

# Economics

## South Africa: Residential property report

### Navigating through a tough cycle

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**What is the latest?** The median property price financed for the month of May rose to R579 000 from R571 000 in April, representing an increase of 2.3% relative to last year, from 2% y/y in April. While this growth remains mediocre, the average home loan financed rose by a proportionately larger amount, providing confirmation that the sample of homes financed were more widely dispersed in May. Recall that over the past seven months or so, higher loan-to-value criteria for lower valued properties gave rise to a somewhat biased sample. Confirmation of improved appetite in the middle-to-higher property space is thus an encouraging development. In addition to the higher average, the number of loans granted in the first four months of the year rose by 4% relative to last year, and improved by a further 1.2% over this period relative to the prior four months.

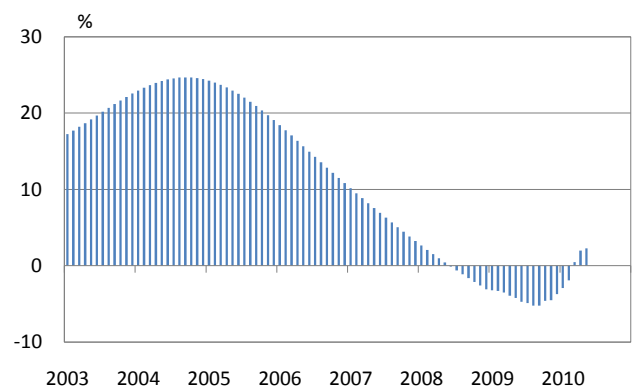
**Our view:** The relatively slow advance in nominal house price growth is consistent with our expectations of a slow credit recovery. Based on our estimate for inflation in May, growth in the real house price is still 2.4% y/y in the red relative to -2.8% y/y in April. According to the South African Reserve Bank's (SARB's) mortgage book for households, and adjusting for asset reclassifications that took affect over the past few months, mortgage growth has shown very few signs of improvement. However, even though there are still signs of financial stress among consumers, they are nowhere near the distress levels seen this time last year. Be that as it may, the broader credit market is signalling that a greater deleveraging cycle is underway. If past trends in household credit appetite are anything to go by, then it could take another two to four years before growth in household credit establishes pre-recession trend growth (see *Money supply alert: Risks of a structurally lower trend in credit? 31 May 2010*). It is concerning that a confluence of factors, ranging from macroeconomic risks to legislative issues are combining to yield potentially lower profitable loan growth opportunities. The following few sections will discuss some of these matters in more detail.

**Macroeconomic risks and the global transmission channel:** Broadly speaking, the economy's recovery up to now has been largely driven by global demand, which benefited the external sectors, i.e. manufacturing and mining. However, the composition of economic

growth drivers has improved in Q1 which is positive from a sustainability point of view. The advances in external trade sectors had positive spillover effects for derived-demand sectors. In the first quarter, growth in the internal trade sector comprising retail, wholesale and motor trade gained traction. However, collectively, autonomous demand growth is still insufficient to offset weakness that could occur, in the event of a significant hit to trade sectors (see *GDP production analysis: Could the Greek saga spoil the recovery? 25 May 2010*).

In a nutshell, the general uncertainty surrounding the growth performance of Europe is a risk to growth. Even if the repercussions of sovereign debt contagion from the Greece, Ireland, Italy, Portugal and Spain (GIIPS) countries were not to materialise, they are harmful to confidence, and may prolong the recovery in economic activity this year. Clearly, the risks of a second hit to global growth arising from a multitude of factors are not negligible and may be particularly problematic to the investment cycle and employment growth given the forward-looking dynamics of these decisions. The risks may be propagated through a multitude of channels, including credit extension, asset markets, the housing market, commodity prices, currency weakness and inflationary pressures. Moreover, government's ability to

**Figure 1: House price growth**



Source: Standard Bank Group

respond to a second-hit to growth is much lower than before. In addition, this time, the global support base that was engineered as the initial response to the global recession, in the form of fiscal and monetary stimuli, will be absent in its intensity. Indeed, the global economy is more delicate now when compared to the initial phases of the global recession. Consumer markets have been substantially affected by rising unemployment in developed markets – ultimately the end markets for exports from many emerging market economies.

There are mainly three channels in which a deterioration in Europe could affect the local economy, and the housing market in particular.

