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## **RODNEY'S RAVINGS**

Is the housing recovery about to fold?

### **EXECUTIVE SUMMARY**

A Westpac economist has in the last few days got lots of publicity by predicting that there will be “a return to low [house] sales volumes and falling [house] prices in the second half of 2009”. This prediction is based on the negative impact of higher longer-term fixed mortgage interest rates and a rising unemployment rate. Irrespective of whether the economist's views are well founded he has done a good job for his employer (i.e. got Westpac's name splashed across the media).

It is common for economists who didn't predict an upturn to find reasons for it to fail when it is in the early stages. When I look at what is happening in the mortgage market, the impact of net migration and the relationship between the labour market and the housing market I conclude that the Westpac economist's predictions are poorly founded. For the only quality and comprehensive analysis of prospects in the national housing and section markets, including coverage of 24 cities/districts, check out our **Housing Prospects** reports (visit <http://www.sra.co.nz/housing.html> for preliminary information on these reports).



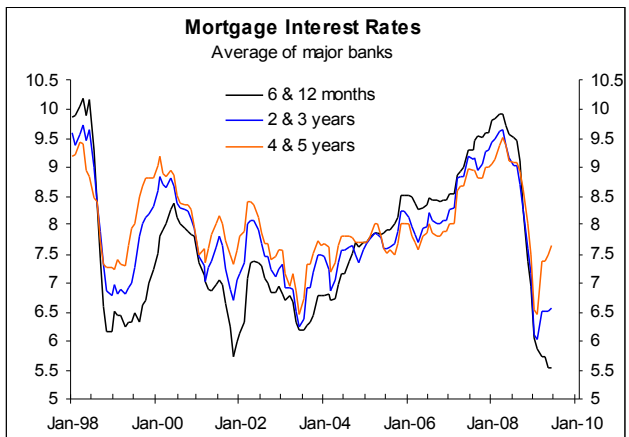
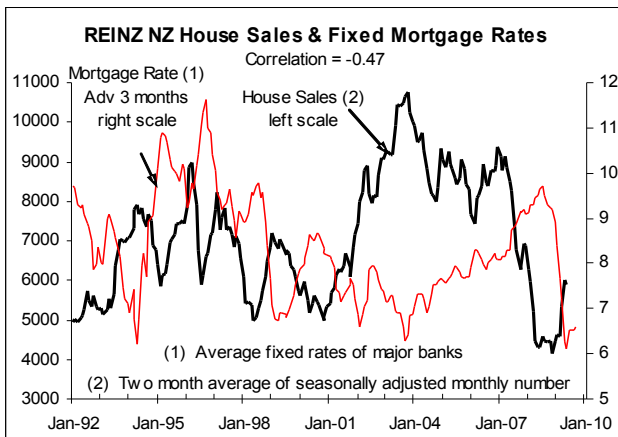
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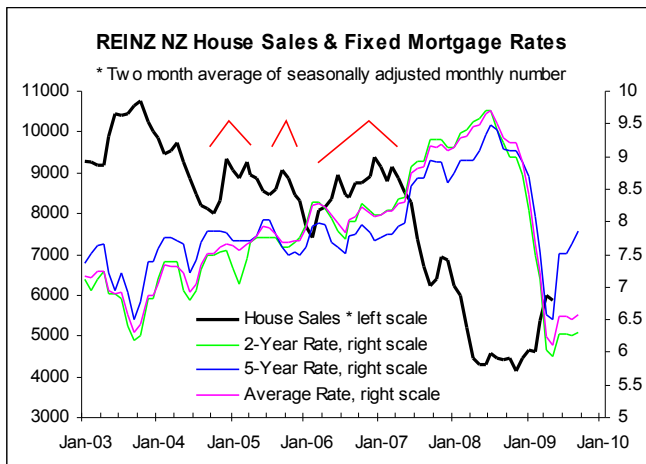
**Is the housing recovery about to fold as a Westpac economist is predicting?**

A Westpac economist has recently got lots of publicity claiming that “the pick-up in housing market is unsustainable”. “The bank’s economists expect rising unemployment and higher long-term mortgage rates to prove stronger than the factors which have seen signs of life returning to the market.” (Source: NZ Herald, 5 June 2009). These quotes are of what Brian Farrow, the NZ Herald’s Economics Editor, wrote. The Westpac economist, Dominick Stephens, is quoted as saying, “We expect a return to low sales volumes and falling prices in the second half of 2009.” Irrespective of whether Dominick’s views are well founded he has done a good job for his employer (i.e. got Westpac’s name splashed across the media). But let’s see how his comments stack up.

The left chart shows the relationship between the number of REINZ house sales and the average fixed mortgage interest rate charged by the major banks. The best fit in the chart is with the red interest rate line advanced or shifted to the right by three months as a leading indicator of the number of house sales. So with the average fixed mortgage interest rate having increased from a low of 6.1% in February to 6.6% currently there is a basis for expecting that the number of house sales might fall marginally over the next three months, but not back to the earlier trough levels. Dominick focused on the long-term fixed mortgage rates and as the orange line in the right chart shows, the average of the 4-year and 5-year fixed rates charged by the major banks has increased from a low of 6.5% in February to 7.7% currently. However, what Dominick appears to overlook or discount is that the average 6-12 month fixed mortgage rate charged by the major banks has fallen from 5.9% in February to 5.5% currently (black line, right chart). The right chart also shows the moderate increase in the average of the 2-year and 3-year fixed rates (blue line).



