# Home Truths

13 June 2019

## Capital gains tax-free: Why we expect house prices to rise

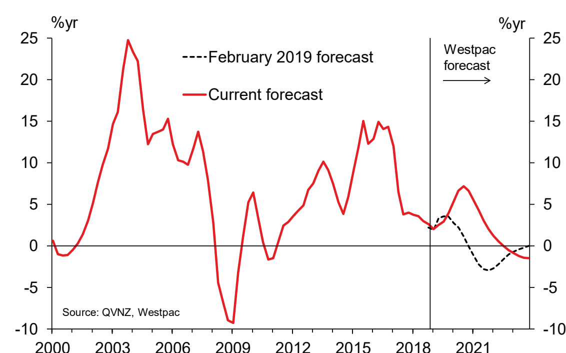
- The New Zealand housing market has cooled recently. Prices are falling in Auckland, and the pace of increase has slowed in a range of other regions.
- But the cancellation of capital gains tax combined with sharply lower mortgage rates will be game changing.
- We expect house price inflation to rise from about 2% now to 7% next year.
- Underlying this will be moderate price growth in Auckland, and more rapid increases elsewhere.
- We expect currently-stagnant Canterbury house prices to start rising more in line with the rest of New Zealand in the near future.
- We are only forecasting a temporary housing market upturn. House price inflation is expected to fizzle beyond 2021 due to rising mortgage rates and the alleviation of housing shortages.

**Westpac house price forecasts**

| | Auckland | Canterbury | NZ ex Auckland and Canterbury | Total NZ |
|---|---|---|---|---|
| 2019 | 0% | 4% | 9% | 4% |
| 2020 | 5% | 9% | 9% | 7% |

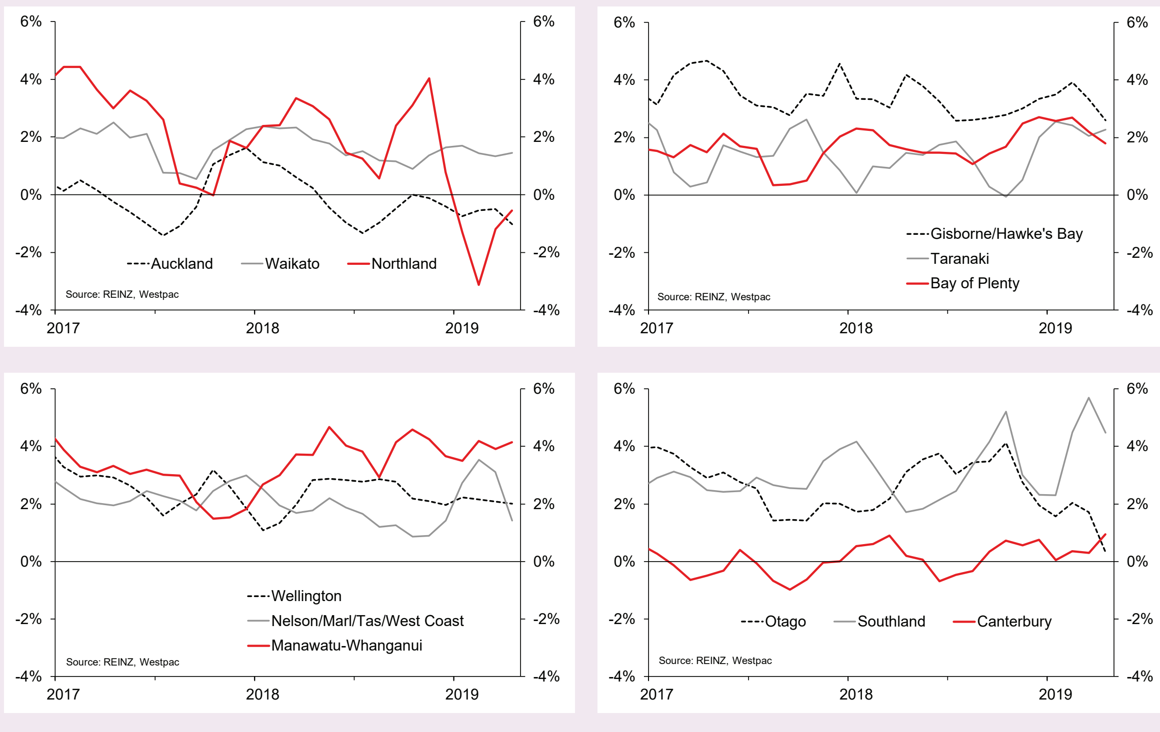
The New Zealand housing market has slowed substantially over the past two years. But the recent cancellation of capital gains tax combined with plunging mortgage rates will be game changing. We expect nationwide house price inflation to lift from 2% at present to 7% over 2020. This bulletin explains how we reached that conclusion, while taking a tour through key issues such as the foreign buyer ban, the split between Auckland and the rest of New Zealand, tax changes, mortgage rates and housing shortages.

