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PROPERTY BAROMETER –HOUSING AFFORDABILITY

The SARB has done more than enough to improve home affordability and thus the residential market. It's time to look elsewhere for solutions.

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HOME AFFORDABILITY DETERIORATED SLIGHTLY, EARLY IN 2012, BUT IS STILL FAR BETTER THAN 4 YEARS AGO

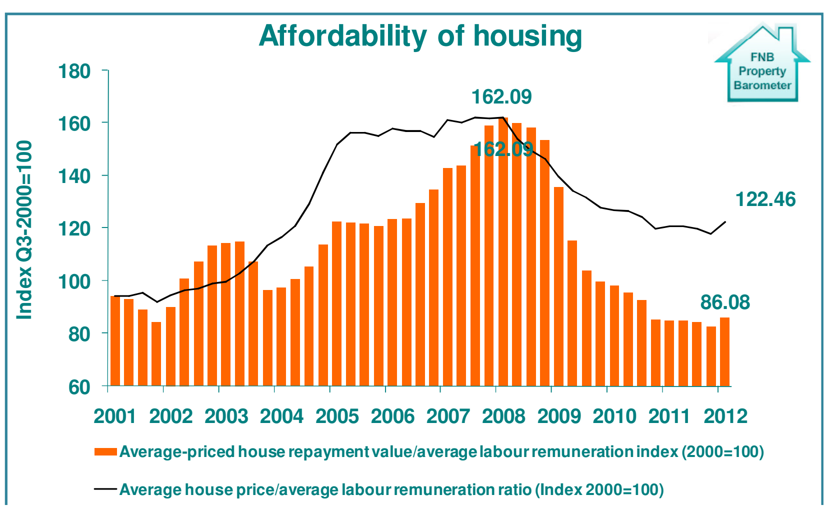
This week, the Reserve Bank (SARB) Monetary Policy Committee (MPC) meets to deliberate on interest rates. In the interest rate sensitive residential market, it is almost "instinctive" for various participants to want to see an interest rate cut each time an MPC meeting takes place.

However, at currently "abnormally" low interest rates (given our longer term consumer price inflation levels, as well as our historic levels of interest rates in SA), I am of the opinion that the SARB has probably "given over enough" in terms of lowering the cost of household debt and stimulating the housing market.

Last week, the release of the SARB Quarterly Bulletin provided average labour remuneration data up until the 1st quarter of 2012, allowing us to update our 2 measures of housing affordability, namely the "average house price/average labour remuneration ratio" (in index form), and the "instalment value on a 100% loan on the average priced house/average remuneration ratio" (also in index form)

Interestingly, we saw a mild increase (deterioration) in both affordability measures for the 1st time since the 1st quarter of 2008.

But this is no real cause for concern at present, because both measures of affordability are dramatically down on the 1st quarter 2008 peak. From an index level of 162.09, the Average Price/Average Remuneration Index was down to 122.46 as at the 1st quarter of 2012, a cumulative drop (improvement in affordability) of -24.4% over precisely 4 years for the average employed cash buyer. For the credit dependent buyer, the improvement in affordability has been far more extreme. From a 162.09 peak in the 1st quarter of 2008, the Bond Installment/Average Remuneration Index has had a cumulative fall to 86.08 as at the 1st quarter of 2012, a massive -46.9% drop.



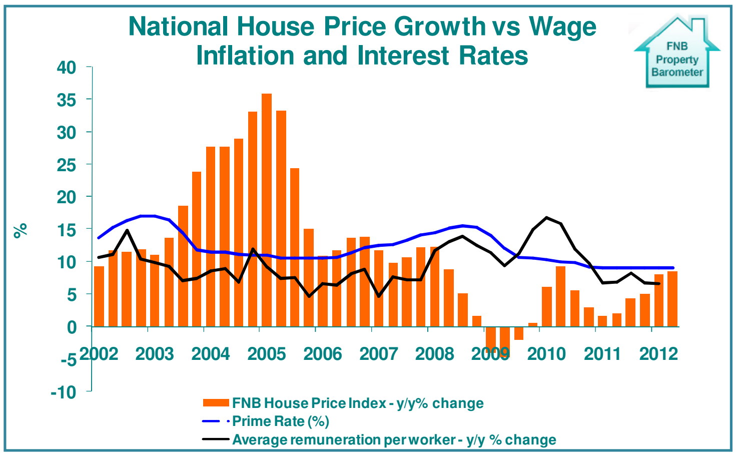
While the Average Price/Remuneration still appears relatively high, only having declined back to mid-2004 levels, the Bond Installment/Average Remuneration Ratio Index has dropped all the way back to lows last seen late in 2001, a period before last decade's house price boom had really gathered too much steam.

