

Negative gearing fades but cash flow provides a positive outcome

STUART WEMYSS

By **STUART WEMYSS**

12:00AM AUGUST 24, 2019 •  3 COMMENTS

You would be excused for thinking that developed economies all over the world are gradually making their way to a zero interest-rate environment. The market is predicting that the RBA will cut rates to half a per cent by mid-2020. If this turns out to be correct, Australian mortgage rates could fall even further.

The most obvious consequence of low interest rates for property investors is that it significantly cuts negative gearing tax benefits.

When interest rates were 7 per cent, property investors were crystallising large income losses. That is because the interest costs and property expenses were a lot more than the property's rental income. The investor could offset this loss against employment income and enjoy a sizeable tax refund (which is referred to as negative gearing).

According to CoreLogic, Australia's gross rental yield is 4.1 per cent. Compare that to the current interest-only investment mortgage rate of about 4.5 per cent and you will see why an investment property's income loss today is only 40 per cent of what it was when interest rates were much higher. As a result, taxation benefits derived from borrowing to invest in property are consequently 60 per cent lower.

In a low interest-rate environment, saving tax is no longer a big drawcard for prospective property investors. This is a good thing as you should never invest predominantly to generate tax benefits.

Another consequence of low interest rates is that using your own cash carries with it a higher opportunity cost.

That is, you must consider what investment returns you can generate by investing your cash elsewhere (and using borrowed funds instead).

If you believe you can achieve an investment return greater than the mortgage rate, then you are better off to use borrowings to invest in property, not your own cash. With such low rates, why would you use your own money (assuming it's safe and prudent for you to borrow)?

Historically, one of the downsides to investing in property is the cash-flow cost of doing so. That is, borrowing to invest in property would usually eat into your personal cash flow, as the property's rental income typically would not be enough to pay for all expenses and costs. While this cost is not eliminated in a low interest-rate environment, it is greatly reduced.

According to Real Estate Institute of Australia data, the housing growth rate in the five largest capital cities has ranged from 6.44 per cent to 7.96 per cent since 1980. Therefore, if you can invest in an asset that produces similar capital growth rates in the future, and it costs you a lot less cash flow to hold the asset, your net investment returns are greatly improved.

For example, I estimate a \$750,000 investment property would cost you \$60,000 in today's dollars to hold for 15 years, compared to \$220,000 at an interest rate of 7 per cent. A property investor is in a much better position today, assuming the property produces the same capital growth.

Of course, a low interest-rate environment could produce adverse outcomes too. When capital (money) is priced so cheaply, investors think less about potential investment returns and risk. This can result in money flowing into inferior investments.

Property prices in the long run are driven by the laws of supply and demand. A location that is in high demand, but short supply, will usually benefit from price appreciation. Normally, investors are attracted to such locations, such as blue-chip suburbs in proximity to the CBD.

However, when money is cheap, investors do not need as high returns to more than offset borrowing costs. This may result in investors being less diligent about a location. This can temporarily distort prices and returns.

Another potentially negative consequence of low interest rates may also include downward pressure on rents. If interest rates are low, particularly for owner-occupiers, at some point it will become cheaper to own your home compared to renting. In this case, there will be less demand for rental properties and that may result in the depreciation of rental income for investors.

In some ways, we are entering uncharted waters. Quality is the best refuge for long-term investors. A quality property will produce quality returns in the long run.

Stuart Wemyss is a financial adviser and author of Investopoly: the 8 Rules for Mastering the Game of Building Wealth.

swemyss@prosolution.com.au

502 Bad Gateway