HOUSEHOLD AND CONSUMER WEEKLY

When interest rates finally do go up, South Africa can't say that it wasn't properly warned.

23 August 2013

Prior to the last interest rate hiking cycle, there were plenty of warning signs….

"Hindsight is a perfect science", some would say, but it is important to examine how we have gone wrong in the past if mistakes are not to be repeated.

When interest rates started to rise in June 2006, many people within the lending as well as the borrowing sectors of the economy were taken by surprise. Looking back, this surprise seems a little strange, as the then governor of the Reserve Bank (SARB), Governor Mboweni, had been warning us repeatedly of possibilities to this effect. And if we didn't want to take him seriously, there was the spectre of strongly rising global commodity prices from 2004 already, and household credit growth (also often a driver of home grown inflationary pressures) was rampant too.

Admittedly, the above factors didn't really feed through into SA's consumer price inflation in a meaningful way until 2006, but when they finally did, in the form of a twin spike in global oil and food prices, the result was severe, with CPI inflation in South Africa eventually peaking at 13.7% year-on-year in August 2008, and interest rates peaking at a prime rate of 15.5%, up from 10.5% 2 years earlier.

The results were extremely painful for the household/consumer sector, not because the interest rate hikes were severe, but rather because the level of indebtedness relative to income had reached an all time high by 2008, at around 83%.

In actual fact, 5 percentage points 'worth of interest rate hikes at a slow pace spread over 2 years wasn't severe at all by our historic standards, especially if one compares it to the sharp 7.25 percentage points' worth of hikes in less than 2 months back in 1998.

…But perhaps we placed too much faith in our limited human forecasting abilities.

So what went wrong? Perhaps it boiled down to too many of us living on either economists' forecasts (and yes, I was a macro forecaster in earlier years) or on our own forecasts, and there is a real problem with that.

Firstly, stating the obvious, is that the future as always remains highly unpredictable for all of us, and as hard as forecasters try they often don't get it right. We as humans are not good at predicting the timing of trend changes. We know that interest rates have to go up at some point, as we know that property or equity bull markets have to end at some point, but we often fall into the trap of believing (perhaps because we want to believe) that it "won't happen just yet". We then apply that cognitive bias called "confirmation bias" to the problem, and search for reasons as to why it won't happen yet, or why "this time it is different"

A "recency bias" also creeps into human forecasting, whereby recent events have a bigger influence on people's perceptions of risk than do events further back in the memory. So, after a nice long period of great economic, consumer and property performance, and with low and stable interest rates, we lulled ourselves into believing that risk levels were low, whatever "low" meant.

But eventually, the inevitable day dawned in June 2006, and the 1st interest rate hike of the most recent interest rate hiking cycle took place. But even when we had to accept the reality that interest rates were rising, many of us tended to forecast moderate interest rate hiking. That is the normal way of the "herd". Because the one or two bold individuals who forecast extreme movements often get ridiculed at the time, many forecasters stick to moderate projected moves. Humans don't like extreme views, extreme being when they deviate too far from the current "conventional wisdom", just ask Professor Tim Noakes with regard to some of the flak he has received on his latest "high protein-low carb" view.

So, if one forecasts a moderate move away from the current position, and you prove to be way out due to a major "shock", you are more likely to be forgiven ("I mean, who could have foreseen this shock???") than the forecaster that did forecast a shock and was way off the mark because it didn't happen.

So interest rates in many minds (and forecasts) were only supposed to rise by 1 or 2 maybe 3 percentage points, not by 5. In fairness to these forecasters, it is also almost impossible to predict the timing of an oil and food price shock of the magnitude that we had in 2008.

So, if forecasting doesn't work so well, what do we do? Pay more attention to "current facts and risk indicators"….

With forecasts often prone to huge error, what then should be our approach? These days I believe in an approach to lending/borrowing based far more on what current risk indicators are telling us, as opposed to depending on forecasts. This in effect means tweaking one's approach far more often as key risk indicators change, and not trying so hard to predict what such indicators are going to do in future.

….And risk indicators are currently significant

And right now, there are some key indicators of risk that need to be taken cognizance of, and not say that we haven't been warned.

On the one hand, the SARB is more accommodating of economic growth these days…..

On the one hand, it would appear that the SARB is more mindful of near term economic growth issues. In the most recent MPC (Monetary Policy Committee) statement, the Governor alludes to this when she says "The downside risk to growth has already resulted in the Bank being more tolerant of inflation at the upper end of the target range than would normally have been the case, an approach that is consistent with a flexible inflation targeting framework". As a result, many forecasters don't see this week's release of the July CPI inflation number, which shot up from a previous rate of 5.5% to 6.3%, as necessarily leading to an interest rate any time soon, with our economic growth rate looking anaemic at best. Indeed, our own FNB forecast is for interest rates to move sideways at current levels until 2015.