**Figure 1: Changes to Westpac's house price forecasts following the cancellation of CGT and reduction in mortgage rates**




On a nationwide basis, house price inflation has slowed from 16% in 2016 to about 2% now. Until recently, the slowdown was concentrated entirely in Auckland (where prices have fallen 4.3% since January 2017) and Canterbury (where prices have risen just 1% over the same period). Over 2017 and 2018 house prices were booming in many other parts of New Zealand, but recently the pace of house price inflation has slowed in Northland, Bay of Plenty, Gisborne/Hawke's Bay and Otago.

**House price growth in regions of New Zealand: Average over three months compared to previous three months**




Over the past two months the facts on the ground have changed dramatically for the housing market, and we think the trajectory of the market is going to change accordingly.

The first big change is that the Government has unexpectedly dropped its proposal for a capital gains tax (CGT). It now looks unlikely that CGT will be introduced any time in the coming decade, whereas two months ago some form of CGT looked probable.

The cancellation of CGT is a tragedy for the efficiency and fairness of the New Zealand economy. Efficiency will suffer as New Zealanders continue to chase land-based investments rather than other productive investments, since the latter are taxed more heavily than the former. Fairness will suffer because those who own houses will continue to enjoy tax-free capital gains, while those who pay rent will do so out of their after-tax income. Not to mention that those who don't own houses will be taxed on their labour income and the interest on their savings as they work towards a deposit. New Zealand will continue down the path of falling home ownership rates, because the lack of capital gains tax will continue to incentivise property investment. And most importantly, house prices will remain higher than they would be if we had a capital gains tax.

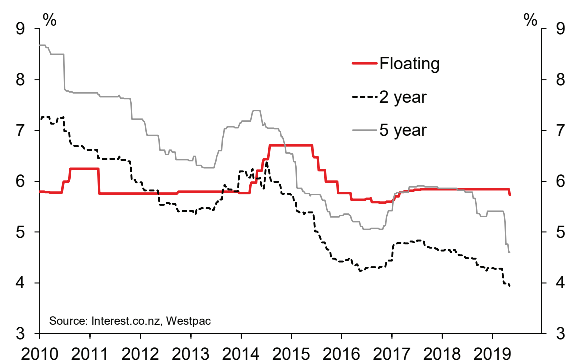
Earlier this year, our house price forecasts incorporated an assumption that some form of capital gains tax would be introduced in 2020, causing a period of house price decline. The rationale for expecting house prices to fall next year has disappeared, and we have lifted our 2020 house price forecast accordingly.

Actually this is not just a forecasting issue – the cancellation of CGT will affect the market immediately. The threat of CGT was previously hanging like a Sword of Damocles over the market, impacting sentiment and prices here and now. Now that the threat has gone, there will be an immediate improvement in market sentiment and a "relief rally" in prices.

## Interest rates and house prices

The second big change recently has been a very sharp drop in mortgage rates. Wholesale fixed interest rates have plunged following the Reserve Bank's recent change of tack towards lowering the OCR. The consequence has been a near-40 basis point drop in the average two-year fixed mortgage rate. Two year fixed rates are now sixty basis points lower than a year ago. Five year rates have fallen even more sharply, and are now 120 basis points lower than a year ago.

