CONSUMER BAROMETER

Household Sector Debt-Service Risk Index

Household Sector Debt-Service Risk rises slightly in the 2nd quarter of 2017

21 September 2017

MARKET ANALYTICS AND SCENARIO FORECASTING UNIT

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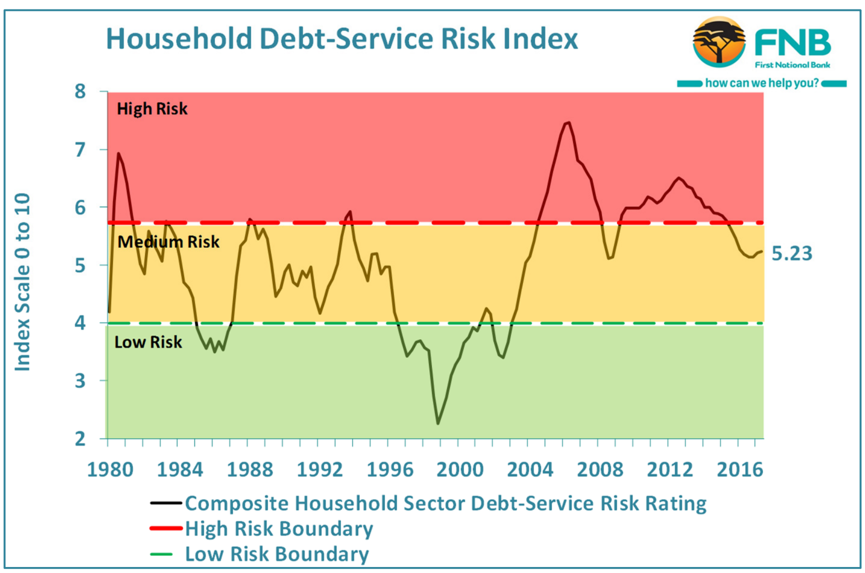
Examining recent years' of improvement in both the Household Sector Debt-to-Disposable Income Ratio (decline) as well as the Household Sector Net Savings Rate (rise), it would appear that weak consumer confidence levels in a stagnant economy are encouraging households as a collective towards a more cautious financial approach. However, with downward pressure on Household Disposable Income growth having escalated as economic conditions have weakened, it appears increasingly challenging for households to make such financial improvements.

THE HOUSEHOLD SECTOR DEBT-SERVICE RISK INDEX

The Household Sector's risk, in terms of future ability to service its debt, rose slightly in the 2nd quarter of 2017, according to our FNB Household Sector Debt-Service Risk Index. This is the 2nd consecutive quarter that the revised Index has risen, from an 8-year best (low) level of 5.14 (scale of 1 to 10) in the final quarter of 2016 to 5.23 in the 2nd quarter of 2017. This mild deterioration comes after a multi-year improving (declining) trend all the way from 6.5 in the 3rd quarter of 2012.

This small rise during the 1st half of 2017 is to a large extent reflective of the weak economic environment making it increasingly difficult for the Household Sector to "cut its coat according to its cloth" in terms of lowering the level of its Debt-to-Disposable Income Ratio.



The Household Debt-Service Risk Index is compiled from 3 variables, namely, the Debt-to-Disposable Income Ratio of the household sector, the trend in the debt-to-disposable income ratio, and the level of interest rates relative to "structural", or longer run average (5-year average in this case) consumer price inflation.

The higher the debt-to-disposable income ratio, the more vulnerable the household sector becomes to unwanted "shocks" such as interest rate hikes or downward pressure on disposable income.

