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HOUSEHOLD SECTOR FINANCIAL VULNERABILITY

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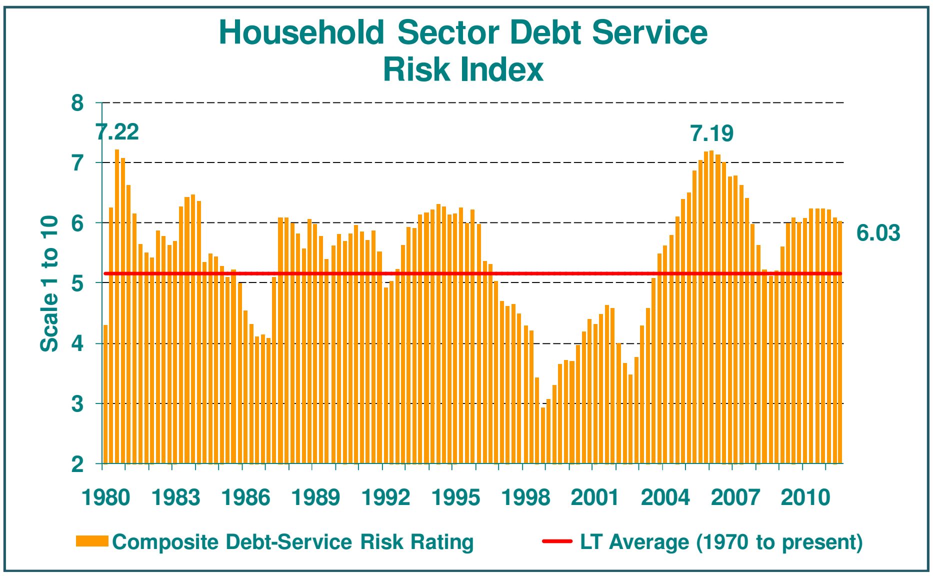
Household/Consumer debt-service risk is slowly declining, but still remains high, and it is not yet time to declare victory in the household sector "balance sheet rebuilding" exercise.

HOUSEHOLD SECTOR DEBT-SERVICE RISK DECLINED MILDLY FURTHER IN THE 3RD QUARTER OF 2011

According to our Household Debt-Service Risk Index, the vulnerability of the country's household sector when it comes to being able to service its debt in future appears to be diminishing. From a previous quarter's index level of 6.10 (on a scale of 1 to 10), the 3rd quarter saw a further mild decline to a level of 6.03. This represents the 3rd consecutive quarter of decline in our simple measure of household debt-service risk.

While we have seen a gradual improvement (decline) in household debt-service risk in 2011, due to a declining trend in the household debt-to-disposable income ratio, it must however be said that the 6.03 index level remains relatively high, still well-above the 31 year average of 5.2. It is not, therefore, yet time for the household/consumer sector to declare victory in the "balance sheet rebuilding" exercise.

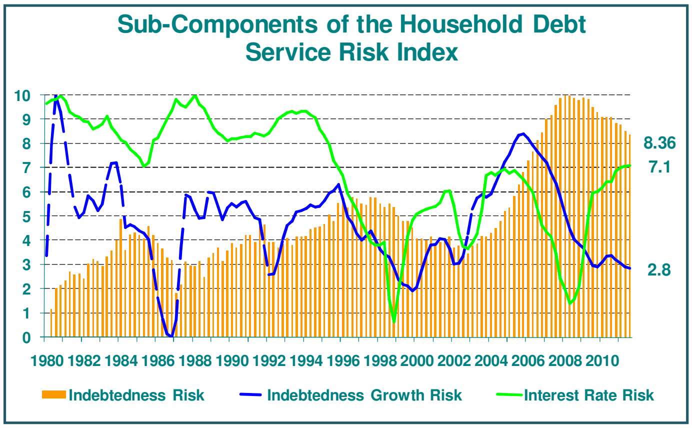


The index is compiled from 3 variables, namely, the debt-to-disposable income ratio of the household sector, the trend in the debt-to-disposable income ratio, and the level of interest rates relative to long term average (5-year average) consumer price inflation.

