HOME LOANS DIVISION

HOUSEHOLD FINANCIAL AND CREDIT CONDITIONS

–SARB 3rd quarter household stats point to a household sector still under financial stress but slowly turning

PROPERTY AND MORTGAGE MARKET ANALYTICS

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SUMMARY – HOUSEHOLD FINANCIAL AND DEBT SITUATION SLOWLY TURNING FOR THE BETTER, BUT FAR FROM SATISFACTORY YET

The release of the December SARB Quarterly Bulletin gives us a far more detailed picture of the economy and household sector's financial condition as at the 3rd quarter of 2009. Both economic growth as well as the household sector's financial and debt position are beginning to move towards a more healthy position, but we have a long way to go before the situation can be deemed to be satisfactory. Real disposable income showed less decline in the 3rd quarter than in the 2nd, but nevertheless remained in negative growth territory. The household debt-to-disposable income ratio showed a small improvement but remains not far enough from its historic high of early last year, due to the pressure on disposable income.

The improvement in household sector credit quality continued in the 3rd quarter, with revised insolvencies figures showing insolvencies declining by -40% year-on-year. However, with little economic growth to speak of yet, and real household disposable income not yet growing positively, it can still be stated that the improvements in credit quality that we have seen to date have little to do with any improvement in the household sector's financial "fundamentals", and are almost entirely attributable to the 5 percentage points' worth of interest rate cuts since late-2008. The interest rate cuts led to a further decline in the household debt-service ratio (the cost of servicing debt, interest+capital, as a percentage of household sector disposable income) in the 3rd quarter, which is the best predictor of debt servicing performance.

For as long as interest rates are relatively low, keeping the debt-service ratio down at a manageable level, the high debt-to-disposable income ratio shouldn't be problematic. But should the household sector go into the next interest rate hiking cycle with indebtedness levels still so high, this could quickly return the pressure to the household sector.

At present, inflation risks appear relatively low, but with services inflation in SA remaining downwardly sticky, and the high base effects of last year's commodity price spike set to exit the year-on-year inflation figures late-2009 or early-2010, causing the possible end of the CPI inflation declining trend, we believe that the interest rate cutting is probably over for the current rate cycle.

Further improvement in credit quality will increasingly rely on the household sector's ability to reduce its debt-to-disposable income ratio, therefore, which should come gradually as a return to positive economic growth turns disposable income growth for the better, while household credit growth looks set to turn negative.

Our "Debt-Service Risk Index" remains at high levels as a result of the ongoing high level of overall indebtedness, and has actually risen mildly over the past 4 quarters. The recent quarterly rises were due to the diminishing scope for further interest rate reduction. The most recent 3rd quarter reading of 6.3 (higher than the revised 2nd quarter figure of 6.2 is still lower than the revised 7.3 risk peak reached in early-2006, but it is nevertheless on the high side, given a multi-decade average of near 5.

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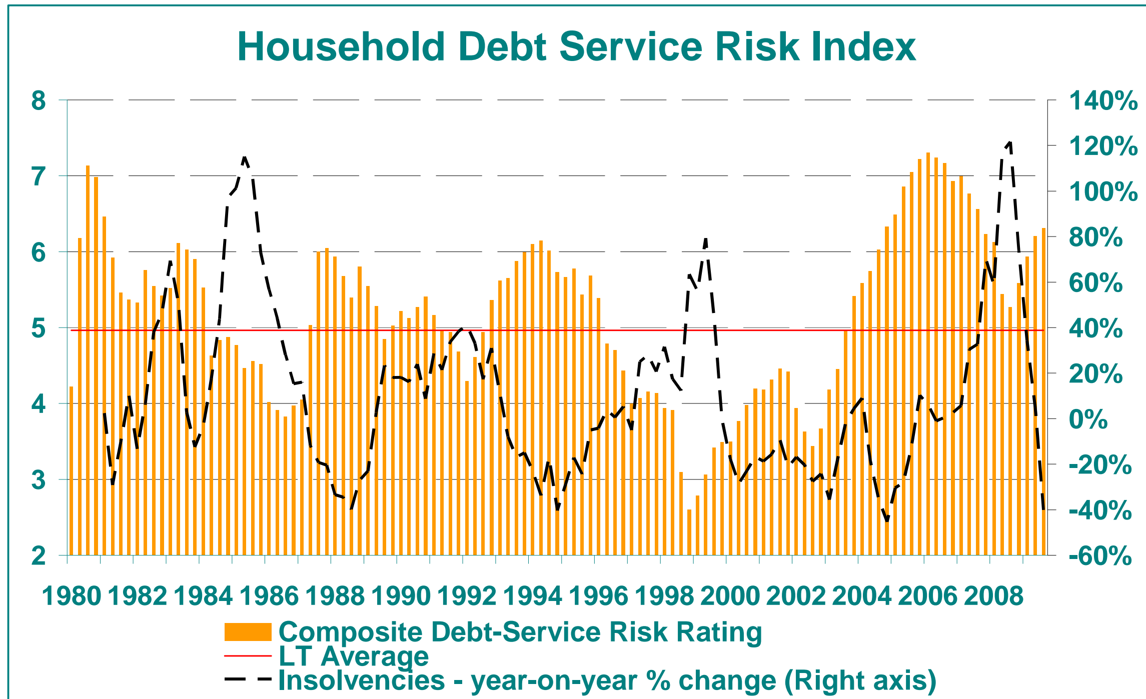
THE HOUSEHOLD DEBT SERVICE RISK INDEX – A VULNERABILITY MEASURE

