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RODNEY'S RAVINGS

Residential building prospects and the miserly forecasters

EXECUTIVE SUMMARY

Even the most optimistic of the economic forecasters surveyed by NZIER in March expects the volume of residential building activity to fall mildly in the 2009/10 March year. By contrasts in the latest **Building Barometer** report we are predicting that the annual number of consents in the 2009/10 March year will be up around 8% based on our analysis of the likely impact of interest rates, net migration, section prices and bank lending behaviour.

In the last two years we have warned our clients about the downside risk to residential building activity including warning them in advance to prepare for the worst case scenario. Our unique leading indicator framework for assessing year-ahead prospects for the likes of residential building activity and housing demand/prices has served our clients well in preparing them for the downturn just as we are now helping them position their businesses for the recovery. This Raving provides insight into why the leading indicator analysis framework we have developed points to the upturn arriving much earlier than predicted by the economic forecasters. Our framework offers a powerful business risk management tool for firms in the residential building industry or for firms impacted by the cycles in residential building.



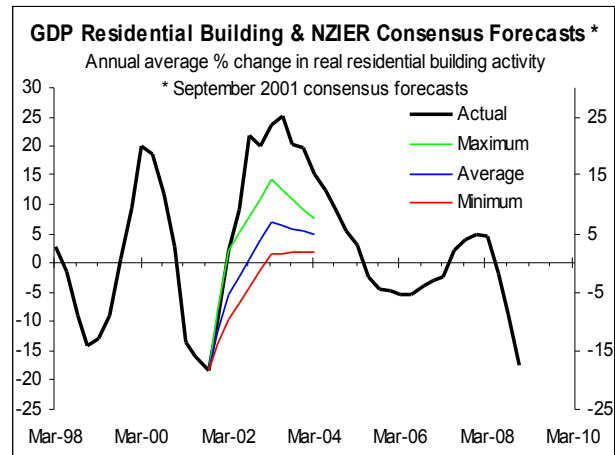
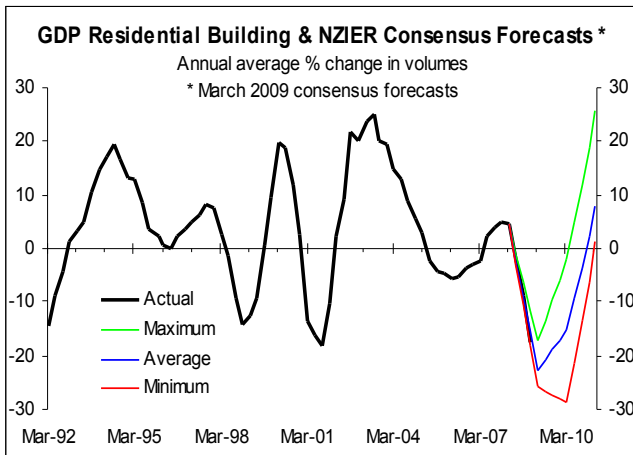
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Residential building prospects and the miserly forecasters

The 10 economic forecasters surveyed by NZIER in March on average estimated that the volume of residential building activity including alterations and additions fell 22.8% in the 2008/09 March year and predicted it to fall a further 15.1% in the 2009/10 March years before experiencing a modest recovery of 7.9% in the 2010/11 March year (see the blue line in the left chart below). The green line shows the most optimistic forecasts while the red line shows the most pessimistic forecasts. Even the most optimistic of the forecasters predicted that residential building activity in the 2009/10 March year would be down 2.1%. No wonder economics is known as the dismal science! The forecasters surveyed in March were: ANZ National, ASB, BERL, BNZ, Deutsche Bank, NZIER, RBNZ, Treasury, UBS and Westpac. The following link will take you to the part of NZIER's website where the reports presenting the consensus economic forecasts are stored - http://www.nzier.org.nz/Site/Publications/Consensus_forecasts.aspx.

