



HOUSING PROSPECTS

Contents of the reports

The **Housing Prospects** reports contain a rigorous, insightful and accurate assessment of prospects for the existing house and section markets. Each report has an executive summary and six parts:

- An assessment of the year-ahead outlook for national house sales.
- An assessment of the year-ahead outlook for national house prices.
- A five point assessment of housing as an investment option.
- An assessment of prospects for the national section market including some regional information.
- An assessment of the outlook for external migration, which drives cycles in population growth.
- An assessment of house price prospects for 24 cities/districts.

There is not a separate section on the outlook for interest rates, but a summary of our assessment of interest rate prospects is included in the first part of the report. The full assessment of interest rate prospects is contained in our monthly economic reports (see <http://www.sra.co.nz/interesting.html> for info on these), while the six-weekly **Monetary Policy Briefing** reports look in detail at the outlook for the OCR (see <http://www.sra.co.nz/monetary.html> for info on these).

The reports are written in plain English, are illustrated with enlightening charts and tables, and generally run to 22 pages. There are 11 reports per annum, with a combined December-January report.

This introductory report doesn't give away all of the trade secrets on how we analysis housing market prospects. But if you are interested in becoming a client of the pay-to-view **Housing Prospects** reports and want to know more about why the framework we have developed works so well please contact us. We are happy to walk would-be clients through a report in detail so they can better appreciate why we can consistently provide accurate and valuable insights for business and/or investment decisions.

Reviewing our track record

This introductory report provides information on the contents of the **Housing Prospects** reports and reviews our track record at picking housing market upturns and downturns. It explains why we can be so accurate in providing clients with advanced warnings of upturns and downturns. Getting it right is what matters and the unique forecasting framework we have developed has a track record of doing just that.

Of course, forecasting the future is an art not an exact science, so even armed with the best forecasting framework in the world – which ours is - we will not always get it exactly right. Who knows when “nuclear bombs” might start falling on Chicken Licken's head. However, we can confidently assert that our track record is matched by none, while if special events like the financial crisis or changes in property tax arise we are quick to incorporate them into the analysis.



Rodney Dickens
Managing Director and Chief Research Officer
Strategic Risk Analysis Limited - www.sra.co.nz
027 288 2209
rodney@sra.co.nz



Getting it right is of utmost importance

We pride ourselves in getting it right. As outlined on pages 4-6, we have a track record of providing sufficiently accurate predictions that our clients can use them as inputs into business and/or investment decisions with a good degree of confidence. This fits with our aim of being a “business risk management partner” to our clients. This is in stark contrast to the often dismal insights provided by the economic forecasters (for example see <http://www.sra.co.nz/pdf/ChristmasRaving2011.pdf>).

The **Housing Prospects** reports provide advance warnings of:

- Upturns and downturns in the number of existing house sales and insights into how significant they will be and how long they are likely to last.
- Upturns and downturns in existing house prices and insights into how significant they will be and how long they are likely to last.
- Whether housing in general offers good longer-term return prospects for investors based on five valuation criteria.
- Whether existing house prices in the 24 cities/districts we cover are likely to significantly outperform or underperform the national outlook over the next 6-12 months.
- Prospects for the section market that can have unique dynamics (e.g. the role of financiers).
- The outlooks for the most important drivers of housing and section market upturns and downturns (e.g. interest rates, net migration and housing affordability).

Distinguishing near-term from medium-term prospects is critical

It is critical to distinguish between near-term prospects, like the outlook for the next year, and longer-term prospects, like the outlook for the next several years and at times longer. This is important because near-term prospects can be very different from longer-term prospects. For example, in the first **Housing Prospects** report released in April 2007 we predicted that the national average house price would increase in 2007 but at a slower pace. At the same time we warned that a speculative bubble had developed and was at risk of bursting. We predicted that house prices would fall significantly in the next downturn and that housing in general offered terrible longer-term return prospects for investors. We also warned that the longer-term return prospects for investors would get worse during 2007 in response to prices increasing. See the **Appendix** for a sample of the relevant text from the April 2007 report.

The national average house price increased only 3.5% in the last three quarters of 2007 before the bubble burst in 2008 when prices fell 9% on average. Even four years later the national average house price was still 3% below the peak level reached at the end of 2007. Of more relevance the real value or purchasing power of the national average house fell 13% between the end of 2007 and the end of 2011. Over this period the national average house price fell only 3% but prices in general, as measured by the Consumers Price Index (CPI), increased 10% excluding the boost from the rise in GST on 1 October 2010. So in terms of how many loaves of bread and lamb chops the proceeds from the sale of a house could buy the value of the national average house fell 13%.