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. A downward trend in the debt-to disposable income ratio contributes positively to the overall risk index. Then, 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 being that the nearer we may be getting to the bottom of the interest rate cycle, and the more the risk of the next rate move being upward becomes.

EXAMINING THE 3 COMPONENTS, THE HIGH LEVEL OF INDEBTEDNBESS STILL KEEPS THE OVERALL RISK RATING HIGH, ALONG WITH A HIGH INTEREST RATE RISK RATING

Examining the 3 sub-indices of the overall Household Debt-Service Risk Index, the Debt-to-Disposable Income Ratio Index remains the highest at 8.36, despite having declined significantly from a level of 10 as at the 1^{st} quarter of 2008, the quarter in which the debt-to-disposable income ratio reached its all-time high. Although the ratio has receded to 75% by the 3^{rd} quarter of 2011, this level still remains extremely high by SA's historic standards.



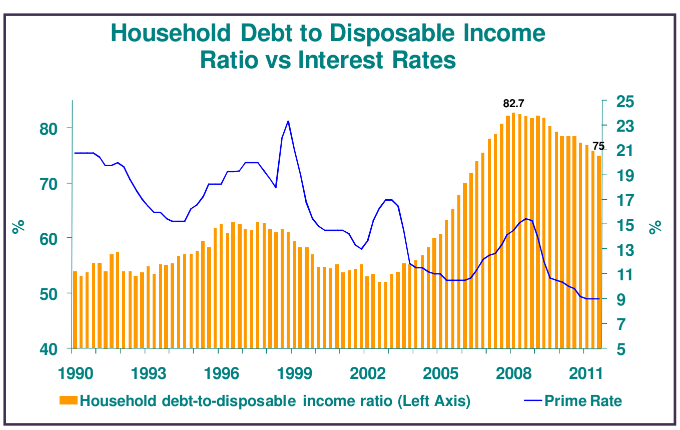
Encouraging, though, is the fact that the debt-to-disposable income ratio has been trending broadly downward since 2008, and the" trend risk rating" is thus at a relatively low level of 2.8, the key positive contributor to the overall risk index.

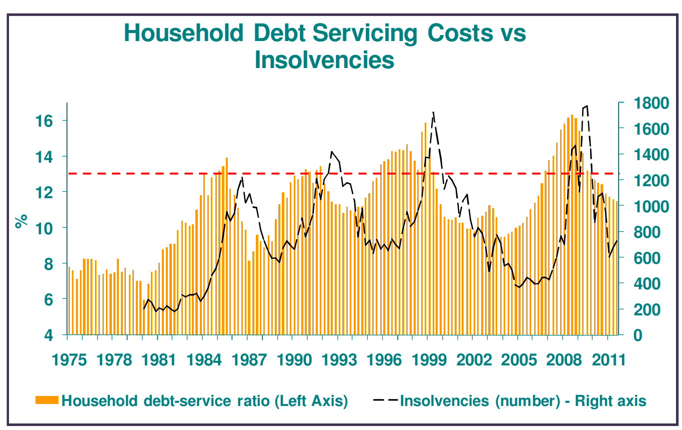
The third component is the Interest Rate Risk Index, which has risen to a relatively high level of 7.1 as at the 3^{rd} quarter of 2011. The reason for its rise since 2008 has been the sharp decline in interest rates since then, from 15.5% prime at mid-2008 to the current 9%. Given that there has been no further interest rate reduction in 2011, this index has only risen marginally this year. That slight rise has been due to a mild increase in the 5-year average consumer price inflation rate (using the private consumption expenditure deflator), which may be pointing to rising structural inflation in SA. This in turn could require higher longer term average interest rates in future. The reasoning behind lower real interest rates pointing to greater household vulnerability is that households that borrow during low interest rate times tend to be more vulnerable due often to a lack of forward thinking and planning by borrowers for the inevitable interest rate hiking cycles. Vulnerability of borrowers who qualify for loans at the peak of the interest rate cycle should thus be less than those qualifying at the low points in the cycle.

