Home prices growing slowly in high tax East Coast cities - is tax reform to blame?

- The 2018 Tax Reform Act passed in Dec 2017 included a cap on the State and Local Income Tax (SALT) deduction of $10k while raising the standard deduction.
- This SALT deduction limit marginally disincentives buying-versus-renting for high-priced homes in areas with high taxes as homeowners are less likely to benefit from deducting local property taxes.
- Home sales witnessed a slowdown in high tax East and Midwest cities in H1 2018 versus a year before. Days listed metrics also showed more lengthening in these areas versus others.
- In contrast, high tax West Coast cities exhibited no signs of influence from the tax reform. The effect may have been masked and even overshadowed by stronger influences from wage growth, population growth, demographics, and the general improvement in the economy.
- While high tax East Coast and Midwest cities witnessed slower home price growth in H1 2018 than the rest of the U.S., it was a continuation of the trend that existed from before the tax reform.
- Slowing sales and more days on market likely point to some potential weakening in home price growth in high tax East Coast and Midwest cities relative to the rest of the U.S. That said, it may be too early to measure the full effect of tax reform on housing and the jury will be out until we get more data.

TAX REFORM FOR 2018 CHANGES INCENTIVES FOR HOME-BUYING IN HIGH TAX, HIGH-PRICED LOCATIONS

In late December 2017, Congress passed and the President approved the Tax Cuts and Jobs Act of 2017 which goes into effect for the 2018 tax year. The bill changed large parts of the corporate tax code, but here, we focus on the changes for individual taxpayers which are likely to directly influence housing. For household taxpayers, the primary changes included lower marginal tax rates and a higher standard deduction (partially offset by eliminating the personal exemption). These tax changes are beneficial to most taxpayers and in a vacuum would increase household net incomes.

However, two changes were also made to the tax code which changed households' incentive to rent versus own a home. First, the mortgage interest deduction was capped on interest for $750,000 of principal versus $1,000,000 earlier. The lower mortgage interest deduction cap reduces the incentive to own a home slightly at the margin for ultra-high end homebuyers who need a mortgage larger than $750k regardless of location.

Second, the State and Local Tax Deduction (SALT) was capped at $10,000. This includes property taxes plus one of sales or income taxes paid to local and state governments. The new SALT deduction cap (combined with higher standard deductions) reduces the benefit of deducting local property taxes from income for federal tax, particularly in high property value areas. As a result, middle and higher income households in high tax cities are less likely to benefit from buying a home and deducting property taxes for federal tax purposes. Additionally, this change is more likely to influence households from high income tax states, who are more likely to use itemized deductions that benefit from SALT. For example, in New Jersey the average 2.28% property tax rate equates to $11,400 on a home assessed at $500,000 before including state income taxes. Deducting this $11,400 on federal would save a homeowner $2,850 annually at a 25% marginal tax rate compared to renting. However, with the standard deduction increased to $12,000/$24,000 (single/married), and the SALT deduction capped at $10,000, owning would provide little or no tax savings versus renting for this hypothetical household (depending on other deductions available). Additionally, this reduced deduction may reduce or outweigh the effects of the lower marginal tax rates on effective tax paid for households in high local tax cities.

FIGURE 1. CHANGES IN HOMEOWNERSHIP TAX INCENTIVES FOR HOUSEHOLDS BY INCOME/STATE TAXES

	Lower Income Household	Middle Income Household	Upper Income Household
High Tax Locales	Tax changes are unlikely to change buy-versus-rent decision	SALT cap may reduce the incentive to own homes in areas with very high property taxes	SALT deduction cap and lower mortgage deduction likely to reduce the incentive to own homes in expensive, high property tax locales
Low tax Locales	Tax changes are unlikely to change buy-versus-rent decision	Tax changes are unlikely to change buy-versus-rent decision	Less likely to be impacted by the SALT cap, but ultra-high end homeowners (>$750k mortgages) may feel effects of lower mortgage deduction cap

Source: Amherst Capital Management as of July 2018

The effects of these tax changes would most likely show in household fundamentals in wealthy, high tax cities. To measure these effects, we divided the cities within the Amherst 20-City HPI index into high tax and low tax cities based on cities within states with the highest usage of itemized deductions (including SALT) in 2015 (Source: Pew Trusts "Cap on the State and Local Tax Deduction Likely to Affect States Beyond New York and California", April 2018, IRS). In addition, we split up the high tax cities between the faster growing West Coast (annualized 5y HPA of 7.3% through Dec 2017) and slower growing Northeast and Midwest (annualized 5y HPA of 3.7% through Dec 2017) based on Amherst 20-City HPI data as of July 2018.

