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Westpac InstitutionalBank

House prices: further to fall

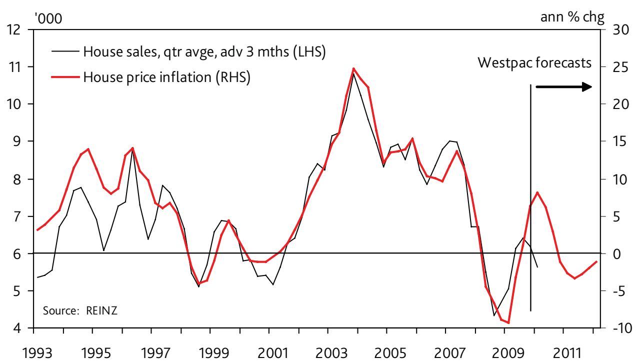
Housing market update July 2010

- **The housing market has been slow over 2010, with low sales, lengthening time to sell, and gently falling prices.**
- **We predict more of the same. House prices have further to fall.**
- **Income tax cuts will reduce the fundamental value of property. Adjustment will involve higher rents, lower prices, and higher home ownership.**

The state of play – past and predicted

It has been a slow year for the housing market. Sales have been subdued all year. Inevitably, the time taken to sell a house has lengthened. The REINZ's House Price Index indicates that prices are now falling, at a gentle pace. And the state of house sales is a solid indication that prices will continue declining through to about September. As we predicted in our last housing update, the 2009 market resurgence turned out to be a "flash in the pan."[1]

Figure 1: House prices and sales



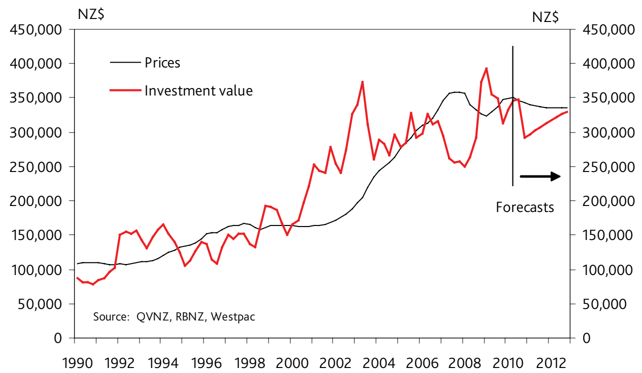
Bugging the market over 2010 have been rising interest rates, impending tax changes, and slowing population growth. The positive vibe of an improving economy has not been enough to counterbalance these negatives. We foresee more of the same. Interest rates will rise further, tax changes are now an unfavourable reality for property prices, and population growth is still slowing. So we are forecasting modest house price declines, in the order of 2% per annum, for 2010 and 2011.

We expect house sales will pick up briefly as property investors reorganise their affairs in light of the new tax reality. But beyond the next few months, we anticipate a long period of fairly subdued house sales. People are less inclined to upgrade their house, or get into property, when prices are flat or falling.

House price overvaluation

In late-2007 we noted that houses were grossly overvalued, and predicted house prices would be *"in five years' time similar to today"*[2]. Almost four years on, prices are 3% lower than they were back then. Over the same period inflation has been 8.8%, so the real house price decline has been almost 12%. We are "almost there" in terms of the adjustment necessary to correct the mid-2000s house price overvaluation.[3] Based on today's fundamentals, we'd say houses are only slightly overvalued. However, impending tax changes will reduce the fundamental value of houses, creating a renewed reason to expect ongoing price weakness.

Figure 2: Prices versus investment value



***Note:** The investment value approximates the value of a median NZ house to a property investor, taking into account interest rates, tax, inflation, and rent. The income tax cuts affect the investment value in December 2010 quarter. Details of the model are in Appendix 2.*

[1] Westpac bulletin *"Flash in the pan"*, 4 June 2009 (available on request).

[2] Westpac bulletin *"House of sticks or bricks"*, 15 November 2007 (available on request).

[3] Our estimate of overvaluation was more modest than others because we saw no reason to presume the house price to income ratio that prevailed in the 1990s would reassert itself. Changes in taxes, interest rates, and inflation have made property ownership more attractive relative to the 1990s. Restricted land supply might also have pushed up prices. Our estimate of overvaluation took account of these mitigating factors.