ALTHOUGH OUR MEASURE OF DEBT-SERVICE RISK HAS BEGUN TO SUBSIDE, IT REMAINS RELATIVELY HIGH, REQUIRING FURTHER REDUCTION FOR COMFORT

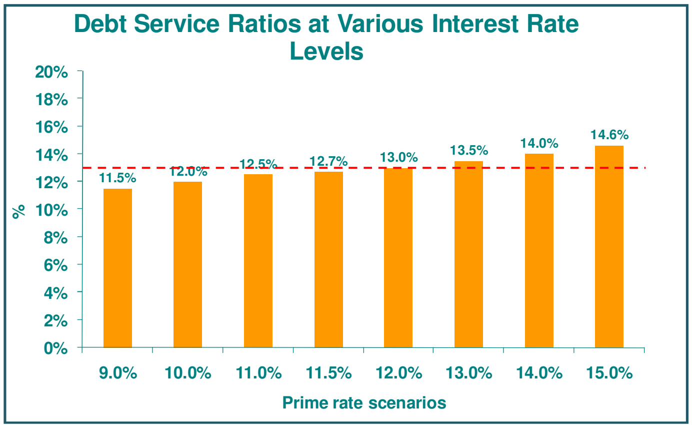
Although the level of the Debt Service Risk Index has begun to decline, it remains on the high side relative to the long term average, and arguably requires further decline to bring the household sector into a situation that could be deemed to be healthy. The reduction in debt-service risk has been brought about by ongoing decline in the household debt-to-disposable income ratio to 75% in the 3^{rd} quarter, down from 75.8% in the previous quarter and now down significantly from the revised 82.7% as at the 2^{nd} quarter of 2008.

However, the 75% level remains high by historic standards, and the household sector thus relies heavily on the Reserve Bank (SARB) to maintain interest rate levels that are low by SA's historic standards. Indeed, it has been the SARB's huge reduction in interest rates from 15.5% prime as at late-2008 to the current 9% that has been the major contributor to bringing down the all-important debt-service ratio (cost of servicing the household debt, interest + capital, expressed as a percentage of household sector disposable income) from a painful all-time high 2008 peak of 16.3% to the far more comfortable 3^{rd} quarter 2011 level of 11.5%.This in turn has significantly improved household credit quality, and the right hand graph below shows insolvencies having dropped dramatically from 2009 to 2011.





However, were the recent 11.5% debt-service ratio to hypothetically represent a bottom turning point in the current cycle, this would be the highest bottom turning point in history, suggesting that it would probably be desirable for the household sector to continue to further reduce its debt-to-disposable income ratio further.

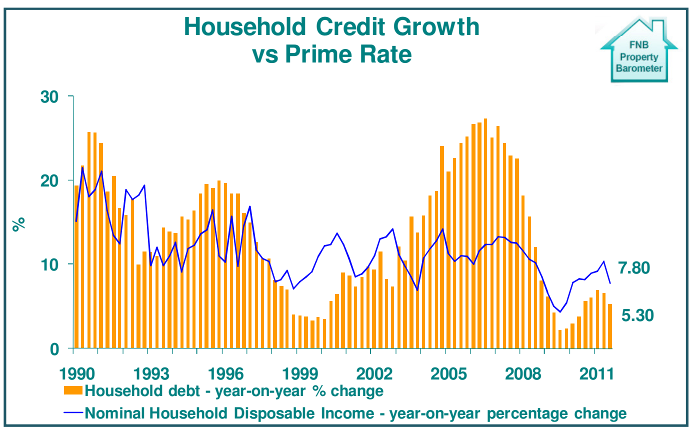


Looking at it another way, I am of the admittedly subjective opinion that a 13% debt-service ratio represents an acceptable maximum at the peak of the cycle. When this ratio rises higher than 13%, that would appear to be where matters become unacceptably painful for the household sector as well as lending institutions, as was the case from around 2007. At the current level of household indebtedness, what would it take for the debt-service ratio to reach a 13% "upper acceptable limit"?

