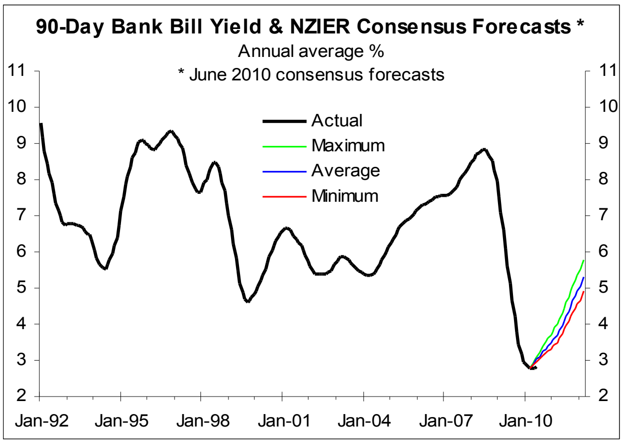

As we cover in our monthly **Building Barometer** reports, the data released each month by REINZ on existing house or dwelling sales is a useful leading indicator for both residential building activity and existing house prices. If residential building activity was going to grow somewhere in the ballpark of 25% in 2010/11 the number of house sales should be in the process of rising pretty strongly. Unfortunately, house sale numbers have fallen over the last nine months (blue lines in the charts above). By contrast, the NBNZ survey of firms' own activity expectations, which is a useful leading indicator of economic growth, has sky-rocketed over the last year (black line, left chart above), while consumers' assessment of current conditions in May reached the highest level since the recession based on the ANZ Roy Morgan survey, which means consumer spending prospects are improving (black line, right chart above).

Based on the rigorous analysis of housing market prospects contained in our **Housing Prospects** and **Building Barometer** reports (visit our website – www.sra.co.nz – or contact me for information in these), there are good reasons why REINZ house (and section) sales have fallen. Short of a miracle housing demand will remain low for the next 12-18 months based on prospects for the primary drivers of the housing market (i.e. the optimistic predictions for residential building activity in the chart on the previous page are likely to be wrong by a long shot). By contrasts, based on the rigorous analysis of economic growth prospects contained in our monthly **Interesting Times** reports, there are good reasons why the economic recovery continues to broaden and strengthen this year. However, the prospect of weakness in housing market activity in 2011 means economic growth is likely to run at least moderately weaker than the forecasters are predicting in the chart on the previous page.

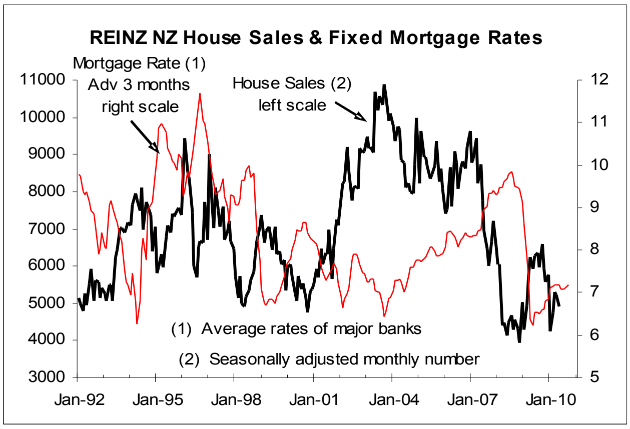
## There is at least one major flaw in the conventional view

Strangely, the economic forecasts are predicting both robust growth in residential building activity over the next two years and significant interest rate increases. The left chart shows the RBNZ's latest predictions for the 90-day bank bill yield, the key short-term wholesale interest rate that drives the floating and short-term fixed mortgage interest rates. What the RBNZ does with the OCR is the primary driver of the 90-day bank bill yield, so the RBNZ's forecasts for the 90-day bank bill yield are akin to OCR forecasts. The blue line in the right chart shows the average prediction for the 90-day bank bill yield by the 10 forecasters surveyed by NZIER in June, the red line shows the lowest predictions by any of the forecasters and the green line shows the highest predictions. Again, there is quite a bit of flocking going on with these interest rate forecasts.




