Home Truths.

16 June 2021

We've been forecasting house prices to flatten off this year, as a result of the changes to the tax treatment of property investors. In this edition of Home Truths, we test our forecast against the latest data, while casting an eye over others' predictions.

From white-hot to red-hot.

There's been quite a lot to catch up on since our last edition of Home Truths. Most significantly, in late March the Government announced a range of measures aimed at tilting the playing field away from property investors and towards homebuyers. For properties purchased after 27 March, investors will no longer be able to deduct their mortgage interest costs from their taxable income. For properties purchased before then, interest deductibility will be phased out over four years.

We concluded at the time that this policy change would have the desired effect. Home Truths has long emphasised that financial factors – including tax rules – are the main determinants of house prices. Removing interest deductibility will significantly reduce what a highly-leveraged investor is willing to pay for a house, putting them down in the rankings behind homebuyers and investors with little or no debt.

At the same time, we recognised that the impact on house prices would need to be weighed against the ongoing appeal of record-low mortgage rates. On balance, we saw the tax changes as removing the upside potential for house prices that we were previously forecasting. We predicted that prices would flatten out over the rest of this year, with a modest drop in the following years once mortgage rates started to rise.

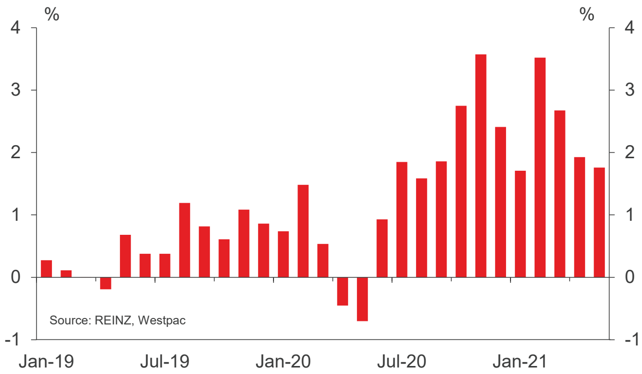
Now with a couple of months of post-announcement data, how is our assessment holding up? While there is some mild evidence of a cooling in the market, at best it's gone from white-hot to just red-hot. That points to some upside risk to our house price forecast for this year.

The REINZ House Price Index rose by 1.8% in seasonally adjusted terms in May, following a 1.9% rise in April. That's still a strong rate of increase, but it does represent a slowdown compared to recent history – in the six months to March, prices rose at an average pace of 2.8% per month. Prices were up almost 30% on the same time last year – that will probably mark the peak in the annual rate, as prices were falling in April-May last year during the Covid lockdown.

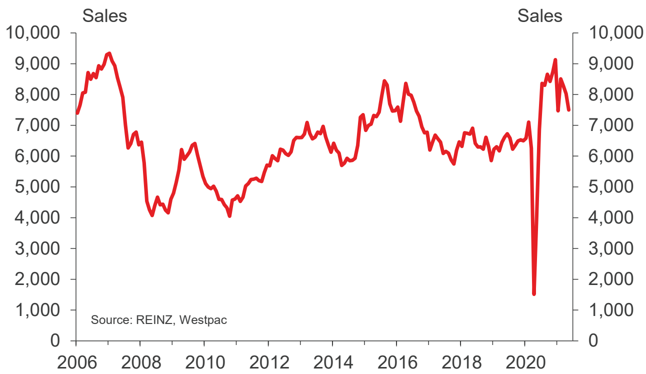
House sales were down about 6% in seasonally adjusted terms. That was the third drop in a row, and puts them 18% below the peak reached in December last year. However, sales are still running well above pre-Covid levels, which likely reflects the appeal of both low borrowing rates and low returns on other investments such as term deposits.

Some have noted that supply remains very tight, with the stock of unsold homes dropping to its second-lowest on record in May. But we view low listings as a symptom, rather than a cause, of rapidly rising prices. Besides, it's not that the flow of new listings is particularly low, rather that it hasn't kept up with the surge in demand over the past year.

Monthly change in House Price Index



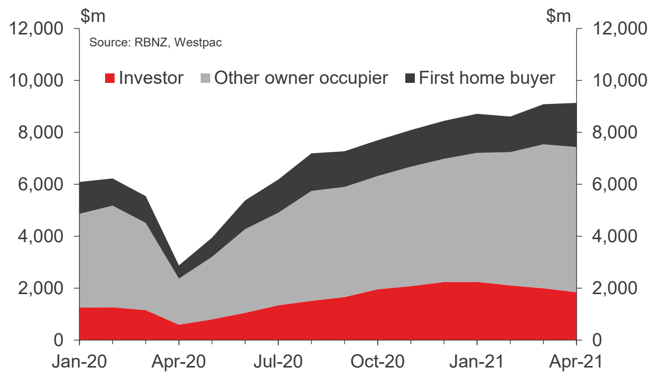
House sales, seasonally adjusted



Aside from prices, the other key evidence that we were looking for was a change in the mix of buyers, with homebuyers (not just first-time buyers) coming to the fore.

