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Residential Property Affordability Review

Home-Related Affordability picture is a mixed bag, with the main home affordability measures improving in the 3rd quarter of 2014, but some "home-related" measures deteriorating

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MARKET ANALYTICS AND SCENARIO FORECASTING UNIT

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Residential Property-Related Affordability is important to both lending institutions as well as their mortgage lending clients, as shifts in affordability have implications in terms of the level of financial pressure that they can exert on households.

Therefore, whereas a dramatic improvement in home and home-related affordability from late-2008 to 2012 was instrumental in lowering levels of bad debt and distressed home selling, further affordability improvements have been slow in coming since then, and certain home-related affordability measures are even deteriorating.

KEY POINTS

The home affordability picture in recent times has been something of a "mixed bag", although we believe that taking all home-related affordability measures into account there has been a mild deterioration through 2014.

- *After 2 quarters of mild deterioration, both of our main home affordability measures, namely the Average Price/Average Employee Remuneration and the Average Home Installment Repayment/Average Employee Remuneration Ratio Indices, improved (declined) mildly in the 3rd quarter of 2014. This was due to the combination of slower house price inflation in that quarter, along with noticeably stronger employee remuneration growth compared to the prior quarter, as strike action abated and employee wage payments normalized.*

- *However, other key related affordability measures have continued their deteriorating trends. The Household Sector Debt-Service Ratio (The cost of servicing the household sector debt burden, expressed as a percentage of Household Sector Disposable Income) continued to rise (deteriorating affordability) late in 2014, having been on a rising trend from a low of 8.5% at a stage of 2013 to 9.3% by the end of 2014 .*

- *Examining "competitor products" to housing, we also saw a deterioration in housing's relative position, with Real House Prices (house prices measured against consumer goods and services prices) rising in the final quarter of 2014, having been on a broad rising trend since 2012.*

- *House prices have continued their rising trend relative to house rentals, slowly increasing the favourability of the rental option relative to home buying.*

- *Finally, arguably the most troublesome deterioration in home-related affordability remains in the area of Municipal Rates and Utilities tariffs, whose affordability deterioration looks set to continue unabated, driven most notably by electricity cost increases.*

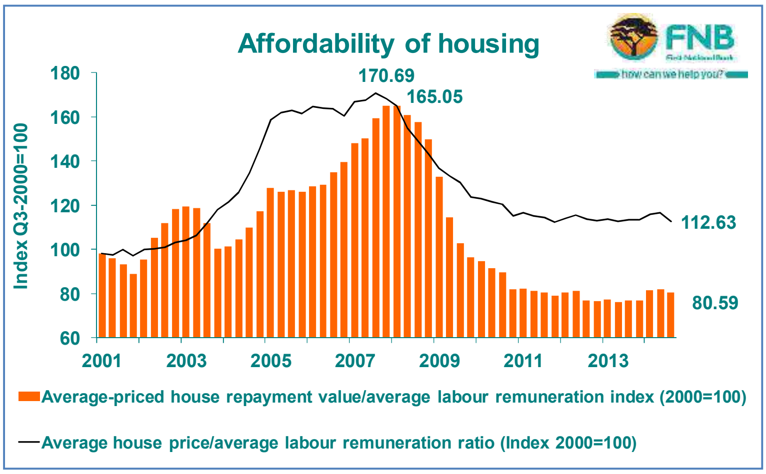
ESTIMATES OF HOME BUYING AFFORDABILITY

The March SARB Quarterly Bulletin enabled us to update our own 2 housing affordability indices for the 3rd quarter of 2014, using the SARB Average Employee Remuneration Index, the FNB House Price Index, and a Prime Rate time series. As at the 3rd quarter of 2014, we saw a slight improvement in these measures of affordability, after prior quarters' deteriorations.

Of our 2 main affordability measures, the 1st measure, namely the Average House Price/Average Employee Remuneration Index, declined (improved) slightly by -3.3% in the 3rd quarter of 2014 compared to the level for the previous quarter.

The 2nd measure, namely the "Installment Payment Value on a new 100% Bond on the Average Priced House/Average Employee Remuneration Ratio" Index, also declined, but by a lesser -1.6% in the 3rd quarter.

Both indices were driven lower by average employee remuneration growth once more exceeding house price growth in the 3rd quarter, but the latter index benefited less due to the impact of a small July 25 basis point interest rate hike, which partially offset the positive impact of higher employee remuneration on affordability.