If borrowers had only the choice of longer-term fixed rates we would expect house sales to fall in the second half of 2009, especially if the global recovery discussed in the last Raving continues and drives longer-term interest rates higher (see <http://www.sra.co.nz/pdf/NZDrevisited.pdf>). But we expect borrowers to focus more on the lower 6-12 month fixed rates, especially because the RBNZ has signalled it will ensure shorter-term interest rates remain low for some time.

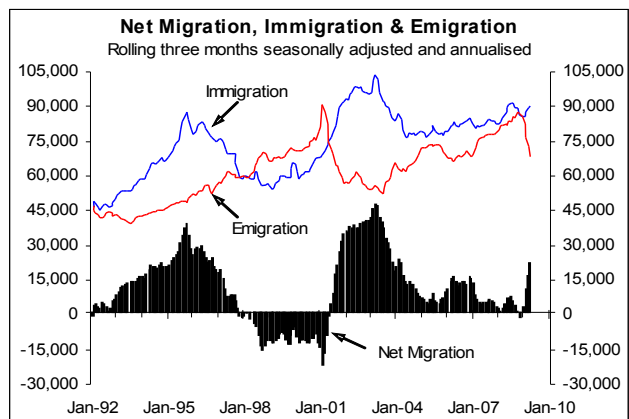
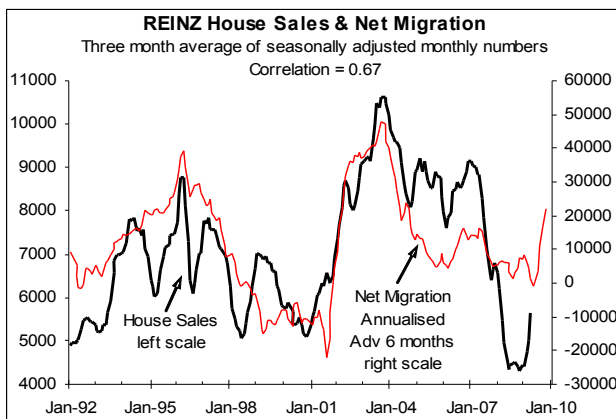


There are precedents for our expectation. In late-2004 what became called the “bank wars” developed. The initial focus was on the 2-year fixed rate that was cut temporarily relative to the average fixed rate (the green versus the purple line). People responded to the lower 2-year fixed rates and it resulted in a temporary spike in the number of house sales (see the first of the three red hats). In the second half of 2005 the 5-year fixed rate fell relative to the average rate (blue versus purple lines) and this resulted in a smaller temporary spike in the number of house sales (the second red hat). In 2006-07 especially falling 5-year fixed rates created another temporary rise in house sales (the third hat).



If people were to be completely myopic and flock to shorter-term fixed mortgage interest rates without concern about what will happen 6-12 months down the track when the mortgages had to be re-priced a good case could be made for suggesting that the number of house sales will rise more over the next few months. And with the RBNZ expected to keep the OCR low for some time to come, even if not until late 2010 as Governor Bollard indicated on 30 April, the shorter-term fixed mortgage rates should remain close to trough levels and ensure that the upturn in house sales isn't kneecapped any time soon. If the housing recovery falters then look for the RBNZ to cut the OCR further and for this to result in even lower shorter-term fixed mortgage rates. And, by the way, the recent sharp upturn in net migration is about to help stimulate housing demand over the second half of 2009 as shown in the left chart below.

So I struggle to see the housing market "return to low sales volumes" in the second half of 2009 on the back of what is happening to mortgage interest rates while the other primary driver of housing demand, net migration, favours upside in house sales in the second half of 2009. If the number of house sales remains at or above the current level than house price won't be falling in the second half of 2009.



The next issue is the relationship between the unemployment rate on the one hand and the number of house sales and house prices on the other. The research I have done on this topic shows that the housing market is a leading indicator for the labour market and not the other way around. The massive fall we have already seen in the number of house sales and the large fall in house prices tell us that an increase in the unemployment rate is in the pipeline. The unfolding upturn in the number of house sales is a leading indicator that points to better times ahead in the labour market. This issue and the relationship between the labour market and consumer spending will be addressed in a forthcoming Raving.

The unemployment rate is at best a secondary driver of the housing market. When the big-hitters of low interest rates and rising net migration line up to underwrite a decent upturn you can largely forget about the labour market. Even if the unemployment rate rises to 7% as some economists are picking, 93% of people will still have jobs (i.e. the vast majority). And it only takes a relatively small proportion of this group to respond to the super-low short-term interest rates for the housing recovery to continue. But what about debt levels and will the banks lend the money needed for the housing upturn? The conventional wisdom seems to be that everyone borrowed truckloads of money during the housing boom and with banks having tightened lending criteria there won't be anyone able to take advantage of the low interest rates.

This view is what I term the "fallacy of averages". The way I look at it the average Kiwi shifts house around every seven years. This means the average Kiwi didn't change house during the housing boom, with changing house being the time when most people gear up to the eyeballs. We are an example of a household that didn't gear up during the housing boom and the surprise to me was how much our friendly bank was willing to lend us when we approached them recently for a mortgage. The rise in the number of house sales that has already occurred wouldn't have been possible if banks weren't lending more to house buyers. I expect the large group of households that didn't gear up materially during the boom years to be those buying and building new houses this year on the back of low interest rates, aided by stronger net migration/population growth. Feedback from a number of banker contacts points to the major banks continuing to play hardball with would-be mortgage borrowers. But as long as I am right in suggesting that there are plenty of households with below average gearing who are in the 93%+ group who still have jobs then there should be enough would-be house buyers who meet even the tighter bank lending criteria to ensure the housing recovery doesn't fold in response to higher longer-term fixed mortgage rates or a rising unemployment rate.