…..However, the fact is that CPI inflation is above the target limit, and somewhere the SARB has a tolerance limit

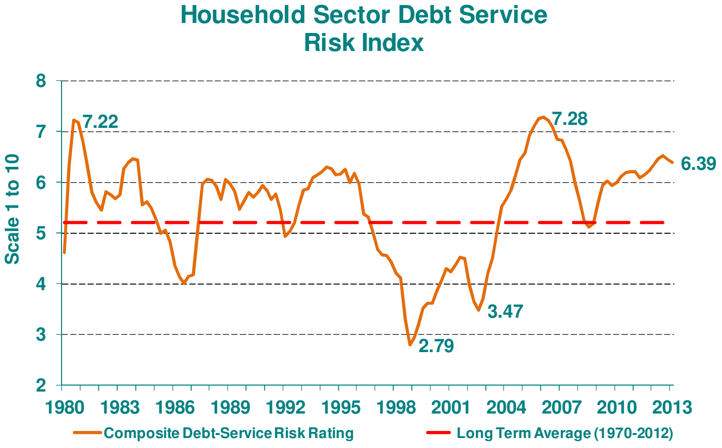
However, the SARB does have "tolerance limits", and we will have to keep guessing as to what those are. It has indicated repeated concern regarding "upside risks" to the inflation outlook, with certain home grown drivers of inflation, notably high wage demands in a troubled labour market, and of course the possible inflationary impact of a volatile rand featuring.

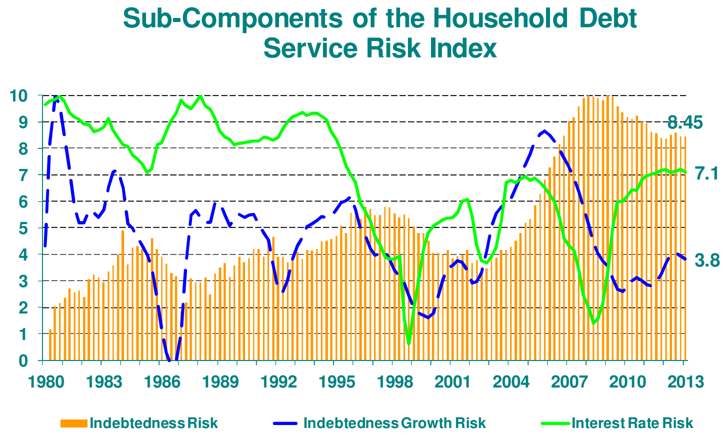
But while we continue to guess what the SARB may do and when, it is important to keep one's eye on the facts and figures that tell us about the "here and now". The fact is that, although the SARB doesn't foresee a prolonged breach of the upper inflation target, CPI inflation is now above the 6% inflation target limit, and the longer it stays at higher levels, the more possible it becomes that inflation expectations (already at 6% and 6.1% for the next 2 years according to the BER survey) become a self-fulfilling prophesy, and though more flexible in approach these days, the other fact is that the SARB still has an official inflation targeting to pursue.

This should be enough for us to be utilizing what time we have left before the next rate hiking cycle to make sure that the household financial situation is in order. Here, again, we humans are prone to errors of judgement, in that we tend to evaluate "absolute" performance as opposed to relative performance. So, we often compare consumer debt-servicing performance in a low interest rate environment with that of high interest rate environments, and then draw the conclusion that we are doing well. That approach is akin to saying that this summer is a hot one because it is far hotter than the past winter, as opposed to evaluating it by previous summers' temperature levels.

There are also enough indicators to tell us that the consumer is still "frail"

Warning lights regarding the state of the consumer have been flashing for a while now. Our own simple FNB Household Debt-Service Risk Index has been at high levels by historic standards for 'some time now, having risen over the period 2008-2012. The index is derived from 3 components, namely the level of the household debt-to-disposable income ratio (the higher the ratio the higher the risk), the direction of the debt-to-disposable income *ratio (rising being higher risk than declining), and the level of real interest rates (the lower the real interest rate level the higher the risk of the end of rate cuts or the start of rate hikes).*