The graph below represents a rating of risks to the household sector's future ability to service debt, in which the Household Debt Service Risk Index has risen over the past 4 quarters up to level of 6.3 from a low point in the 3rd quarter of 2008 of 5.3. The previous high point was a revised 7.3 in the 1st quarter of 2006.



The Household Debt-Service Risk Index (expressed on a scale of 1 to 10 with 10 being the highest level of risk) is an attempt at measuring the vulnerability of households when it comes to the future ability to service their debt. 3 variables play a role in its level:

• The level of the household debt-to-disposable-income ratio (higher debt-to-disposable income ratio implies higher risk)

• The direction of the household debt-to-disposable income ratio (rising debt-to-disposable income ratio points to higher risk than a declining trend), and

• The level of real interest rates. This measure of real interest rates is somewhat different in this instance, being the difference between prime rate and the 5-year average consumer price inflation rate. The reason for using a 5-year average inflation rate is to get to more of a "structural level" of inflation, because periodically we will have extremely low levels of inflation which could temporarily lead to low interest rate levels, but which could be "unrealistic" and could imply steep hiking and pain once inflation "normalises". As prime rate moves nearer to the 5-year average inflation rate (i.e. declining in real terms as has recently been the case), the lower the scope for further rate cuts and the greater the chance that the next rate move is up. Should the SARB pursue with negative real rates al la US Federal Reserve, this too creates risks in terms of stimulating unsustainable credit growth. Either way, periods of low real interest rates are seen as ones where the risks to the household sector's debt service ability rise, also because of the more aggressive way that they tend to borrow in such times.

The Household Debt Service Risk Index has been rising over the past 4 quarters due largely to the sharp reduction in interest rates to levels nearer to the structural inflation rate, significantly lowering the probable scope for further interest rate reduction, and increasing the possibility that the next interest rate move is up. Accompanying this, progress in reducing the debt-to-disposable income ratio has been limited and the ratio remains very high. So, while we are still at a lower risk level than the high peak in the risk index back in 2006, the levels of debt service risk still remain high. This doesn't necessarily mean we should expect an imminent rise in household sector loan arrears. Rather, it suggests that the household sector remains highly vulnerable to any possible economic "shock", because of high indebtedness and more limited scope to ease monetary policy from here on (compared to mid-2008 when rates were still far higher), implying the need to proceed with caution from a borrower/lender point of view.

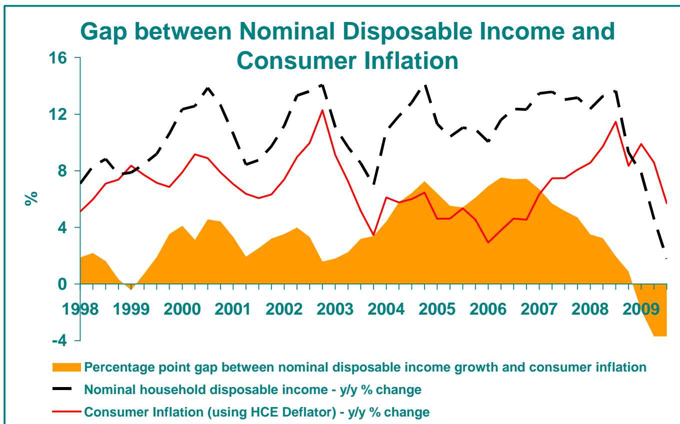
QUARTER 3 THE "HOUSEHOLD SECTOR FINANCIAL CONDITIONS" TABLE SHOWS AN EVEN GREENER (IMPROVING) PICTURE THAN PREVIOUS, WITH BOTH DEBT-SERVICE ABILITY AND THE DRIVERS OF HOUSEHOLD INCOME GROWTH IMPROVING