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Tax changes and house prices

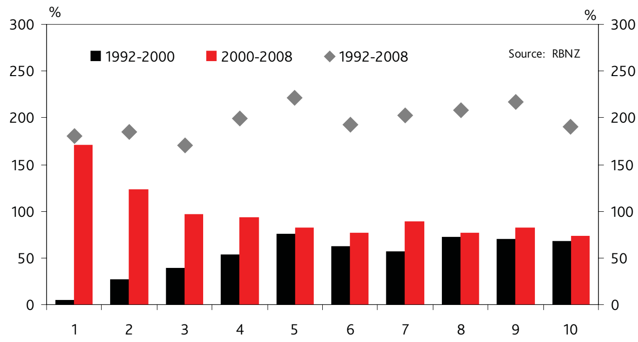
The cut to income tax will reduce the tax-shelter value of property ownership. The link between income tax and house prices is obtuse, so in the appendix we've provided two practical examples of how tax cuts will reduce the incentive to own property. The link exists because New Zealand's tax system allows property owners to avoid income tax while enjoying tax-free capital gains. Landlords receive tax rebates for cash losses on their properties, but their capital gains are usually untaxed. The recent tax cut will make landlords' annual rebates smaller, thus increasing the cost of owning an investment property. Freehold owner occupiers avoid income tax in the sense that any other investment would incur income tax on the flow of benefits, while owner occupied housing does not.[4] The tax cut will improve the return on alternative investments relative to buying a bigger/better house.

Other tax changes have smaller implications for house prices. Much has been made of the removal of depreciation allowances, but that's actually a minnow. It will seriously harm cash flow for a few highly-leveraged property investors, but it will only slightly reduce the overall attractiveness of property investment by removing what was, in effect, an interest free loan (investors were required to pay back any depreciation claims upon sale, had the property not actually depreciated). The GST hike is positive for prices on two fronts – it drives up the price of building new houses, and it makes housing (which is exempt from GST) a more preferred form of consumption.

We estimate that house price inflation over the next few years will be about 10% less than it would have been if the tax system had remained unchanged. The Treasury's estimate of the price impact was more modest, at 2%. With landlords now receiving a smaller tax subsidy, the yield on rental properties will have to rise. Our calculations suggest rents will end up about 7% higher than they would have been had the tax system remained unchanged. Finally, higher rents and lower house prices will tend to increase the rate of home ownership, relative to what would have occurred in the absence of tax change. It will take years for these changes to work through the market. Most likely, we will experience years of higher rent growth and weak house prices, rather than a big-bang adjustment as soon as tax cuts are implemented.

We expect lower-end property prices will be hit hardest by the reduction in income tax. Landlords will probably prove more sensitive to tax, and they are most active in the cheaper market segments. Furthermore, the potential buyers of top-end properties will get the biggest after-tax income boosts, so prices in that bracket should outperform. We expect an element of "price dispersion" in the market over the next few years, similar to the experience of the 1990s when tax changes were unfavourable to landlords and favourable to high income earners. The opposite (price compression) occurred in the 2000s *(see Figure 2)*, after the introduction of the 39 cent income tax rate enhanced the incentive to buy rental property and simultaneously reduced after-tax incomes of top-end wage and salary earners.

Figure 3: Growth in property values by price decile of suburb



Interest rates

The 2009 boost to the housing market may have been partly caused by buyers rushing in while mortgage rates were low. Now that floating rates are on a rising trend, buyers seem more reluctant. We expect floating mortgage rates to steadily rise to a "new normal", higher than the average that prevailed in the 2000s. Bank funding costs are much higher than they were last decade, and the Reserve Bank cannot use the OCR to shelter us from that forever. Higher average mortgage rates over the coming years will curtail affordability and reduce demand for housing – yet another reason to anticipate subdued prices.

Economy

As we've said elsewhere, the NZ economy is well into the recovery phase that normally follows recession. Unemployment is falling, and job security is much improved. The situation is expected to improve further over the next couple of years as wage growth eventually accelerates from its current snail's pace. Better job prospects should encourage more youngsters to fly the coop and enter the rental market.

Supply/demand balance

The final reason to expect subdued house prices over the next few years was covered in last week's bulletin on housing supply/demand balance. The 2009 price spike may have been partly related to an emerging housing shortage, as population growth was high and house building was low. By our reckoning the housing shortage is now stabilising and the situation will begin to normalise next year. This implies that the "shortage premium" will wane over the next few years, further suppressing price growth.

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[4] Bank deposits incur income tax on interest. Shares incur income tax on dividends. Owning a business or a farm incurs income tax on profit. Even investing in education incurs tax on the higher income one hopes to receive as a payoff. Little wonder New Zealanders choose to invest in property above all else.

