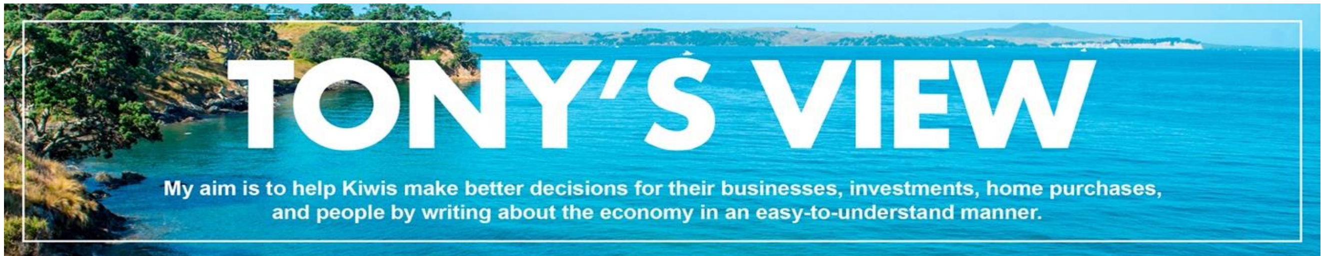

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Risk off too late

Early last year I gave a series of presentations to a large group of home building companies operating out of the South Island. What I told them was that we had entered the endgame for the boom in house prices and for the boom in house construction which had been underway since 2012.

I advised them not to blindly accept all the extra customer orders coming through and to take some risk off the table. My concern was that having boomed the home building sector had dragged in a lot of inexperienced, over-optimistic, and under-capitalised property developers and building contractors who would be weeded out when many problems building up in the sector grew stronger.

I specifically cited these factors as underpinning my concerns and my warning.

Record consents

The annual number of consents had soared from 13,500 in 2011 to just over 40,000. They had reached the highest number since 1975 although at 0.8% of the population were still well below the 1.3% back then. Nonetheless, such growth over a long period and with more in prospect raised the risk of many operators over-trading.

Effect of record low borrowing costs

Interest rates had been cut to record lows by the Reserve Bank in 2019 and again in 2020. Such rates could not last and the signs of strong growth in the economy meant that this special stimulus to growth, including from the printing of money, would soon start to get unwound. Construction is quite sensitive to interest rate changes both directly and via the impact on dwelling sales and prices which eventually affect construction.

False returning expat expectations

A lot of the surge in construction was in the belief that our handling of the pandemic was so great the one million Kiwi expats would be flooding back to our shores as soon as they could get into the country – and maybe the other 7 billion or so people on the planet would seek entry as well.

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I pointed out how misplaced such a belief was and that at some stage we would revert to talking about a brain drain rather than a migration-driven population boom.

Shortages everywhere?

I noted that there was a shortage of houses in Auckland courtesy of weak construction since shortly after the apartment building boom of the early-2000s. But outside of Auckland any shortages would be minor, and people were mistaking regional price movements driven by the spread of FOMO out of Auckland for market adjustments to rising occupancy rates/shortages.

FOMO frenzy

FOMO – the fear of missing out – had soared in the housing market but could not continue at the high levels seen from August 2020 through to February 2021. Just as eventually people would hop off the crypto pyramid scheme, they would also pull back from believing that house prices will always rise strongly, and they would be an idiot not to buy or build anything in order to make some easy money.

Staff shortages

I noted the existing shortage of staff and delivered a message that the shortages would worsen. This would cause soaring costs through higher wages and other labour-related costs, plus delays in construction.

The weeding out will be worse than expected

We can now see around us that developers are failing. From my various monthly surveys, I am seeing comments that development land scooped up during the frenzy is being placed back on the market. Some developers have erected billboards inviting investors. Some are failing and each week brings at least one story of a person who paid money for a house to be built failing to take delivery as yet and fearful that they have lost tens of thousands of dollars.

Buyers are backing away from ordering new houses and people in the building sector talk of a hole in their activity levels appearing in 6-12 month's time.

Not only is the correction I warned about underway, but it will be a lot greater a decline in magnitude than expected for a variety of reasons including these.