This shows the SARB to have more than "done its bit" in terms of stimulus for the residential property market, although consumer inflation and not house price inflation, is its official focus.

But why then does the housing market remain relatively mediocre? Well. Perhaps it isn't as mediocre as some would suggest. Many are still benchmarking current performance with the property boom of last decade, which was the biggest boom in our country's recorded history and probably not to be repeated in a hurry. Perhaps the current market is more "normal" than we think for the low growth economy that SA is.

Housing Affordability Factors Constraining Further Improvement in the 2 measures

However, there are indeed some constraining factors hampering further improvements in housing affordability, and some lie outside of the SARB's sphere of influence.

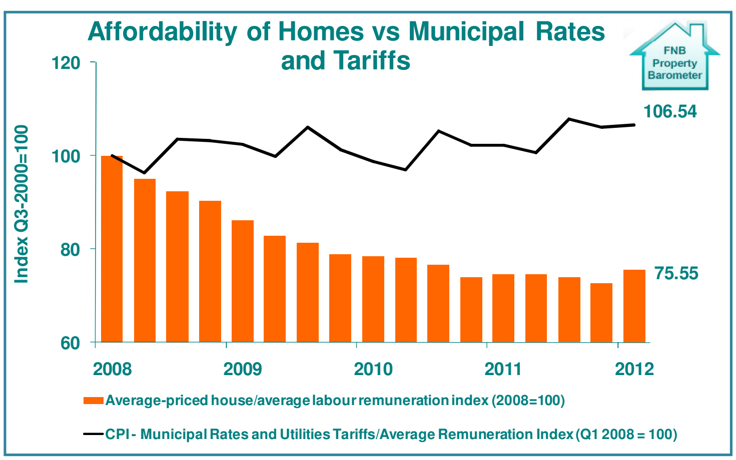


A contributor to the big improvement in the 2 housing affordability measures over the past 4 years was strong average wage inflation around 2009/10, a lagged response to a major cost of living spike in 2008. Year-on-year increase in the average remuneration per worker peaked at a massive 16.8% in the 1st quarter of 2008. Since then, the pace of growth has slowed to 6.6% by the 1st quarter of 2012, a rate which was exceeded by average house price growth 8% year-on-year, implying a slight deterioration in housing affordability.

Other "Indirect" Affordability Constraints

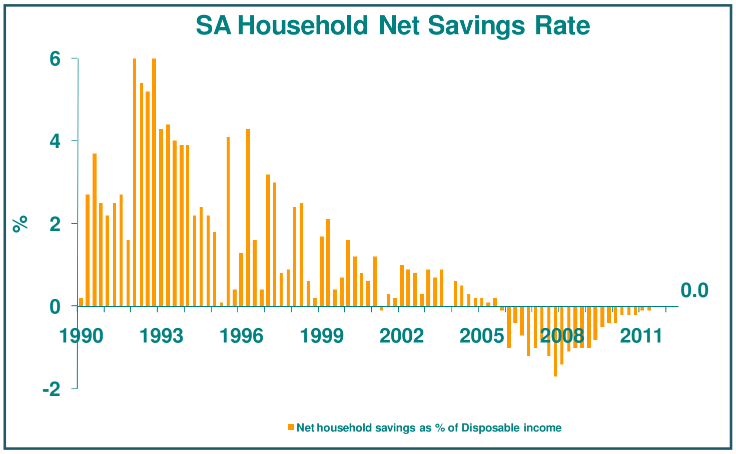
By "indirect" affordability constraints I refer to factors that do not directly affect the two above measures of affordability, but nevertheless have implications for people's ability to afford homes.

The affordability of housing is also impacted by "home running costs". Costs directly related to the home are municipal rates and utilities tariffs.



