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Residential Property Affordability Review

For credit-dependent home buyers, the Housing Affordability picture continued its broad deterioration in the 1st quarter of 2016

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MARKET ANALYTICS AND SCENARIO FORECASTING UNIT

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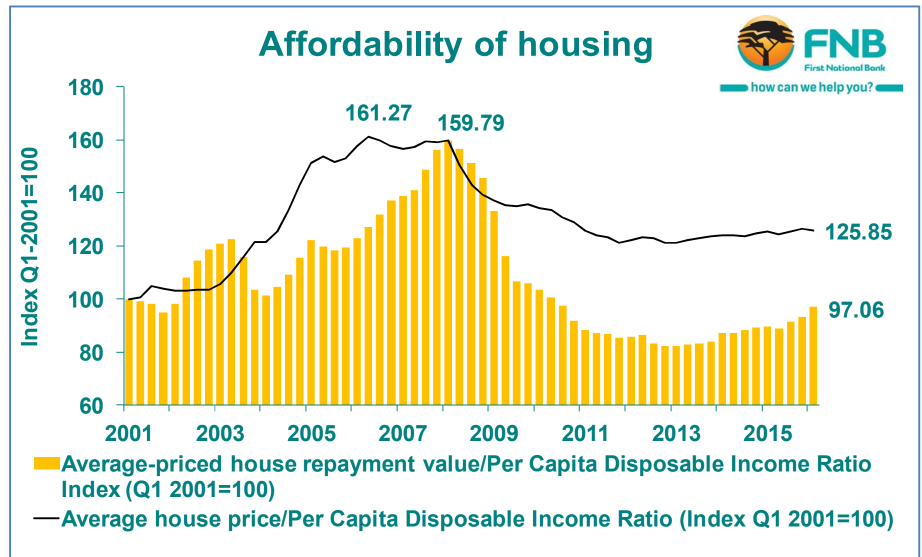
THE MAIN HOME AFFORDABILITY RATIOS

For credit-dependent home buyers, the home affordability picture deteriorated further in the 1st quarter of 2016, continuing a gradual deteriorating trend that began back around 2013, driven by further interest rate hiking early in the year.

Of our 2 main affordability measures, the 1st measure, namely the "Average House Price/Per Capita Disposable Income ratio Index", declined (improved) very slightly by -0.3% in the 1st quarter of 2016 compared to the level for the previous quarter.

However, the 2nd measure, namely the "Installment Value on a new 100% Bond on the Average Priced House/Per Capita Disposable Income Ratio Index", rose (deteriorated) by +4.3% in the 1st quarter.



The Price/Income Ratio Index declined slightly due to a slowing in quarter-on-quarter house price inflation, from 1.9% in the 4th quarter of 2015 to 1% in the 1st quarter of 2016, whereas quarter-on-quarter Per Capita disposable Income growth remained unchanged at 1.3% over the 2 quarters.

The Loan Instalment/Per Capita Disposable Income Ratio, however, has had upward pressure from further hiking in interest rates to the tune of 75 basis points during the 1st quarter of 2016.

Examining the longer trends, the cumulative result of house price growth outperforming per capita income growth since 2013, has been a +4% deterioration (rise) in the Average Price/Per Capita Disposable Income Index

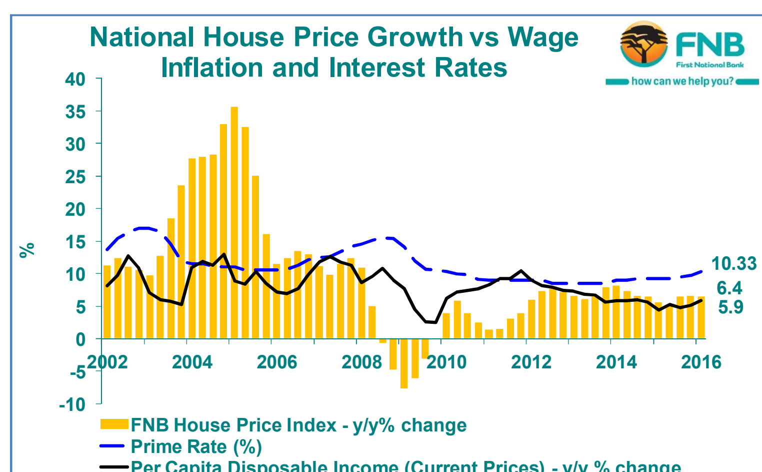
from the final quarter of 2012 to the 1st quarter of 2016. Add to that the past 2 years of interest rate hikes, and over the same period the Instalment/Per Capita Disposable Income Index has risen (deteriorated) by a more significant +18.3%