Housing upturns and downturns don't happen by accident

From the very first report we have made a clear distinction between near-term and longer-term prospects. And our assessments of both have been uncannily accurate. This is not because we have a magic caldron or have been lucky. It is because housing market upturns and downturns don't happen by accident. In normal circumstances they are driven by interest rates and population growth/external migration. At times other factors will be important (e.g. the behaviour of investors, tax changes, affordability and the financial crisis). We have unparalleled frameworks for assessing both how the drivers will impact on the housing and section markets and the outlooks for the main drivers of housing cycles. Equally, there are sound ways of assessing whether housing offers good, bad or indifferent longer-term return prospects for investors and we use such techniques (and wishful thinking isn't one of them).

By distinguishing near-term from longer-term prospects we were able to correctly warn clients that the 2007 upturn in house prices posed great risks for would-be investors. And by association it posed risks for firms that derived income from the level of housing market activity. Equally, we correctly warned that the

While Strategic Risk Analysis Limited will use all reasonable endeavours in producing reports to ensure the information is as accurate as practicable, Strategic Risk Analysis Limited, its employees and shareholders shall not be liable (whether in contract, tort (including negligence), equity or any other basis) for any loss or damage sustained by any person relying on such work whatever the cause of such loss or damage.

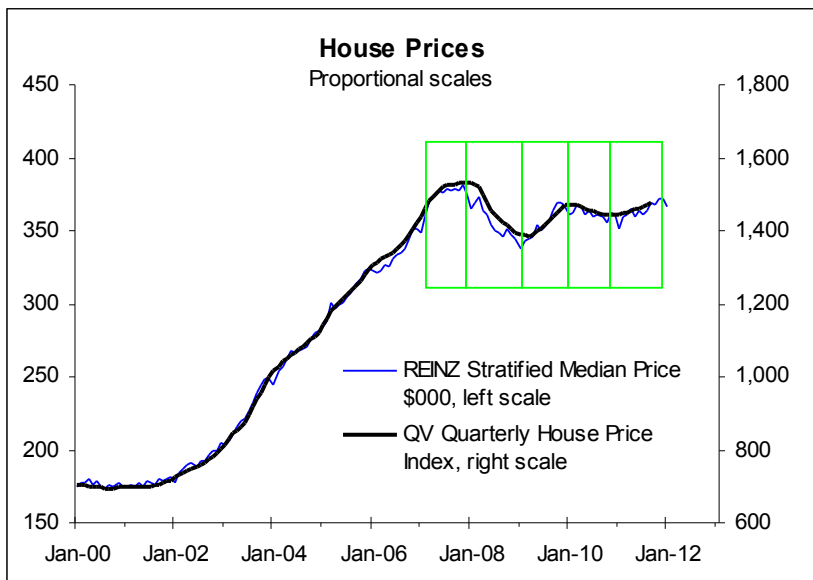


temporary upturn in house prices in 2009 would be a “sucker’s rally” (i.e. would not be the start of the next major cyclical increase in house prices, while there would be downside risk after it).

The issue of housing affordability and how it impacts on both the housing market and the economy more generally is poorly understood despite it being of huge relevance. The **Housing Prospects** report puts affordability in context and explains both how it has impacted on the number of sales and hence on house prices, and how it is likely to impact in the future. Related to the issue of affordability are the behaviours of first home buyers and investors. The reports also provide assessments of how these two groups are likely to behave and the implications for the housing market. We also consider how economic cycles and especially consumer confidence will impact on house prices.

We have an unparalleled track record

Let’s first review our track record at predicting upturns and downturns in house prices and then review our track record at picking upturns and downturns in the number of house sales, with both closely linked. Since we started producing the **Housing Prospects** reports in April 2007 there have been five legs in house prices. These are highlighted by the green boxes on the chart below and involve the following:



- A moderate increase in 2007.
- A sharp fall in 2008.
- A moderate increase in 2009.
- A small fall in 2010.
- A small increase in 2011.