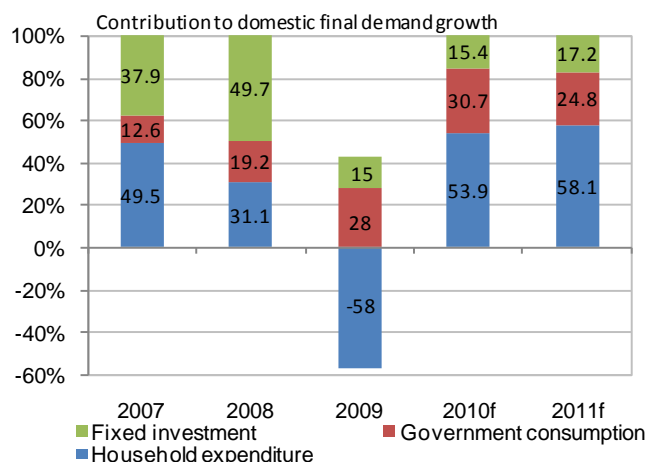
- Weaker economic growth stemming from the impact of fiscal austerity, and limited monetary policy support could adversely affect the economy through lower demand for South African exports. There are also negative consequences for the US, as the dollar may strengthen significantly, leading to a large trade imbalance as Europe is a key trading partner of the US. This may keep unemployment high in the manufacturing sector, as domestic output is replaced with cheaper imports. The same accounts for the local economy, if exports are hit, employment will be adversely affected. To the extent that weakness in the labour markets is sustained, but particularly in manufacturing and mining, there will be limited low-income property growth potential as these sectors largely employ semi- to unskilled workers.
- A weaker Western dynamic suggests that the East and other emerging market economies will have to increase output by more than currently envisaged. It is unlikely that these economies will offset this slack indefinitely, which will ultimately weaken the global demand for commodities, clouding the outlook for commodity prices. In this event, the exchange rate remains vulnerable and intermittent risk aversion could affect growth in equity markets. (The rand exchange rate is seen weakening to an average of ZAR8.14/USD by the fourth quarter of the year.) Moreover, growth in financial assets will be critical to sustain the improvement in households' net wealth position. The SARB reported that households' net wealth<sup>1</sup> position improved in Q4 last year, rising by 9% y/y following declines of 11.2% in 2009 H1. Growth in financial assets was the key contributor to this improvement.
- To the extent that the housing market is seen as an asset class, it is likely that there could be contagion to housing markets. While interest rates are globally at historical lows, housing market dynamics are negatively influenced by the large unemployment base, more risk averse banks (despite credit flowing more easily), and no new fiscal support in the form of tax concessions. These aspects serve to limit global property price growth, which may have negative repercussions locally as well.

<sup>1</sup> Household net wealth comprises household total assets, that is, total fixed assets plus financial assets less liabilities. Financial assets include household deposits with financial institutions, their share in pension funds and a proxy for their holdings of shares.

However, we don't perceive the global housing market as a particularly strong channel for contagion. The local housing market has a very weak level of correlation with international house prices, as local forces play a larger fundamental role. Admittedly, there is some sense of shared sentiment between property investors, but less than, for instance, equity investors.

On balance, these risks warrant a relatively cautious view of the economic outlook and housing market. Figure 2, illustrates that household demand will be the critical driver of domestic demand, followed by government expenditure, albeit weakening. Household consumption expenditure (HCE) is seen growing by around 2.4% this year, following last year's 3.1% contraction, but risks outlined above, suggests that HCE growth could be capped at 3% next year. In turn, the current deleveraging underway in the corporate sector, alongside aforementioned risks, portends a slower return to private sector investment growth. As such, we flag the risk that the economy may see a considerable momentum loss in growth between the end of 2010 and next year.

