12 November 2009

Westpac InstitutionalBank

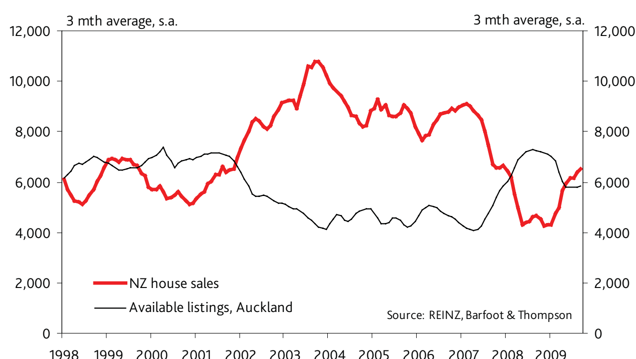
Housing encore

Update on the New Zealand housing market

- **House price inflation is heading double-digit in the near-term, but we foresee a downturn in late-2010.**
- **House building activity is expected to pick up strongly.**

New Zealand housing is displaying all the symptoms of a bull market. House sales have risen sharply, and now stand around their long-run average. The time taken to sell has shortened. The number of houses listed on the market has fallen. All indicators are typical of a market upturn, and point to a significant price increase.

Figure 1: NZ house sales and available listings



According to the REINZ Monthly House Price Index, house prices are now 8% higher than they were in January 2009, although they remain 4% lower than the November 2007 peak. Prices have risen 4.2% over the past three months. It is fair to say house prices are booming again.

The market revival is being led by the major urban centres, especially Auckland. According to Quotable Value, annual price gains in Auckland Wellington and Christchurch have all exceeded the national average gain. The major urban centres also led house prices down in 2008, so it is not surprising that they are leading the recovery.

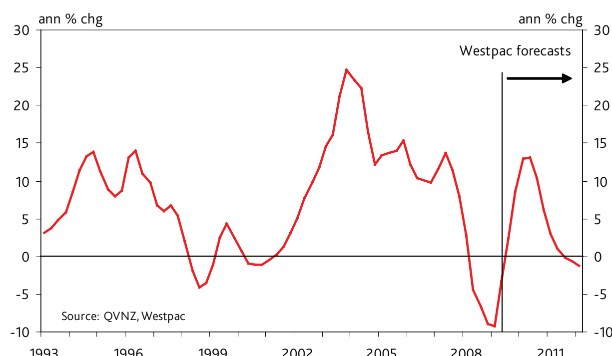
So what is causing all the excitement? Improved economic confidence is no-doubt playing a role. In addition, there are two key factors driving prices higher:

- Strong population growth combined with lack of building activity has created a shortage of new houses.
- Low mortgage rates.

Both of these drivers are necessarily temporary. This bulletin details our thoughts on the current market. The conclusions are:

- Conditions will favour rising prices for some time yet. We expect the annual rate of house price inflation to go double-digit by the middle of 2010.
- In 2010 we expect interest rates to rise, net migration to slow, and a strong increase in house building. This will negate the market's short-term strength and cause a downturn, possibly involving another brief period of house price decline, or a longer period of house price stagnation.
- We have the downturn tentatively pencilled in for late-2010, but the timing is extremely difficult to pick, and depends mostly on when the Reserve Bank acts to raise the OCR.

Figure 2: Westpac house price forecast



The shortage of new houses

In 2008 New Zealand net migration (arrivals less departures) was 3,800. For 2009 net migration is likely to be around 22,000. Although population growth has accelerated from 0.9% to 1.3%, the residential construction industry has been relatively inactive. House building is running at only 14,000 per year, whereas 25,000 houses per year are needed to accommodate this rate

