TONY'S VIEW

Input to your Strategy for Adapting to Challenges

Feel free to pass on to friends and clients wanting independent economic commentary

ISSN: 2703-2825 Thursday 25 March 2021

My Aim

To help Kiwis make better decisions for their businesses, investments, home purchases, and people by writing about the economy in an easy-to-understand manner.

Because of the importance of the issue, I have devoted all of this week's issue of Tony's View to the government's housing policy changes announced on Tuesday morning.

Frenzy no more

Asset prices can sometimes move in cycles, but those cycles can be disparate distances apart. That is, sometimes the gap from peak to peak might be five years, sometimes seven or ten years. So be careful not to get too fixated on exact timing of a cycle.

It is more accurate to think in terms of the price of an asset sometimes rising at an exceptionally strong pace, and at other times not rising much at all, or even falling.

Why do asset prices do this – specifically with regard to houses? To help answer that question lets ask this one instead. Thinking about all of the tens of thousands of people scrambling over each other recently trying to buy a property, ask yourself this question. Why did they not buy two years ago? Or three years ago?

Most will be kicking themselves because they did not buy before this latest price boom.

It is extremely unlikely that all of these people only just in the past nine months scraped together a big enough deposit or secured a good enough job to satisfy bank borrowing rules.

Why did the panicking people in the market (up until Tuesday 9.00am) not purchase when they had more listings to choose from, when there were average to below average people in the auction rooms, and when there were few if any stories of properties selling for large percentages above valuations?

A key reason is likely to be that although they would almost universally had an expectation that house prices would rise, they did not expect any strong rise in the immediate future. They would have felt that time was on their side so why engage now with the stressful action of searching for, bidding on, settling on, then occupying or renting out a property?

But once prices started to rise these people would have no longer felt that time was on their side. They would have quickly formed the opinion that waiting now entailed a real cost and that the equation had changed in favour of acting now rather than waiting.

This change in sentiment in response to evidence of prices rising is a key reason why prices rising beget prices rising and why central banks get concerned and worries eventually grow and about a boom then bust cycle.

But this is only scratching the surface of the multitude of factors explaining a typical house price cycle, let alone this one. There are also the people who had no plans for buying now and were not holding off while looking. Instead, these people have plans to buy down the track and intend making a purchase at a time of their choice in a relaxed fashion.

But once they could see prices rising sharply, they decided to bring forward in time their intended purchase from 2021 into 2020, or 2022 into this year, maybe even 2023 and 2024 into 2021.

Periods of booms in asset prices thus gather their own momentum and fuel by dragging in those who could have bought in the past but did not get around to it or feel incentivised or energetic enough to do it, plus those who were intending to buy in the future.

You end up with three layers of buyers in the market all at once.

But there has been more in play that just these factors. One especially strong one recently is people bidding what they know are ridiculously high prices for properties for one if not both of two reasons.

First, there are the many people who have been outbid in the past. They are tired, their stress levels are high, they worry all the time about not being able to make a purchase, they are tired of repeatedly paying for valuations, LIM and builders reports, and they're just sick and tired of missing out at countless auctions and tenders. With encouragement from real estate agents well aware of the dynamics of the market recently they go in big with everything they've got, paying well over the odds.

Second, there are people bidding high prices not because they are necessarily tired of searching and just want the nightmare to end, but because they have, or have chosen to have, a different perspective on time than others. They are bidding based not on where they feel the market is now, but where they believe it will be next year, in 2023, or even in 2024.

(These two groups of people will be feeling particularly bad now.)

Just as future buyers get dragged into the present market when conditions boom, so too do future prices.

On top of all these factors we have FOMO – fear of missing out. These buyers can be people who never had any intention of buying a property but seeing reports every day of seemingly simple and big gains being made they decide they can secure and in fact deserve their slice of the action.

So, they enter the market also, educating themselves maybe about property investment and if they are sensible enough securing some professional paid-for guidance on how to develop and structure a housing portfolio or a portfolio which includes housing investment.