**Figure 2: Average advertised mortgage rates**



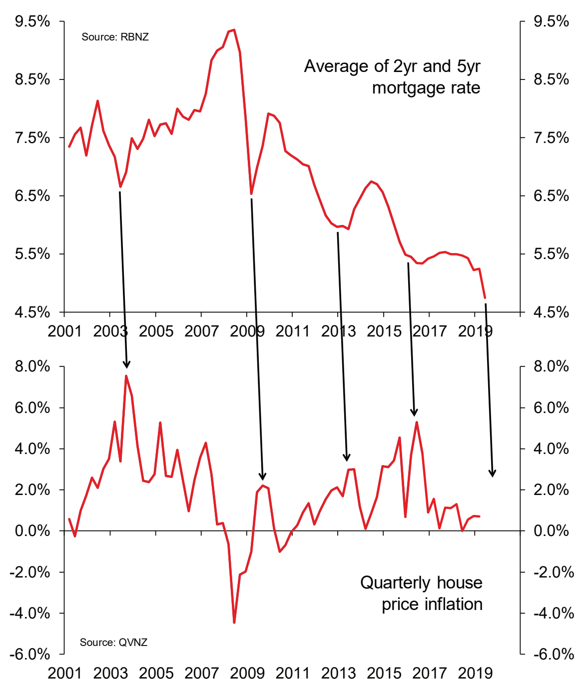

In general, lower interest rates cause higher asset prices. Low interest rates cause investors to buy assets in a "search

for yield" when they can't get much from a simple bank deposit. And low interest rates reduce the cost of asset ownership (indebted owners find borrowing cheaper, and for those using their savings to buy an asset the opportunity cost is lower).

The New Zealand version of this phenomenon is that lower mortgage rates reliably lead to higher house prices. Lower mortgage rates make borrowing money to buy a house more affordable – a homebuyer can now pay 10% more for a house while still making the same interest payments on a two year fixed mortgage. For a landlord, being able to lock in low fixed rates means that the numbers are more likely to add up on a new investment. And New Zealand savers who become fed up with even-lower term deposit rates will probably cast their eye to property ownership before anything else.

Over the years we have found that the ups and downs in mortgage rates have been a great guide to how the housing market will fare over the coming year or two – figure 3 shows how the link has worked in practice. Importantly, we find the ups and downs in mortgage rates are much more important than physical supply and demand in determining short-term house price dynamics. The various models we use to link interest rates and house prices are all pointing to house price growth in the low-double-digits over the year ahead. However, we have discounted our forecast down to 7% because the market is facing some offsetting negative drivers.

**Figure 3: Quarterly house price inflation and mortgage rates**




## Overcoming the negatives

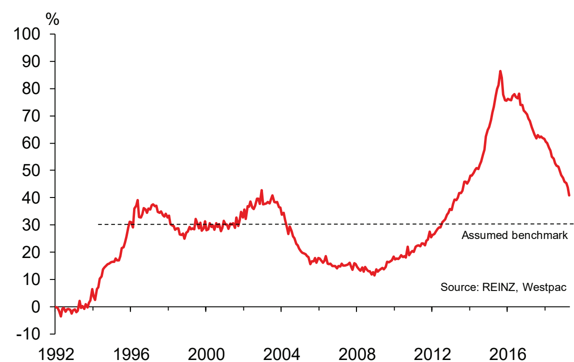
The Bright Line Test, under which capital gains are taxed if an investment property is flipped within five years, has been a negative for the market over the past year, although the impact on prices has probably now passed. This year "ring fencing" will be the new issue – property investors will no longer be able use losses on rental properties to reduce their overall income tax bill, although they will still receive tax credits that can be used to offset future taxable income from their property portfolios. Our research indicates that deductibility was worth between zero and 6% of a house's value to a property investor, depending on how leveraged they are. We reduced our year-ahead house price forecast by a couple of percentage points to allow for the impact of ring fencing, and we anticipate the market tilting towards less leveraged property investors.