FIGURE 2. SPLITTING UP THE AMHERST 20-CITY HPI BETWEEN HIGH TAX AND LOW TAX AREAS

	High Tax Cities/States (East and Midwest)	High Tax Cities/States (West Coast)	Low Tax Cities/States
Top 10 High Deduction States	New York, Connecticut, New Jersey, Washington, D.C., Massachusetts, Minnesota, Maryland, Illinois	California, Oregon	None
Average Itemized Deduction (simple average by state), includes SALT and other deductions	$16,264 at 38% use rate	$15,528 at 35% use rate	$8,798 (use rate not available)
Amherst 20 HPI Cities	Boston, Chicago, Minneapolis, New York, and Washington	Los Angeles, San Diego, San Francisco, and Portland	Phoenix, Dallas, Denver, Miami, Tampa, Atlanta, Detroit, Charlotte, Las Vegas, Cleveland, Seattle
Average 5y HPA Through Dec 2017 (before tax changes)	3.7%	7.8%	6.9%

Source: Amherst Capital Management as of July 2018, PEW Research, IRS as April 2018

EFFECTS ARE LIKELY JUST BEGINNING TO APPEAR IN DATA

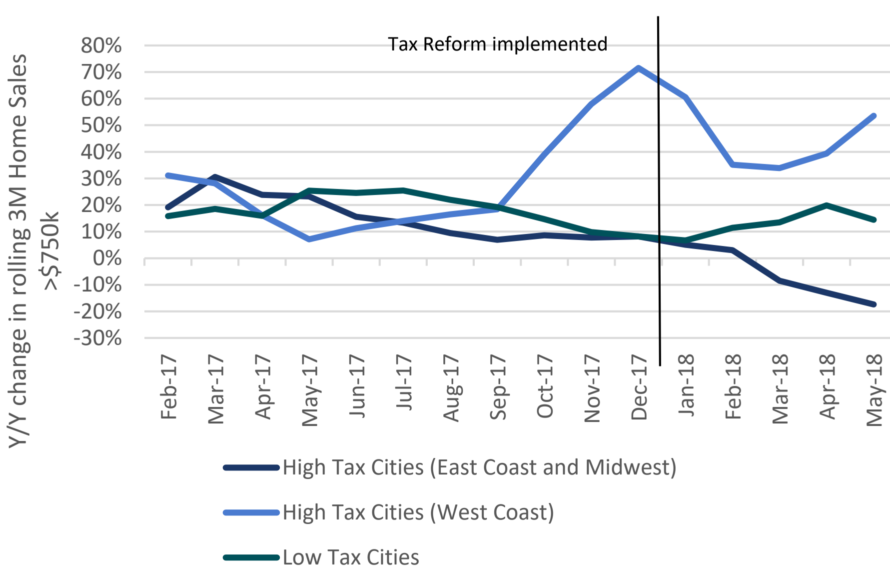
We believe the changes in tax code only affect home fundamentals at the margin, and we would not expect these effects to outweigh larger factors such as economic growth, housing supply, population growth, wage growth, and cost of living, etc. However, we would expect to see relative underperformance for expensive homes in high tax cities.

HOME SALES SHOWING SOME SIGNS OF SLOWING IN HIGH TAX AREAS OUTSIDE CALIFORNIA

Very often, weaker home prices are preceded by slowing transaction volumes and even longer days on market. Given it is still early days after the tax reform, we first focused on any effects in home sales volumes and the length of time homes are spending listed for sale. We do see signs of this for East and Midwest high tax cities, where rolling three month home sales showed signs of declining on a year-over-year basis (Figure 3), while low tax city home sales continued to grow. However, home sales growth remained very strong on the West Coast, where the economic boom likely continued to drive sales.