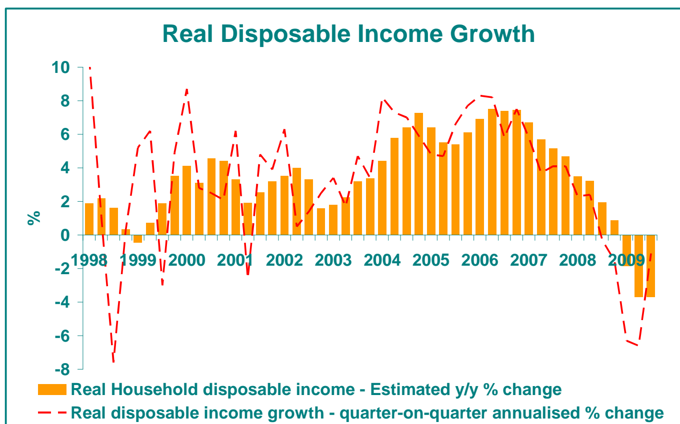
In what may appear contradictory to the Household Sector Debt-Service Risk Index's recent rise, still more green appears on the screen for the 3rd quarter, suggesting further improvement in the environment from a household sector financial and credit quality point of view. Most important was a further mild decline in the household debt-to-disposable income ratio in the 3rd quarter. The "de-leveraging" is in its early stages, after having been delayed by the recession having exerted heavy pressure on disposable incomes. Although many of the "fundamentals" of the Household sector are improving, as reflected by the green blocks, they remain weak, and with interest rate cuts possibly over for the current cycle, it is crucial that both the economy and the household sector's incomes growth gains more traction before the interest rate cutting stimulus begins to wear off at a stage next year.

Household Sector Financial Conditions and Determinants Thereof	Q2-2008	Q3-2008	Q4-2008	Q1-2009	Q2-2009	Q3-2009	Q4-2009
Real Disposable Income Growth (q/q ann.)	Declining positive growth	Negative Growth	Declining negative growth	Declining negative growth	Declining negative growth	Diminishing Negative Growth	N/A
Employment Growth	Declining positive growth	Declining positive growth	Negative growth	Accelerating Negative growth	De-celerating negative growth	N/A	N/A
Average Real Wage Growth	Negative Growth	Zero growth	Positive growth	Positive growth	Zero growth	N/A	N/A
SARB Leading Economic Indicator Growth - qtly avg. (q/q ann.)	Accelerating negative growth	Accelerating negative growth	Accelerating negative growth	Diminishing Negative Growth	Positive m/m growth	Positive m/m growth	Positive m/m growth
Real Economic Growth (q/q ann.)	Rise in positive growth	Decline in positive growth	Negative Growth	Declining negative growth	Diminishing Negative Growth	Positive growth	N/A
Debt servicing costs and main drivers thereof							
Interest Rates on debt (quarterly average)	Rising	Rising	Declining	Declining	Declining	Declining	Sideways
Consumer Price Inflation	Rising	Rising	Declining	Declining	Declining	Declining	Declining
Household debt-to-disposable income ratio	Declining	Declining	Rising	Rising	Declining	Declining	N/A
Household debt-service ratio	Rising	Rising	Rising	Declining	Declining	Declining	N/A
Drivers of household wealth							
Household Net Saving-to-GDP Ratio	Dissaving	Dissaving	Dissaving	Dissaving	Dissaving	Dissaving	N/A
Real house prices (y/y%)	Accelerating negative growth	Accelerating negative growth	Accelerating negative growth	Accelerating negative growth	Accelerating negative growth	De-celerating Deflation	De-celerating Deflation
JSE All Share Index monthly average	Positive growth	Negative Growth	Deterioration in Neg. Growth	Less negative growth	Positive growth	Positive growth	Positive growth
Indicators of household confidence							
Consumer Confidence Index (FNBBER)	Declining	Declining	Declining	Rising	Rising	Rising	Rising
% of total residential property sellers selling to emigrate	Rising	Rising	Declining	Declining	Declining	Declining	N/A

Improvement | More-or-less neutral | Deterioration

HOUSEHOLD DISPOSABLE INCOME DECLINE CONTINUES, BUT LOOKS SET TO TURN FOR THE BETTER IN REAL TERMS





The declining trend in consumer price inflation continued in the 3rd quarter of 2009, a trend which set in due to the onset of a huge global commodity price slump in the 2nd half of 2008.