## What about falling Auckland house prices and the foreign buyer ban?

The biggest negative, and the biggest unknown, for the market at present is the foreign buyer ban. This is mainly affecting Auckland. Foreign buyer data has shown that foreign buyers play a significant role only in Auckland and Queenstown Lakes. But in Queenstown many of the foreign buyers are Australian and are therefore exempt from the ban, leaving Auckland as the key place to focus on.

To understand the Auckland market, figure 4 shows how the relative price of houses in Auckland and the rest of New Zealand have evolved since 1992. Consider two houses, one in Auckland and one elsewhere, that were each worth the same dollar value in 1992. By 1995 both houses had risen in value, but the Auckland house had risen by 30% more. Auckland maintained that 30% premium for the best part of a decade. Some of that premium dissipated in the mid-2000s, but it reappeared in the early-2010s. But then in the mid-2010s something unprecedented happened – the Auckland house price premium suddenly blew out to 80% above the 1992 level.

**Figure 4: House prices in Auckland relative to rest of New Zealand**
**(Change in relative price since 1992)**




One factor behind the Auckland relative price bubble may have been a rush of buyers from China. Vancouver, Sydney and Melbourne all experienced similar house price booms over and above their respective countries, and were also reportedly target cities for Chinese buyers. The Chinese authorities cracked down on capital exiting the country from 2016 onwards, and since that time Sydney, Melbourne,

Auckland and Vancouver have all had much weaker housing markets than the rest of their respective countries.

Another possible driver of the Auckland bubble was the release of the Unitary Plan. At the time, we highlighted that this had created a rush to buy favourably zoned land, which might subsequently have faded.

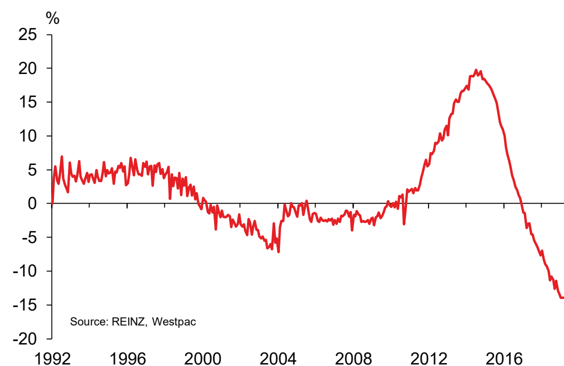
Either way, figure 4 illustrates that the Auckland relative price bubble has well and truly burst. Recently, Auckland house prices have slowly fallen while prices in the rest of New Zealand have risen rapidly. Consequently, the Auckland premium has shrunk dramatically from 80% above the 1992 level to just 40%.

We regard 30% above the 1992 level as a reasonable benchmark for the Auckland premium. We cannot see why the Auckland premium today should be smaller than the premium that prevailed for a decade from 1995 until 2005. Our expectation is that Auckland house prices will continue to underperform the rest of New Zealand only until the Auckland premium returns that benchmark 30% level. On that basis, we are forecasting Auckland house prices to flat line this year, and to rise 5% next year, while prices in the remainder of New Zealand rise at a high-single-digit pace. Beyond next year, we expect Auckland house prices to behave similarly to prices in the rest of New Zealand.

## The Canterbury market

The other exceptional housing market in recent years has been Canterbury. Prices and rents shot higher in the wake of the earthquakes and the resulting shortage of housing. Canterbury house prices rose by 20% more than prices in the rest of New Zealand ex Auckland (see figure 5). But as stock has come on line – and as the market has foreseen more stock coming in the future – the price of Canterbury houses has dropped away. Relative to prices in the rest of New Zealand ex Auckland, Canterbury house prices have fallen 35% from their peak, and are now trading 15% below the relative prices that prevailed before the earthquakes. We doubt that Canterbury will trade at a bigger discount than that – the relative attractiveness of living in Canterbury has not changed that dramatically.