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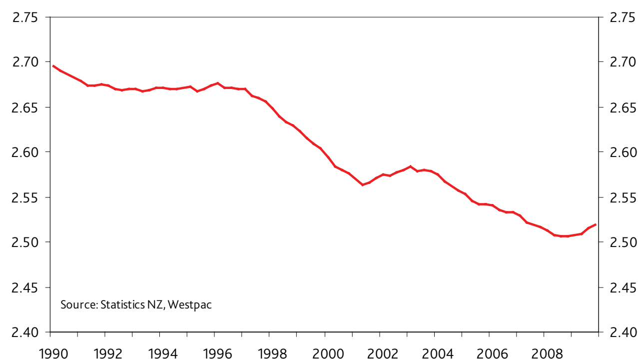
of population growth. This has left New Zealand with an acute shortage of houses. New Zealanders are actually 'crowding' more people into each house, for only the third time since 1960. History shows that when crowding occurs, higher house prices and strong growth in residential building activity are sure to follow.

Figure 3: People per house



Rising house prices should be providing an incentive for developers to build more houses and alleviate the obvious shortage. So all and sundry, Westpac Economics included, are anticipating a very rapid increase in residential construction activity. But even our forecast 50% increase in residential construction activity over two years would leave construction activity at a low level, and would not be enough to completely alleviate the housing shortage.

The reason we are not picking an earlier or sharper increase in construction is that finance for NZ property development is extremely difficult and/or expensive to secure. Most of the finance companies that provided high-risk mezzanine finance at low cost during the last building boom have disappeared. Banks are wary of high-risk lending and are charging much wider spreads because they are themselves facing a higher cost of funds. It is worthwhile explaining just how we expect the construction industry to overcome its finance problems to deliver the houses New Zealand needs.

The relative expense/difficulty of financing property development has seen the price of bare land fall by far more than the price of houses. The ratio of house prices to section prices has widened sharply in the past year, the first significant rise since 1990.[1] So the reward for putting a house onto bare land – the developers' margin – has increased substantially. Our contention is that eventually, the developer's margin will get large enough to enable developers to overcome the high cost of finance. There is a price for everything, and if the price paid to developers rises high enough, they will find a way to develop!

Figure 4: Section prices and house prices

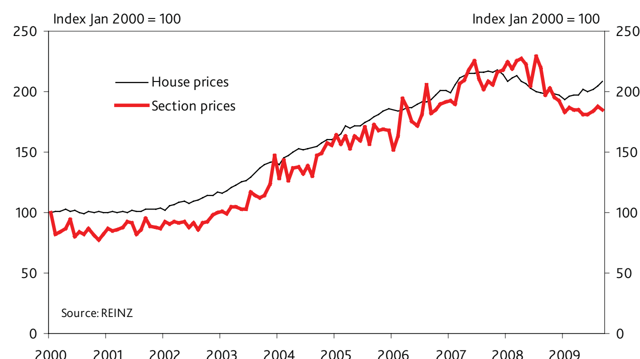
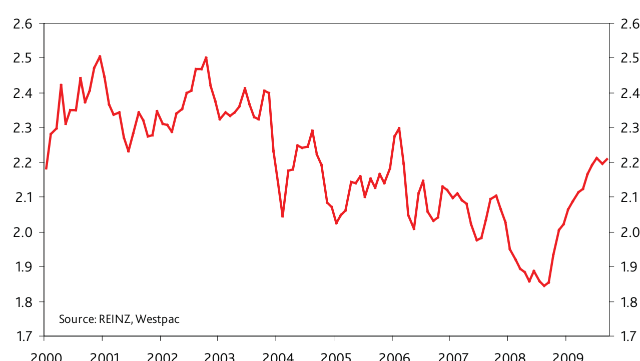


Figure 5: Ratio of house prices to section prices



The new environment we envisage, where developers' margins are higher but finance is more difficult to obtain, suggests the structure of the residential construction industry could change. Large, well-capitalised corporations that can draw on international balance sheets will be the most able to seize this profit opportunity. Small-scale builders that are mostly cash-flow positive might go from building two houses per year to building three. But mid-size developers who are highly leveraged may suffocate from lack of finance.

A second possibility is that the cost/difficulty of obtaining finance could ease. In this case the price of bare land would rise again, construction activity would blossom, and the developers' margin would shrink. We view a complete return to the loose lending conditions of 2004 – 2007 as exceedingly unlikely. But some easing in credit constraints is sure to follow economic recovery, as has always happened in the past.