The very limited evidence that we have on this to date suggests that this switch is indeed happening. The Reserve Bank's mortgage lending figures, after seasonal adjustment, suggest that total new lending held up in April compared to March. Within that, lending to investors has declined – and has done so for the last few months, which likely reflects the reintroduction of loan-to-value restrictions (banks began applying these before the official start date of 1 March). However, lending to homebuyers actually rose further in April. Considering that homebuyers have also been subject to a tightening in LVR restrictions (just not as much as for investors), that's a pretty impressive performance.

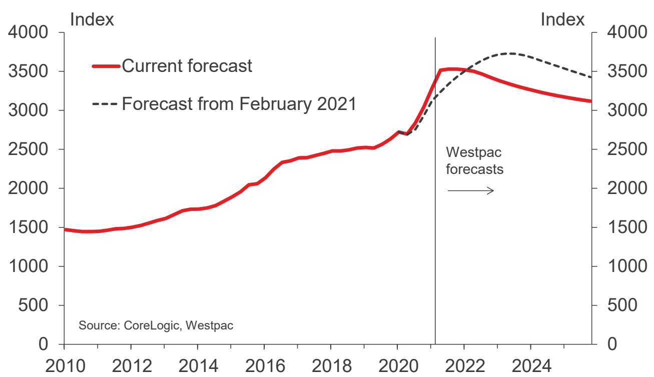
New mortgage lending, seasonally adjusted



That's an additional challenge to our forecast – it suggests that even with investors on the back foot, homebuyers have been quite willing to step in and pay these kinds of prices. It also creates a dilemma for the Government and the RBNZ in terms of any further steps to cool the housing market, since the Government has made it clear that it doesn't support any measures that would disadvantage homebuyers.

For now, we're sticking with our view that house prices will flatten off by the end of this year. However, we have revised up our profile for house prices over the course of this year, reflecting the strong gains in recent months and allowing for some further momentum in the near term. Given that prices have already risen by 12% since the start of the year, 2021 is still shaping up as one of the strongest years on record for house price growth.

House price level forecasts



The greater test of the housing market will come once mortgage rates start to rise from their record lows. Notably, the longer fixed-term mortgage rates (3-5 years) have risen substantially in recent months, reflecting the improving economic environment here and internationally. However, the shorter terms (up to 2 years) that are the most popular among borrowers have actually fallen further. These rates are more closely linked to expectations of the OCR, and are likely to rise as the date of OCR hikes draws closer.

The third rail.

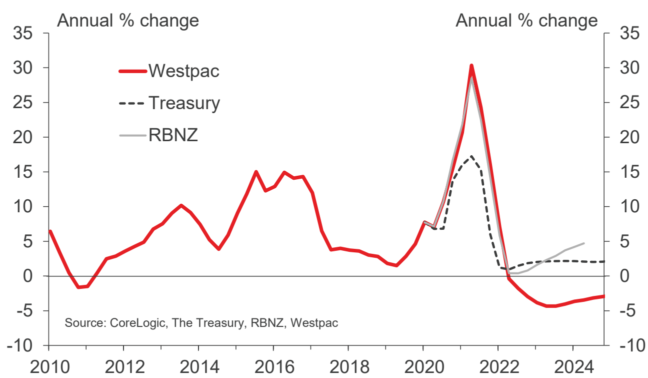
It's fair to say that our house price forecast has not been widely embraced. However, we were encouraged by the fact that both the Treasury (in last month's Budget) and the RBNZ (in its Monetary Policy Statement) have taken a similar view to us on the year ahead – if not for the years beyond that.

Of the two, the Treasury's assessment is closest to our own. They estimated that removing interest deductibility would leave house prices 16% lower than otherwise over the long run, which is similar to our estimate of the impact. The difference is that the Treasury's baseline forecast had house prices continuing to rise over the long term, and this also features in their updated forecast.

We suspect the reason for this is that the Treasury's modelling uses assumptions about long-run *growth rates*. In contrast, our approach explicitly relates the *level* of house prices to fundamentals. This is why we were already forecasting a drop in house prices in the later years, once mortgage rates had risen sufficiently. The change in the tax rules for investors has simply meant that we have brought that date forward.

The Reserve Bank's forecast also sees house price inflation slowing to near-zero over the next year. However, it then expects house price growth to accelerate again, reaching around 5% by 2024. Moreover, that happens even with a much more aggressive profile for mortgage rates – the RBNZ is projecting OCR hikes from the second half of 2022, whereas the Budget forecasts assumed no increase in the OCR before June 2024.

House price growth forecasts



Meanwhile, other forecasts and property market experts have given a range of views on how quickly or slowly house prices will rise in the coming years – but none of them have contemplated an outright drop. Falling house prices remains the third rail that no-one is willing to touch.

Why would that be? We suspect there's a little too much reliance on the idea that the Government won't allow house prices to fall because it's politically unpalatable – housing makes up the majority of households' wealth in New Zealand. But that gives the Government too much credit – if it really had that degree of control over house prices, would it have allowed them to rise by 30% in a single year?

More to the point, our forecast of a drop in house prices is based solely on monetary policy settings, which are not in the hands of the Government but of the (operationally independent) Reserve Bank. And the RBNZ can't continuously underwrite the housing market with low interest rates, if that would conflict with its inflation target.

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