Consents hit 50,000+

The number of consents in the past year has soared from 40,000 to almost 51,000. The strains on resources are far greater than

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SMARTER THINKING, GREATER RETURNS.

anticipated and the dragging into the sector of inexperienced operators is even worse.

Brain drain

There is open talk of a brain drain of young people from New Zealand (home buyers and construction staff) in response to the soaring cost of living, high house prices, and high demand for labour in Australia in particular. Wages are much higher across the Tasman than here in New Zealand and the incentive to shift much larger than was looking to be the case a year ago.

This brain drain will not just mean fewer buyers but will eat away at the sentiment of Kiwis not leaving, making them less willing to commit to a new (or used) house purchase.

Cost of living impact

None of us anticipated that the average household cost of living would soar by 6.9% in the past year even though we did expect a rise from 1.5% back then. The strain on household budgets is contributing to the outflow of people from New Zealand and a greater whipping back down of housing demand than we ever thought would be the case.

Accelerated mortgage rate rises

Mortgage interest rates have risen at a faster pace than anticipated and that pace globally is accelerating. Central banks have finally realised their efforts to combat a pandemic-induced depression have contributed to soaring inflation they must quickly get back under control.

Even before central banks effectively decided in recent months and weeks to pass an interest rates shock through their respective economies, borrowing costs here had already gone up by 2% - 3%.

Again, the interest rate-induced slashing of housing demand is much greater than I anticipated early last year.

House prices 15% more ridiculous

House prices rose another 15% from where they were during my series of talks early in 2021 through to the peak in November. The market became much more over-priced than expected and the potential/need for a correction back the other way towards more sustainable prices is thus a lot greater. So far that extra 15% has been only half removed.

Falling prices have a spiralling downward effect on demand as we have recently seen in the markets for shares and crypto cons.

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Russia invaded Ukraine

Just as luck would have it, at exactly the same time as the excesses caused by irresponsibly loose monetary conditions came due for correction, Russia has invaded Ukraine. This has caused an energy price shock to run through the world economy and there is a well established correlation between energy prices rising and economic activity cooling substantially, often resulting in global recession.

China still naked against covid

Also, China has failed to vaccinate its population against Covid-19 and sits as naked and exposed now to the illness as was the case for all of us before we were vaccinated. The new China environment of shutdowns of factories, neighbourhoods, cities and ports at any time means supply chains for the world will remain disrupted well into next year.

The upshot of all of these extra pressures on top of the ones I identified for the builders in my audiences over a year ago is that FOMO has collapsed, FOOP has soared, and the reality check on the home building sector will be worse than it would otherwise be.

The horse has bolted

It is now too late to take risk off the table. Most operators will in some way or another be exposed to others in the sector who in turn are exposed to some of the many over-optimistic people who will see their businesses liquidated in the coming two years.

Does this mean that house construction will collapse? It will certainly fall fairly soon. But the backlog of orders is so great that the extent of the decline will be limited.

We have all proven that we don't have models which can accurately predict construction levels. But it seems reasonable to expect the annual number of consents being issued to fall from 51,000 to below 40,000 in the coming 12 months and 30,000 the year after.

Fundamentally, Auckland remains under-supplied with houses. But I remain doubtful that the same thing can be said for most other parts of the country. In particular I am of the view that in some regions there has been a surge in construction amidst talk of deep shortages on the basis of a population surge in the past two years caused by the pandemic. Many people have shifted to the regions either because they can work from home (small numbers I suspect), or they have brought their long-lasting retirement-related relocation plans forward in time.

Many people who were going to sell up in Auckland and shift to the regions over 2023-25 may have already done so.

Housing markets move in cycles. The upward leg of the construction cycle has been a decade-long doosy. We are in the early stages of a correction which might run for 2-3 years. A challenge for the government and the sector will be keeping the flow of newly trained tradespeople in New Zealand as they see businesses fall over and job availability eventually deteriorate from perhaps late this year.

And one final point. In 12 months there will probably be an over-supply of plasterboard in New Zealand.

If I were a borrower, what would I do?

