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Residential Market Stability Risk Review

Residential Market stability risk declines (improves) slightly after prior rising trend

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MARKET ANALYTICS AND SCENARIO FORECASTING UNIT

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Residential Market macro risk declined in the 1s quarter of 2016, according to our Housing Market Risk Indices, albeit very slightly. This slight decline is largely due to behavior within the relatively "well-behaved" Household Sector and Housing Market. It is the broader economy, with its major imbalances, that poses more significant risks to the housing market than the housing market's behavior itself.

KEY POINTS

- *The FNB Composite Housing Market Risk Index declined slightly in the 1st quarter of 2016, from 34.31 previous to 33.91. However, it had until recently risen noticeably since 2013, and this remains in the upper part of the Medium Risk Zone, still bordering on "High Risk". The index is currently well below the all time high risk level reached in 2006, but at the same time far above the historic low of early-1999.*

- *Household Sector Vulnerability continues to decline as the Household Sector Debt-to-Disposable Income Ratio declines.*

- *Slow Household Sector Disposable Income growth, and interest rates above house price growth, limit the level of any unhealthy speculative activity of "over-exuberant" behavior in the market.*

- *Housing remains very expensive by historic standards, keeping Affordability Risk on the high side, but this may be starting to change as real house price growth loses steam.*

- *The risk of the New Development Sector building new housing at levels that can create major oversupplies is not believed to be significant.*

- *While the housing market's own behavior, therefore, does not currently appear to be creating a major "risk build-up", the state of the country's broader economy poses significant risks to the Housing Market, with big Macroeconomic imbalances having built up.*

- *Economy-wide risks include limited room for monetary stimulus currently, due to interest rates still being relatively low. In addition, South Africa is already living well "beyond its means:, as reflected in a wide 5% of GDP Current Account Deficit, which basically reflects Gross Domestic Expenditure well in excess of Gross National Income. Furthermore, there also exists limited scope for fiscal stimulus, with Government having increased its Debt-to-GDP ratio to near 50%. Given this lack of scope for further stimulus, economic growth continues to stagnate. This stagnation poses further risk through its contribution to a lack of employment and poverty alleviation. That, in turn, is a potential contributor to rising, and potentially disruptive, social tensions and political volatility in the country.*

1. RESIDENTIAL RISK INDEX SUMMARY: RESIDENTIAL MARKET WELL-BEHAVED BUT KEY RISKS EMANATE FROM THE BROADER ECONOMY

The FNB Composite Household Sector, Residential Market and Economic Risk Rating attempts to provide some measure of risk "build up", or "build down" in the Residential Property Market at a macro level. This relates to risks that could at some future stage make the residential market vulnerable to instability. The Composite Index is compiled using a number of key Household Sector Financial, Housing Market and Macroeconomic data series.

Important to the health of the Housing Market is the health of the Household Sector's finances. In this regard, the moderately good news continued to flow from 1st Quarter 2016 SARB (Reserve Bank) data. Most importantly, the Household Sector Debt-to-Disposable Income Ratio continued to decline, measuring 76.6%, down from the prior quarter and now all the way down from 87.8%. In addition, revised SARB figures have also begun to show early signs of a move to a higher savings rate by households. This has long been overdue. It may be the tougher economic and financial environment, and rising concern regarding the economic future, that has begun to move households to a "healthier" rate of savings. It's not great yet, with the Net Savings Rate still being a negative -0.8% of Disposable Income, implying that the little gross saving that exists is not yet sufficient to cover the depreciation on fixed assets owned by households. But it is nevertheless a start, having gradually crept up from a -2.3% low point in 2012.

While the improvement in the rate of savings has not yet been significant, the decline in the Debt-to-Disposable Income has been, and it has reduced Household Sector vulnerability to interest rate hiking. This has probably led to a far better outcome in terms of bad debts, than would have been the case had interest rates have risen as they have and we had not had a decline in the Debt-to-Disposable Income ratio level post-2008.

And while slow Household Sector Disposable Income growth currently provides little boost for housing demand, it keeps the consumer more cautious, and take "exuberance" away from the market.