Appendix 1: Effect of tax cuts on property owners

Example 1

Before income tax cuts

John has a high income and no savings. If he borrows to buy a rental property worth $350,000, he receives a tax rebate on cash losses from the property (we unrealistically assume he can borrow 100% for the purposes of illustration). His property investment saves him $7,600 in tax. He endures a cash loss, but the expected capital gain makes this a worthwhile investment.

	Without rental property	With rental property
Labour income	**$100,000**	**$100,000**
Rental property		
– Rental income		$15,000
– Expenses		–$7,000
– Mortgage interest		–$28,000
Net taxable investment income		**–$20,000**
Expected capital gain (4% p.a. tax free)		**$14,000**
Tax		
– Tax on labour income	–$27,550	–$27,550
– Rebate on investment loss		$7,600
Total tax	**–$27,550**	**–$19,950**
After-tax earnings	**$72,450**	**$74,050**

Benefit of property ownership = $1,600

After income tax cuts

After the reduction in income tax, John finds that his property investment is only saving him $6,600 in income tax. As he must now pay more of the cash loss himself, he finds that the investment in property is barely worthwhile.

	Without rental property	With rental property
Labour income	**$100,000**	**$100,000**
Rental property		
– Rental income		$15,000
– Expenses		–$7,000
– Mortgage interest		–$28,000
Net taxable investment income		**–$20,000**
Expected capital gain (4% p.a. tax free)		**$14,000**
Tax		
– Tax on labour income	–$23,850	–$23,850
– Rebate on investment loss		$6,600
Total tax paid	**–$23,850**	**–$17,250**
After-tax earnings	**$76,150**	**$76,750**

Benefit of property ownership = $600

Example 2

Before income tax cuts

Jane has a high income and savings of $350,000. If she put the money in the bank, she would receive $22,000 in interest, but would pay $8360 of that in tax. Instead, she buys a median NZ house in which to live. She saves on rent and expects capital gain, but must pay expenses. The net benefit of her property investment is $22,000 per annum, tax free. Home ownership saves Jane $8360 in tax.

	Bank	Owner occupier
Labour income	**$100,000**	**$100,000**
Bank deposit		
Interest income	**$22,000**	
Own house		
– Saving on rent		$15,000
– Home maintenance expense		–$7,000
– Expected capital gain (4% p.a.)		$14,000
Net tax-free income		**$22,000**
Tax		
– Tax on labour income	–$27,550	–$27,550
– Tax on investment income	–$8,360	
Total tax	**–$35,910**	**–$27,550**
After-tax earnings	**$86,090**	**$94,450**

Benefit of property ownership = $8,360

After income tax cuts

After the tax cut, the option of putting money in the bank only incurs $7260 in tax. Home ownership now reduces Jane's income tax bill by just $7260 per year. The tax advantage of home ownership relative to other investments is smaller.

	Bank	Owner occupier
Labour income	**$100,000**	**$100,000**
Bank deposit		
Interest income (6.3%)	**$22,000**	
Own house		
– Saving on rent		$15,000
– Home maintenance expense		-$7,000
– Expected capital gain (4% p.a.)		$14,000
Net tax-free income		**$22,000**
Tax		
– Tax on labour income	–$23,850	–$23,850
– Tax on investment income	–$7,260	
Total tax	**–$31,110**	**–$23,850**
After-tax earnings	**$90,890**	**$98,150**

Benefit of property ownership = $7,260

Appendix 2: Investor value of housing, details

The investor value of housing model notes that the rental market will be in equilibrium if rental income plus expected capital gains are equal to mortgage interest and expenses, after allowing for tax and a risk premium. Under New Zealand's tax system the equilibrium condition is:

$$\text{Rent}(1-t) + P\pi^{e} = P(i+f)(1-t) + Pe,$$

where t is the marginal tax rate, P is the house price, π^{e} is the long run expected rate of capital gain on property, i is the mortgage interest rate, f is tax-deductible maintenance costs as a proportion of the house's value, and e is a risk premium. Rearranging, the investor value is given by:

$$P = \text{Rent}(1-t) \,/\, (\,(i+f)(1-t) - (\pi^{e} - e))$$

The $346,000 current investor value is based on the following assumptions:

- Rent = $11,650, based on June 2008 Household Economic Survey and subsequent change in the CPI actual rentals category.
- Tax = 38%.
- i = 7.9% (average of 5-year and 2-year mortgage rate)
- f = 3.15% (based on conversations with property investors).
- π^{e} = 4.8%, composed of 2.8% expected inflation plus real capital gain of 2% per annum.
- e = 1.3%, calibrated to make investor value mean approximately equal to actual house price mean during 1990s.

We assume the tax rate drops from 38% to 33% in the December quarter of 2010, and the interest rate rises to 8.1% by December 2010.