The accompanying graph shows the debt-service ratio at the current debt-to-disposable income ratio, for different hypothetical interest rate scenarios. According to these, a prime rate of 12% would cause the household debt-service ratio to reach 13% at a 3rd quarter household debt-to-disposable income ratio of 75%.

That means that the household sector probably only has room for what would be a very mild interest rate hiking cycle of 3 percentage points, before "severe pain" sets in. It would thus do well to continue to borrow cautiously in 2012, and to make further progress in reducing its level of indebtedness.

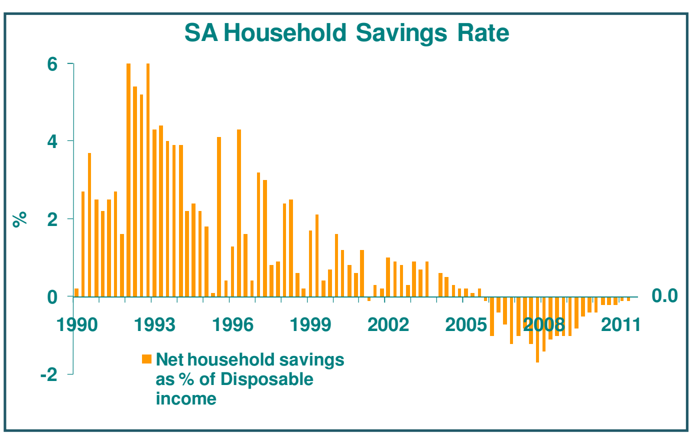
HOUSEHOLD CREDIT STILL WINNING THE RACE TO STAY LOWER THAN DISPOSABLE INCOME GROWTH, BUT BOTH ARE SLOWING.



Indeed, it would seem likely that a further reduction in the level of indebtedness relative to disposable income is possible due to household borrowing growth slowing. However, signs of a slowing economy along with slowing disposable income growth would suggest that this progress will be slow going.

Household sector credit growth slowed further from 6.6% year-on-year in the 2nd quarter to 5.3% in the 3rd quarter, enabling it to remain below a slowing nominal disposable income growth rate of 7.8%, down from 10.4% in the 2nd quarter.

THE HOUSEHOLD SECTOR ALSO SHOWS SMALL SIGNS OF IMPROVING ITS DISMAL SAVINGS RATE,…..



Savings is important in order to create wealth and thus strengthen one's financial position either through increasing the level of fixed or financial assets, and this has been an area of weakness in household sector finances in recent years.

Should the economy not deteriorate back into recession, it is also possible that the household sector could move into a position of net saving, versus the net-dissaving of recent years (net dissaving implies that the level of gross saving is insufficient to cover depreciation on fixed assets owned by the household sector).

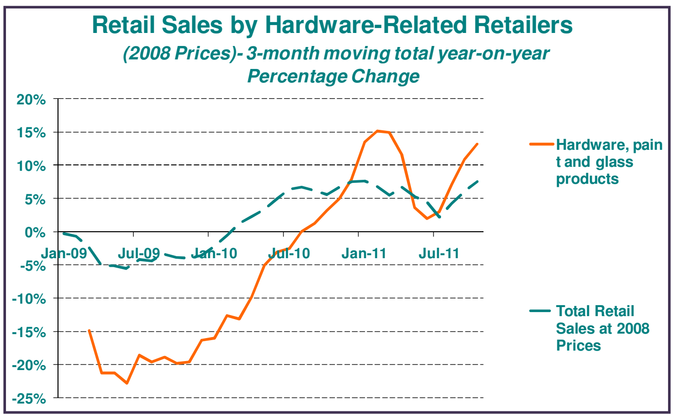
From a net-dissavings rate of -1.7% of disposable income at the end of 2007, the household sector has finally clawed its way to a net savings rate of zero after being in net dissaving since late-2005.