Interest rates

The second driver of the bull-market in housing is low interest rates. In our last housing update (4 June 2009) we correctly predicted that low interest rates would drive a house price recovery. But we incorrectly surmised that rising long-term rates would soon squash the market. Long-term interest rates have gone up, but house prices have just kept on rising, with the market reacting more to low short-term rates. That is worrying. Because if low short-term rates are driving prices up, then the inevitable increase in short-term interest rates will eventually drive house prices down again.

[1] The ratio trends down because sections are getting smaller while houses are getting bigger. This makes the widening of the ratio all the more remarkable.

If this market remains hot, houses could become overvalued again. We like to judge the long-run fundamental value of houses by the Investment Value of Housing. Concepts such as the house-price-to-rent ratio or the house-price-to-income ratio are deeply flawed, because they fail to take account of changing interest rates, taxes, and inflation. The Investment Value of Housing is founded on the price-to-rent ratio, but correctly adjusts for prevailing interest rates, taxes and inflation.

It is future mortgage payments and capital gains that matter to today's house buyers. So any assessment of house prices must make assumptions about future interest rates and inflation – quite fraught in today's uncertain world! The table below shows how the degree of over-valuation according to our Investment Value of Housing depends on the **long-run average** mortgage rates and inflation rates that might prevail in the future (negative numbers imply under-valuation). We favour 2.8% inflation and 8.0% - 8.5% mortgage rates, suggesting houses are between 2% and 17% above their long-run sustainable level. The reader can make his/her own judgement as to which future scenario is most likely.

Percentage overvaluation according to Investment Value*		Expected inflation			
		2.00%	2.40%	2.80%	3.20%
Expected interest rate	9.00%	69	50	31	12
	8.50%	55	36	17	-3
	8.00%	40	21	2	-17
	7.50%	25	6	-13	-32
	7.00%	10	-9	-28	-47

* The Investment Value is the Net Present Value of renting a property out, under the following assumptions:
- Annual Rent: $14,700
- Long-run real capital gain: 3%
- Tax rate: 38%
- Maintenance costs: 3.2% of house value per annum
- Risk premium: 1% (calibrated to approximately equalise historical average investment value and historical average house price)

The table really does illustrate the uncertainties around the future value of property. If inflation rises above 3% on average, buying a house now could turn out to be the best financial decision you ever made. If New Zealand were to spin into Japan-style deflation, buying a house now would be a decision to regret. A word of warning: the analysis is based on the assumption that NZ's tax regime does not change. A capital gains tax, land tax, or lower income tax would all be unambiguously, and significantly, negative for house prices (and probably positive for rates of home ownership). Considering the risk of adverse tax developments does tilt us toward viewing NZ property as slightly overvalued relative to long-run fundamentals. We will write more on tax and house prices in an upcoming bulletin.

Although house prices may be high relative to long-run fundamentals, today's buyers are not fools. Today's buyers are getting an opportunity to take up cheap financing. It is worth paying a bit extra for a house to get it now, while interest rates are low. Today's one-year fixed mortgage rate is 6%, compared to the historical average of 8%. Buying today and taking a one-year fixed mortgage would save 2% of the house's value in interest costs compared to "normal". So buyers should be willing to pay up to 2% extra to secure the house now. Houses could reasonably trade at a greater premium if interest rates were expected to persist below 8% for more than one year (which is what we expect). It is perfectly reasonable for short-term interest rates to have a short-term effect on house prices, although the effect should be small relative to major considerations like taxation and long-run inflation.

Conclusions

Housing market sceptics are advised to stand aside for a while. This market has a head of steam on it, and prices are heading higher in the short run. But eventually, house prices will be high enough to incentivise a pickup in construction activity. And eventually, short-term interest rates will rise. When one or both finally come to pass, the market will turn and house prices could fall again. And changes to the tax regime could be seriously negative for house prices.

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