All of the above, along with interest rates rising to levels above average house price inflation, leaves little room for speculators, and mediocre capital growth translates into a limited number of buy-to-let investors buying based on capital growth.

There is thus little, if any, sign of the housing market getting "overheated" or "over-excited". It is a by-and large rational market, although still on the expensive side by historic standards , which is a legacy from the pre-2008 boom years.

But that is not to say that the market is free of risk. To the contrary, the risks remain very significant. However, they emanate largely from outside the housing market itself, and lie in frightening abundant supply in the broader South African and even Global economy.

There exists limited room for monetary stimulus currently, due to interest rates still being relatively low. In addition, South Africa is already living well "beyond its means:, as reflected in a wide 5% of GDP Current Account Deficit, which basically reflects Gross Domestic Expenditure well in excess of Gross National Income. Furthermore, there also exists limited scope for fiscal stimulus, with Government having increased its Debt-to-GDP ratio to near 50%.

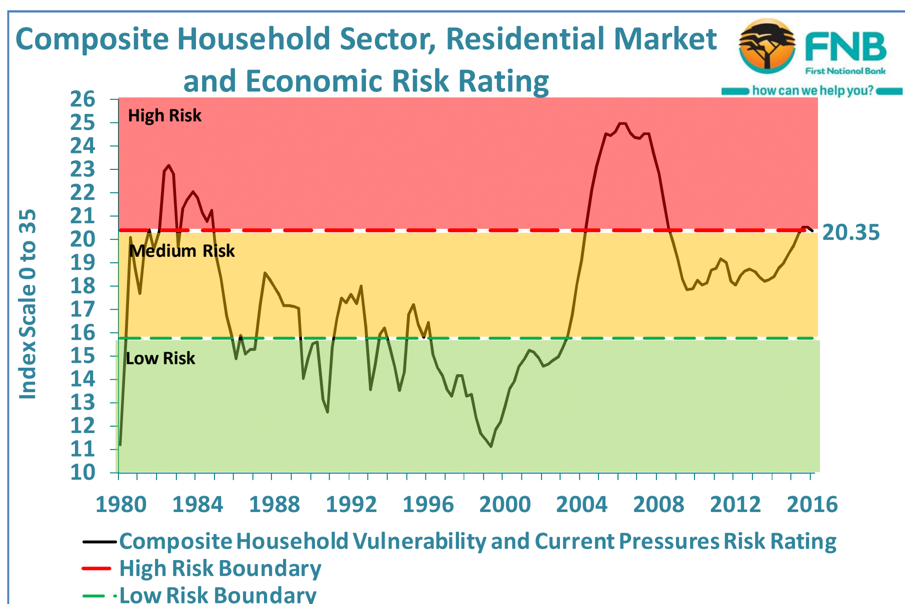
Given this lack of scope for further stimulus, economic growth continues to stagnate. This stagnation poses further economic risk through its contribution to a lack of employment and poverty alleviation. That, in turn, is a potential contributor to rising, and potentially disruptive, social tensions and political volatility in the country.

These are the key risks to the Residential Market, despite the market itself behaving relatively well and not going out of its way to create its own imbalances. Therefore, our Composite Household Sector, Residential Market and Economic Risk rating has declined (improved) slightly from 20.52 in the previous quarter to 20.35 in the 1st quarter of 2016 (scale of 0 to 35). This has taken the level from just inside the "High Risk"

zone to just inside the upper limit of the "Medium Risk Zone. The fact that the index is within what we deem to be the "Medium Risk" Zone is due largely to the behavior of the Housing Market itself, and its largely "rational behavior", with a lack of any widespread exuberance and unhealthy speculative activity. But the fact that it still borders on the upper boundary of the Medium Risk Zone is largely due to the very high risks prevalent in the broader macro-economy.