So how "affordable" or "in-affordable" is the housing market? The 2 affordability measures are still vastly improved (down) on their late-boom highs around 2006-2008. The Average House Price/Per Capita Disposable Income Index is -22.6% down on its boom time high reached in the 2nd quarter 2006, while the Installment/Per Capita Income Ratio is -39.3% lower than its 1st Quarter 2008 high point.

On the other hand, however, the Price/Per Capita Income Ratio Index is still 25.9% above the 1st quarter 2001 "pre-boom" level. But keeping property still "temporarily" comparative affordability-wise to early-2001 has been a period of abnormally low interest rates in recent years, which has meant that the Loan Instalment/Per Capita Disposable Income Index is actually still -2.9% below (more affordable than) the 1st quarter 2001 level.

The drivers of the 2 key affordability ratios

We may be at the stage where the rising trend of recent years in the 1st of the 2 affordability indices, namely the Average Price/Per Capita Disposable Income Ratio, has almost come to an end for the time being.



The Residential Market has remained well balanced, translating into average house price inflation being similar to general price inflation in the 1st quarter of 2016. In a very low economic growth environment, if Nominal Per Capita Disposable Income growth also merely keeps up with general inflation, that would keep this ratio fairly stable.

During the 1st quarter, average house price growth was 6.4% year-on-year while Per Capita Disposable Income was slightly lower at 5.9%, and looking forward we would expect the 2 growth rates to not be too dissimilar.

However, the 2nd affordability index, namely the Installment/Per Capita Disposable Income Ratio Index is expected to continue to rise a bit further in 2016 due to our expectation of further mild interest rate hiking.

THE HOME RUNNING COST-RELATED AFFORDABILITY PICTURE

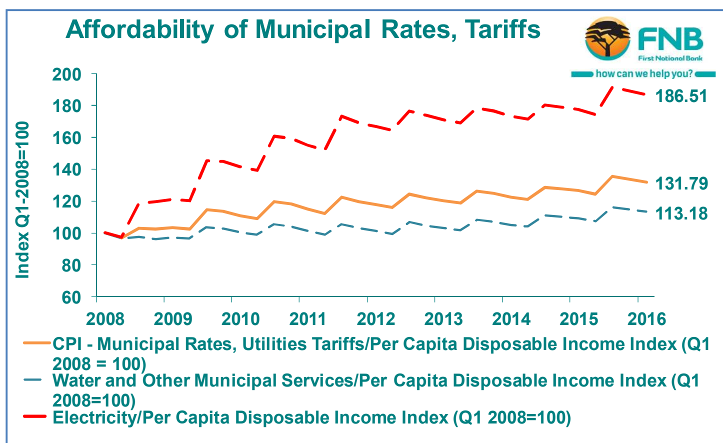
Estimates of home running cost-related affordability

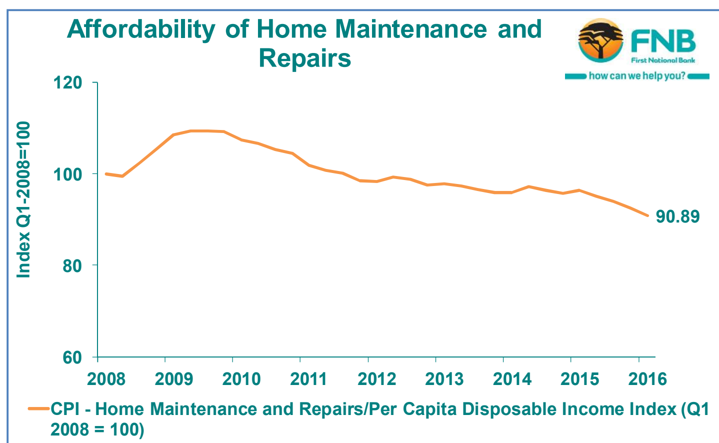
Next we consider measures of affordability that are related to the home, i.e. those that are running cost related, and to this effect we use components of the CPI (Consumer Price Index) to construct an affordability index for Municipal Rates and Tariffs, along with an index for Maintenance and Repairs Costs.