We provided clients with advance warnings in each instance. We could do this because the unique forecasting framework we use was specifically designed to pick upturns and downturns before they occur. Our framework has been developed and refined over a period of more than 20 years. It is a true business risk management framework as distinct from the “black box” forecasting frameworks

used by the economic forecasters. As an aside, our experience includes having been involved in building economic forecasting models at the Reserve Bank, so we have firsthand experience of the short-comings of economic forecasting models. These shortcomings were what encouraged us to develop the unique forecasting framework used in the **Housing Prospects** reports and in our other pay-to-view reports. For information on our work experience and background visit <http://www.sra.co.nz/theteam.html>.

Our prediction that there would be a moderate increase in national house prices in 2007 to be followed by a bursting of the bubble in prices was discussed on page 2 and in the **Appendix**. Below we document the advance warnings we provided before the other four legs in house prices shown in the chart above.

In the March 2008 **Housing Prospects** report, before the 9% fall in the QV quarterly measure of the national average house price in 2008 gathered any pace, we wrote the following:

“High interest rates, below average population growth, overly-g geared investors and owner-occupiers being forced to sell, and an excessive level of spec building, are all coming home to roost. While the suggestion that the national median house price could fall 7-10% this year might sound like the ravings of a doomsayer in normal circumstances, these are clearly not normal circumstances.”

In the March 2009 report, before house prices started to increase, we wrote:

“There is the chance of a ‘sucker’s rally’ in house prices starting later this year and flowing into 2010 fuelled by the unsustainably low interest rates and the upturn in net migration. But super low interest rates don’t make housing fundamentally affordable. ... It will be a drawn out process over a number of years and along the way periods of rising house prices are quite likely just as it is the possible that another period of falling actual house prices will occur.”

While Strategic Risk Analysis Limited will use all reasonable endeavours in producing reports to ensure the information is as accurate as practicable, Strategic Risk Analysis Limited, its employees and shareholders shall not be liable (whether in contract, tort (including negligence), equity or any other basis) for any loss or damage sustained by any person relying on such work whatever the cause of such loss or damage.



In the March 2010 report, before house prices started to nudge lower, we wrote:

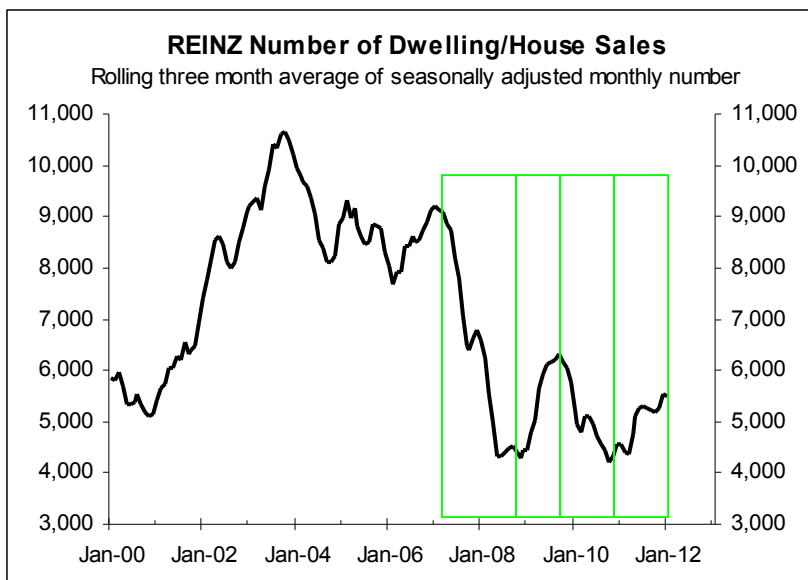
“Winter has come early with downward pressure on the national average house price not far away, although some major regional differences are emerging. The property tax-investor issue is clouding the tea leaves, but the general outlook this year is negative for sales and prices.”

In the April 2011 report, before the latest rise in prices gathered any pace, we wrote:

“The further moderate fall in mortgage interest rates in March should provide a bit more of a boost to the number of sales in the June quarter, which could be aided a bit by the organic recovery we hope may start to unfold this year. The moderate recovery in the number of sales we expect this year will end the downward grind of house prices and could even generate a modest increase in house prices.”

We haven't always got the timing spot on, but we have fulfilled our objective of providing clients with advance warnings of significant upturns and downturns in national house prices. Armed with our unique forecasting framework we expect to continue to provide subscribers of the **Housing Prospects** reports with advance warnings of upturns and downturns in house prices.