These things cannot continue, and they never do. There is always an unwinding. It is simply a question of what will cause it, when will it happen, how high will the market be when it happens, and what the nature of the pullback will be. Will it involve falling prices, or just the cessation of price gains?

Ahead of the event, we cannot know the answer to any of these questions. I don't, you don't, the Reserve Bank and commercial banks don't, and neither does anyone in government.

But this boom has now ended, just after 9.00am on Tuesday.

The Covid frenzy endgame

On Tuesday at 9.00am the government announced a range of measures aimed at tilting the field against investors and in favour of first home buyers, in favour of growing supply, and towards more sustainable prices. Let’s start with the small stuff, then get to the pool of cold water thrown on the fire. The government has responded in kind to the ridiculous 25% rise in house prices since June.

Brightline test

The brightline test has been extended from five years to ten years. I expected it would go to either seven or ten years so no surprises there and the impact will be fairly small. Only a handful of people may be dissuaded from investing in residential property because they will have to pay tax on their nominal capital gain if they sell less than ten years after purchasing.

The effect of the change will be to encourage some people to hold onto their properties for a longer period of time than would otherwise be the case. It will reduce investor demand only marginally.

Housing Acceleration Fund

The government has allocated a $3.8bn contestable fund which councils can call on for grants to help fund infrastructure needed to allow growth in the number and speed of subdivision development around the country. This is a very positive development.

It addresses a key issue discussed briefly last week which is that the government can greatly influence housing demand, but their ability to address supply is severely limited by the fact that councils control supply. Ratepayers as a rule don’t want to pay higher rates for infrastructure development to let more people live nearby, clogging up their roads, taking away green space, and filling up schools.

Those latter concerns will remain, so we should not be thinking that the $3.8bn fund will radically increase house supply. But it will help facilitate greater growth in supply over the long-term.

Homes & Communities land fund

$2bn has been allocated for Homes and Communities (the old Housing Corp.) to purchase land for social housing. This is a very positive development given what is about to happen to demand for social housing in New Zealand in light of the big policy change which I am deliberately taking my time getting to.

The $2bn fund will tend to place upward pressure on land prices.

First Home Products

There will also be a tiny bit of upward pressure on prices from the raising of the income and house price limits for first home buyers to access the First Home Grants and Loans.

Apprenticeship funding

More money has been provided for more apprenticeships in the construction sector. This is a very positive development because a key constraint on the speed with which new housing can be made available is lack of staff. That constraint is likely to become fairly binding in the next few years not just in terms of putting houses up but developing the subdivision infrastructure in the first place.

There is already hefty demand for people in the infrastructure space as councils contemplate many years of replacing aged infrastructure under the ground, which is falling apart, and the government tries to get more of its redundant job creating shovel ready projects off the ground.

Removal of interest cost deductibility

And so, to the big and unexpected change. I had expected that the government might change the ability of existing investors to deduct interest rates to the extent of maybe 10% of those costs. Then, I figured that they would raise that 10% to 20% and so on over the years.

Instead, from October 1 this year existing investors will lose 25% of their ability to deduct interest cost. That is, they can only claim 75% of their interest costs against their rent revenue when calculating income to be taxed from their rental property.

This 75% will continue through to April 1 2023 after which 50% of interest cost will no longer be able to be deducted. This falls to 25% from April 1 2024, then a year later no interest expense will be able to be offset against rental income.

I have emphasised this four-year time period for fully removing interest cost deductibility because it means not all of the coming adjustment in prices as a result of the change will happen at once. The impact will be spread over time.

However, for all new purchases by investors the loss of all interest cost deductibility will happen right now. It looks like investors purchasing new builds will not only still retain a five-year brightline test but may also retain the ability to deduct interest costs. There is consultation to be done on this and the wording in the press release from the Beehive read like this

"The full removal of interest deductibility from 1 October 2021 will apply to all investment properties other than potentially new builds - purchased on or after 27 March."