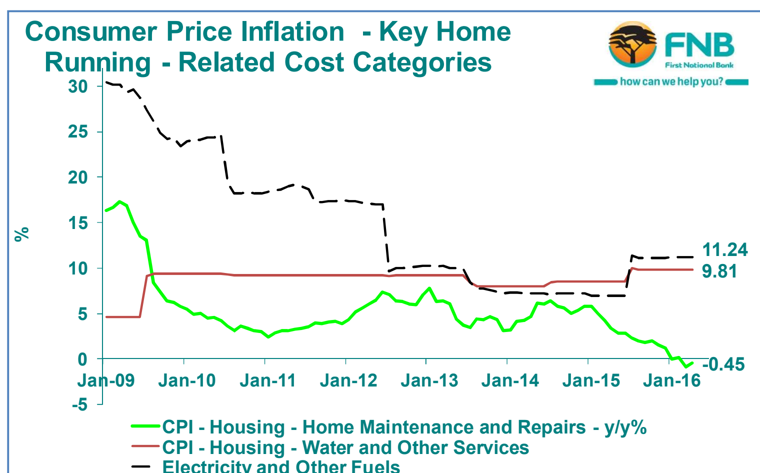
The "Municipal Rates and Tariffs/Per Capita Disposable Income" Index has moved higher through the 2008-15 period. This affordability measure has deteriorated (risen) by 31.8% from beginning of 2008 to the 1st quarter of 2016.

Major upward pressure has been exerted on this index by high inflation in the area of electricity tariffs, but moderated in part by less extreme Municipal Rates and Non-Electricity Tariffs cost inflation. The Electricity Affordability component is the most troublesome part of the Rates and Tariffs bill, and its affordability index has escalated (deteriorated) by a massive 86.5% since the beginning of 2008. It looks set to experience more upward pressure, as Eskom continues to annually press for more above-inflation tariff hikes as electricity demand declines.

The Water and Non-Electricity Tariff/Per Capita Disposable Income Index has risen (deteriorated) by a more moderate 13.2% from 2008 to 2016, while the Home Maintenance and Repairs/Per Capita Disposable Income Index has actually declined by -9.1% over the period.







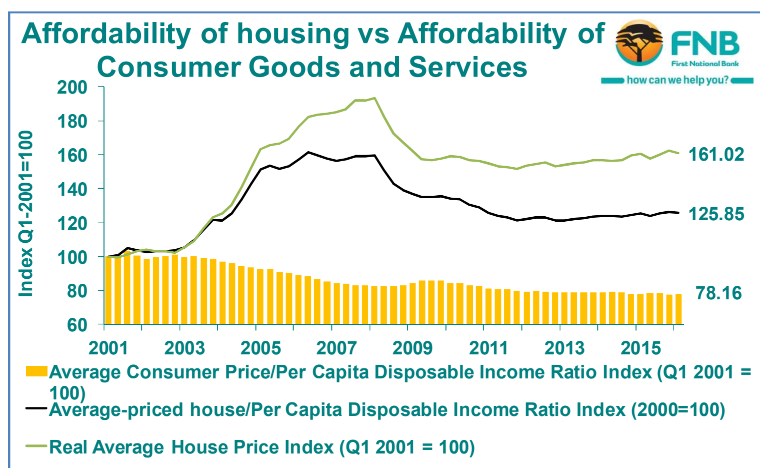
The CPI (Consumer Price Index) for Electricity and Other Fuels shows year-on-year inflation of 11.24%, with the CPI for Water and Other Services (includes assessment rates) not far behind on 9.81%

By comparison, the CPI for Home Maintenance and Repairs has recently entered deflationary territory to the tune of -0.45%, possibly due to a partial "crowding out" of this economic sector by municipalities and utilities with their extreme tax/tariff hikes.

