



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 sign up to the **RAVINGS** and the free **Property Insights** reports on our website – www.sra.co.nz – where you will also find information on our pay-to-view reports.

RODNEY'S RAVINGS

Housing Hell Update

EXECUTIVE SUMMARY

In the first **Housing Hell** Raving released on 27 August 2007 before the proverbial started hitting the fan we wrote: "The NZ housing boom has been sponsored by the RBNZ, just as the UK housing boom has been sponsored by the Bank of England and the US housing boom was sponsored by the Fed. The recent fallout in the US housing market - falling house prices, collapsing residential building activity and the mortgage/liquidity crisis - give us some insights into what can happen when a central bank sponsored housing boom turns nasty. The NZ housing market will not be immune to fallout."

In that Raving we argued that NZ had experienced a speculative bubble in house prices because prices had increased way out of line with fundamentals like incomes and rents. We calculated that "to get the gross rental yield back to the historical average of 7.7%, the average rental income will have to increase 71% or the median house price will have to fall 42%. Or, more likely, some combination of the two will unfold." That Raving, which has stood the test of time and can be accessed on our website via the following link - <http://www.sra.co.nz/pdf/housinghell.pdf>, also looked at the UK and NZ experiences over past major cycles/bubbles and concluded that it was normal for the % fall in real or inflation adjusted house prices after major booms/bubbles to be around half the size of the % increase during the boom/bubble (i.e. if the real national median house price increased by 80% during the boom it would fall around 40% during the inevitable downturn). This implied that NZ real house prices would have to fall around 40%.

The current Raving revisits the **Housing Hell** theme and looks at the two stages of the demise in the housing market that subscribers to our **Housing Prospects** reports get regular updates on. The **Housing Prospects** reports are a must have for any business impacted by the housing market or any investors wanting to make informed decisions. If you want to know more about these reports or any of our pay-to-view services please visit our website (www.sra.co.nz) and/or get in contact with me.

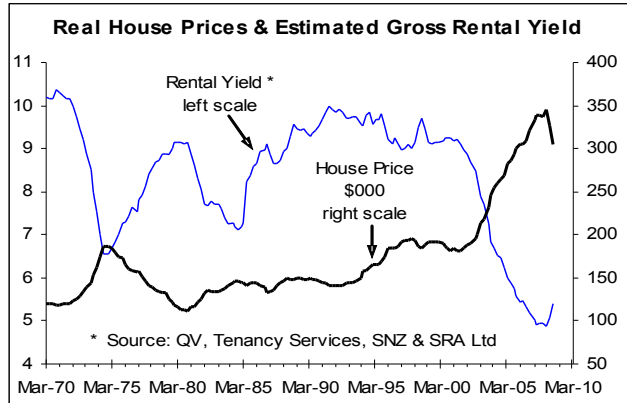
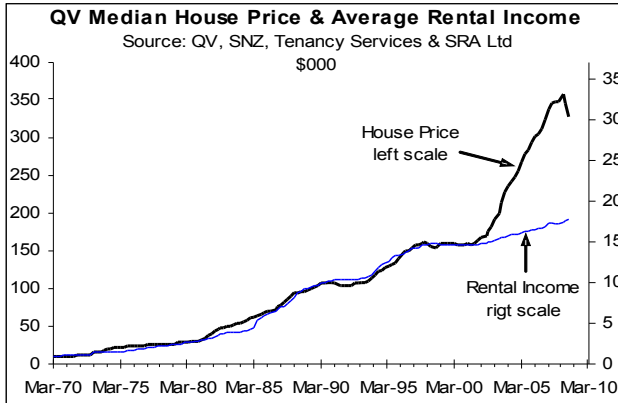


Rodney Dickens
Managing Director and Chief Research Officer
Strategic Risk Analysis Limited
09 437 6699 (Whangarei) 027 2882209
rodney@sra.co.nz



Welcome to the nightmare

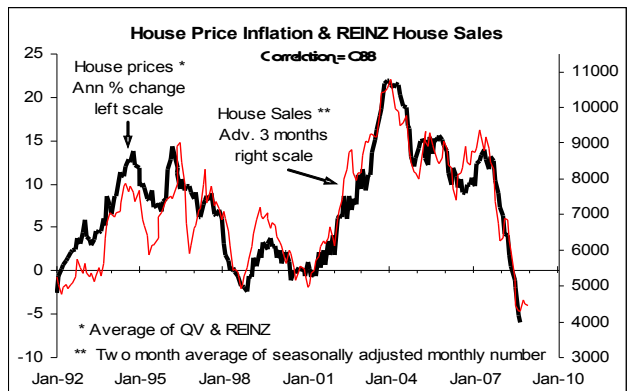
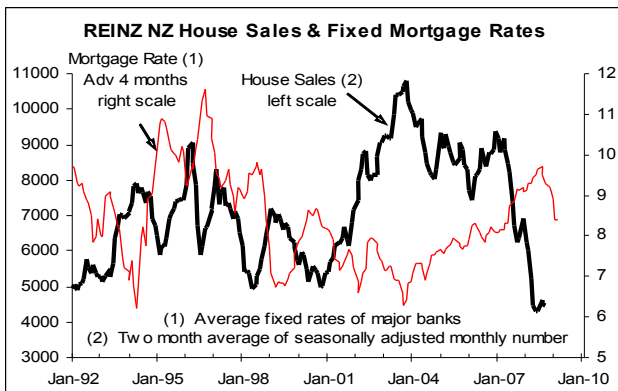
The top charts below are two of the regulars in the “Is it a good time to invest in housing?” section of the **Housing Prospects** reports. They show the challenge (or nightmare!) facing the NZ housing market. The left chart shows the sky-rocketing of the NZ median house price between 2002 and 2007 (the black line) relative to the average annual gross rent for rented dwellings (the blue line). Consequently, the rental yield fell to the lowest level on record in 2007 (the blue line in the right chart, left scale). This is classic speculative bubble material (i.e. asset prices getting completely out of line with the relevant income stream). The yawning gap in the left chart is starting to be closed as the national median house price falls while rents creep higher, so the rental yield has nudged higher this year, but house prices are still living in cloud-cuckoo-land relative to the level of rents and incomes.