Nothing I write here or anywhere else in this publication is intended to be personal advice. You should discuss your financing options with a professional.

Monetary policy volatility

Our central bank, by focussing on maximising employment well above sustainable levels and failing to recognise what the economy was doing despite having the biggest group of economists in the country, did not competently implement monetary policy last year. The cost of their excessive stimulus applied to the NZ economy and loss of focus on low inflation is now being borne by the many borrowers who bought houses on the basis of unusually low mortgage rates last year not realising the whipping back up which would occur.

The cost is also being borne by a generation of young people forced to pay high prices for a house and take out high debts because the Reserve Bank provided such strong encouragement for people to treat housing as an investment rather than a home. Excessive monetary policy easing turned housing into a pyramid scheme.

The cost is also being borne by employers unable to find staff as they are heading off to Australia for not just higher wages but cheaper housing.

The cost is also about to be borne by many people who have entered the unrealistically booming home construction sector over the past

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year who will see their family wealth disappear as their businesses fail in the next 2-3 years.

It should be noted that conduct of monetary policy in Australia has also been very poor. The Federal Reserve Board also has little to be proud of regarding not recognising the inflation threat early enough.

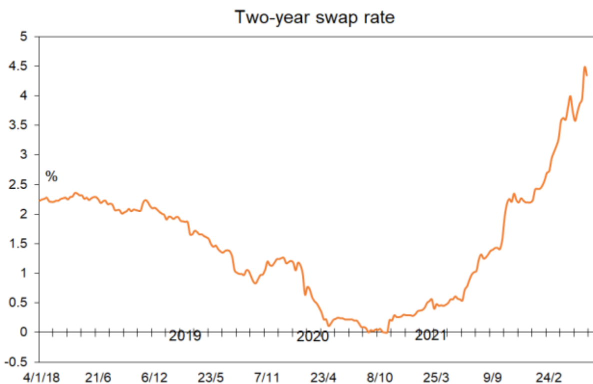
Now our central bank, like other central banks caught up in a messiah complex, is scrambling to re-establish credibility, but with extra ground to catch up. There are risks in this.

Further upside beckons for NZ interest rates as the Reserve Bank factors in higher than expected inflation rates offshore and some weakness in the NZ dollar.

However, and this has been my key message since early this year, the crunch in household spending which the Reserve Bank needs to eventually crush inflation is well underway. My monthly Spending Plans survey fell into negative territory in February and shows extra deterioration in spending plans over the past two months. The Westpac McDermott Miller sentiment reading has caught up with these already reported sentiment declines and fallen to a record low.

Monetary policy whipped down too far. It risks now over-shooting on the other side as the Reserve Bank strives to rebuild its lost credibility. Then it will whip back the other way. Meaning what? Meaning that NZ interest rates are likely to start falling earlier than most people are thinking. Hence the incentive for borrowers to grit their teeth and fix short rather than long. It comes down to one's ability to ride a roller coaster running on a steep central bank track.

This week there has been something of a shift in emphasis around the world away from picking how high inflation rates will go and the pace with which monetary policies will be tightened, towards the implications of the increasing probabilities of national recessions.



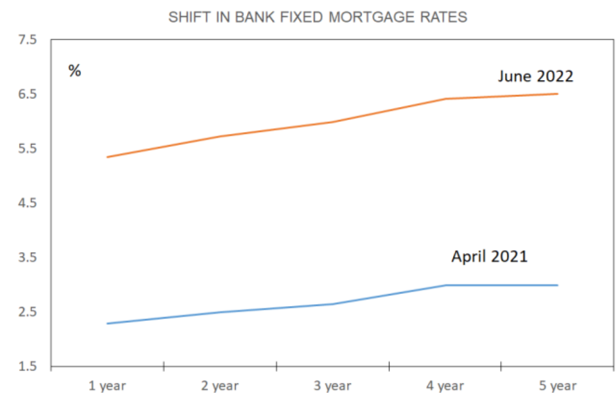
These new recession worries have contributed to a decline in the US ten-year government bond yield this week to 3.15% from 3.4% last week. They have also placed some mild downward pressure on NZ swap rates at which banks borrow to lend for fixed rate mortgages. Assistance here came from Australia's Reserve Bank Governor making comments implying little chance of a 0.75% rate rise there in the near future.

