WESTPAC HOME TRUTHS

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Michael Gordon, Acting Chief Economist
+64 9 336 5670
michael.gordon@westpac.co.nz

Keeping up with the times.

- We've downgraded our house price forecast to a 15% decline over two years.
- We correctly identified that house prices would fall as mortgage rates rose from their lows.
- But mortgage rates have now gone well beyond what we expected, as expectations of Official Cash Rate hikes have ramped up.
- We think that the market is overcooked in that regard, but we also recognise that it's likely to remain that way for a while.
- That will mean further downward pressure on house prices this year.

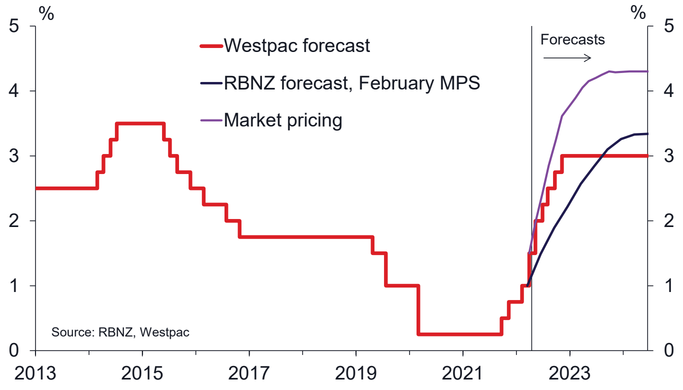
New house price forecast: A 10% drop this year, and a further 5% next year.

Since our last *Home Truths* in February, the housing data has validated our view that the market has turned. House prices have been falling since the end of 2021, and at a fairly rapid pace compared to history (considering that any drop in prices at all is a rare occurrence). Higher mortgage rates, and in particular the sharp rise in fixed-term rates that began around September last year, are having the impact we expected on what buyers are willing to pay for a property.

We've held a fairly consistent line on interest rates in recent times. Back in November, we predicted that the Official Cash Rate would reach a peak of 3% over the next couple of years. At the time, that was at the top of the range of market forecasts, and indeed we faced some questions about whether the economy could really withstand a rise in interest rates of that scale.

But since then, market opinion has caught up to and even overtaken our view. By February, interest rate markets were also factoring in a peak OCR of around 3%; today, that implied peak is now substantially above 4%. Whether that's a genuinely held view about local economic conditions, or whether we're just being dragged around by overseas markets, is a moot point. The fact is that it's the market interest rates that determine banks' funding costs, and hence what they charge to borrowers.

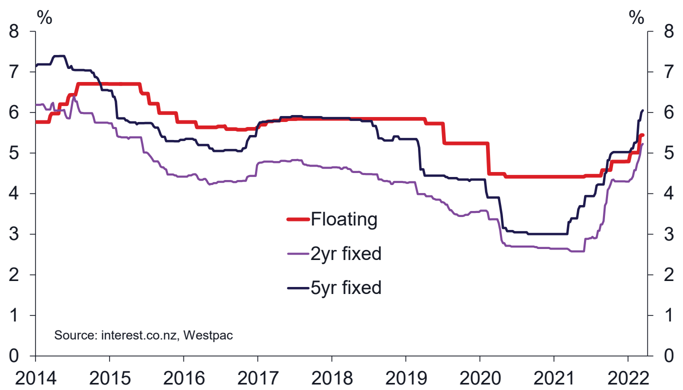
Official Cash Rate



As a result, mortgage rates have already risen beyond where we expected them to peak in this cycle. And while we'd argue that the market is overcooking it in terms of the OCR outlook, the reality is that it will continue to do so until given a clear reason to think otherwise. (That reason will be a substantial drop in house prices, making it something of a self-defeating prophecy.) So it's time to refresh our forecasts of where house prices will go in the year or so ahead.

The first step is that we need to make a judgement about where mortgage rates will peak. In our previous forecasts we – perhaps optimistically – assumed that market interest rates would settle somewhere broadly in line with our OCR view. That would have seen, for example, a two-year fixed term mortgage rate top out at a little under 5%. The two-year rates currently on offer are around 5.2%, and it's likely that they have further to go in the near future.