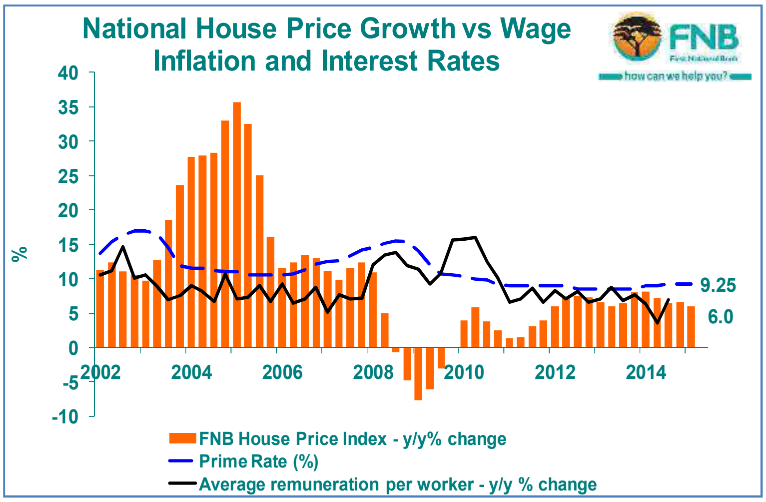


The affordability levels remain far improved on the highs of "in-affordability" experienced back around 2007/8. The cumulative decline (improvement) in the 2 affordability indices since their 2007 peak levels are -34% in the case of the Average Price/Income Ratio Index and -51.2% in the case of the Instalment/Income Ratio Index.

However, despite a one quarter improvement in the affordability measures, the broader trend has been "sideways to slightly higher" since around 2013, with the big improvements(declines) having taken place from 2008 to 2012.

SLOWING HOUSE PRICE GROWTH INCREASES LIKELIHOOD OF AFFORDABILITY MOVING SIDEWAYS IN THE NEAR TERM

The slight housing affordability improvement in the 3rd quarter of 2014 had to do with the combination of an acceleration in Average Employee Remuneration, according to SARB figures, along with a slowing in Average House Price Inflation in that same quarter.



The acceleration in employee remuneration growth came after a bout of heavy strike action in the prior quarter was arguably responsible for hampering this growth, and merely reflects a return to "normality".

Average Employee Remuneration growth accelerated from a lowly 3.5% year-on-year in the 2nd quarter to 6.9% in the 3rd quarter of 2014.

Simultaneously, average house price inflation declined from 7.2% year-on-year to 6.4% over the same 2 quarters, meaning that employee remuneration "out-inflated" house prices slightly.

However, working partly against the positive impact of these 2 variables was a 25 basis point interest rate hike by the SARB in July, which impacted negatively on the Installment/Remuneration Affordability Ratio, containing the extent of its improvement

Looking forward into 2015, the outlook for affordability may have improved somewhat. Whereas we had started the year expecting stronger house price inflation during 2015, compared with 2014, initial data on house prices as well as economic data suggest that both the housing market and the economy are in a "soft patch", and are not really benefiting from the stimulus of sharply lower oil prices.

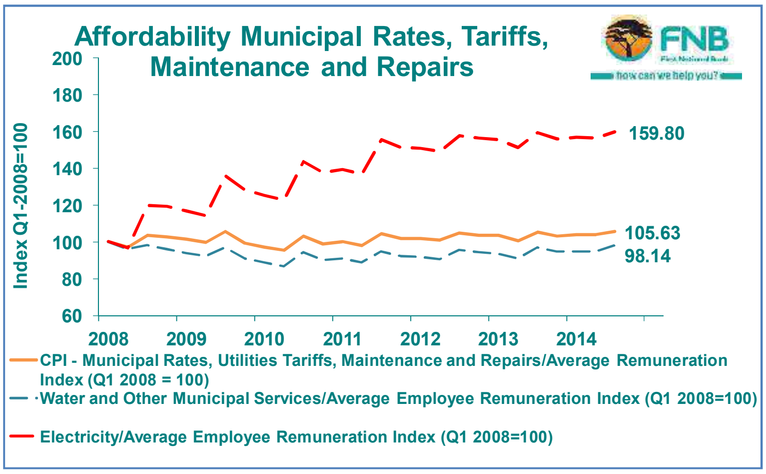
It looks increasingly likely, therefore, that house price growth will not meaningfully exceed employee remuneration growth, the former recording a 6% year-on-year rate as at February 2015 and still slowing gradually. This leads us to expect a more-or-less sideways movement in the 2 affordability measures, based on the FNB forecast that interest rates will remain unchanged through 2015.