What will happen?

Looking at this from the new investor's point of view it means if one anticipated buying a property delivering $20,000 per annum in rent, financed with debt costing $15,000 in interest, then ignoring all other costs, taxable income would have been $5,000. The tax bill would be $1,650 at 33% and the investment would be cash flow positive.

Now, tax will be levied on the entire $20,000 of revenue delivering a tax bill of $6,600. The tax bill goes up $4,950 and the property is now cash flow negative.

The returns to investing in residential property have altered – not just for the 24% of people purchasing investment property with a mortgage, but many of the 12% who pay cash. They would pay cash having raised debt on other properties they own in many instances. That debt will eventually be affected.

Therefore, the change in interest cost deductibility will lead to a reduction in investor demand for property. This will affect bidding at auctions.

At the same time some investors will look to sell, even if the cash flow hit on them might not add up to much in the next 24 months. This effect will be spread over the next four – six or so years.

We can reasonably expect that the frenzied, desperation driven bidding we have seen in auctions will now end. Prices will start a retracement, some of which was going to happen anyway as a result of investors purchasing now no longer able to enjoy a normal six-week settlement period and get settlement done before May 1 when a 40% deposit will be required.

Overall, investors in residential property will be worse off, but some will gain. These are the people investing without any debt, so for whom interest cost deductibility is irrelevant. They will see the value of their portfolios give up some of the ridiculous 25% price gains on average nationwide since June last year.

But they will enjoy higher rents. Rents will rise because investors will look for compensation for their inability to deduct interest costs. How much rents will rise is anyone's guess, but the boost above normal rises will probably be spread over the next four years. A rise in average rents above 30% in the next four years could easily occur following rises of 22% since Labour came to power late in 2017 and since then have pushed landlord costs higher.

Many landlords have refrained over the years from charging what the market will bear because they empathise with their tenants and have been able to say to themselves that sacrifice of rental return will mean little in the context of long-term capital gain.

But now more people will have that capital gain taxed, and their properties will deliver far lower yields along the way.

Therefore, many will feel, and have, no choice other than to potentially radically raise their rents when they come up for their annual review.

So, at the same time as the quantity of rental stock will decline as investors sell to owner occupiers, rents will rise. The social problem out of this will be for the people at the lower end of the socio-economic spectrum who will find rents moving much further out of their reach and with even less ability to find a property.

Consider for instance an article you might have read this Wednesday describing the homelessness situation in Napier. Will the situation for those people get better or worse as a result of the stock of rental properties declining, rents rising, and more people seeking accommodation for each rental property offered because fewer people on average occupy an owned property than a rented one?

Their situation will get worse.

The message from the government is that they no longer want people to pursue rental property ownership as a business for which normal deductibility of expenses applies. They are actively disincentivising ownership of property for rental – hence the reduction to come in rental supply and rise in rents.

And it will not just be people on low incomes facing this problem. Students in Wellington are already struggling to find any accommodation, let alone something affordable. Now the situation is about to get a lot worse. One outcome of this is likely to be students seeking to study in a more affordable location where rents will not be as high. There will likely be transfers from Wellington in particular down to Canterbury.

Other students might opt to pursue their study at a vocational institute much further south in Invercargill. In fact, this dynamic opens up an opportunity for polytechs to grow campuses located in regions where housing is more affordable to young people. It may be a harder call for a university to set up a new campus but that cannot be ruled out. The Kapiti Coast/Horowhenua area looks destined to have one.

There has already been a blowout in the number of people on the state house waiting list. A lot more people will now join the queue. A lot more people will find themselves homeless, and a lot more people will need to be housed in motels around the country.

Walking down Courtenay Place in Wellington will become even less safe as more people of all ethnicities find themselves unable to secure accommodation. If there was intense pressure on the Associate Minister for Housing responsible for homelessness before, the pressure in the next three years will now become far greater.