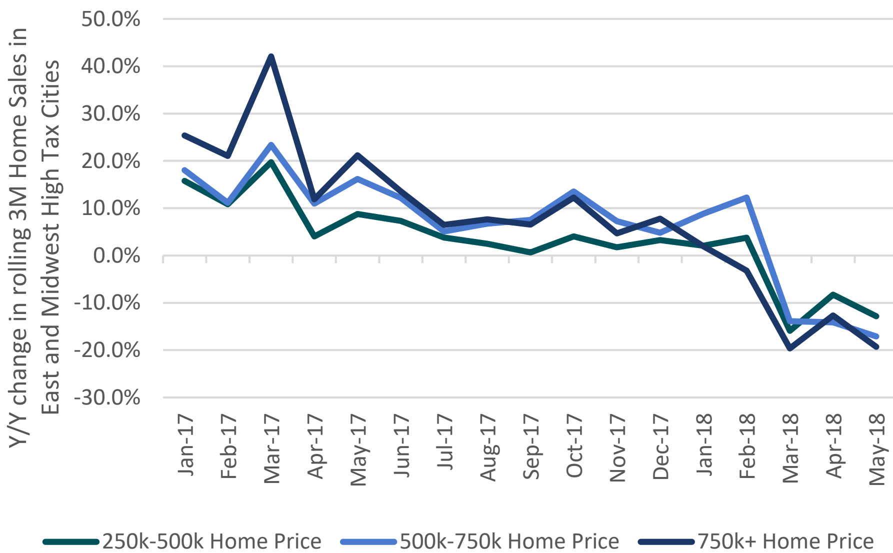
Interestingly, it is hard to ascertain if the slowdown in East and Midwest high tax cities is being caused directly by tax changes. This is because home sales growth appears to be slowing down in these cities even for lower priced homes whose buyers are less likely to be impacted by the tax changes (Figure 4). On the margin, we believe tax reform changes have a role to play here and lower transaction volumes in lower priced buckets might just be a spillover effect from the higher priced ones.

FIGURE 3. HIGH-PRICE HOME SALES SHOWED SIGNS OF DECLINE IN EAST AND MIDWEST HIGH TAX CITIES IN H1 2018



Source: Amherst Capital Management as of July 2018 Note: Using Amherst 20-City HPI as of July 2018. Areas grouped using simple average of cities. High Tax East Coast and Midwest Cities are Boston, Chicago, Minneapolis, New York, and Washington. High Tax West Coast Cities are Los Angeles, San Diego, San Francisco, and Portland. Low Tax Cities comprise remainder of Amherst 20-City HPI cities. High Tax areas based on cities within top 10 states with highest use of deductions in tax returns from Pew Trust Research, IRS as of April 2018

FIGURE 4. BUT EVEN LOWER PRICED HOME SALES IN EAST AND MIDWEST HIGH TAX CITIES SHOWED SIGNS OF SLOWING IN IN H1 2018



Source: Amherst Capital Management as of July 2018

DAYS LISTED METRICS ALSO SHOW SIGNS OF INCREASING IN EAST COAST HIGH TAX CITIES

Similar to slowing sales, the number of days that listings have been on the market also showed signs of worsening in high tax East Coast and Midwest cities relative to others. The median listing time for home sales increased slightly to 66 days in the first half of 2018 in high tax east coast cities, but still remains relatively quick overall (particularly for the slower winter months). In contrast, listing times decreased meaningfully in the West Coast high tax cities and low tax cities from the Amherst 20 HPI cities. Overall, the median days on market remains low across the country, but the high tax East Coast and Midwest cities did not participate in the shortening in H1 2018.

FIGURE 5. CHANGE IN MEDIAN DAYS LISTED FOR HOMES FOR SALE BY TAX REGION AND PRICE POINT

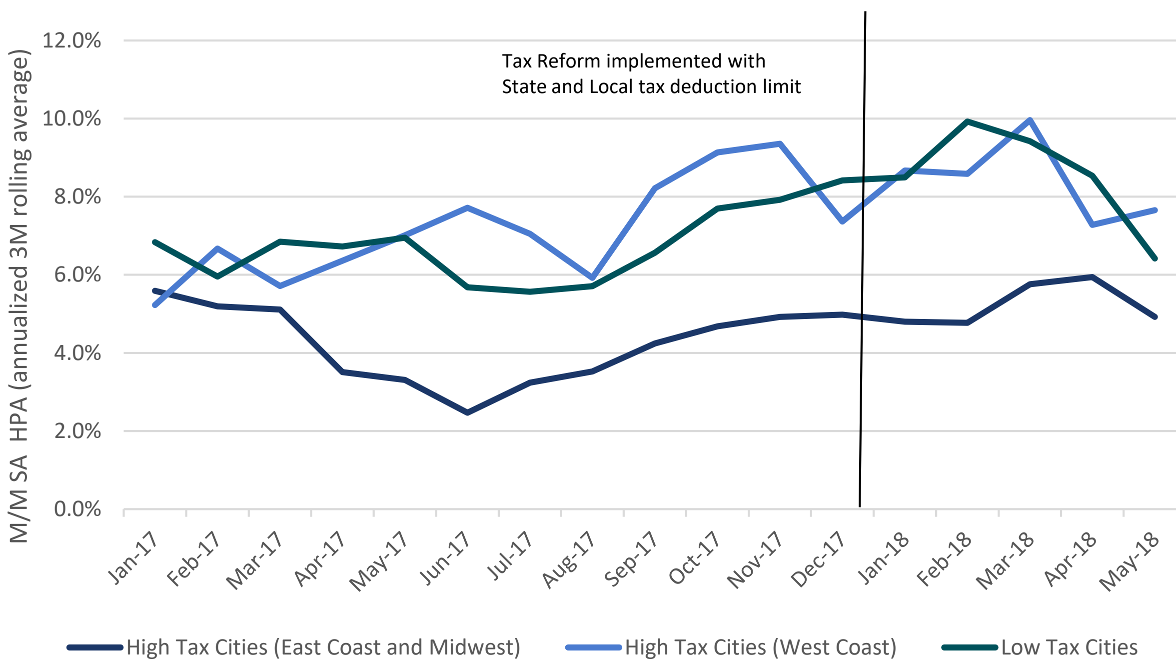
	Median Days Listed in H1 2018			Change from H1 2017		
	High Tax Cities (East Coast and Midwest)	High Tax Cities (West Coast)	Low Tax Cities	High Tax Cities (East Coast and Midwest)	High Tax Cities (West Coast)	Low Tax Cities
250k-500k Listing Price	45	24	30	-2	-9	-5
500k-750k Listing Price	52	27	38	1	-14	-6
750k+ Listing Price	66	33	51	1	-17	-10