Conditions are volatile in all financial markets currently and people should be careful not to become overly pessimistic about where things are headed, and not to also be too complacent about the challenges which central banks face. My concern is that established behaviour of our central bank means that just as they failed last year, they may also get things wrong for the next couple of years and continue to be a source of instability in our economy.

For that reason, there is a greater need to think about interest rate risk management in terms of protecting yourself against the poor performance of our central bank as well as the usual uncertain economic factors. A spread of fixed rate terms may best suit most business and farming borrowers. For homeowners it perhaps pays to note that banks are competing mainly in the one-two year areas, cash back offers have returned, and medium to long-term rates are so high I wouldn't touch them with a bargepole.

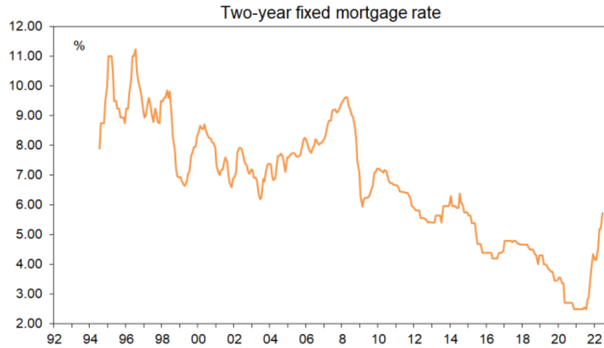
Most major lenders have increased their fixed mortgage rates this week, and given that the rest will soon follow, the data I am using this week are based on the new rates established by the early movers rather than the lowest of the lot.

The common five-year fixed rate has now risen from last year's 2.99% which I was such a fan of to around 6.2% - 7.0%. The following graph shows how fixed rates are now 3.0% - 3.5% above their lows of last year.



Restraint on the housing market from a sharp jump in mortgage rates is already in place – hence the dearth of buyers. There is little extra

real estate weakness to come from tightening monetary policy.



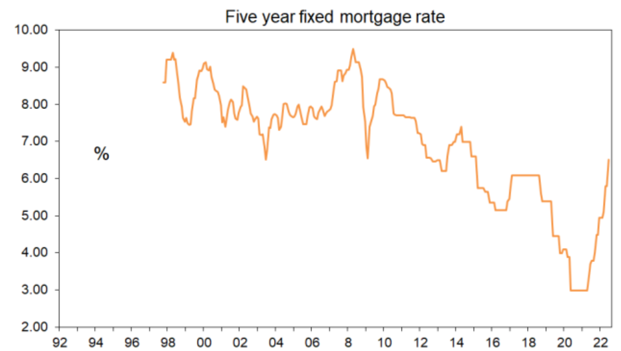
But restraint on household spending from rising rates will not peak until the turn of the year when most borrowers will reset to much higher rates.

My current expectation for the one-year fixed mortgage rate in June each year is shown in the first column of the table below. I focus on that rate because there are many people who have fixed one-year repeatedly since 2009 and the strategy has worked very well.

The second column shows what the one-year rate will average over the next 2-, 3-, 4-, and 5-year periods. The last column shows the current best 2 – 5 year fixed rates charged by the lenders I track.

	Forecast 1 year rate	Rolling average rates	Current fixed averages	
2022	5.35		5.35	1 yr
2023	5.75	5.55	5.73	2 yr
2024	5.00	5.37	5.99	3 yr
2025	4.25	5.09	6.41	4 yr
2026	4.00	4.87	6.51	5 yr

If these forecasts prove correct (I'd give that a 10% probability), rolling one-year fixed will deliver an average rate for the next two years of 5.55%, three years 5.37%, four years 5.09%, and five years 4.87%.



If I were a borrower, what would I do?

I would not fix longer than two years.

To see the interest rates currently charged by major lenders go to www.mortgages.co.nz

Tview Premium contains more interest rates discussion and graphs than included in Tony's View.

Links to publications

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