If your business is impacted by the level of housing market activity (i.e. the number of existing house sales) our track record of providing advance warnings of upturns and downturns is even better than is the case with house prices. Since April 2007 there have been four legs in the national number of sales and for sales in almost all of the 24 cities/districts we cover (see pages 6-7 for info on the city/district content of the reports). These are highlighted by the green boxes on the chart below and involve the following:



- A massive decline in 2007-08.
- A significant increase in 2009.
- A significant fall in 2010.
- A staggered increase in 2011.

We provided clients with concise advance warnings in all four cases. The leading indicator forecasting framework we use is even more useful at picking when upturns and downturns in the number of sales will arrive than it is at picking the timing of upturns and downturns in house prices. If you are interested in subscribing to the **Housing Prospects** reports we will reveal all our trade secrets so you can better appreciate why we are able

to provide accurate advance warnings of upturns and downturns in the number of existing house sales.

In terms of our track record, the following excerpts from the **Housing Prospects** reports document our success in providing advance warnings of the upturns and downturns highlighted in the chart above.

In the inaugural report in April 2007, prior to the large tumble in the number of existing dwelling/house sales in 2007-08, we wrote:

“The 0.5% rise in mortgage interest rates over the last two months and the lower migration numbers over the last few months imply significant downside risk for the national number of house sales over the next several months.”

The chart shows that the fall in the number of sales temporarily paused in late-2007/early-2008 and for a while there looked like a chance that the fall had ended, but in the March 2008 report, before most of the second leg of the fall had occurred, we wrote:

“The latest round of mortgage interest rate increases have occurred earlier than we have been predicting because of the boost in overseas funding costs faced by banks and caused by the US crisis, which we had not predicted. Consequently, demand for housing is likely to reach close to past trough levels this year, which we had not expected to happen until next year.”

While Strategic Risk Analysis Limited will use all reasonable endeavours in producing reports to ensure the information is as accurate as practicable, Strategic Risk Analysis Limited, its employees and shareholders shall not be liable (whether in contract, tort (including negligence), equity or any other basis) for any loss or damage sustained by any person relying on such work whatever the cause of such loss or damage.



As the quote from the March 2008 report above reveals, the fall in the number of house sales in 2008 to past trough levels occurred earlier than we initially predicted. Since we started producing **Housing Prospects** reports in April 2007 this is the nearest we have come to getting the timing and/or magnitude of an upturn or downturn wrong. But we had been warning clients for some time that there was the real risk that rising mortgage interest rates would eventually mean the number of sales would tumble to around previous trough levels. In the January 2008 report we describe this as “Hurricane Bollard III”, but the financial crisis rather than Governor Bollard delivered the final blow.

In the November 2008 report, well before the upturn started in 2009, we wrote:

“The escalation of the financial crisis has cast a shadow over housing demand but the associated large interest rate cuts could fuel a reasonable rebound in the number of house sales over H1 ‘09.”

Just before the 50% rebound in the number of sales started in early 2009 we wrote the following in the January 2009 report:

“In normal circumstances a drop in mortgage interest rates of the magnitude we have seen would fuel a rebound in the monthly number of house sales from 4,000 to around 7,000. The recovery will be muffled especially because of the tightening of lending criteria by the banks and to a lesser extent because of both the deteriorating labour market/economy and the moderate fall in immigration numbers. So maybe the number of house sales rebounds to 5,500-6,000 per month by April rather than 7,000 (after adjusting for seasonally variations in the numbers). It seems likely that some more interest rate cuts will be delivered in the first half of this year that will help further stimulate housing demand.”

In the November 2009 report we warned of potential downside risk before it arrived in 2010. We wrote:

“Grey clouds are gathering and we are worried that the number of house sales could face earlier downside risk than we have previously suggested was likely.”

There is a combined December/January report and in the January 2010 report we wrote:

“The odds have increased that the start of a reasonably significant fall in the number of house sales is underway, driven by the negative impact of rising interest rates.”

In the February 2010 report we started to focus on the negative impact of the proposed changes in property taxes. In that report we wrote:

“The tumble in house sales in January is partly due to the negative impact of rising mortgage interest rates and partly due to investors deserting the market, frightened off by the proposed changes to property taxation rules to be announced in the 20 May Budget. However, not only are investors likely to remain wary of buying more properties until they know where they stand, but some will be trying to exit their investments, driving up the stock of properties listed for sale.”