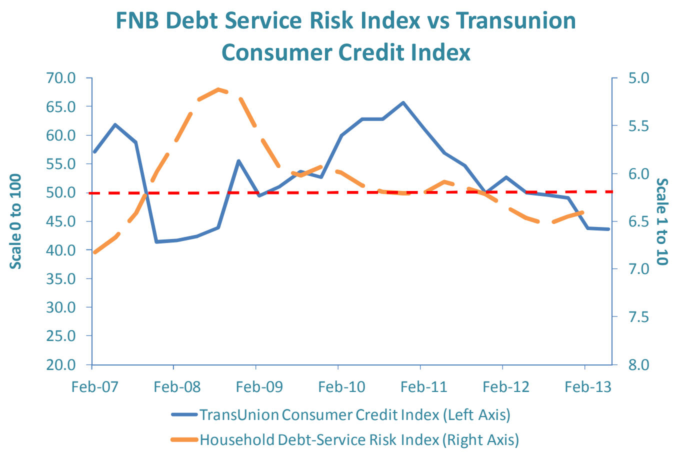




Raw Data sources: SARB

The Risk Index rose initially due to sharp declines in real interest rates, indicating the diminishing scope for further monetary stimulus going forward. Later in the rising phase, however, it was also driven by some return to a mild rising trend in the debt-to-disposable income ratio following a few years of decline. And so, as at the 1st quarter of 2013, the Debt-Service Risk Index sat at a level high by historic standards, and well above the long term average, with scope for rate cuts appearing to have dramatically diminished, and household indebtedness still high with a debt-to-disposable income ratio of 75.4%

And then, from rising risk we moved to actual deterioration in consumer credit health more recently. Not surprisingly, about 2 and a half years after the Debt Service Risk Index began to rise, rising risk manifested itself initially in a slowing pace of improvement in consumer credit health, according to the Transunion Consumer Credit Index, and then as from mid-2012 this turned to actual deterioration in consumer credit health. The left hand graph below shows the inverted Debt Service Risk Index bottoming in 2008, 2.5 years before the best point in Consumer Credit Health was reached in late-2010.

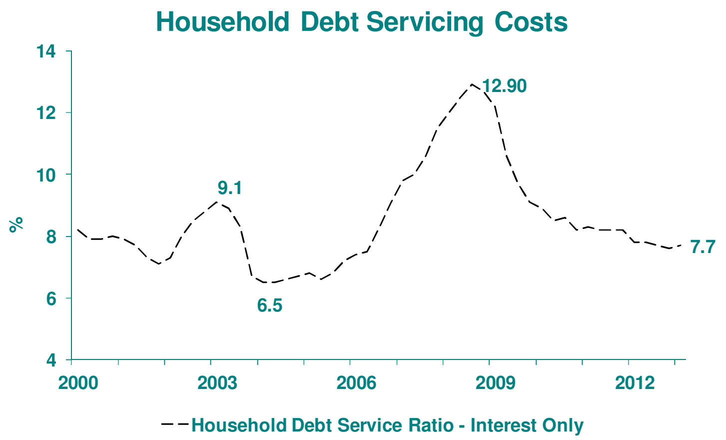


The Transunion Consumer Credit Index has been below the crucial level of 50 for 3 consecutive quarters, signaling deterioration in consumer credit health

Data source: Transunion, SARB

So the ominous signs have been with us for a while

So the ominous signs have been with us for a few years now, and much of the credit health trends are explained in one single ratio, i.e. the Household Debt-Service Ratio, i.e. the cost of servicing the household debt burden expressed as a percentage of household sector disposable income. This began to decline in 2009 as interest rate cuts dramatically reduced the cost of servicing the debt, while some small decline in the debt-to-disposable income ratio also played a role.



In the 1st quarter of 2013, the Household interest only Debt-service ratio of the SARB rose slightly from 7.6 to 7.7. This is not yet a significant rise, but does suggest that the dramatic improvement (decline) since 2009 has all but ended.

Data source"SARB

But more recently, an end to the decline in the debt-to-disposable income ratio, driven by rapid non-mortgage credit growth, and perhaps a rising effective interest rate as the partial switch towards higher interest non-mortgage forms of debt continues, has meant the end of the decline in the debt-service ratio. And the 1st quarter actually saw a slight rise in a ratio that is arguably the best single explanatory macro-variable of non-performing debt levels.

So that's the reality. Forget about forecasts of where interest rates may go. The household sector debt-service ratio may have started turning upward slowly if we don't slow the rate of credit growth and reduce the level of indebtedness (debt relative to disposable income). This possible bottom point in the cycle is still well-above the previous cycle's low point of 6.5% back in 2004, and this is despite a significantly lower policy interest rate (repo rate) now compared to then. As one would expect then, consumer credit health has also begun to deteriorate in line with the debt-service ratio trend.