This inflation decline has cushioned the blow to real disposable income delivered by the recent economic recession, because it meant that consumer price increases have been eating into nominal disposable income at a diminishing rate.

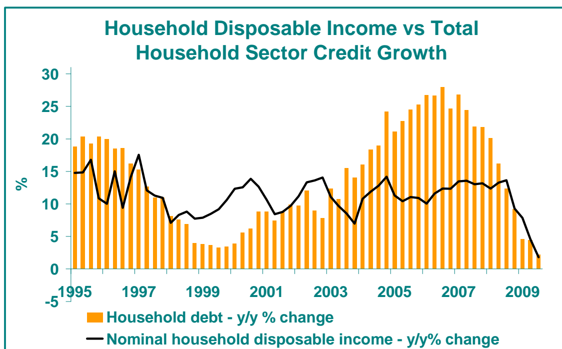
However, cushioning the blow, as opposed to eliminating the blow, was the best we could expect given the severity of the recession. With nominal disposable income growth having slumped to lower rates than that of consumer inflation, it meant that we have had 3 consecutive quarters of negative year-on-year growth in **real** disposable income and 5 consecutive quarters of negative growth on a quarter-on-quarter basis.

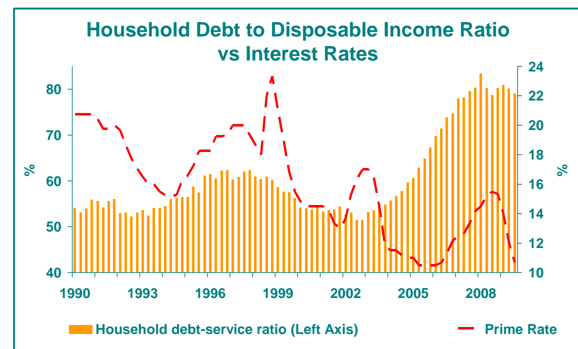
Nevertheless, we are starting to see some light at the end of the tunnel. The gap between consumer price inflation and disposable income growth didn't widen any further, meaning no further deterioration in the rate of decline in real disposable income on a year-on-year basis, while on a quarter-on-quarter annualised basis real disposable income declined by only -1.1%, vastly better than the previous quarter's -6.6%, and is probably only one quarter away from resuming positive growth.

DE-LEVERAGING PROCESS CONTINUES AT A SLOW PACE

It was as far back as the 3rd quarter of 2006 where growth in household sector credit outstanding peaked at 30% year-on-year. Thereafter, a rising cost of servicing the debt, due to the combination of the growth in value of the debt as well as rising interest rates from mid-2006, began to slowly have an impact, sending credit growth into a multi-year declining growth trend.

However, it was only early in 2008 that the credit growth rate got down to rates similar to the rates of growth in disposable income, and as a result we could begin to see a peak forming in the important debt-to-disposable income ratio. Since the 2nd half of 2008, there has been a "race to the bottom" between disposable income growth and household credit growth, with the recession hitting income growth hard, thereby limiting the pace of decline in the debt-to-disposable income ratio.

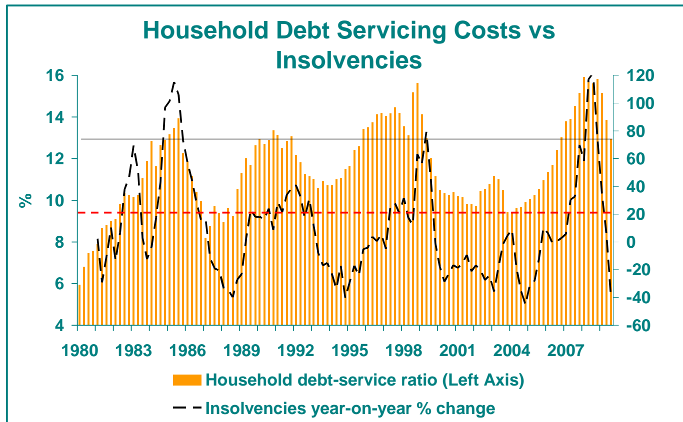




Nevertheless, we saw some further mild downward progress in the debt-to-disposable income ratio from 80.1% in the previous quarter to 79%, and it is likely that a seemingly inevitable move of outstanding household credit into negative territory should see this declining debt ratio trend continue next year. The ratio is now 4 percentage points down on the early-2008 peak of 83% (SARB figures have seen upward revisions in the most recent Quarterly Bulletin).

