BNZ Weekly Overview

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Mission Statement

To help Kiwi businesspeople and householders make informed financial decisions by discussing the economy and its implications in a language they can understand.

Housing

I've not written much about the housing market in the past year compared with most years since late-2008. I jumped into the housing analysis and commentary pool back then because of the forecasts flying around in late-2008 regarding house prices headed for a collapse of 40% in New Zealand.

That popular forecast came from one of the early pioneers in the business of scaring people so they become eyeballs on a website trying to make money from people visiting it. There was no actual analysis behind the forecast, just an understanding of basic human psychology. Namely, we scare easily and if we see something bad happening in one place we wonder if the same thing might happen to us.

Specifically, as I went to considerable pains to point out then and for so many years afterward, New Zealand did not enter the 2008-09 Global Financial Crisis with either an over-supply of housing or very bad home lending practices. Not until maybe 2012 did there arise general acceptance that an over-supply never existed and that a shortage was present and growing rapidly.

By then it was too late to do anything about it in Auckland. People who had been putting off buying a house since 2007 started flooding into the market at the same time as older people realised well ahead of interest rate forecasters that NZ interest rates would not be returning to old levels and better yielding alternatives to bank term deposits needed to be found.

And at that time things became a lot worse for home buyers as the migration cycle with Australia turned and with help from other factors the net migration flow went from a loss of 4,000 people to a net gain a year ago of 72,000. The horse had bolted.

With general acceptance that a shortage existed, predictions of big price declines could not gain much credibility any longer. So an alternative narrative was thrown into the mix to get young people placing their eyeballs on the now greater number of web-focussed news services. This was the view that there is an inter-generational war going on, that young people were being denied a future of reasonably priced home ownership by rapacious older people who should have the decency to do the world a favour and die.

Instead these older people are set to live 10-15 years longer in retirement than the previous generation thanks to better living (fatter but healthier), and lives not spent digging coal or potatoes from the ground with a shovel.

There is no intergenerational war, certainly none declared by older people. Just ageism promoted by some media businesses seeking to shock their readers and keep their eyeballs for a few minutes longer. Nonetheless, the narrative works and social media firestorms kick off at any hint that one does not buy into the new narrative – as happened with this publication early last year.

But history aside, there is one very specific key point which I want to make this week regarding the housing market. At the moment young people are being encouraged to believe that the Tax Working Group was set up to improve housing affordability for them and that such improvement will in fact come not too many years from now.

This cultivated expectation is based on the false idea that making people pay tax on their property investments will generate such a wave of selling that prices will correct greatly. It won't and they won't and here is why.

Back in the 1970s my paternal grandparents retired from Palmerston North to a little house at Amberley Beach north of Christchurch. We visited frequently, and because at the time I had some breathing problems I got to spend some time off school in the bracing sea air away from the killing smog of Christchurch. One of the especially attractive things to me of visiting my grandparents was reading their collection of Readers Digest magazines, some of which were quite a few years old. I liked the articles about people's experiences in disasters, crawling back to camp after having a bear rip one's scalp off etc. along with the word quiz right at the front. But my favourite bits were the jokes.

Some of the funny anecdotes turned out not to be funny at all, but instead reflected the very core of what Readers Digest was and I guess is - a provider of insights into human behaviour. And there is one such little story which struck me at the time and which continues to occupy my mind even today, four decades later.

It was about someone who would go out walking and to make the walk more enjoyable would sometimes set a goal of reaching a lamppost before some casual ambler in front. If the walker could see that they were not going to make this goal they would shift it to the next lamppost or one after that.

There are a number of things you can take from this story and the lesson I took is that the dopamine hit of feeling or achieving some success or meeting a goal is good, and shifting the goalposts to achieve it is no big deal if you are the self-motivated person who set the goal in the first place. You've got time. Chill out, reframe your contest, your timeframe, and keep walking. Just keep walking. And that is why introduction of a capital gains tax will not produce the big selling and pullback of fresh investors from the housing market that some people are expecting.

By and large older folk and younger ones who have become investors have time on their side before they "need" to sell – maybe 15 years more than in the past. The vast majority have not bought property simply to make a pile of cash in only two or three years – though the media would have us believe that this is the timeframe most of these people have adopted. Government Ministers continually use the misleading word "speculators" without any evidence they are able to present regarding the motivations of investors.

Some people may well have a timeframe in mind. But it is likely to be quite a number of years and involve a combined return from rental yield and capital gain. They know that achieving capital gain is a long-term process and you (me, anyone) cannot predict short to medium-term property price changes. Most of them know what well known commercial property investor Bob Jones has repeatedly noted over the years. You buy and you hold. And the kicker is this. Very, very, very few of them will at any stage have sat down and calculated what long-term returns they could expect from residential property investment versus commercial property, versus managed funds, versus a self-created portfolio, versus an offshore investment, versus diversified corporate bonds etc.

Very few investors will, if a capital gains tax comes in, be able to say that as a result of this change their expected return from residential property investment has now dropped below a calculated expected return from equities so they will switch to investing in the sharemarket. The argument that discouraging property investment will produce a wave of funds seeking exposure to our shrinking number of listed NZ companies is wrong.