By contrasts in the latest **Building Barometer** report we are predicting that the number of consents for new dwellings in the 2009/10 March year will be up around 8% based on our analysis of the likely impact of the likes of interest rates, net migration, section prices and bank lending behaviour. Maybe banks are slower to resume lending growth than we are assuming, maybe the global crisis delivers another shock, maybe the sizeable improvement in net migration we expect doesn't unfold and maybe developers are slower than we expect to cut asking prices for sections which is required to improve the competitiveness of building new houses relative to buying an existing house. These are uncertain times and it would be arrogant of us to suggest we knew all the answers. But equally the shot that Governor Bollard fired across the market's bow on 1 April should give plenty of insight into his thinking about what he wants to see happen (i.e. by hell or high water he is going to deliver a recovery!). The following link will take you to the unscheduled comments by Bollard on 1 April - <http://www.rbnz.govt.nz/news/2009/3598327.html>.



It is not unusual for the economists to be either slow at predicting an upturn or unduly pessimistic about the scale of an upturn. The right chart above shows the range of predictions by the economic forecasters when surveyed by NZIER in September 2001 when the last upturn had already commenced. The consensus view was that residential building activity in the 2002/03 March year would increase a moderate 7% while it actually increased 23.7%. Even the most optimistic of the forecasters was only predicting a 14% increase which is interesting because when the September 2001 survey was conducted the number of building consents had already increased 16% from the trough levels on a seasonally adjusted basis. The seeming inability of the economic forecasters to pick the timing and/or magnitude of upturns in residential building in part reflects an underlying conservatism and is partly because they don't have the tools required to pick turning points. By comparison a major advantage we have is the leading indicator framework we have developed and successfully used over a number of years that is designed to pick turning points in residential building activity among other things.

The case for being more optimistic about residential building prospects

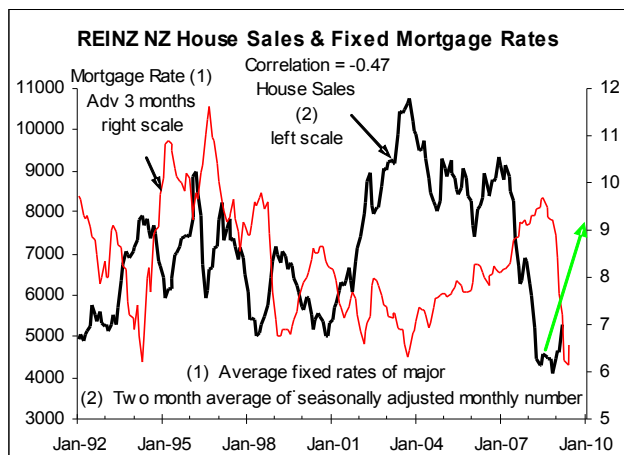
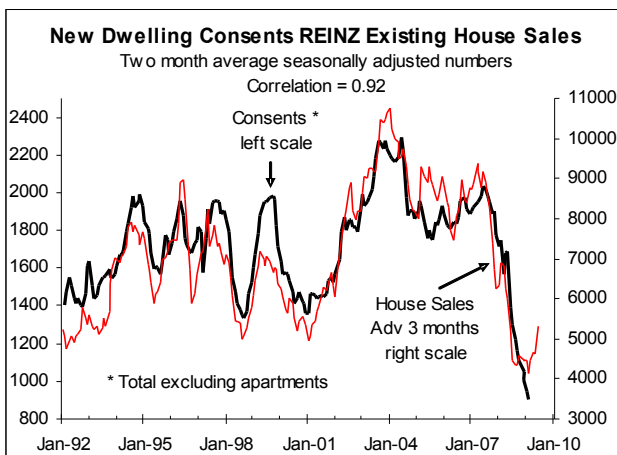
The strength of our year-ahead forecasts for residential building activity is that they are based on leading indicator analysis of how the key drivers will impact including interest rates, net migration/population growth, new housing affordability (i.e. how does the cost of new housing stack up relative to existing house prices), and the impact of changes in banks' lending criteria. The two charts on the next page offer a flavour of the analysis in the **Building Barometer** reports to justify our view that the upturn in residential



building activity will start much earlier than the economists are predicting with the full analysis reserved for paying clients. If you are interested in information about the **Building Barometer** reports use the following link to our website - <http://www.sra.co.nz/building.html> - and/or contact me.