2. THE SET OF RESIDENTIAL PROPERTY MARKET RISK RATINGS

SUMMARY GRAPH, AND TABLE OF COMPONENTS OF THE RISK RATING: COMPOSITE HOUSEHOLD SECTOR, RESIDENTIAL MARKET AND ECONOMIC RISK RATING – RATING: 20.35 - MEDIUM



	Q1 2016	Prev.	Yr Ago
Debt Service/New Lending Risk (0-10)	5.54	5.73	5.95
Household Savings Risk (0-10)	9.37	9.52	9.52
Disposable Income Windfall Risk (0-10)	3.45	3.64	3.40
Over-investment/Speculative Risk (0-10)	3.72	3.91	4.63
Affordability/Price Competitiveness Risk (0-10)	7.60	7.61	7.37
Building Oversupply Risk (0-10)	4.22	3.90	2.51
Household and Housing Market Risk (0-60)	**33.91**	**34.31**	**33.38**
Economy-Wide Vulnerability Risk (0-10)	7.50	7.49	6.99
Current Economic Pressures Risk (0-10)	6.09	5.94	5.18
Composite Household, Housing and Economic Market Risk Index (0-35)	**20.35**	**20.52**	**19.73**
Low Risk			
Medium Risk			
High Risk			

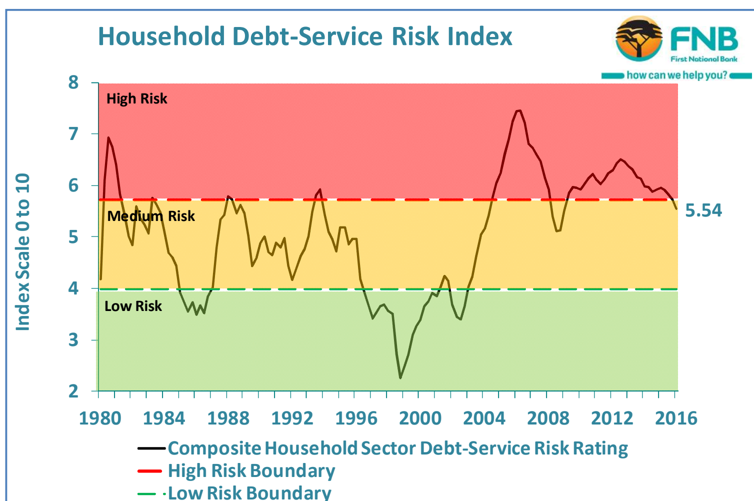
HOUSEHOLD DEBT-SERVICE RISK INDEX – RATING: 5.54 - MEDIUM

The rationale: The Household Debt-Service Risk Index attempts to look at the vulnerability of the Household Sector in terms of its future potential ability to service its debt.

The compilation of the Index: 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 "shocks" such as interest rate hikes or downward pressure on disposable income. A rise in the debt-to disposable income ratio contributes negatively to the overall risk index (i.e. exerts upward pressure on the index) and vice versa for a downward trend. 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 is that we may be getting nearer to the bottom of the interest rate cycle and the end of rate cutting relief, and the more the risk of the next rate move being upward becomes, or at least the less the chance becomes of further cuts. In addition, households tend to make poorer borrowing and financial decisions on average, while it is tougher for lenders to assess aspirant borrowers, when money is cheap, so better borrowing/lending decisions are arguably made when interest rates are relatively high. Therefore, we view low interest rate periods as ones where risk generally builds up, and vice versa for periods of relatively high interest rates.

The Index: Household Debt-Service Risk Index declines (improves) further, moving into the "Medium Risk" Band, thanks to a declining (although still-high), Household Debt-to-Disposable Income Ratio



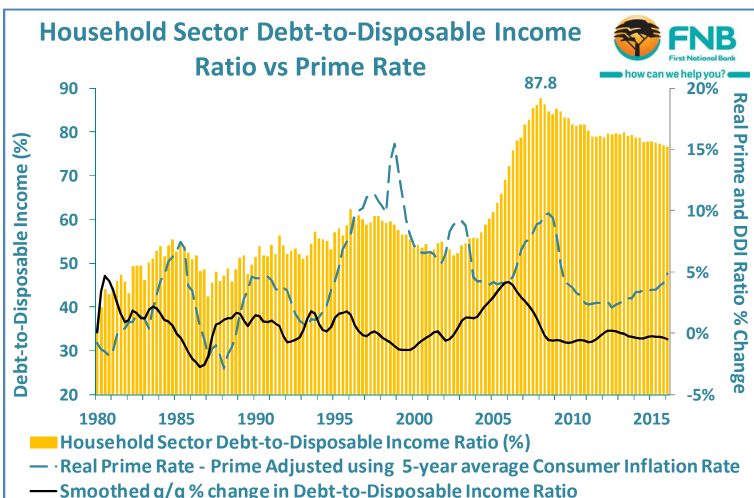
From a 4th Quarter 2015 index level of 5.73 (on a scale of 1 to 10), the 1st quarter of 2016 saw a further decline to 5.54. This represents a continuation of the broad declining trend (improvement) in the Household Debt-Service Risk Index since late-2012.