COMPETITOR PRODUCT AND RELATED AFFORDABILITY

"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 remains 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

resultant price inflation surges during demand booms.

Therefore, despite the Average House Price/Per Capita Disposable Income Index (Q1 2001 = 100) being significantly down on its 2008 high, by the 1st Quarter of 2016 it still sat at 125.85 (25.85% up on the 1st quarter of 2001), while the Average Consumer Price/Per Capita Disposable Income Index(Q1 2001 = 100) had dropped as low as 78.16 (thus 21.8% down on its 1st quarter 2001 level), having never really risen in the boom years of 2000-2007.

Thus, over the boom years, housing lost major ground on consumer goods and services in terms of relative affordability, and never fully "recovered". This "loss of ground" over time is in part addressed by the longer term more towards building smaller-sized residential units on smaller-sized stands.

So, when we use the PCE (Private Consumption Expenditure) Deflator to deflate house prices into real terms (with Q1 2001=100 for the Real House Price Index), we see that the Real FNB House Price Index is still a massive 61.02% higher than in early-2001, as at the 1st quarter of 2016. The Real House Price Index is also mildly elevated from its end-2011 relative low point, to the tune of +6.2%.

However, of late average house price inflation has come increasingly into line with consumer price inflation, the latter having risen back to more "normal levels" not far from 6% and the former moving not far above 6% either. And in the near term, given economic and interest rate pressures on the housing market, we don't expect noticeable further loss in housing's "price-competitiveness", when compared with consumer goods and services price levels. To the contrary, we may even see a move to real house price decline, thus for the time being ending the trend towards less competitively priced housing relative to consumer goods and services. This would be driven by the lagged effects of rising interest rates and a weak economy.

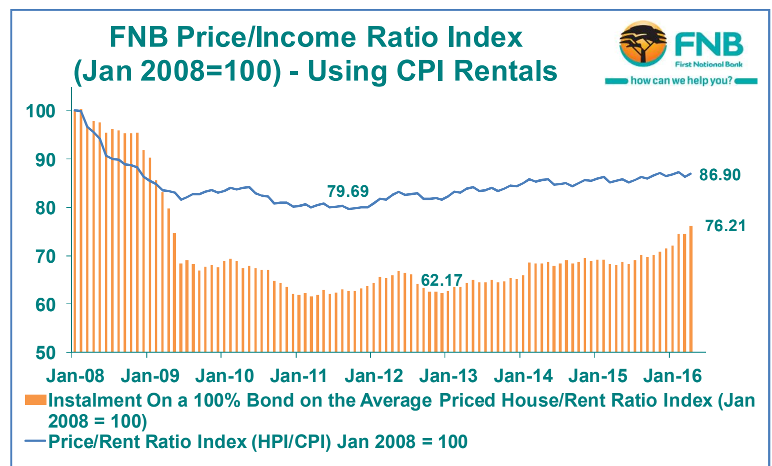
Rentals and the House Price-Rent Ratio

Analysts often become concerned when the Price-Rent Ratio is very high, as it can begin to make the rental option very appealing, contributing at some stage into a drop in home buying and a fall in house prices.

House price booms typically take this ratio higher.

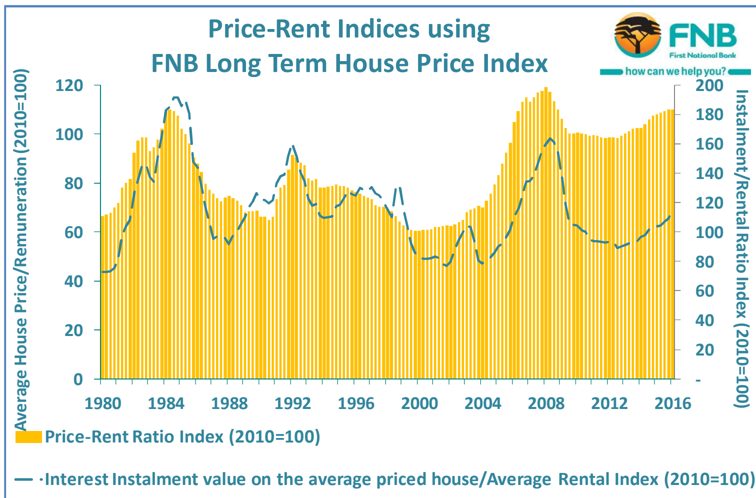
To this effect, we use the FNB House Price Index and the CPI for Actual rentals. We show it in index form (because the CPI is an index), with January 2008=100.