Just prior to the staggered cyclical upturn in the number of house sales got underway in earnest in 2011 we wrote the following in the March 2011 report:

“The horrific Christchurch earthquake on 22 February will provide a moderate but temporary boost to housing demand in the rest of the country, in part because of people leaving Christchurch at least temporarily but more because it triggered a 0.5% OCR cut that we believe was justified even before the quake.”

In our August 2010 monthly economic report (visit <http://www.sra.co.nz/interesting.html> for info on these) we had flirted with the idea that the next move in the OCR would be down. At the time the bank economists and the Reserve Bank were still predicting significant increases in the OCR. Our view was largely based on the negative impact on economic growth from the housing market downturn we had warned about at the start of the year. In the January 2010 **Building Barometer** report we had warned of the risk of a fall in residential building activity in the second half of the year (see <http://www.sra.co.nz/building.html> for info on these extremely insightful reports). This was prior to the first major earthquake in Canterbury in September 2010. Our better ability to assess economic growth prospects means we could offer clients superior insights into prospects for both mortgage interest rates and the housing market.

What we are particularly good at doing is assessing the likely impact from all the relevant drivers of the number of house sales, including the normal drivers (i.e. interest rates and net external migration) and where relevant shocks or other factors (e.g. the financial crisis, changes in bank lending criteria, property



tax changes). And we convey what it all means for the outlook for the number of house sales and house prices in a concise manner using Plain English.

Wishful thinking doesn't make housing a good investment option

The experience in the housing market since 2007 should have taught most people that the old rules of thumb can't always be relied upon. Before 2008 it was widely held that house prices would never fall much, but this myth was busted in 2008. Past experience was that downturns were short-lived before house prices marched ever higher, but house prices have now languished for four years so this rule of thumb is under threat. People regularly use recent experience as the basis for assessing the future, but experience prior to 2008 prepared no one for the impact of the financial crisis or what happens after the sort of speculative bubble in house prices that occurred between 2002 and 2007.

Having a sound basis for assessing where along the continuum between fantastic value and terrible value housing lies as an investment should have always been important. Anyone using a sound basis for assessing the "value" of housing would have avoided getting burnt by the boom-bust cycle. Equally, anyone currently using a sound basis for assessing "value" is much better off than people who continue to rely on old rules of thumb or blind faith. By "value" we mean a basis for assessing future return prospects as distinct from the "market valuation" provided by valuers that assess the fair price in the context of current market conditions. Market valuations tell you nothing about likely future returns.

Proper valuation techniques are used in a number of fields including for assessing whether the shares of listed companies offer good value, although any valuation is only as good as the person undertaking it and the assumptions used to derive the valuation. We use five criteria for assessing whether housing in general offers good value. The five criteria are:

- The current level of house prices relative to rents and an assessment of prospects for house prices relative to rents which are at the heart of returns for investors.
- The rental yield offered by housing relative to interest rates. This provides insights into whether investing in housing will be cashflow positive or negative and whether housing is offering the higher return it should relative to low risk fixed interest investments.
- The level of house prices relative to incomes and prospects for house prices relative to incomes which are at the heart of affordability. This has little relevance to the year-ahead outlook for house prices but is of great relevance to longer-term return prospects for housing.
- The cashflow difference between buying and paying a mortgage on the one hand and renting and paying rent on the other. For investors this provides insights into how rental income will stack up relative to interest costs. It also provides insights into the likely behaviour of would-be first home owners, which has implications for the behaviour of house prices relative to rents.
- The level of house prices relative to the level of prices in general. This provides another perspective on housing affordability and is relevant to housing demand. If housing is expensive relative to incomes and prices in general people will economise on housing, with major implications for the number of house sales and house prices. This is a critically important issue, but also one that is poorly understood in terms of both the impact it has had on the housing market in recent years and how it will unfold in the future.

We use a chart to put the current readings for the five valuation criteria in the context of the respective best and worst ever readings. This framework provides a sound basis for assessing housing as an investment option and more generally for assessing longer-term prospects for house prices. This makes it a valuable aid for investors but is equally valuable to people deciding whether to buy or rent.

The state of the section market is of major importance

The **Housing Prospects** reports contain insightful analysis of developments in and prospects for the national section market and some regional information. The analysis of the section market will be particularly useful for developers, building companies and councils, while developments in the section market have implications for the existing housing market.