This improvement (decline) in the 1st quarter moves the index down into "Medium Risk" zone, whose upper threshold is a level of 5.73.

However, the index remains on the upper edge of the Medium Risk Zone, which is not yet a "comfortable" place.

The Key Drivers of the Index's Recent Movement:

Keeping the Debt-Service Risk Index at the high end of the Medium Risk zone are a still-high Debt-to-Disposable Income Ratio, and relatively low Real Prime Rate



Positive influences on Debt-Service Risk Index direction: A rise in Real Prime and further decline in the Debt-to-Disposable Income Ratio

Negative influence on the Debt-Service Risk Index direction: The pace of decline in the Debt-to-Disposable Income Ratio has slowed recently.

HOUSEHOLD SECTOR SAVINGS RISK– RATING: 9.37 - HIGH

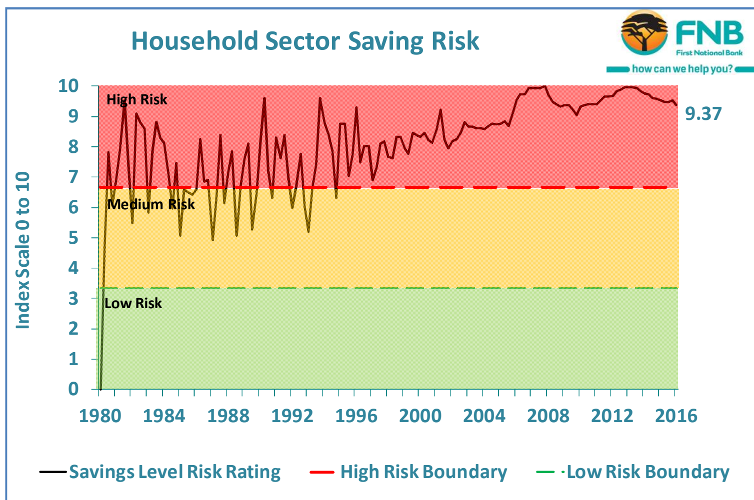
The rationale: We view the level of Household Sector savings to be important in understanding housing market risk. The Household Sector adjusts its consumption and saving habits as economic times change. The lower the savings rate at the time of some significant economic shock, the higher the risk of a more significant increase in savings and reduction in spending by households. Households could raise savings due to perceived job insecurity, or to compensate for a slowing growth in Net Wealth due to slower asset price growth.

This can be negative for both economic growth and housing demand in the short run. On the other hand, a high rate of savings already in place at the time of an economic shock may lower the risk of a dramatic reduction in already-low household spend.

The compilation of the Index

The index is compiled from 1 variable only, namely the Household Sector Net Savings Rate expressed as a percentage of Household Sector Disposable Income. This net savings rate refers to the gross savings rate adjusted for depreciation in fixed assets owned by the Household Sector. The weaker the net savings rate, the higher the risk rating and vice versa, on a scale of 0 to 10.