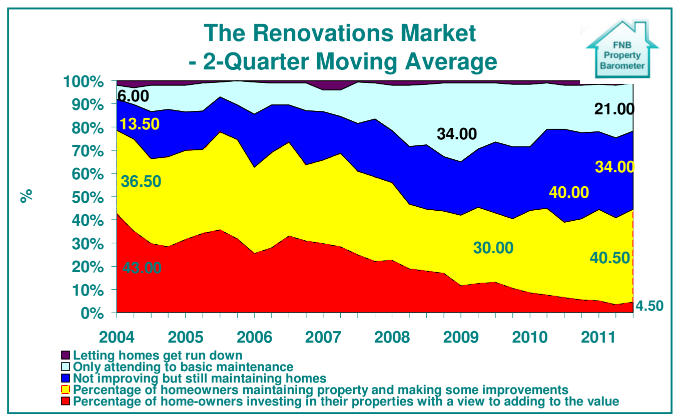
Like the debt-to-disposable income ratio, few would argue that a zero percent net savings rate is still a weak number and requires significant further improvement.

….AND SOME FINANCIAL IMPROVEMENTS ARE "HIDDEN AWAY" IN AN INCREASING FOCUS ON MAINTAINING FIXED ASSETS,….

Both retail sales figures as well as the FNB Estate Agent Survey have pointed to an improvement in the level of home maintenance in 2010/11. By type of retailer, retailers of hardware, paint and glass products saw real sales accelerate further to a rapid +13.2% year-on-year, for the 3 months to October, now far above the overall real retail sales growth rate of +7.6%. This rapid growth comes off a very low base created by a dramatic fall in hardware, paint and glass retail back in the recession period of 2008/9.

The FNB Estate Agent Survey supports this hardware retail recovery. Estate agents are asked to provide their perception of home maintenance levels in their areas. Whereas the percentage of total home owners believed to be only doing basic maintenance was at 34% around early 2009, this percentage has decreased to 21% by the 3rd quarter of 2011, as the 2 higher levels of maintenance, namely those home owners doing full maintenance, and those doing full maintenance as well as making some improvements, saw their percentages increase.