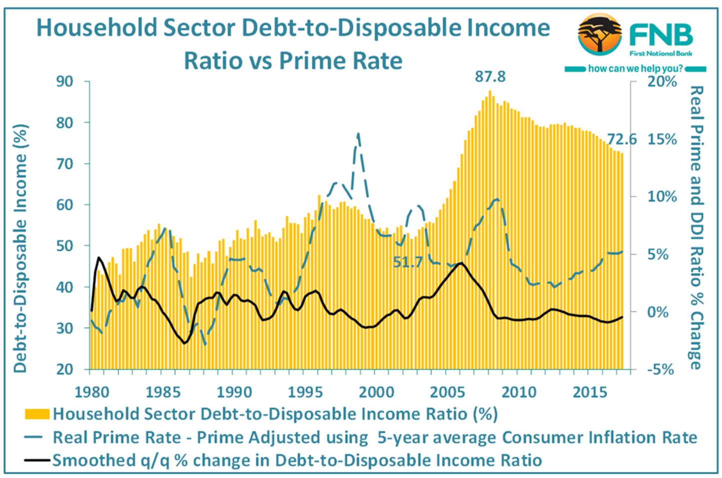
Secondly, an upward trend in the debt-to disposable income ratio, or even possibly a slowing pace in a downward trend, contributes negatively to the overall Risk Index (i.e. exerts upward pressure on the index) and vice versa for a downward trend.

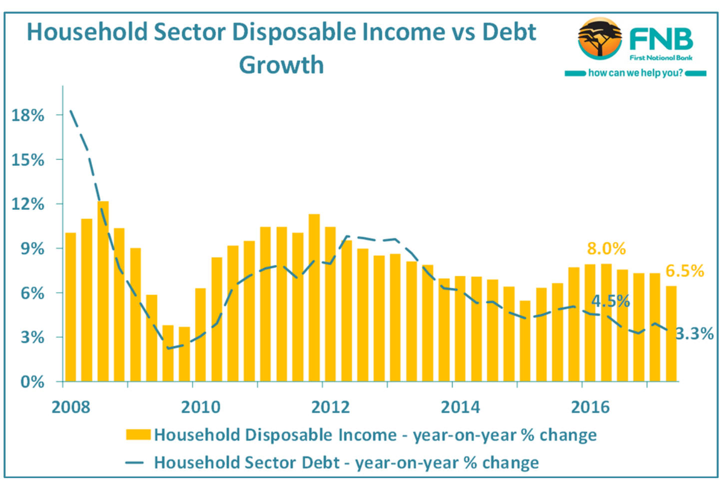
Then, thirdly, the nearer Prime Rate gets to the "structural" inflation rate (using a 5-year average consumer inflation rate as a proxy), i.e. the lower this estimate of real interest rates becomes, the more vulnerable the household sector becomes. The reasoning behind this is that the lower the real interest rate levels, the nearer we may be getting to the bottom of the interest rate cycle and the end of rate cutting relief, and the more the risk of the next rate move being upward becomes.

In addition, households tend to make poorer borrowing and financial decisions on average when interest rates are at relatively low points in their cycle, while it is tougher for lenders to assess aspirant borrowers when money is cheap. In short, better borrowing/lending decisions are arguably made when interest rates are relatively high.

Therefore, we view low interest rate periods as ones where risk generally builds up, and vice versa for periods of relatively high interest rates.

The Key Drivers of the Index's Recent Movement:





The 1st key driver of the Debt-Service Risk Index, i.e. the Debt-to-Disposable Income Ratio itself, continued to decline in the 1st and 2nd quarter of 2017, thus remaining a source of downward pressure on the Index. The Real Interest Rate Risk Rating, too, has been on a declining trend in recent years as our calculation of Real Prime Rate has gradually risen (although this may change in the 3rd quarter with the advent of interest rate cutting).

So the key cause of this recent rise (deterioration) was a slowing rate of decline in the Household Sector Debt-to-Disposable Income Ratio.

This slowing pace of decline in the ratio is a mild concern, because it begins to suggest that it is perhaps becoming tougher for households to achieve a much-needed further reduction in the Debt-to-Disposable Income Ratio. This difficulty is arguably the result of very weak economic growth and its impact on employment and Disposable Income growth.

A positive development in recent quarters has taken place in the form of further slowing in the growth in value of Household Sector Debt, from 4.5% year-on-year in the 2nd quarter of 2016 to 3.3% in the 2nd quarter of 2017.

However, Nominal Household Sector Disposable Income growth has slowed slightly faster, from 8.0% to 6.5% over the same period, 1.5 percentage points' worth of slowing compared to a lesser 1.2 percentage points in the case of Household Debt.