I calculate a Municipal Rates and Tariffs/Average Remuneration Index in the same manner that the home affordability indices are done. On the graph to the left, this is compared to the Average House Price /Average Remuneration Index (both indexes having Q1 2008 as 100). This comparison illustrates that, whereas the average house price/average remuneration ratio has dropped -24.4% in the past 4 years, the rates and tariffs/remuneration ratio has risen 6.54% over the same period. The cost of buying a home and some of the key costs related to a home are therefore currently running in two different directions.

The constraining factors go further, however. Home Loans Banks have regularly been criticized for their lack of lending. Admittedly, they are far more conservative in their lending practices than was the case in the boom, which ended about 4-5 years ago. However, one could also argue that lending practices in the boom years were "overdone", and that the current approach is more-or-less appropriate.

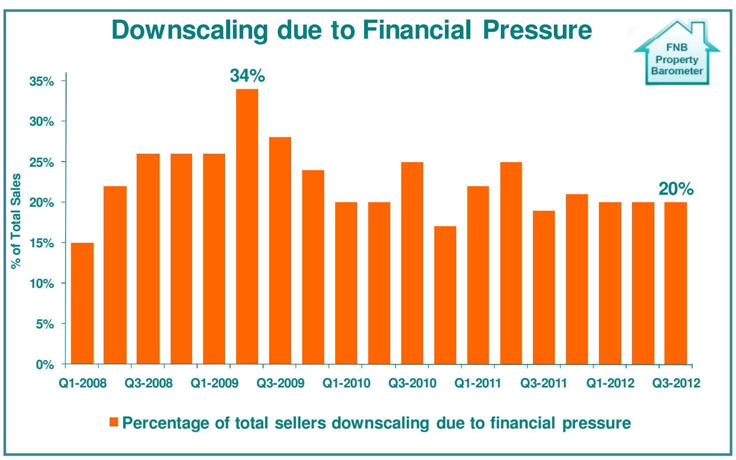


What isn't appropriate, though, is SA's extremely poor level of household savings. Last week's SARB Quarterly Bulletin release showed 2nd quarter household net saving to be stuck for the 4th consecutive quarter on zero percent of disposable income. This implies that what little gross saving is taking place is just sufficient to cover the depreciation on fixed assets owned by the household sector. With such a poor savings rate it is small wonder that many households applying for a home loan cannot afford the deposit often required to acquire such a loan.

This savings shortage is a serious structural issue not only constraining the housing market but also many people's ability to retire financially sound. Granting more credit is not a long term solution, a higher savings rate is.

A further key housing market constraining factor is the very high level of the household debt-to-disposable income ratio, which has reportedly started to rise again over the 1st 2 quarters of 2012 to 76.3% (not far below the early-2008 all time high of 82.7%). Off this very high base, the household sector's ability to grow its credit levels for home buying is arguably very limited.

And finally, the overhang from the "perfect storm" of 2008/9 is still being slowly sorted out. That "storm" was the combination of a food and petrol price inflation-induced cost of living spike at the time, a simultaneous 5 percentage point increase in interest rates from mid-2006 to mid-2008, and a sharp recession in which some estimates were that up to 1 million jobs were lost.



SAs highly-indebted household sector is still dealing with the effects of that shock. In the FNB Estate Agent Survey, the percentage of households estimated to be downscaling due to financial pressure was still as high as 20% in the 2nd quarter of 2012. Perhaps this figure, more than many others, points to a significant number of SA households having lived beyond their means, and having insufficient buffers for the inevitable economic shocks that befall us from time to time.

IN CONCLUSION

So this week the MPC deliberates once more, and consumer price inflation at 4.9% for July suggests that further interest rate reduction can be justified from a narrow inflation targeting point of view. But from the household sector's longer term financial health would this be the right thing? The SARB has already greatly improved housing affordability through the massive interest rate reduction since late-2008, despite only a moderate response by the housing market has been witnessed.

What needs to happen now before the housing market moves to sustainably stronger levels is for the level of household indebtedness relative to income to decline, for the savings rate to improve significantly, and for the big adjustment to be made to sharp rates and utilities tariffs related to housing. These financial health improvement probably won't be achieved by further interest rate reductions should they occur.