Given that January 2008 was right at the end of the real house price boom, we believe that it represented an extremely high level in the Price-Rent Ratio. After a drop through 2008/9, and again in 2011, the index began to rise noticeably as the residential market strengthened. The index was at 86.90 in April 2016, up 9.1% from September 2011.



While 86.90 is believed to still be a high number, the other important ratio, i.e. the Instalment on a 100% bond on the average-priced house/Rent Ratio Index, is far lower. It has been kept far below January 2008 levels by a sharp drop in interest rates from late-2008. It reached a low of 62.17 as at December 2012. However, the combination of house price inflation broadly out-pacing rental inflation, along with gradual interest rate hiking over the past 2 years, has taken this ratio 22.6% higher by April 2016, to a reading of 76.21.

This remains well-below the January 2008 100 level though, as interest rates are still at relatively low levels. But, of course, rates have been in the process of rising, gradually reducing the attractiveness of the home buying option relative to rental in recent years.

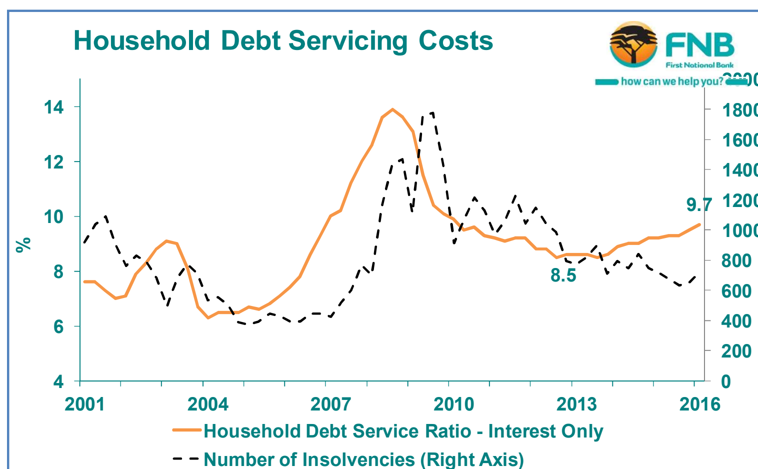


In order to give a longer term perspective of the level of the Price-Rent Ratio, we have used 2 different quarterly series, namely our FNB Long Term House Price Index (compiled from Deeds data) and a long term rental estimate using SARB Household Consumption data for actual and imputed rentals.

A multi-decade high was reached late in 2007 at the back end of the boom period, and the most recent levels look not too dissimilar, i.e. still very high by historic standards.

Credit Affordability

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



The best measure of the affordability of Household Credit is the Debt-Service Ratio (The cost of servicing total household sector debt, expressed as a percentage of Household 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 9.7% by the 1st quarter of 2016, lifted in part by the SARB's 2 percentage points' worth of repo rate hikes, but in part by a partial shift by households toward greater utilization of higher priced non-mortgage credit.

CONCLUSION

House price inflation is far from strong, and we may be approaching a time when it battles to outpace Per Capita Disposable Income growth or general consumer inflation, thus implying limited or no further increase in REAL house price inflation for a while at least.

However, for credit-dependent home buyers, we don't believe that the home buying affordability deterioration is quite over yet, anticipating a further half of a percentage point's worth of increases in interest rates by early next year.

In addition, there is no end in sight yet to municipalities and utilities' drive to raise tariffs at a significantly faster pace than either consumer price or household income inflation. Therefore, there doesn't appear to be any end in sight to the deteriorating affordability trend in this very important area of home running costs.