Figure 2: Contribution to growth in domestic demand

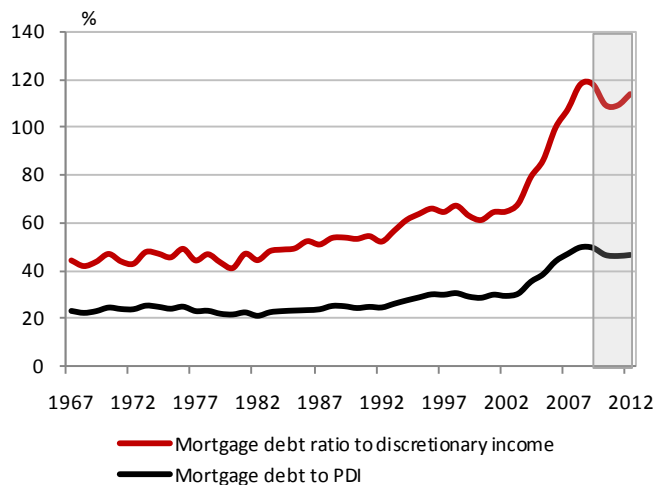


Sources: SARB, Standard Bank Group

**Housing affordability and household credit appetite:** Housing affordability has received a shot in the arm from slow, and even declining, house price growth in conjunction with the 30-year low borrowing costs. Historically, house price growth recovered after approximately two quarters following the onset of an easing in the interest rate cycle. However, a confluence of factors have served to weaken this lag to more than a year, which includes, the impact of the global recession, households' over indebtedness, the consumer debt review process, the National Credit Act, and banks' lending criteria. The intensity of this cocktail yet again confirms that a vicious hangover will limit a full-blown property boom that would have been expected in past cycles given the sheer size of the 6.5 percentage points drop in the prime rate between 2008 and 2010. Below, we will assess households' mortgage affordability ratio (mortgage debt-to-income) from both an income (denominator) and repayment (numerator) perspective. The more commonly analysed ratio, akin to household

debt-to-personal disposable income (PDI) ratio, is the mortgage debt to PDI ratio, illustrated in Figure 3. Assuming nominal house price growth of 6.5% and nominal income growth of around 8% this year, and allowing for a 150 basis point increase in the prime rate in 2011, the mortgage debt to income ratio remains at marginally above 40% over the next two years. (These assumptions will be maintained for further analysis). Thus, relatively strong after-tax income growth could see the debt-ratio improve, not due to any debt deleverage, but rather due to an improvement in the denominator. The contention with using after-tax disposable income is that it hides the actual level of “free” disposable income available to consumers with no regard for consumers’ fixed monthly expenses.

**Figure 3: Household mortgage debt-to-income ratio**



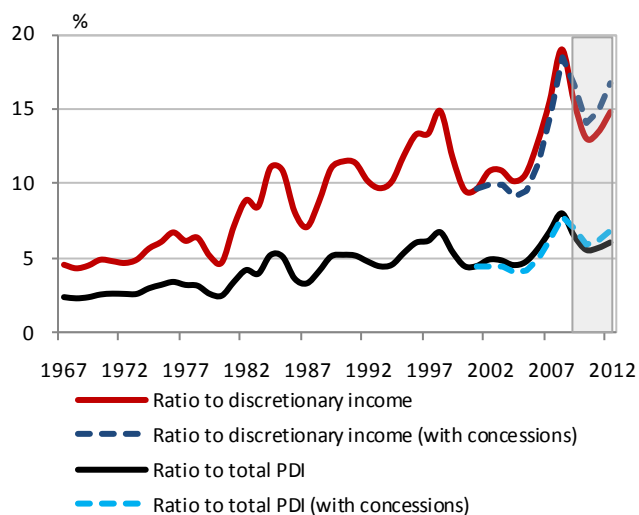
Sources: SARB, Standard Bank Group

A more reliable gauge of debt-to-income could be gleaned from disposable income after tax and spending on necessities, such as food, transport (services and fuel), electricity (and other utilities), housing and education. This is a more accurate reflection of the capacity of households’ balance sheets to absorb more debt. Since 2006, mortgage debt as a ratio to discretionary income has risen above 100%, and peaked at 118% last year, owing to both swelling outstanding debt, but also greater income erosion from high inflation rates on the aforementioned components. Clearly, a falling inflation profile to below 5.3% over 2010/11 from more than 7% before has its advantages. Amongst the low inflation components are food and transport services. However, with administered price inflation at double digit rates, with more inflationary pressures due in electricity, utilities and other public services, households’ discretionary income levels will be squeezed. We anticipate a moderate increase in the ratio of mortgage debt to discretionary income to around 114% in 2012, as a result of increases in these prices offsetting nominal income growth. This level is more than 30 percentage points above the SARB’s household debt-to-income ratio. Rather than signalling a distressed group of consumers, this ratio seeks to highlight that the market for significant debt accumulation is limited. This is particularly the case among households in the middle-to-lower income space who spend a

proportionately larger share of their income on these basic commodities.

