Westpac

Institutional Bank

Home Truths

13 October 2014

A fresh perspective

This month Home Truths presents a fresh perspective on the housing market, before providing a quick wrap of the latest market data.

One interesting way to assess the state of the housing market is to ask the following question: What rate of capital gain would a property investor require to justify buying an average house today?

The net rental yield on a residential investment property, once maintenance costs and management fees are taken into account, is generally less than the mortgage rate required to finance the property. Investors are willing to accept such low yields only because they anticipate capital gains – the kicker being that those capital gains are tax-free, whereas other investment returns are taxed.

Figure 1 charts the long-term average capital gain that would have been required to break even on an investment in an average New Zealand house, given the level of house prices, rents, interest rates, maintenance costs and taxation that prevailed at the relevant time.

During the early-2000s a mere 3% long-term capital gain was required to break even, because interest rates were so low, and house prices were low relative to rents. No wonder there was such a craze for property investment at the time.

As house prices and interest rates rose during the 2000s, it became harder and harder to justify investing in property on the basis of expected capital gain. At one point, a long-term capital gain of 5.7% per annum would have been required to justify investing.

The hubris has subsequently cooled, and today's numbers look more reasonable. We calculate that a long-run capital gain of 4.4% per annum is required to justify investing in an average house today. However, that calculation is based on today's interest rates (we used a mortgage rate of 6.3%, being the average of today's two-year and five-year fixed mortgage rates). Should interest rates rise in the future, as we suspect they will, the required capital gain may once-again rise into unrealistic territory.

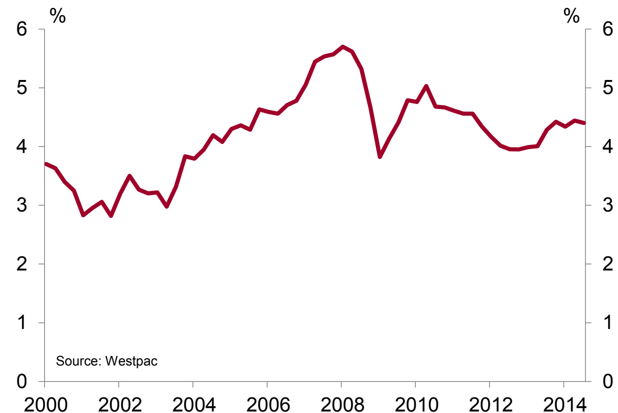
Pre-election limbo

We now have final confirmation that New Zealand house prices experienced a mid-year recovery after the slowdown earlier this year. Quotable Value's "official" quarterly house price index shows that prices rose 1.8% in the June quarter, after a 0.6% increase in the March quarter. Interestingly, Auckland was not a standout during the mid-year market revival – Auckland house prices performed no different to the national average in the June quarter.

That said, it looks as though the mid-year market revival was short-lived. The latest monthly data suggests that the pace of house price inflation eased off as we entered the second half of the year. QV's monthly index suggests that house prices rose by around 1½% in the September quarter. The REINZ's House Price Index has been even weaker, but that measure is probably skewed by the changing composition of house sales. All up, our long-held forecast for house price inflation of around 5% this year is still looking about right.

As for market turnover, there is little to report at the moment. Seasonally adjusted house sales rose 4% between May and August, but made no further gain in September. This probably reflects a bit of a pre-election limbo period, so we will await October's data before making any firm judgements.

Figure 1: Implied expected capital gain, NZ property investors



REINZ housing data, September 2014

	Sep-14	Aug-14	Sep-13
House sales, number, s.a.	5937	5944	7014
Mth % chg	-0.1	0.4	3.9
Ann % chg	-12.0	-16.3	18.9
Days to sell, sa	38.2	38.7	33.8
House Price Index (s.a.)	3933.2	3932.8	3776.4
Mth % chg	0.0	0.2	0.6
Ann % chg	4.1	4.8	9.8

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