If a capital gains tax comes in, and that is a 50:50 call, this is what is going to happen. Investors will shift their target to a lamppost further down the street. They will give themselves a few more years to achieve a wealth goal, the magnitude of which they really have always just been guessing about anyway. They will look to boost running yield by raising rents, perhaps by improving the quality of their property and targeting better tenants.

In fact for the lowest quality tenants out there I have a message. Your future is bleak. You're going to be hit by three things. One I have just mentioned. Landlords will target better quality people and actively discriminate between those who can prove their propriety and those who cannot. Second, rents will rise more than would otherwise be the case which is the key argument in one of the advisory papers associated with the Tax Taskforce from which they conclude that a CGT will probably in fact raise average house prices rather than cause them to fall. The mechanism for this to happen will be young people escaping rising rents by buying. (Let me note again, still no apology has come from those "analysts" who post-2009 told young people they

should rent because buying would lead to lost equity.)

Third, as some landlords sell and fewer repurchase for rental purposes, young people will finally be able to move out of their folks' homes and achieve the ownership dream which I believe most of us aspire to. As they move out of their parent's house having stayed at home for years longer than anticipated or desired, they occupy the house which previously had tenants. The tenants will not be welcomed into the bedrooms now made vacant by the 25-35 year olds finally leaving home. They will have nowhere to go.

This will place additional pressure on the government and local authorities to boost the availability of social housing and as a society we should be prepared to pay for such accommodation to be provided for these displaced members of our society. Note – as more building resources are devoted to constructing "affordable" housing fewer higher priced, larger dwellings will be built and a bigger price gap will open up between these housing types. Jumping from the necessary first home to the desired second or third home is about to become much more difficult.

Are there house price implications in all of this? I see nothing in front of me suggesting that house prices are going to fall away to any degree or that they will newly bound up again. This cycle ended two years ago in Auckland and the rest of the country will join in the flatness soon. There really is nothing new and special going on. That's why I assign a 50+% chance to the Reserve Bank easing LVR requirements in a cyclical manner in their November Financial Stability Report.

All I see are politicians lying about the true nature of most property investors, poor prospects for occupants of the lowest portions of our socioeconomic spectrum, and dashed dreams to continue for young buyers still thinking that a big house price correction is headed their way.

Their best hope? Enter our country's two Lotto games – the official one and KiwiBuild. But watch for the first story of poor KiwiBuild quality. All it will take is one tv tour of a poorly built KiwiBuild home (think Paul Holmes at Wellington's 1990 Sesquicentennial debacle) and the properties will be forever tainted, whether justified or (almost certainly) not, and a permanent price differential will arise, as has happened for leasehold property and is coming slowly for properties by the sea and in high earthquake risk areas. Don't ignore those seaside and faultline risks.

Were I a young person starting afresh now I'd be in Kiwisaver because of the home purchasing advantages it will give me, I'd be cultivating people with spare funds for the help they could give. (This seems to be a glaring gap in our capital markets.) I'd be thinking about offering them or others an equity-sharing scheme. I'd look to work myself into employment offering flexible work hours and locations so I could reduce peak time commuting issues, I'd look at locations near public transport, I'd look well away from the city centre, and I'd look for something very few other people might want to touch. (Yeah, you know what I want to write here – would have been a good move last year given the change in testing standards wouldn't it!)

I'd look for property either with something wrong with it or some characteristic which other people would turn their noses up at. And I'd approach the house hunt as an ongoing activity, going for a regular walk rather than a time-focussed tramp, one for which I would always be prepared to alter my goals and aim for a different lamppost further down the road.

And one final point. My experience is that when lending conditions change in Australia a tendril of those changes feeds through to New Zealand with a lag. Currently across the ditch banks are tightening up their lending criteria, particularly in the areas of more accurate assessment of a borrower's ongoing expenses, more accurate assessment of their income, and full knowledge of their total debt obligations to all other lenders. The old days of borrowing from one provider to show a deposit to another, making up income and expenditure numbers with bankers nodding their heads knowing they are fictitious are disappearing. Lending conditions are tightening over there and some version of this tightening will surely land on our shores as well.

If I Were A Borrower What Would I Do?

As expected this morning the Reserve Bank left the official cash rate at 1.75% and retained their expectation that a rate rise is unlikely until late-2020. They discounted the recent stronger than

expected 1% GDP growth during the GDP quarter and noted that the boost to inflation coming from currently rising fuel prices will be “looked through”. They also noted downside risks to growth.

There seems to be a clear bias toward cutting interest rates if anything negative comes along. But then again, they are probably doing what we wrote a couple of years back – waiting until inflation actually physically threatens the 3% upper limit of the target range. Having twice got it wrong tightening monetary policy and having to quickly reverse rate rises since 2010 they can surely be forgiven for wanting to poke the whites of the eyes of inflation before moving for a third time.

Were I borrowing currently I'd probably fix three years.

The Weekly Overview is written by Tony Alexander, Chief Economist at the Bank of New Zealand. The views expressed are my own and do not purport to represent the views of the BNZ. **This edition has been solely moderated by Tony Alexander.** To receive the Weekly Overview each Thursday night please sign up at www.tonyalexander.co.nz
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