**Figure 5: House prices in Canterbury relative to New Zealand ex Auckland (Change in relative prices since 1992)**




We expect the Canterbury housing market to turn around soon. We are forecasting Canterbury house price inflation of 9% for 2020, which is the same as the rest of New Zealand ex Auckland. Note that this is only enough to keep the Canterbury house price discount steady – restoring the relative prices that used to prevail would require a much bigger housing market upturn in Canterbury than we are forecasting.

In fact, there are already signs that the Canterbury housing market is turning around. Prices have been creeping higher in recent times, market turnover is up, the stock of unsold homes sitting on the market is down, and rents are rising.

## Physical supply and demand, and the longer term outlook for house prices

Physical supply and demand conditions have not changed much recently, and therefore have little bearing on the near-term price outlook. The number of people per dwelling in Auckland remains extremely high, indicating a severe shortage of dwellings. There is a less severe shortage in Wellington and a few other centres. But now that net migration has slowed and construction activity has lifted sharply, the number of people per dwelling has more or less flat lined. In other words, building activity is now roughly commensurate with population growth and shortages are currently getting neither better nor worse. This means physical supply and demand is not really influencing rents or prices one way or the other at present.

**Figure 6: Westpac net migration estimates and forecast**

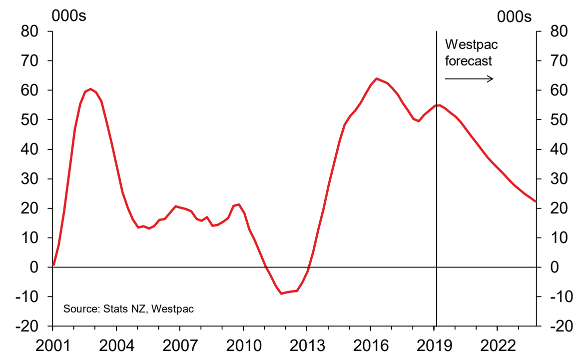
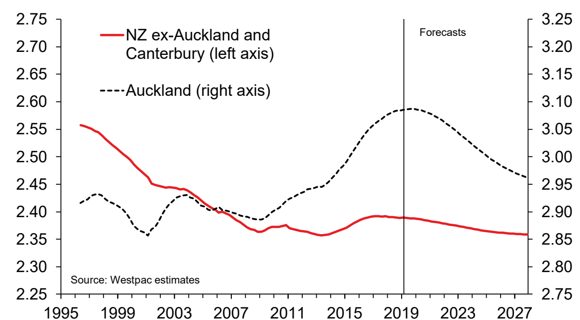



**Figure 7: Number of people per dwelling, Auckland and the rest of New Zealand**



It will be a different story further into the future. We expect construction activity to remain very high for some time, while net migration drops. In time, this will cause dwelling shortages to gradually diminish. This will put downward pressure on rents and house prices (although other factors such as interest rates and tax policy will remain more influential for house prices). The expected alleviation of housing shortages is one reason we expect house prices to stagnate or fall later in the 2020s.

Another reason to expect flat or falling house prices later in the 2020s is rising mortgage rates. The same logic linking lower mortgage rates today to higher house prices in the short term applies in reverse. We expect mortgage rates to rise through the 2020s due in part to a slowly rising OCR, and due in part to the Reserve Bank's requirements for banks to hold more capital, which will push mortgage rates up independent of the OCR. This general rise in mortgage rates will push house prices down relative to rents in the mid-2020s.

The final negative for house prices next decade is that we expect tighter credit conditions in the 2020s. In recent times, credit conditions have eased. Since the RBNZ loosened its LVR mortgage lending restrictions at the start of the year, the frequency with which banks lend more than 80% of a house's value has increased. But the Reserve Bank is steadily imposing more onerous microprudential regulation on banks. That, combined with the aforementioned bank capital requirements, is likely to lead to tighter credit conditions next decade, which will tend to constrain the housing market.

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