House values: shifting foundations

- **High interest rates expected to slow housing market.**
- **Previous work suggested that houses were fairly valued in 2006.**
- **Since then a sharp rise in mortgage rates has reduced the investor value of property.**

Summary

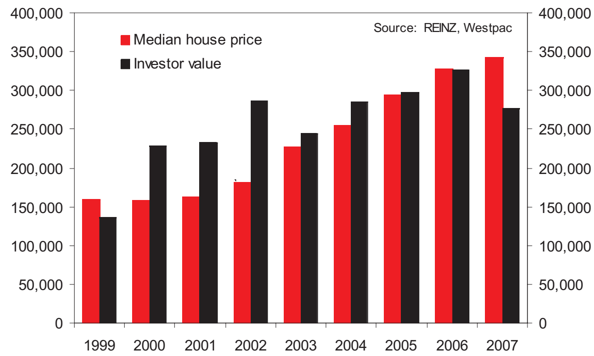
A couple of months ago we published research that valued property according to investment fundamentals. We showed that rents, interest rates, tax rates, and expected capital gains (inflation) all play important roles in the investor value of housing. The house price boom of this decade was mainly due to:

- A fall in mortgage rates that made it cheaper to borrow money.
- The increase in the top tax rate to 39 cents in the dollar, which increased the incentive to chase capital gains over income and made housing more valuable as a tax shelter.
- An increase in the average inflation rate, which pushed up the average long-run capital gain that an investor could reasonably expect to receive tax-free.[1]

The research suggested that the house price increases of this decade were not a bubble. Rather, property was seriously undervalued in 2001 – 2004, so investors were quite rational to crowd into the market. House prices were bid up, but it wasn't until 2005 that houses were selling for their true value. As at the end of 2006, the investor value of housing was $327,000. The median selling price was $328,000, so we concluded that the houses were fairly valued at the time.

But that was then and this is now. There have been huge changes in the past couple of months. Mortgage rates have experienced an extremely sharp increase, following rate-hikes from the Reserve Bank and interest rate increases on wholesale markets. 5-year mortgage rates are at their highest since before the housing boom began. The minimum carded mortgage rate on offer at the major banks is 8.6% fixed for five years, compared to 7.9% as recently as February. These interest rate increases have reduced the value of property as an investment asset.

Figure 1: Investor value and actual selling prices



Our current valuation on the median house is $278,000. That assumes a 5-year mortgage rate of 8.5%, a 2% increase in rents over the six months to June, and a long-run average capital gain of 6% per annum. Compare that valuation to the latest REINZ data, which shows that the median house was selling for $343,500 in March. Property is now overvalued from an investor perspective. That means buying an investment property at today's prices, while paying today's mortgage rates, is unlikely to yield a good return.

[1] The effects of inflation/capital gains were only briefly touched on in our previous article. We explain the importance of inflation for property investors below.

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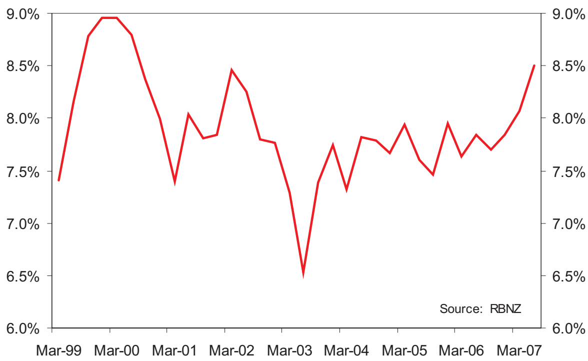
Figure 2: 5-year mortgage rates



Effect on the wider housing market

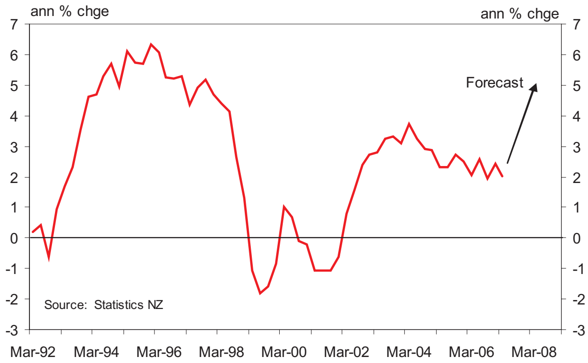
Houses are now selling for much more than they are worth to property investors. That will effectively remove one element of demand for property, especially at the lower end of the market that encompasses investment properties and first homes. In addition, high prices and high mortgage rates will be tilting ordinary people's rent-or-buy decisions in favour of renting and away from buying. On all fronts the housing market looks set to cool.

It could take some time before actual selling prices begin to reflect the lower investor value. House prices typically have momentum, meaning periods of rising prices don't suddenly stop dead in their tracks. Economic conditions are strong, with low unemployment and the Working For Families package increasing many people's take-home pay. That means plenty of people are keen to buy property.

Our overall predictions are:

- There will be a notable absence of investors from the market, and house sales will slow.
- Rents could rise more quickly. Annual rental increases could be between 4% and 6%, compared to an average of 2.7% over the past five years. However, even the top of that range would not be nearly enough to cover the cost of higher mortgage payments for landlords.[2] A 6% increase on average yearly rental income is $645, whereas the hike in mortgage rates will cost a fully leveraged landlord $2400 per annum (on the median property).
- House price inflation will slow, perhaps in the second half of the year. If interest rates remain at their current levels for a long time, or go higher, houses could fetch less than they are selling for now, especially at the lower end of the market.
- We don't expect serious fallout such as widespread mortgagee sales so long as employment conditions remain strong.