But will the national median house price fall 40%?

Commentators on house price prospects like representatives of the real estate industry understandably often put a brave face on things. For some months after the national number of house sales had started to plummet, but before this had been reflected in falling prices, comments on the monthly numbers by REINZ often held out hope that a major fall in prices could be avoided. On the other hand, some commentators who look at the likes of the yawning gap in the left chart above are inclined to conclude that house prices will tumble 30% or more reasonably quickly. We see a two stage process occurring, with stage one probably more than half finished while stage two, which is likely to prove to be a long and winding road, will probably start around mid next year.

The charts below are relevant to our assessment of stage one, during which we expect the national median house price to fall 10-12%, although probably a bit more if the international financial crisis doesn't start backing off soon. As an aside, all our pay-to-view reports now include updates on the state of the international financial crisis, while as and when we see necessary our clients get special updates on the state of the crisis and its potential implications.



The starting point for assessing the near-term outlook for the national median house price is an understanding of how the primary drivers of housing demand – interest rates and net migration – impact. At the moment migration is something of a sideshow, so while it is covered in our regular client reports and will be of material importance at times we will only consider the impact of interest rates for the moment as presented in the left chart above. The black line in the chart shows the national number of dwelling or

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house sales reported each month by REINZ, although we have adjusted the monthly numbers to remove the seasonal pattern and taken a two month rolling average to smooth out some of the volatility in the monthly numbers (also note the left scale is the one relevant to the black line). The red line measures the average fixed mortgage interest rate charged by the major bank and it has been advanced or shifted to the right by four months to reflect how long it takes on average for changes in interest rates to impact on the number of house sales. After shifted the red line four months to the right or into the future you can see that most of the peaks in interest rates line up pretty well with the troughs in house sales, while the troughs in the interest rates generally line up with the peaks in house sales.

Most of the upside in the number of house sales to be driven by the significant fall in interest rates since they peaked in April still lies ahead given the normal lagged response, although the upturn is a bit behind schedule. And with all of the uncertainty created by the escalation of the international financial crisis in October it is possible the upturn in sales has been delayed further. Tighter lending criteria by banks and limited appetite by investors will also be playing a part in downsizing the response of house sales to the fall in mortgage interest rates. But it would be unprecedented for there not to be at least a moderate upturn in the number of house sales, like an increase to 5,000-5,500 per month, given the magnitude of the fall in mortgage interest rates to date (i.e. we think the train is running a bit late rather than having been cancelled). While the odds favour even lower mortgage interest rates driven by the RBNZ cutting the OCR.

The bottom right chart on the previous page shows the relationship between the number of house sales, which reflects mainly the level of demand for housing, and annual inflation in the national median house price (the black line which is based on an average of the REINZ and QV measures). Just as the number of sales takes four months on average to respond to changes in interest rates, annual house price inflation takes three months on average to respond to changes in the number of sales. This is represented in the chart by the red house sales line (right scale) being advanced or shifted to the right by three months as a leading indicator of annual house price inflation (the black line and left scale). So the lack of response by house price inflation to the initial plummet in the number of sales never meant prices would magically hold up in the face of much lower demand but rather just reflected the normal lagged response of prices to changes in the demand-supply balance. As the chart shows, the tumble in house price inflation has obediently followed the plummet in the number of house sales with close to the normal three month lag.

There are reasons, as discussed in our regular reports, why annual house price inflation may undershoot the near-term prediction provided by the bottom right chart on the previous page, but in terms of the timing of house price cycles the chart should remain as useful as ever. So based on our expectation that housing demand and the number of house sales will increase at least moderately over the next several months it implies that the downward pressure on house prices will abate in the first half of next year. This is why we expect the first stage of the correction in the housing market to end around mid next year.