Source: Amherst Capital Management as of July 2018

SIGNS OF THE TAX REFORM HAVE NOT YET APPEARED IN HPA DATA

Home prices continue to grow at historically strong rate, with the overall Amherst 20-city HPI index growing at a 6.5% y/y rate in May 2018 and there are not yet obvious signs of tax reform affecting HPA. Seasonally adjusted numbers indicate a slowing of home price growth in April-May 2018 versus Q1 2018 with growth rates of 4.4% and 8.3% respectively. This data also bears out when dividing the Amherst 20-city HPI into tax groupings (Figure 6). At the same time, there is no material worsening in trend for the high tax East Coast and Midwest cities that can be discerned as yet.

FIGURE 6. QUARTERLY HPA GROWING MORE SLOWLY ACROSS TAX REGIONS



Note: Using Amherst 20-City HPI as of July 2018. Areas grouped using simple average of cities. High Tax East Coast and Midwest Cities are Boston, Chicago, Minneapolis, New York, and Washington. High Tax West Coast Cities are Los Angeles, San Diego, San Francisco, and Portland. Low Tax Cities comprise remainder of Amherst 20-City HPI cities. High Tax areas based on cities within top 10 states with highest use of deductions in tax returns from Pew Trust Research, IRS as of April 2018.

CLEAR EFFECTS FROM TAX REFORM MAY SHOW IN H2 2018 AND 2019

Overall, signs for a relative underperformance in high tax cities from the tax reform bill are not yet clear six months since passage. Slowing sales and more days on market likely point to some potential weakening in home price growth in high tax East Coast and Midwest cities relative to the rest of the U.S. That said, it may be too early to measure the full effect of tax reform on housing and the jury will be out until we get more data.

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ABOUT AMHERST 20-CITY HPI INDEX

Amherst home price index is generated and maintained by Amherst Insightlabs LLC. The index tracks price changes of single-family detached properties in 20 core based statistical areas (CBSA). The index is published monthly and is based on the Case Shiller repeated sales methodology. The 20 cities are based on the Case Shiller 20-City Composite and consist of Atlanta, Boston, Charlotte, Chicago, Cleveland, Dallas, Denver, Detroit, Las Vegas, Los Angeles, Miami, Minneapolis, New York, Phoenix, Portland, San Diego, San Francisco, Seattle, Tampa and Washington, D.C. Unlike HPI published by S&P Case Shiller Weiss, Corelogic and Federal Housing Finance Agency (FHFA), Amherst 20-City HPI is a distressed-free index which does not include price changes due to foreclosures, short-sales, bank repossession and REO resale. The repeated sales HPI rely on tracking price changes in transactions of the same house over time. For each arms-length and distressed free home sale transaction, a search is conducted to find information regarding previous arms-length and distressed-free sales of the same house. If an earlier transaction is found, the two transactions are paired into a "sale pair." Sale pairs are designed to track price changes over time for the same house, while holding the quality and size of each house constant. After sales pairs are formed, the index is calculated under a weighted least square framework, in which weights are based on price anomalies and time interval within pairs.

(1) March 31, 2018. AUM includes gross assets managed in the single-family equity and commercial real estate strategies, which includes $272 million and $66 million of leverage, respectively.

(2) Seed capital Investor. It is not known whether the listed client approves or disapproves of the adviser or the advisory services provided.