Figure 3: Rental inflation



Interest rates find their mojo

The Reserve Bank raised interest rates by 2.25 percentage points over 2004 and 2005, yet house prices marched steadily upwards. Some readers may question why we expect the latest 0.50 percentage points of OCR increases to have such a strong impact on the housing market when the previous OCR hikes were impotent. There are two key reasons:

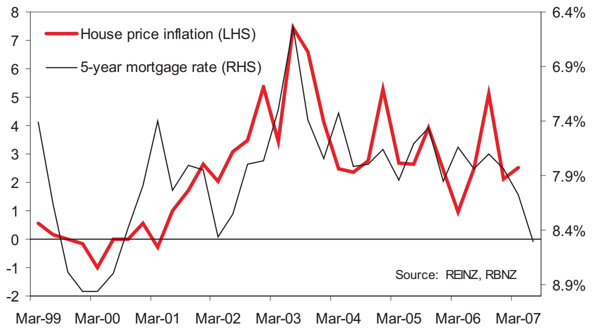
1. In 2004 houses were selling for less than their underlying value. Interest rate hikes reduced some, but not all, of the disparity by reducing the investor value of housing. But until prices reached "equilibrium" in 2005, there was little the RBNZ could do to prevent house prices adjusting higher. By contrast, this time we are starting from a point where property is already fully valued.
2. It is long-term interest rates that matter for mortgages, not the OCR. During 2004 and 2005, long-term mortgage rates moved very little, whereas they have jumped by more than 0.70 percentage points in the past month alone.

[2] When the market is misaligned, house prices tend to adjust much faster than rents. Since 1990 annual rental inflation has ranged from -1.8% to +6.3%, whereas annual house price inflation has varied much more widely, from -4.1% to +24.7%. It is unlikely that rents will rise by enough to compensate landlords for higher mortgage rates.

Table: Investor value of property

	Annual Rent	Interest Rate	Expected Long-Run Capital Gain (3.3% plus expected inflation)	Top Tax Rate	Underlying Value of Property	Actual Selling Price
Dec 2006	10,640	7.8%	6.0%	39%	**$327,000**	**$328,000**
Jun 2007	10,855	8.5%	6.0%	**39%**	**$278,000**	**$343,500**

Figure 4: Quarterly house price inflation and 5-year mortgage rates from previous quarter (inverted)



Long-term outlook

On current fundamentals, the numbers don't appear to stack up for new investors. First home buyers will also be struggling to justify higher mortgage rates. But fundamentals can change, so the next question is when will conditions improve for buyers? By all accounts, it could be long time before the fundamentals move in investors' favour. Mortgage rates may well go up again before they go down. If tax rates move anywhere it will be downwards, making property less valuable as a tax shelter. And the long-run rate of capital gain is unlikely to move any higher. It is only over the longer term that a slow and steady increase in rents, combined with a return to lower interest rates, will eventually lift investor values.

Inflation matters

The importance of inflation for investors was not described in any detail in our previous article, because we wanted to emphasise the importance of interest rates and tax rates. But given the number of questions we have fielded on inflation / capital gains, we thought that now would be a good time to explain.

Investors typically make a tax-deductible loss on their properties each year, in exchange for a tax-free capital gain. When inflation is higher, the rate of capital gain on property is higher. Economists normally point out that the effects of inflation come out in the wash, because nominal interest rates, wages, etc rise alongside prices. But the crucial thing for property investors is that higher capital gains associated with inflation are tax-free. If nominal interest rates rise because of inflation, that's tax-deductible. Higher inflation amplifies the tax advantages of owning investment property.

In New Zealand, the low-point for inflation was the late-1990s. Since then the average expected rate of inflation has risen from 1.7% in 1999 to 2.7% in 2006. Thus the long-run average rate of capital gain that investors can reasonably expect, tax-free, has risen by one percentage point since the late 1990's.[3] The price of housing has been driven up to reflect this.

Implications of our findings

The early part of the house price boom was not a bubble. Rather it was a rational adjustment that reflected the new fundamentals of lower mortgage rates, higher tax, higher inflation, and more economic stability. Riding the tide of adjustment turned out to be an excellent choice for property owners. But times have changed and the easy gains are taken.

For property investors, the future definitely looks leaner. Only those investors who are taking maximum advantage of the tax regime will make good returns. Retirees and lower-income investors who are on lower tax rates may find that their property is worth more to somebody else as a tax shelter. Consequently, we expect ownership of investment property to become increasingly concentrated amongst those on the top tax rate.

As for aspiring first-home buyers, the outlook is mixed. High house prices and high mortgage rates will make it difficult to buy, and the outlook for diminished capital gains will make ownership a less attractive financial proposition. But first-home buyers will be facing considerably less competition at tenders and auctions from investors.

For tenants, rents are expected to rise. But renting will still be much cheaper than paying a mortgage – owner-occupiers must pay a full mortgage, whereas renters only contribute towards a *tax-deductible* mortgage. High mortgage rates will make renting more attractive and buying more daunting. The trend towards renting for longer is likely to continue.

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[3] We estimate the fair-value expected capital gain rose from 5% in the 1990s to 6% today, based on house prices increasing at 3.3% plus inflation over the very long run. The fair-value rate of capital gain is a long-run average concept, not a forecast of where you think prices will go next year.