# TONY'S VIEW

**Input to your Strategy for Adapting to Challenges**

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

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**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.

## Perspective

Take yourself back to just over a year ago. Covid-19 was spreading around the planet, we had entered into something called a lockdown, we faced the greatest uncertainty for our economy, our asset markets, and our personal lives that most people had ever seen. Our worries were deep, and we expected not just falling economic activity and rising unemployment but falling house prices as well.

Things have not turned out as expected. In particular, the only minor fall in house prices of 3% while we were physically in lockdown was less than anticipated, and no sane soul predicted the 25% bounce in average prices between May and February.

So, ask yourself this. What miracle has just happened to deliver, you, me, your neighbour, the government, and that bloke down the pub, an ability to predict house price changes which not a single one of us had a year ago?

No miracle has occurred. We are flying just as blind now as we were back then, with the same probability of getting our predictions right.

Now ask yourself this. What happened to the people back then who embraced the negative scenario with a loving vengeance and sold their shares while pulling out of the housing market? They did not do so well.

So, think about what is going through your mind currently as we face another shock – not a global one, not external, but one delivered by the government. Chances are you're highlighting in your head the way various groups will suffer as a result of the policy change. Let's run through a few of those thoughts we're all having.

Renters are stuffed because rents will rise.

First home buyers are stuffed because investors will buy new builds before they do, their ability to save a deposit will slow because their rents will rise and going down the rentvesting route has been all but closed off.

Poor people are stuffed because a reduction in rental supply will see them on the streets.

Investors are stuffed because their costs have gone up, more will pay capital gains tax, and they might be hit out of the blue with more regulations down the track.

The government is stuffed because they have brassed off a great number of people and probably have lost the middle-class National voters who went their way last election.

The Opposition are stuffed because they cannot argue against the goals the government is pursuing and have no useful alternatives to offer.

Let's now try to put some of what has just happened in perspective.

### Capital gain offset

The average dwelling in New Zealand has risen in value over the past 12 months by about 21.5% or roughly $100,000. Various people with calculators have suggested that the average investor will face an extra $5,000 in costs per annum as a result of the removal of interest expense deductibility.

In other words, the past 12 months has covered them for the next 20 years or so.

Or we can look at it another way. To make back the $5,000 per annum, the average dwelling price only needs to rise in value by about 0.7% a year.

Having said that, along the way cash flows for some people will be a problem, and many investors say they never plan to sell.

**Interest rate equivalent**

The removal of ability to deduct interest as an expense is, for someone on the 33% tax rate, the same as having their interest rate raised by half. So, if they were paying 3% the rate is now 4.5%.

The Reserve Bank has cut the official cash rate by 1.5% since May 2019 while the average two-year fixed mortgage rate has declined since then by about 1.8%. Borrowers are basically back to the interest rate cost they were facing in the first half of 2019. House prices were not falling then, investors were buying property, and there was no wave of investor selling.

**Four-year phase in**

It will take four years for current owners of investment property to feel the full effects of the policy change. That gives them time to sit back for now and consider what to change and how, in more calm circumstances. For many, the answer will be a continued focus on keeping good tenants and that will limit how much of the extra cost they throw onto those people.

**Bank deposit rates are low**

People have been flooding into property partly because deposit rates in banks are at levels which deliver shrinkage of wealth after tax and inflation. That is still the situation after the March 23 announcement and likely to remain so through into 2023.

The thought of selling then having the cash sit in the bank will be a strong brake on the willingness of many to quit their housing asset this year and next.

**Expats still to return**

It is still likely that after whatever price adjustment happens this year, house prices will continue to rise on average at a pace well above inflation and wages growth.

There is likely to be upward pressure from the many Kiwi expats people expect to come home when the borders fully open, not to mention some foreigners. Plus, the return of tourists eventually will take some houses back out of the long-term rental pool into short-term holiday accommodation. The country faces strong demand for primary sector exports with talk abroad of a commodity price super cycle. Growth prospects are good.

**Some investors have no mortgage**

According to CoreLogic, about 12% of people buying property on average pay cash. These people do not have their cash flows affected by the tax changes so if anything may be hoping debt-laden investors sell so they can acquire some good properties.

**Auction attendance**

I sat in on an auction in Auckland City this week. The room was quite full and the bidding firm. There was no air of despondency amongst the agents (or new hope by buyers), and things seemed to be selling. I have had similar feedback from other people attending auctions. As yet the impact seems fairly muted.

**FOMO continues**

After Easter I will release the results of my monthly survey of real estate agents all around New Zealand, undertaken with REINZ. I’m not going to give the preliminary numbers here but suffice to say while they show easing off of numbers at Open Homes last weekend and auctions, most agents still see prices rising, most still see FOMO in play, and most still feel the market is biased in favour of sellers.

But these are early days in reaction to the policy changes and we have to be careful not to over-read early statistics.

**Land prices will rise**

The government has allocated an extra $2bn in borrowing power to Homes & Communities to purchase more land. Councils have a $3.8bn fund they can call on to develop land infrastructure. Investors have been incentivised to buy new dwellings, many of which get built on – land!

Rising land prices could prove a net price boost for many investors.

**Listings remain low**

There is a shortage of properties for people to buy and it is possible that hopes of some extra listings coming forward will bring some new or returned buyers into the market.

After all, this is exactly what happened as soon as lockdown ended. First home buyers jumped in looking for listings, hoping that the investors would be gone, and some distressed sellers might be there. We could easily see the same effect again.