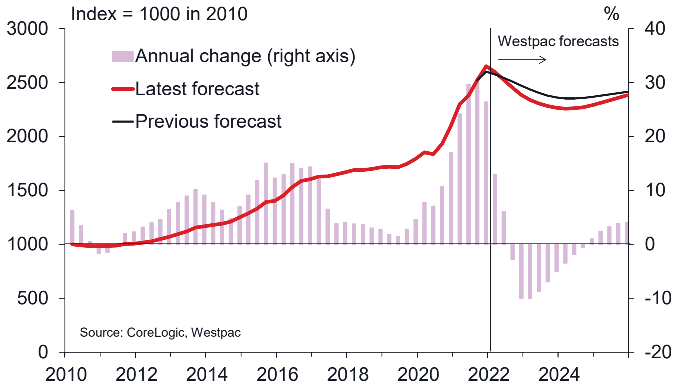
Average advertised mortgage rates



We maintain our view that fixed-term mortgage rates are much closer to their peaks than their troughs for this cycle. There is so much tightening already baked into the market that even if the Reserve Bank did lift the OCR all the way to 4%, fixed-term mortgage rates won't need to move anywhere near as far. That varies depending on the length of the term – a one-year rate will still continue to rise as we approach the date of the peak OCR, whereas a five-year rate need not rise much further at all.

Armed with our new mortgage rate assumptions, we find that our 'fair value' estimate of house prices is likely to fall even further below current prices than we previously thought. As we've detailed before, our 'fair value' model is based on financial factors – mortgage rates account for most of the variation, but rental yields, tax settings and expected inflation also play a role. We don't use this model alone to produce a house price forecast, but it does provide an important steer on the market's direction – house prices will tend to move towards the 'fair value' when there is a substantial gap between the two.

House price forecasts



Accordingly, we've revised our view of how far house prices will need to adjust to bring the market more into balance. We previously expected a 10% peak-to-trough fall in prices over this year and the next; we now expect a total drop of 15%. We've also front-loaded the fall, with a 10% drop in 2022 and a further 5% in 2023.

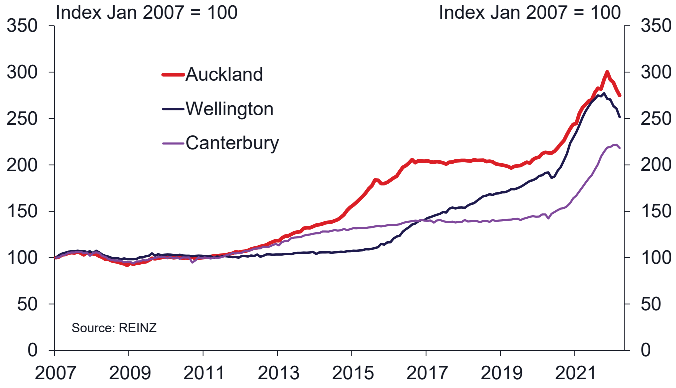
A 15% drop seems very large compared to history, but to put it in context, it would only take average prices back to where they were at the start of 2021. That just illustrates the ferocity of the rise in house prices during what turned out to be a brief period of super-low interest rates.

We should note that our forecast is based on the CoreLogic house price index, which is a quarterly average. A higher-frequency measure like the REINZ monthly house price index will see a larger peak-to-trough decline than this. Also, it's a forecast of the national average; we don't forecast house prices by region, but obviously there are some regions that will see a bigger than average decline, and indeed are already on track to do so.

The REINZ index shows that prices have already fallen by 4.7% in the four months to March, with the downturn now spread widely across the country. The April figures are expected to be released next week, but other indicators such as listings on realestate.co.nz, and the Auckland sales figures from Barfoot & Thompson, suggest that the market remained in decline. Both sellers and buyers are stepping back from the market, but the latter are stepping back faster, which means that the stock of unsold homes has risen to a three-year high.

Our modelling suggests that a true 'market clearing' price right now would be more than 15% below current levels. However, we also consider the dynamics of the housing market when we form our forecasts. In the absence of distressed sales (which we don't expect to be a major factor), property owners generally won't sell at a loss if they don't have to. This means that some of the adjustment will come in the form of lower turnover instead of lower prices.

REINZ house price index by region



Property listings, seasonally adjusted

Contact the Westpac economics team

Michael Gordon, Acting Chief Economist
+64 9 336 5670

Satish Ranchhod, Senior Economist
+64 9 336 5668

Nathan Penny, Senior Agri Economist
+64 9 348 9114

Paul Clark, Industry Economist
+64 9 336 5656

Any questions email:
economics@westpac.co.nz

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