The logic of the economic forecasters appears to run something like the following: an economic recovery is underway and will be followed by a couple of years of robust economic growth and, fitting with this prediction, residential building activity will grow robustly while the strong growth will result in significant interest rate increases. The only problem with this view is that the economy does not work like this.




The chart shows a consistent inverse relationship between the monthly number of house sales reported by REINZ and the average mortgage interest rate. If interest rates go up significantly, existing house sales fall roughly three months later, which is shown in the chart by the red interest rate line being advanced or shifted to the right by three months. And where REINZ house sales go, consents for new residential buildings follow 4-5 months later. The chart shows no instances of interest rates rising significantly, as all the economic forecasters are predicting, and house sales subsequently rising. Someone forgot to tell the economic forecasters that significant interest rate increases and robust growth in residential building activity are mutual exclusive outcomes.

On the bright side, the average mortgage interest rate has not changed over the last few months, which implies that the number of house sales should remain reasonably stable over the next few months before grey clouds start rolling in on the back of OCR hikes. Unfortunately, our analysis of prospects for net migration, the second of three key drivers of housing activity, also points to a less than favourable future for housing. The major housing affordability problems is also casting a dark shadow over the housing market, with this being the primary reason why housing activity is currently significantly below normal or average levels (see http://www.sra.co.nz/pdf/AffordableHousing.pdf for a discussion of this critical issue).

There is nothing new in the economic forecasters having predictions for residential building/housing market activity that are at odds with their predictions for interest rates. The mathematical forecasting model used by the RBNZ is supposed to stop such inconsistencies, but the rigour imposed by the forecasting model is easily overcome by the people running the forecasts. I have seen it first hand from my time working at the RBNZ. If the forecasters don't like what the model is predicting they simply override parts of the model and surprise, surprise the forecasts come out just like the forecasters want them to look like. In this context, forecasting is more about justifying the preconceptions of the forecasters than it is about applying a rigorous framework to arrive at well-founded predictions.

Many of the 10 forecasters surveyed by NZIER have not built rigorous forecasting models. Rather than torturing their forecasting models to produce predictions that are consistent with their preconceptions or wishful thinking, they simply scratch their heads a few times and in general end up with predictions that are either a snip below or a nudge above what the RBNZ is predicting (i.e. they flock).

I do not play the flocking game and have instead spent 25+ years building a rigorous and independent forecasting framework. This framework is currently telling me that it would take a miracle for residential building activity to experience the robust growth the forecasters are predicting for the next two years.

If your business is tied to the housing market or the economy you should want to have access to the best available analysis of housing market and economic growth prospects. If you want to know what actually drives housing market cycles you should attend one of the **Housing Workshops** we are running (see http://www.sra.co.nz/pdf/HousingWorkshops.pdf - although there is now only space at the 19 July workshop). Equally, if you want to know what actually drives cycles in economic growth you should attend one of the Economic Workshops we are running (see http://www.sra.co.nz/pdf/EconomicWorkshops.pdf for information on these). If you attend one of these you will understand the unique and valuable insights we have to offer on housing and economic prospects, with these insights being updated in our regular pay-to-view reports.

I have also developed a unique framework for assessing NZD/USD prospects and we are running NZD/USD educational workshops (see http://www.sra.co.nz/pdf/NZDUSDWorkshops.pdf). For more general information on our workshops, including why I am qualified to run them, visit the workshop section of our website - http://www.sra.co.nz/workshops.html.

We are in negotiations with various parties to run these workshops in Christchurch in late September, so please register your interest with denise@sra.co.nz if you would like to attend the workshops in Christchurch. In this instance the Housing Workshop will have a Christchurch/Canterbury focus rather than the Auckland focus in the workshops we are currently running in Auckland.

,