As a result of the squeeze on Household Disposable Income growth in recent quarters, we have seen the slowing in the pace of reduction in the all-important Debt-to-Disposable Income Ratio. Should this "squeeze" continue to intensify, one can get to a situation where the Debt-to-Disposable Income Ratio even starts to rise despite a pedestrian pace of borrowing growth by the Household Sector.

The key pressures on Disposable Income growth are arguably:

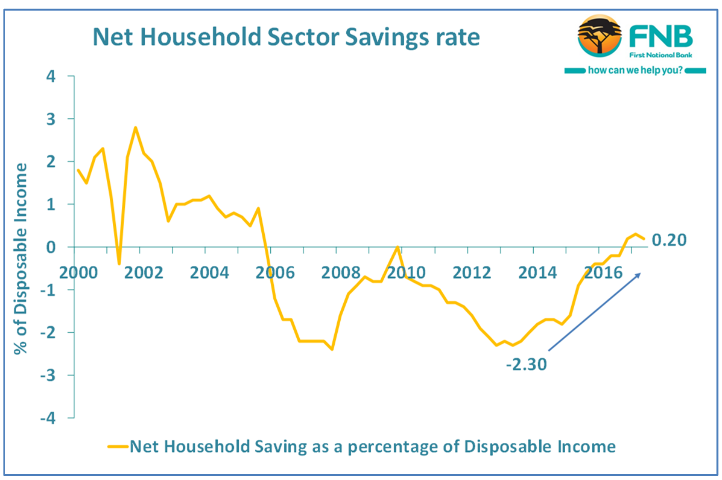
1. Weak economic growth has helped nominal wage bill growth broadly slower. In the 2nd quarter of 2016 Nominal Remuneration of Employees' year-on-year rate of increase was 8.2%, but this slowed to 6.4% by the 2nd quarter of this year. These recent growth rates are a far cry from the post-2008/9 recession high of 12.9% reached in the 2nd quarter of 2010. The weak economy is also likely to have contained growth in Gross Operating Surpluses amongst self-employed people and small Household Sector businesses, as well as various sources of investment incomes due to households.
2. On top of a weak economy, Government continues to apply effective personal and wealth tax increases each year, increasing its cut of Household Income. From 10.9% of Household Income, Income and Wealth Taxes have risen steadily to 15.2% in 2016, and will almost certainly rise further in 2017 due to a lack of inflation bracket creep adjustments to personal tax rates.

CONCLUSION

In short, our FNB Household Sector Debt-Service Risk Index has begun to rise mildly in the 1st half of 2017, following a healthy multi-year improving trend from late-2012 through to 2016. This 2-quarter deterioration in the Index does not yet reflect a rising Debt-to-Disposable Income Ratio, but rather a recent slowing pace in this ratio's declining trend. This, in turn, reflects increased downward pressure in Nominal Disposable Income growth, caused by the various impact points of economic weakness as well as rising tax burdens.

The Household Sector appears to want to do "the right thing", in terms of adapting to these tougher economic times, by containing indebtedness and increasing its savings rate. This is the "normal" response, and has been reflected in not only the multi-year decline in the Debt-to-Disposable Income Ratio, which admittedly is also due to tighter lending criteria by banks since around 2008, but also in some improvement in the Net Savings Rate of Households.

Typically, we do see some improvement in the savings rate in times of economic weakness and low levels of consumer confidence. We saw a short-lived improvement (diminishing) in the Net Dis-savings Rate of Households (Gross Savings net of Depreciation on Fixed Assets), back around the "Great Recession" of 2008/9, from -2.4% of Disposable Income at the end of 2007 to zero by the end of 2009. Economic growth improvements then led to renewed deterioration in the dissavings rate. But as economic stagnation once again set in from 2012 we have seen an improving trend in Net Saving from -2.3% of Disposable Income in mid-2013 to a positive Net Savings Rate of +0.3% by the 1st quarter of 2017.



However, in the 2nd quarter the Net Savings Rate receded slightly to +0.2% of Disposable Income, and at such levels remains weak. Despite the still-low level, the improvement from a far worse rate in 2013 does point to a desire of increasingly concerned households to adapt to weak economic conditions by becoming financially more cautious. But the fact that improvement in the savings rate is so slow going is arguably reflective of the poor economy and the mounting constraints it places on disposable income growth.