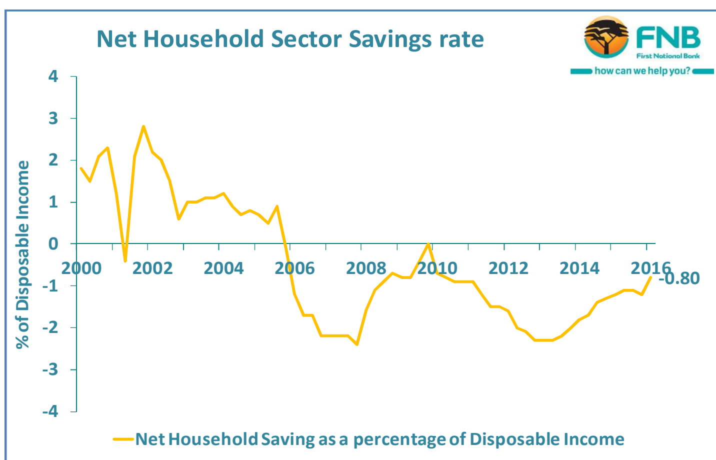
The Index: Household Sector Savings Risk remains extremely high, given the dismal savings rate, but signs of improvement have started to surface.

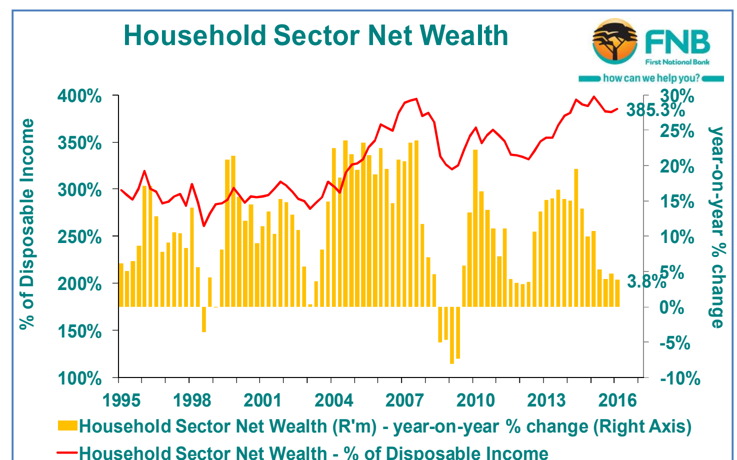


The Household Sector Savings Risk Index remains extremely high, with a rating of 9.37 in the 1st quarter of 2016 (on a scale of 0 to 10). This is a little lower than the previous quarter's revised level of 9.52.

The Key Drivers of the Savings Risk Index's Recent Movement:

The Net Savings rate remains very weak, in negative territory, sustaining a very high Savings Risk. However, we have for a while anticipated that weak consumer confidence along with slow growth in the value of Net Wealth of Households recently, would begin to encourage a more conservative consumer who saves more. Revised SARB figures appear to suggest that such a move to a higher savings rate is starting, although the level remains very weak to date.



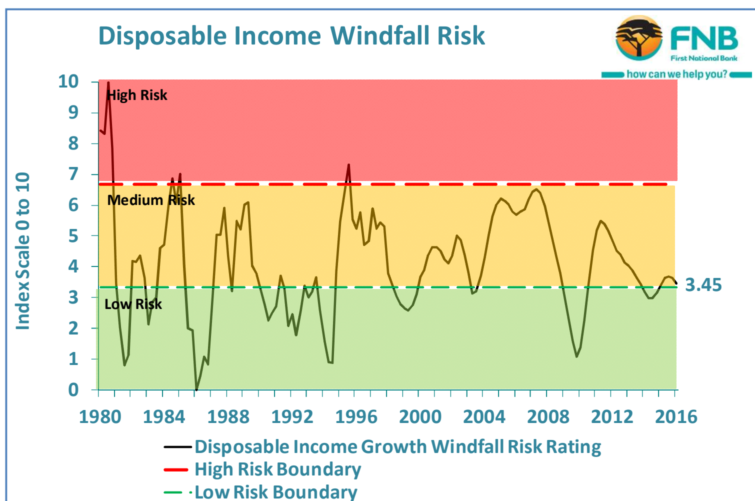


DISPOSABLE INCOME WINDFALL RISK– RATING: 3.45 MEDIUM

The rationale: Household spending and borrowing behavior can tend to become more aggressive, or even reckless and highly risky, in times of “economic windfalls”. When abnormally big new job offers, bonuses, salary increases and dividend payments are the order of the day, such as in economic boom times, the big risk is that households begin to assume that these windfalls will continue forever, set their spending and borrowing commitments accordingly, and end up over-committed or over-indebted. Times of abnormally high disposable income growth thus pose a high “Disposable Income Windfall” Risk, which can lead to “over-investment” in, and ultimate de-stabilisation of, the residential market.