The left chart shows the number of house sales reported by REINZ each month as a leading indicator of the number of consents for building new dwellings (excluding apartments – our reports include separate analysis of the outlook for apartments among other things). We have estimated the REINZ March number of sales based on the data provided by Barfoot & Thompson (see <http://www.barfoot.co.nz/Market-Info/Stories/March-09-Residential-Settled-Sales.aspx>) and a major national agency. The red line is a two month average to remove some of the volatility in the monthly numbers. We have also seasonally adjusted the monthly numbers to remove the seasonal pattern (see the last Raving for discussion of the ins and outs of seasonal adjustment - <http://www.sra.co.nz/pdf/SeasonalAdjustment.pdf>) and give a better indication of the underlying trend in the number of REINZ house sales. The best fit in the chart is with the red line advanced or shifted to the right by three months so it acts as a leading indicator of the number of consents for new dwellings (the black line, again a two month average of the seasonally adjusted monthly number is used). The red line points to the potential for a rebound in the number of consents over the next several months. The fit in the chart isn't perfect from month-to-month so maybe the rebound in consents will be a bit later or a bit weaker than predicted by the chart. Other than when changes in the consenting requirements/documentation had an adverse impact on the number of consents in 2005 the chart shows that it would be rare for consents not to follow the lead of REINZ house sales with around a three month lag. But it isn't unusual for consents to either rise or fall more than REINZ house sales.

The right chart shows the impact of mortgage interest rates on the number of REINZ house sales with the red interest rate line advanced or shifted to the right by three months reflecting how long changes in interest rates on average take to impact on house sales. The green line shows the sort of increase in the number of house sales there should have been in response to the massive fall in mortgage interest rates if these were normal times. With banks tightening lending criteria after the financial crisis escalated last September the upturn in house sales was delayed and may have been significantly watered down. But the upturn has finally arrived and feedback from the market place, including Tony Alexander's latest monthly survey of real estate agents, suggests that the upturn has got a head of steam up. The following link is to the part of the BNZ's website where you can sign up for Tony's weekly reports including the monthly surveys of many industries - http://www.bnz.co.nz/About_Us/1,1184,3-29-319.html?tid=PHPTonyAlexander.



Some further significant increase in the number of REINZ house sales seems likely over the next few months which, based on the left chart above, implies further upside potential in the number of residential building consents over the next six months or so. But these are uncertain times and one of the challenges still faced by the residential building industry, as discussed in the **Building Barometer** reports, is the economics of building a new house relative to buying an existing house.

A challenge faced by residential building

The February 2009 Raving titled **The economics of the section market** provided insights into the relative attractiveness of building a new house versus buying an existing house. It pointed to the need for developers to drop section prices if they wanted to compete with existing properties for which prices were falling (see <http://www.sra.co.nz/pdf/SectionEconomics.pdf>). Since February we have seen signs that

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some developers realise that the game has changed and as a result they are cutting section prices, but as discussed in the **Building Barometer** and **Housing Prospects** reports the downward pressure on section prices is only starting to warm-up. A law of economics most appropriate in the current situation is that market participants can't control both prices and volumes (i.e. developers who don't cut their prices can in general look forward to selling few sections while those that move early can expect to benefit most from the prospective increase in demand).

If few developers recognise the new competitive reality the upturn in new house building will be significantly weaker than the upturn in REINZ house sales. But even then we would expect higher net migration/population growth to play a part in driving an upturn in residential building. So even if developers in general stick to the peak asking prices for sections there will still be some recovery in residential building activity because it won't take too long to soak up the pockets of unsold spec houses. However, we expect enough developers to realise that to sell a significant number of sections will require new, lower benchmark section prices, so maybe the upturn in residential building consents could be surprisingly strong over the next year or so.

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