We assess prospects for national section sales and section prices. We assess the demand-supply balance in the section market relative to the balance in the existing housing market and focus on the behaviour of

While Strategic Risk Analysis Limited will use all reasonable endeavours in producing reports to ensure the information is as accurate as practicable, Strategic Risk Analysis Limited, its employees and shareholders shall not be liable (whether in contract, tort (including negligence), equity or any other basis) for any loss or damage sustained by any person relying on such work whatever the cause of such loss or damage.



section prices relative to existing property prices. These have implications for demand for existing housing relative to new housing.

The drivers of section sales and section prices are very similar to the drivers of the existing housing market that we cover in detail in the reports. However, the section market can have some unique dynamics, like the impact financiers are having on subdivision development.

Is your city/district likely to outperform or underperform national house prices?

The **Housing Prospect** reports contain analysis of near-term house price prospects for 24 of New Zealand's 73 cities/districts. Our aim is to give early warnings of when house prices in any of the 24 markets are about to significantly outperform or underperform national house prices. We also identify when local prices are cheap or expensive relative to the national average.

The cities/districts covered are: Whangarei, Rodney, North Shore, Waitakere, Auckland, Manukau, Hamilton, Thames-Coromandel, Tauranga, Rotorua, Taupo, Gisborne, Napier-Hastings, New Plymouth, Palmerston North, Wanganui, Wellington, Hutt (Lower Hutt), Nelson, Marlborough, Christchurch, Selwyn-Waimakariri combined, Queenstown Lakes and Dunedin.

In general house prices in the large cities/districts are highly correlated with national house prices. This means the drivers of the national housing market are of major importance in assessing house price prospects for the 24 cities/districts. This is the case in part because interest rates are set nationally and are the most important driver of housing market cycles. In addition, for most cities/districts local population growth is highly correlated with national population growth.

Some markets tend to underperform during certain parts of the cycle and outperform in other parts. Whangarei is the prime example of this. Consequently, there are periods when it becomes cheap or good value relative to the national market and times it becomes expensive relative to the national market.

For some cities/districts local factors at times have a larger impact than the national drivers. For example, the Christchurch earthquakes have had a major impact on demand for housing in the Selwyn and Waimakariri districts that surround Christchurch. We do not provide detailed insights for each of the 24 cities/districts, but we do assess how the local demand-supply balances stack up relative to the national average. This means we can generally provide advance warning of when local prices are about to significantly outperform or underperform national prices.

When the demand-supply assessments are combined with the assessments of whether local prices are cheap or expensive compared to the national average price it provides a basis for picking which cities/districts should be focused on or avoided by investors. It also provides insights for locals trying to decide whether to buy to occupy or to rent and wait to buy later.

Appendix – From day one we got it right

Excerpts from the Executive Summary of the April 2007 **Housing Prospects** report:

“National house price inflation should move higher over the next several months as a lagged response to the earlier rise in the number of house sales and the lower number of days it is taking houses to sell. While rising interest rates and lower migration numbers mean house sales should fall significantly over the next several months, demand will remain high enough to ensure that the national median house price keeps increasing in the second half of the year, albeit at a slower rate. However, signs are emerging that all is not well in the housing investment market, while excess spec building is occurring in parts of the country, both of which should ring warning bells for would-be investors.

Housing in general represents terrible value but is in the process of becoming even worse value from a long-term return perspective. Is the market experiencing a spec bubble? There is good reason to believe it is. However, bad value does not stop prices rising in an investor/spec driven market, but it does mean much greater downside risk to prices in the next market downturn, especially for the parts of the market where get-rich-quick investors have driven prices dramatically above the affordability of would-be owner-occupiers.”

For more detail on our 2007 prediction that the speculative bubble in house prices would burst review the first **Housing Hell** Raving we released in August 2007 (see <http://sra.co.nz/pdf/housinghell.pdf>). This was followed up by **Housing Hell Revisited** in March 2008 (see <http://sra.co.nz/pdf/housinghellrevisited.pdf>) and **Housing Hell Update** in November 2008 (see <http://sra.co.nz/pdf/housinghellupdate.pdf>).

While Strategic Risk Analysis Limited will use all reasonable endeavours in producing reports to ensure the information is as accurate as practicable, Strategic Risk Analysis Limited, its employees and shareholders shall not be liable (whether in contract, tort (including negligence), equity or any other basis) for any loss or damage sustained by any person relying on such work whatever the cause of such loss or damage.