However, in 2016 we would anticipate a deterioration in the Installment/Remuneration Affordability Measure, based on the expectation that the SARB will resume gradual interest rate hiking in that year.

THE HOUSING-RELATED AFFORDABILITY PICTURE CONTINUES ITS "GRADUAL SLIDE"

Estimate of home running cost-related affordability

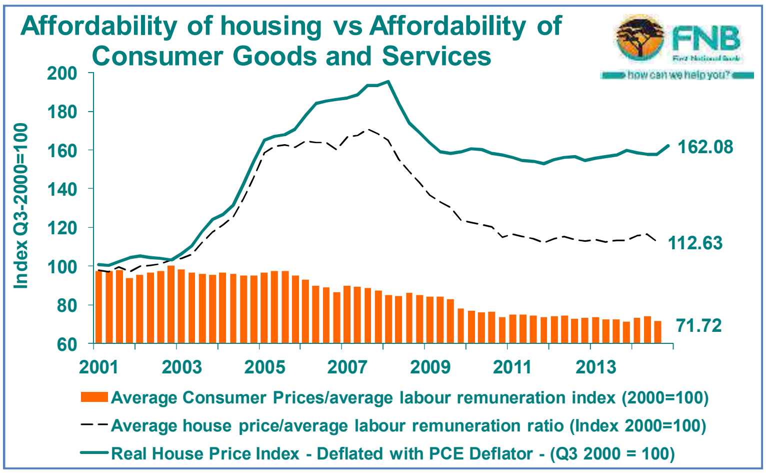
Next we consider measures of affordability that are related to the home, i.e. those that are running cost related, and to this effect we use components of the CPI (Consumer Price Index) to construct a CPI for Municipal Rates and Tariffs, along with the index for maintenance and repairs costs. Unlike the home buying-related affordability measures which saw improvement from 2008-2012, the "Municipal Rates, Tariffs, Maintenance and Repairs/Average Employee Remuneration" Index has been on a gradual broad rising (deteriorating) trend through the entire 2008-14 period.



This affordability measure rose (deteriorated) slightly during the 3rd quarter of 2014, by +1.4% on the previous quarter, and it is now +5.63% above its level at the beginning of 2008, having been driven higher for the most part by high inflation in the area of electricity tariffs, but moderated in part by lower maintenance and repairs cost inflation. The Electricity Affordability component is the troublesome part of the Rates and Tariffs bill, and its affordability index has escalated by a massive 59.8% since the beginning of 2008, having risen a further +2.2% in the 3rd quarter of last year.

"Competitor Product" Affordability

It is also important to consider the "price competitiveness" of housing versus consumer goods and services that in part compete with it for a share of household disposable income.



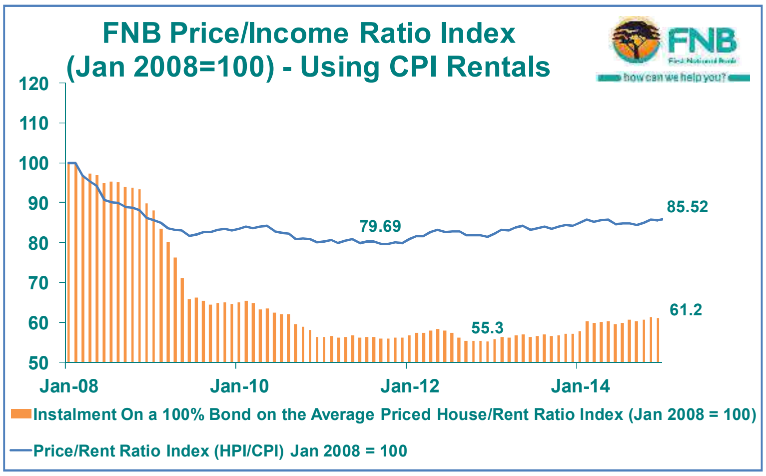
Relative to where we started back in 2000, at the start of the housing and consumer booms, housing is significantly worse off today. Limited housing supply back in those boom years, when demand surged, led to massive house price growth and resultant affordability deterioration. By comparison, affordability of consumer goods and services continued to improve throughout the boom years, with especially the importable consumer goods not experiencing major supply *constraints and price inflation surges during demand booms.*

Therefore, despite the Average House Price/Average Remuneration Index (with the year 2000=100) having improved (declined) quite dramatically up until 2013, by the 3rd Quarter of 2014 it still sat at 112.63, while the Average Consumer Price/Average Remuneration (with the year 2000=100) had dropped as low as 71.72, having never really risen in the boom years of 2000-2007.