The process of household "de-leveraging" is normally a multi-year one, and to give one an idea of how long it could last, one only needs to look at the previous phase of debt ratio reduction, which lasted 4 years spanning 1998 to the end of 2002. We are almost 2 years into the current debt-ratio reduction phase, and given the extent of the cut-back in new borrowing/lending over the past 3 years or so, I would expect this reduction phase to last at least to 2012.

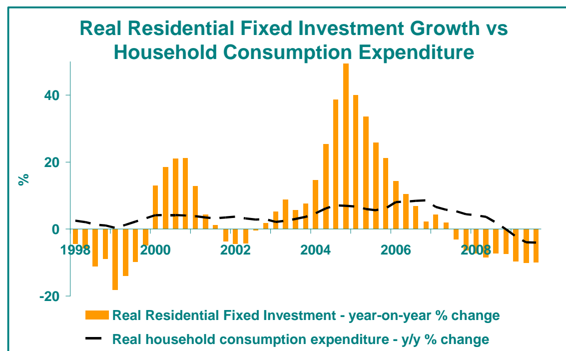
For the time being, though, the high debt-to-disposable-income ratio keeps the debt-service ratio at a relatively high level despite 5 percentage points' worth of interest rate cuts since late-2008. The debt-service ratio (the cost of servicing the household debt burden – interest+capital – expressed as a percentage of disposable income), a great predictor of home loan default rates, declined further to 12.9% in the 3rd quarter, but this is almost entirely due to interest rate cuts and far less due to the decline in the debt-to-disposable income ratio to date. 12.9% is well down from the all-time high of 15.9% in the 1st quarter of last year (Recent SARB data revisions now lead to this calculation putting the 1st quarter of 2008 ratio slightly above the 1998 high when prime peaked at 25.5%), but it is still near to previous cyclical highs. Not surprisingly, therefore, while having seen some improvement in credit quality, it is probably safe to say that the levels of "stressed debt" are probably still too high for comfort.

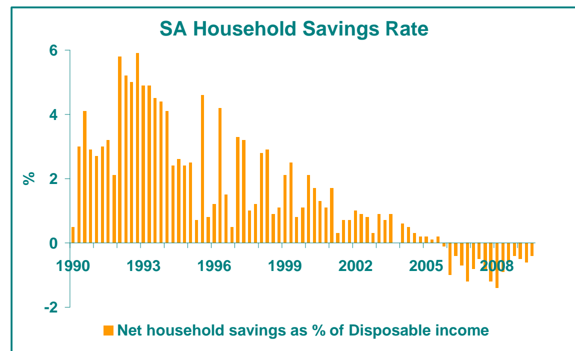


BOTH CONSUMPTION AND RESIDENTIAL FIXED INVESTMENT CONTINUED TO DECLINE, BUT STILL LITTLE SIGN OF IMPROVED SAVING BY HOUSEHOLDS

While it is encouraging to witness the debt ratio starting to decline, less encouraging is the still-dismal rate of savings amongst SA's households as a whole. A situation of net dis-saving still remains, to the tune of -0.4% of disposable income, which implies that according to SARB estimates the limited amount of gross savings that exists is not yet enough to cover depreciation on fixed assets. This is in part a reflection of SA's ongoing lack of savings culture. However, it is also reflective of the recent pressure on disposable income, because real consumption expenditure in the 3rd quarter was down year-on-year by -4.1%, but this was an insufficient spending cut to make a significant improvement in the savings rate.

It should come as no surprise, therefore, that real residential fixed investment was down -9.9% down year-on-year in the 3rd quarter, similar to previous quarter's -10.1%.





CONCLUSION

The rise in the household debt-service risk index, at a time when household sector financial fundamentals are starting to turn for the better, could appear somewhat contradictory. However, this is not necessarily the case. The Risk Index does indeed take into account the fact that the debt-to-disposable income ratio is starting to decline. However, it also takes into account the fact that the ratio remains very high, as well as the probability that the scope for further interest rate cuts has diminished dramatically, if not run out.

Household sector financial fundamentals are starting to point in the right direction, but still remain weak. If and when these have strengthened a little further in 2010, it could well get to a situation where a more substantial decline in the debt-to-disposable income ratio will start to offset the risk of a lack of scope for further rate cuts. For the time being, however, a high debt ratio still leaves the household sector highly exposed to any surprises, and hence the high Debt-Service Risk Rating assigned to it.