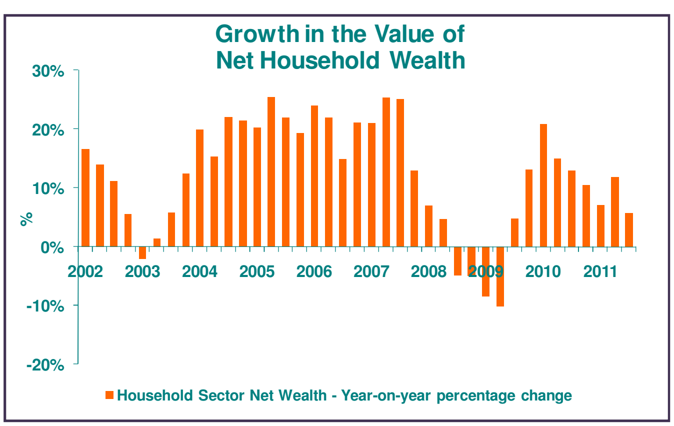


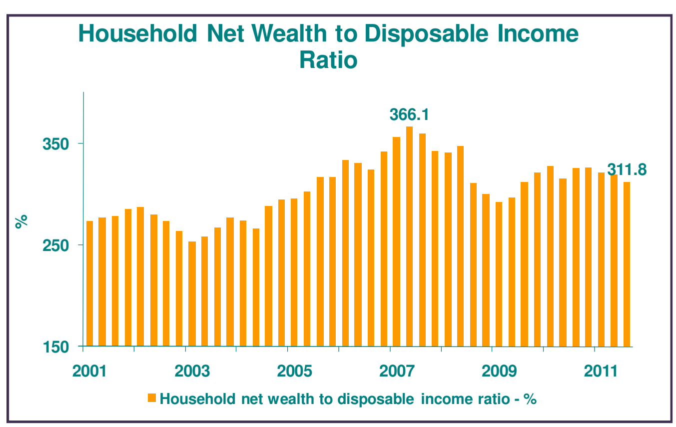


…BUT WEALTH CREATION IS MADE TOUGH GOING BY A STAGNATING ECONOMY AND RESULTANT ASSET PRICE GROWTH STAGNATION..

Growing net wealth has been slow going in 2011, due to a heavy reliance on asset price growth in the absence of significant household savings. With economic growth stagnating (GDP recording only 1.3% and 1.4% quarter-on-quarter annualized growth in the past 2 quarters) this year, and with it both property and equity price growth stagnating, growing the value of assets owned by the household sector has been slowing.

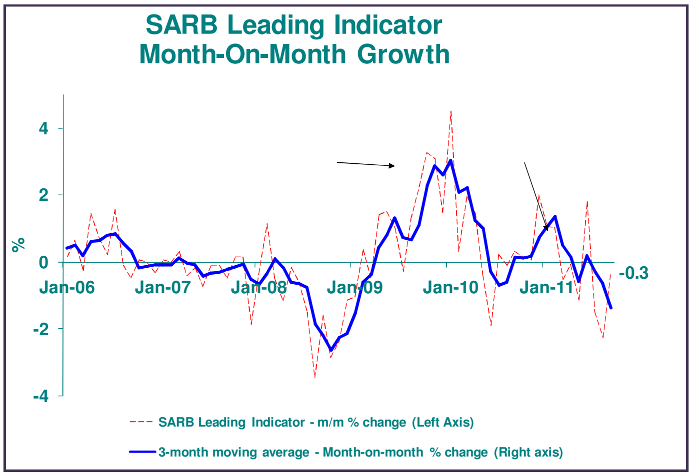
Growth in the value of household net wealth slowed from an estimated 11.9% year-on-year in the 2nd quarter to 5.7% in the 3rd quarter, the resumption of a slowing trend that has persisted since the 20.8% growth peak reached in the 1st quarter of 2011.As a percentage of disposable income, household net wealth declined further from 319.2% in the 2nd quarter to 311.8% in the 3rd quarter.





IN CONCLUSION – NOT YET TIME TO DECLARE VICTORY IN THE BALANCE SHEET REBUILDING PROCESS.

Through further reduction in its debt-to-disposable income ratio in the 3rd quarter, our Household Sector Debt-Service Risk Index has improved (declined) further, implying that very slowly the household sector is now reducing its vulnerability to any unwanted shocks, which can either be in the form of rising inflation and/or interest rates, or through weaker economic growth which in turn can exert pressure on disposable income growth.



However, the progress in reducing the debt-to-disposable income ratio looks set to continue to be slow going due to increasing pressure on disposable income growth, as the economy looks set to see its growth slow. This, at least, is if the SARB Leading Indicator is anything to go by as an indicator of near term economic performance. This indicator has seen decline month-on-month in the most recent 3 months' data points, with a weakening global situation playing a key role.

A weak economy as we enter 2012 is also likely to keep the pace of savings low, although it would appear that households are intent on increasing their rate of saving of late.

Finally, a stagnant economic situation could make asset price growth slow going, as it has in 2011.

All of this implies that the household sector has significantly more work to be done in strengthening its balance sheet. A still-lower debt-to-disposable income ratio is required if it is to be able to comfortably weather a normal SA interest rate hiking cycle whenever that should come. Given the likelihood of further mediocre economic times, asset price growth is not a given, and it is thus also crucial that the household sector savings rate be lifted significantly to assist in increasing net wealth.