Therefore, over the boom years, housing lost major ground on consumer goods and services in terms of relative affordability, and never fully "recovered". So, when we use the PCE (Private Consumption Expenditure) Deflator to deflate house prices into real terms (with 2000-100 for the real House Price Index), we see that the Real House Price Index is still a massive 62.08% higher than in mid-2000, as at the 4th quarter of 2014. The Real House Price Index is also mildly elevated from its end-2011 relative low point to the tune of +6%.

Therefore, there has been some broad deterioration in this measure of affordability as the residential market strengthened from 2012, and recently low consumer price inflation, largely as a result of sharply lower oil prices, makes it almost certain that further real house price increase has been taking place early in 2015.

Price-to-Rent Ratio



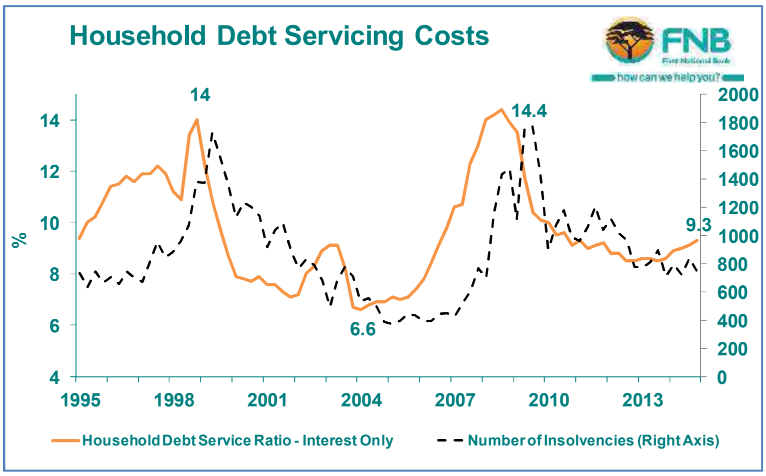
Then there is the more direct "competitor" product, i.e. the rental home. It is important to measure home prices against rental trends, because households do have the choice of renting in larger numbers when the cost of home buying become relatively more costly, or vice versa.

Indeed, we have seen a broad rise in the Average House Price/Average Rental Ratio Index from late-2011 to early-2015, as well as the Installment Repayment Value on the Average-Priced Home/Average Rental Index.

These indices have been rising due to house price inflation being faster than average rental inflation, while the Instalment/Rental Index version had an added driver in the form of the interest rate hikes of 2014.

Therefore, relative to rentals, it would appear that the home buying option's attractiveness has deteriorated somewhat since 2011, not surprising given a relatively strong home buying market period that we have been through.

Credit Affordability



Finally, there is the matter of credit affordability, which is a function of how much credit is outstanding, the level of disposable income, and of course the prevailing level of interest rates.

The best measure of the affordability of Household Sector credit is the Household Debt-Service Ratio (The cost of servicing the household sector debt burden, expressed as a percentage of Household Sector Disposable Income).

The SARB's "interest only" version of this ratio, after ending its downward trend in 2013, began to rise late in 2013, from 8.5% in the 3rd quarter *of that year to 9.3% by the 4th quarter of 2014, lifted in part by the SARB's January and July interest rate hikes, and in part by a partial shift by households to greater utilization of higher priced non-mortgage credit.*

IN CONCLUSION

Therefore, the home affordability picture in recent times has been something of a "mixed bag" of late. However, we believe that taking all affordability measures into account there has been a general deterioration through 2014.

After 2 quarters of mild deterioration, both of our main home affordability measures, namely the Average Price/Average Employee Remuneration and the Average Home Installment Repayment/Average Employee Remuneration Ratio Indices improved (declined) mildly in the 3rd quarter of 2014.

However, other key related affordability measures have continued their deteriorating trends. The Household Sector Debt-Service Ratio continued to rise (deteriorating affordability) late in 2014.

Examining "competitor products" to housing, we also saw a deterioration in housing's relative position, with Real House Prices (house prices measured against consumer goods and services prices) continuing to rise, and house prices continuing their rising trend relative to house rentals.

And finally, arguably the most troublesome deterioration in home-related affordability remains in the area of Municipal Rates and Utilities tariffs, whose affordability deterioration looks set to continue, driven most notably by electricity cost increases.