In a similar vein, debt service costs (including the capital repayment) rose to 19% of discretionary income<sup>2</sup> in 2008, before easing to 15.5% in 2009 – a 3.5 percentage point gain (Figure 4). Compared to the conventional ratio using total disposable income, the gain in affordability between 2008 and 2009 was limited to only 1.5 percentage points. In 2009, consumers were forced by the recession to restructure spending, which together with the impact of lower inflation in some of these items, led to a decline in nominal growth in spending on fuel and electricity. However, since the decline in debt capital repayments was larger than the increase in discretionary income (owing to the 6% reduction in borrowing costs between 2008/09), households have been left better off, as overall affordability improved relative to their fixed expenses. A further improvement is envisaged this year, with the ratio seen easing to 13.1% this year before heading up towards 14.8% in 2012. This may provide a firming foundation for property growth in the year ahead. However, as seen from past trends, even at 13.1%, this ratio is still at the peak that reigned during the previous economic downswing in 1997.

**Figure 4: Mortgage debt affordability (including capital repayment) and pricing scenarios**



Sources: SARB, Standard Bank Group

Another veneer is added to the affordability metrics, by including the actual level of borrowing costs that were affected by rate concessions (mortgages at a discount to prime). Mortgage finance was arguably underpriced during the property boom, as the average rate of finance below the prime rate ranged between 0.5% and 2%. During the recession banks tightened lending proportionately more by granting lower loans relative to value, while also raising finance costs marginally above prime as banks better managed their credit risks. If we assume a gradual reversal in pricing methods over the next two years (refer to *Money supply alert: Risks of a structurally lower trend in credit?* 31

<sup>2</sup> For every R100 of discretionary income, R19 is spent on mortgage debt repayment (including capital and service costs).

May 2010), this could increase the monthly repayment on a house of R850 000 by around 13% (assuming a 2% reduction in concessions), which is an additional R1 195 per month out of the pocket. Should this occur on an industry wide basis, it holds risk for growth in the property market, as individuals will have to save more before entering the market. This could potentially increase the lead time before first-time home buyers re-enter the market and may favour higher-income households who are better equipped in dealing with these costs.

**Summary and outlook:** The median house price financed is on a slow recovery path. The outlook for the sector remains constructive; however, a confluence of factors will limit the market from showing a significantly higher recovery this year. Despite improved affordability, the housing market remains constrained by (1) high household indebtedness, (2) high unemployment, (3) risks to the economic growth outlook, and by extension income growth.

All these factors jointly limit the scope for the granting of profitable finance, which is required given the vulnerability of the economy to global dynamics. Moreover, the transmission channel of weakness in Europe into the economy, and, more particularly, the housing market is as follows: (1) weaker exports, hurting employment and income prospects, (2) a volatile exchange rate in the face of risk aversion and weaker commodity prices, which could weaken financial asset growth, (3) discontent with the housing market as an investment class given the high levels of unemployment. These factors could combine to weaken the economic growth momentum between the end of this year and 2011. Overall, the longer uncertainty lingers, the more protracted the envisaged weakness in private sector capital formation and employment – thus a wide output gap is maintained for longer.

Household credit appetite may thus be limited, as fears of income and employment security may re-emerge should these risks gain traction. Moreover, housing affordability is seen improving this year, which will provide scope for property price growth. However, affordability metrics will be less favourable for individuals who spent a proportionately larger amount on electricity, transport and other basic necessities owing to envisaged administrative inflationary pressures. Should inflation surprise on the downside and growth continues its upward trajectory this year, the housing market could register growth between 6% and 8% in the second half of the year. At this juncture, growth between 3% and 5% seems more likely.

#### Note on the methodology used in calculating Standard Bank's house price index

The way in which house prices are measured means that they are inherently volatile, not unlike many other economic indicators. Measuring house prices is complicated by the fact that the available data usually stem from the properties sold during a particular period, rather than from a well-designed sample that is representative of all houses. This is aggravated by the heterogeneity of houses. Changes in the measured prices may be the result of actual changes in the general price level; or changes in the distribution of the houses being sold, for example more sales of luxury houses may push up the measured house prices even without changes in general prices; or the changes may simply be random.

Given these data challenges, the international best practice is to use the median or middle price, rather than, say, the average house price. The median is the price such that half of all houses are more expensive and half less expensive than that price. It is substantially less volatile and less sensitive to the typical problems found in house price data. Standard Bank's data are therefore based on the median house price of the full spectrum of houses. Furthermore, national data from the Deeds Office are available only with a relatively long lag of up to nine months, so data from Standard Bank, which has a market share of about 27.7%, and whose data are generally highly correlated with those of the Deeds Office, are a good proxy for the national market.

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