The future and beyond

We specialise in assessing near-term prospects for house prices using tried-and-true leading indicators like those presented in the two charts at the bottom of the previous page. And based on the leading indicator approach our track record at picking what the national median house price will do in the year ahead is pretty good, both for upturns and downturns. Our **Housing Prospects** reports also assess near-term house price prospects for 24 cities/districts. Most of the 24 cities/districts and especially the larger centres have a high correlation with national house price inflation (i.e. our prognosis for near-term national house price inflation is the most important consideration in assessing house price prospects for most of the 24 places, although we supplement the national analysis with an assessment of the local demand-supply balance). But when it comes to predicting what will happen to house prices two years out or three years out our crystal ball is a bit hazy. However, when major cycles are in play, as is the case at the moment, we can provide valuable insights into the likely returns from investing in house over the next several years.

To do this we employ measures to assess whether housing represents good, bad or indifferent value like those on page 2, but our approach is not to be mistaken with the valuations that valuers provide which by design reflect what a property is worth in the current market not whether it represents a good investment. We analyse the dynamics of housing demand and supply (e.g. the economic incentive for people to buy versus rent and whether the financial/economic conditions favour young people living at home with Mum and Dad or buying/renting their own place). We look at historical local and international precedents. We look at the interaction between the housing market and the rest of the economy including the interrelationship with interest rates and net migration. And based on this analysis we expect stage two of the correction in house prices to be just as large as stage one but for it to have a quite different complexion.

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House prices only fall when demand is especially weak and when there are some people who are either forced sellers (e.g. mortgagee sales) or need to sell because of changed circumstances (e.g. they are leaving town for work reasons). And this is the environment we have been in for much of the last year and are still in. However, with the RBNZ determined to not only revive the economy from the recession but to also protect it from fallout from the international financial crisis, it seems a sure bet interest rates will be cut sufficiently to underwrite a reasonable upturn in house sales. Uncertainty surrounds how much interest rates will need to be cut to underwrite a rebound in the number of house sales rather than about whether there will be a sufficient upturn in house sales to end stage one of the correction in house prices.

It cannot be ruled out that the RBNZ will get overzealous in its attempts to revive the economy and defeat the economic fallout to come from the international crisis, just as it was overly enthusiastic in cutting interest rates in response to the 2001 and 2003 international crises. So if the world doesn't end as a result of either the crisis or an invasion by rabid chickens it is possible that housing demand will be high enough in the second half of next year to result in a mild to moderate increase in the national median house prices even though the housing market will still not by then represent good value for investors. But there are reasons why Governor Bollard will have limits on his ability to be Father Christmas. He has put his "go for growth" badge back on before he has the headroom needed to allow the economy to again grow at a strong clip. The relevant issues are addressed in our monthly **Interesting Times** reports – the most read economic reports by firms serious about managing business risks emanating from the economy. A future Raving about how to profit from economic cycles will also address this issue although the ETA of this Raving will depend on how the weather is for golf over the next few weeks.

Our best guess is that housing demand will be high enough to avoid another large fall in the national median house prices over the next few years but not strong enough to stop house prices falling relative to prices in general as measured by the Consumer Price Index (CPI). This is what happened after the last mega boom in house prices in 1972-73, as shown by the black line in the top right chart on page 2. This line measures what has happened to the national median house price relative to the CPI (i.e. the real or inflation-adjusted national median house price). Real house prices increase if actual house prices increase more or fall less than prices in general, while real house prices fall if actual house prices rise less or fall more than the CPI. After the 1972-73 mega boom the national median house price didn't fall but house price inflation ran well below general inflation meaning the real value or purchasing power of houses fell dramatically between 1974 and 1979 (around 50%).

During stage two of the correction in the housing market we expect real rather than actual house prices to do most of the adjustment, but it is likely to be a winding road along which there will be periods when house prices rise more than the CPI and probably also periods when actual house prices fall. And eventually housing in general will again represent a good investment. The key factor overseeing this adjustment, other than the fact that housing will still not be a good investment in general even after the end of stage one of the correction in prices, is that the recession is unlikely to be deep enough or long enough to provide the RBNZ with the headroom needed to allow a sustained period of strong economic growth to occur.

There is a time for every season, including a time to be negative about housing

Whenever people sign up to or unsubscribe from the complementary Ravings and Property Insights reports our website thoughtfully sends me an email with the details. If someone unsubscribes, which does happen occasionally, they are given the option to let me know why. I had a chuckle a few weeks ago when someone unsubscribed because our complementary reports were "too negative on property". It reminded me of the song Turn! Turn! Turn! Especially the following words: "A time to be born, a time to die; A time to plant, a time to reap; A time to kill, a time to heal; A time to laugh, a time to weep". See the following link for the full lyrics - http://www.lyricsfreak.com/b/byrds/turn%2Bturn%2Bturn_20026419.html.

If there was one time in a lifetime to be negative about property market prospects, especially residential property, this is it! But negativity for the sake of negativity is no more help in finding answers than is blind faith. We aim, armed with the best analysis and judgement around, to be negative when it is appropriate and to be positive when the piper is playing that tune. It makes me wonder if we will have people unsubscribe when we are next enthusing over the forthcoming boom in house prices, but for some strange reason I just don't see that happening. But thankfully the enlightened will stay tuned to this channel, and especially to our pay-to-view channel, because of the value we offer to firms and individuals wanting to make informed decisions.