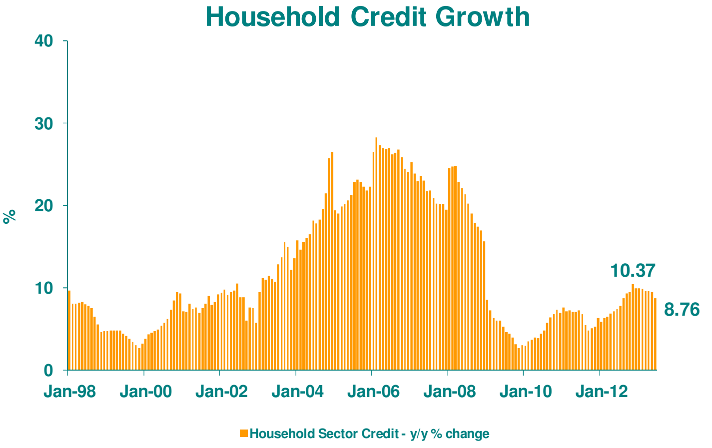
Deteriorating credit health at such a good point in the interest rate cycle is undesirable,….

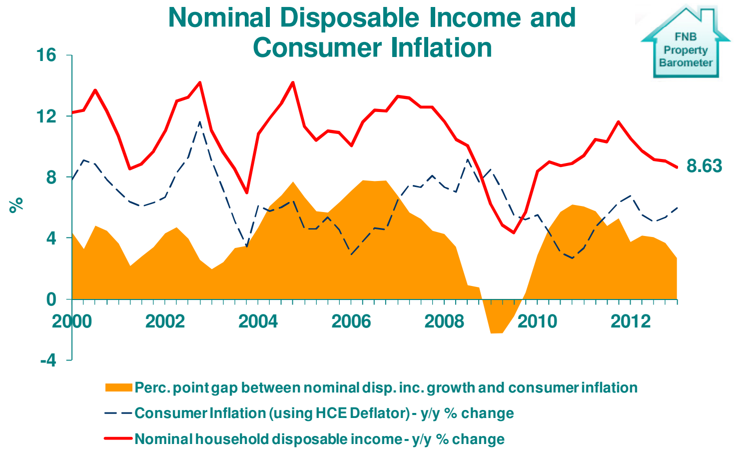
So, into a deteriorating phase of the credit cycle at a time when interest rates are at multi-decade lows and very stable. That is arguably not a desirable situation. And with the SARB citing "upside risks" to inflation, and weak economic growth having slowed household sector real disposable income growth, we have probably had enough warning that it is time to get the "consumer house" in order before the next interest rate hiking cycle, whenever that may be.

…However, there are some encouraging signs

Having spoken of various warning signs such as inflation being above the upper target limit, and credit health already having deteriorated even prior to any interest rate hiking, one further warning in the form of "verbal intervention", by most notably National Treasury, may be having a positive effect. Back in 2012, Treasury started to voice its strong concerns over the pace of unsecured lending growth.

In recent times, we have seen certain forms of non-mortgage lending growth starting to slow, perhaps as a result of this "verbal intervention", and as a result overall household sector credit growth has begun to slow from a peak of 10.4% in October 2012 to 8.8% by June 2013.





Slowing household sector credit growth is a much needed positive step towards restoring consumer credit health through hopefully lowering the debt-to-disposable income ratio. However, this alone is not necessarily enough. Important is that credit growth moves to a level below that of household sector disposable income growth, itself having slowed to 8.6% year-on-year as at the 1st quarter of 2013.

In Conclusion – Forecasts are always hazardous, but we know enough to know what to do

In short, in a slow economic and income growth environment, slowing household credit growth should be seen as positive. There have been ample warning signs of "upside risks"" to inflation, and "downside risks" to economic and household income growth, all factors that can have an impact on household financial strength.

There have also been ample warning signs that consumer credit health is deteriorating, arguably inappropriate at a time when interest rates are at an "extreme" cyclical low point or at least close. A lot more than this we don't need to know. I am of the opinion that it is important to make significant strides in reducing the household debt-to-disposable income ratio significantly (preferably to at least below 70% in my subjective opinion) prior to the next interest rate hiking cycle whenever that may come.

Next week, therefore, will produce 2 pieces of crucial data. Firstly, on Tuesday 27 August, GDP data will give a hint of what to expect in terms of the household disposable income growth numbers for the 2nd quarter, while Friday 30 August will see the SARB give us an indication of whether household sector credit growth showed a further slowing in July.

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