I can now cite three of my surveys containing results all collected since March 23’s announcements. They all show reduced investor willingness to buy. But my experience of previous cycles, previous shocks, (that of 12 months ago in particular), tells me that the path ahead will not necessarily be that projected by simply extrapolating these results.

Frankly, times like these are when the professional investors shine.

# TONY'S VIEW

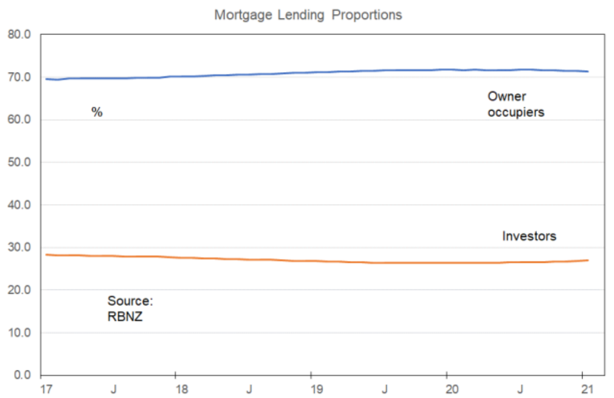
## New Zealand's Housing Markets

### Will rents rise?

Every month I participate in a session of the one-hour OneRoof talkback show hosted on Newstalk ZB. Here is the link to the most recent one last Saturday.

https://www.newstalkzb.co.nz/on-air/the-weekend-collective/the-oneroof-radio-show/tony-alexander-how-the-governments-housing-package-will-impact-renters-and-first-home-buyers/

Some of the questions which callers ask are quite good and I thought I'd cover off a couple of topics raised here. One was with regard to the proportion of mortgage lending which goes to investors as opposed to owner occupiers. At the end of January those proportions respectively were 71.3% and 27%. The remainder is mortgage debt extended to businesses for residential properties.




As the graph shows, the proportion of bank mortgage lending to investors has remained essentially unchanged over the past four years for which data are available.

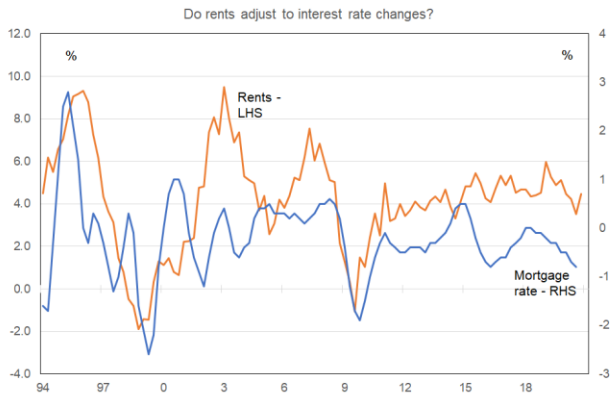
The other question, the first on the show and a very inciteful one, was around the proposition that the removal of tax deductibility would lead to rents going up. I have characterised the change as akin to retaining full tax deductibility but having one's interest rate multiplied by 1.5 assuming a 33% tax rate.

That is, if an investor currently is paying an interest rate of 2.5%, they have now just been jumped up to 3.25% for new purchases or will reach that in four years time for existing holdings. If one is paying 3% then the rate effectively has become 4.5%. If 4%, then now 6%.

In the past when interest rates have changed, have investors adjusted their rents? I only had a few minutes before the session when I was in fact analysing this question and did not get things completed before the talkback show started. So, the answer I gave was not complete. Now it is.

I have examined this question with a simple plotting of the quarter on year ago rate of change in nationwide rents (in orange) against the quarter on year ago change in mortgage rates (in blue).

The graph shows that rents do tend to change with a lag to changes in mortgage interest rates. But interest rate reductions from 2015 to now have not really been passed on in reduced rent growth. In fact, rents have most recently shot up in the absence of a rise in interest rates – undoubtedly a catch-up after the Covid rent freeze.



Therefore, the correlation is not exact. But we may simply be able to put the most recent six-year period of strong rent rises despite interest rate changes down to strong gains in house prices and government-driven increases in rental operating costs.

The tax change just announced will not show up in our graph because while it is equivalent to an interest rate hike for investors it is not going to register on any interest rate measure.

The effect of the tax change will be spread over the next 3-5 years. Therefore, to the extent interest rate rises have in the past pushed up rents, this effect will lead to higher growth in average rents around New Zealand, but not all in one go.

We have to remember also that investors have an established history of spitting the dummy whenever the government makes changes which negatively affect them. Yet there is zero evidence of follow-through from earlier threats to quit the sector. This time however things could be a bit different given the lumping of the tax change on top of increased expenses related to Healthy Homes, ring-fencing of losses, and decreased ability to manage one's property.

It is highly likely that we will in the next few years see a structural decline in the proportion of the housing stock owned by investors (but a structural rise in their proportion of new builds). But we will also see alongside a structural improvement in the quality of rental accommodation and security of tenure for tenants (desirable things), higher average rents and a pushing out to the state sector of tenants considered less desirable by the personal criteria of the property owners.

## Links to publications

Tony's View Spending Plans Survey

Tony's View Business Survey

REINZ & Tony Alexander Real Estate Survey

REINZ REAL ESTATE INSTITUTE OF NEW ZEALAND

Oneroof weekly column

OneRoof

mortgages.co.nz & Tony Alexander Mortgage Advisors Survey

mortgages.co.nz