Ultimately, who wins? First home buyers (maybe), people in the infrastructure, land development, and construction sectors. The construction sector benefit arises because the government is leaving the brightline test at five years for investors in new builds. They are also consulting on the idea of still allowing interest cost deductions for investors in new builds. The measures will incentivise new construction which is good from an economic growth point of view.

First home buyers will face reduced competition at auctions and get marginally improved access to government subsidies to help them achieve home ownership. But the trend toward rent-vesting will likely stop. This involves first home buyers purchasing a property as an investment then taking the capital gain when they sell as a deposit towards the first house they will own and live in.

That route excludes accessing first home buyer grants when making that second purchase, and they can't access their Kiwisaver money for that purchase either. So probably not a great number of people have gone down that route.

But now, the extension of the brightline test means it is highly unlikely many would contemplate ten extra years renting before living in an owned house. Plus, removal of the ability to deduct interest cost as an expense means their expected returns from a rental will fall sharply.

This will cut demand for property in the regions as rent-vesters probably were focussing on such markets with their greater availability of lower-priced properties. Regional property demand will also fall from investors generally, but will city-based investors feel more or less inclined to favour the regions over their home market?

Note that investors will now be actively incentivised to buy new builds because of the probable continued ability to deduct interest costs. This new layer of demand for new builds will raise prices which developers are able to price their units at and make purchasing more difficult for first home buyers. Given that more and more new builds have been towards the affordable end of the market, the pushing away of first home buyers into an older housing market which they probably can't afford (land, larger dwelling), could see many of these buyers now worse off.

In fact, young buyers may soon only be able to reasonably access the worst quality existing housing stock when it comes on the market. Old dungers.

They will probably still have to buy with a mortgage in the regions, but the reduced level of debt means lower non-deductible cash outflows than for a city purchase.

I do not know the extent to which this effect will offset the overall depressing effect of reduced investor purchases.

Exporters win because there is now a reduced chance of interest rates being pushed up by the Reserve Bank next year (though fixed rates still face upward pressure from developments overseas). The NZD has already shed about 2 cents in response to this change in the NZ monetary policy outlook.

Owners of sections and developable land win because extra construction which will eventually occur will require more land.

Who loses? Almost all investors, all renters, real estate agents and mortgage advisors through reduced turnover, and anyone who has bid against the odds recently to secure a property and now faces that property's market value declining for some of the rest of this year.

To put the coming price declines of uncertain magnitude in context – prices in February on average were ahead 25% from May and 21% from a year earlier. If prices on average now fall 10%, they will go back to where they were in those dim, dark, horrible days of October. If they fall 5%, we will be back where we were in the first few days of February. 15% takes us back to August last year.

Personally, much as I see some people seemingly restraining themselves from forecasting price declines, I have no trouble doing so because the nine months to February were so abnormal.

I will only feel concerned about the economy more generally if prices fall by more than 20%. What is my best guess for how far prices fall on average? About 10% with things bottoming out sometime just after the middle of the year.

But do keep one thing in mind. No-one on the planet got their house price forecasts correct a year ago so do not at all expect any of us to be right this time around either. Last year brought a pandemic shock to the housing market delivering effects we did not foresee. Wy should this new shock be any different?

What do you do now if you are contemplating saving and investing for your retirement? I strongly advise taking some time to calm down, then engaging an Authorised Financial Advisor (I am not one) to discuss your long-term wealth growing options. It will not at all be certain that your optimal route is to sell your existing rental property, or to refrain from purchasing one.

For your guide, next week in Tview Premium I will look at my data to try and gauge which parts of the country are most vulnerable to investors stepping back from buying and also raising their selling over the next few years.

Links to publications

Tony's View Spending Plans Survey

Tony's View Business Survey

REINZ & Tony Alexander Real Estate Survey

Oneroof weekly column

mortgages.co.nz & Tony Alexander Mortgage Advisors Survey

Tony Alexander Regional Property Report