The compilation of the Index

The index is compiled using long term Real Household Disposable Income growth. We calculate the 4-quarter average year-on-year growth rate in Real Disposable Income (our feeling is that a “windfall needs to be sustained for a while before it leads to recklessness, hence the 4-quarter average), and then calculate the differential between it and the long term Real Disposable Income growth average since 1970. The higher the 4-quarter average growth rate is relative to the long term average, the higher the risk rating is, and vice versa.

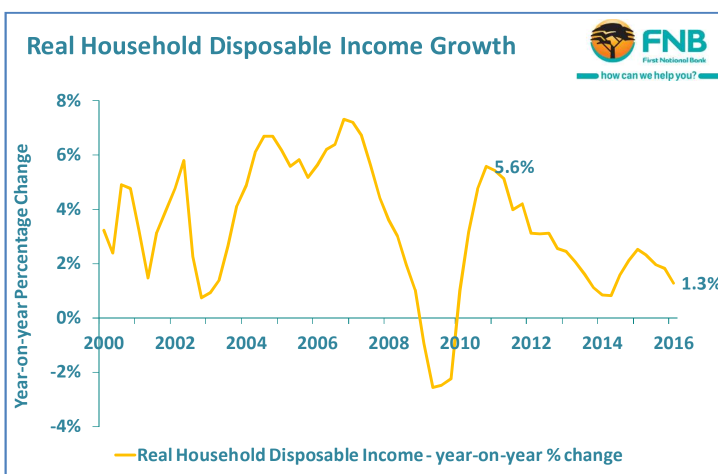


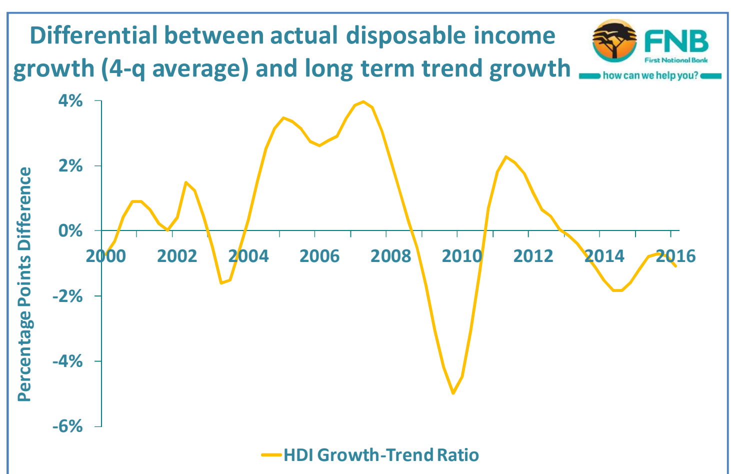
The Index: The Disposable Income Windfall Risk remains relatively low, hovering within the Medium Risk zone near the “Low Risk” and “Medium Risk” boundary, and posing little threat in this weak economic environment.

The Household Disposable Income Windfall Risk Index hovers on the border of the “Medium Risk” and “Low Risk” zones, at a 1st quarter 2016 level of 3.45, slightly lower than the previous quarter’s 3.64.

Key Drivers of recent movement in Disposable Income Windfall Risk

Real Household Disposable Income growth recorded 1.3% year-on-year growth in the 1st quarter of 2016. This was slightly down on the prior quarter, contributing to the lower Windfall Risk Rating. There remains, therefore, little threat of “Windfall Madness” in the current environment of weak economic and income growth, and poor consumer confidence.





RESIDENTIAL PROPERTY SPECULATIVE, PANIC AND OVER-EXUBERANCE RISK – RATING: 3.72 - MEDIUM

The rationale: The combination of strong house price growth and cheap credit can drive buying frenzies on an extreme scale. This can lead to market "overshoots", and financial over-commitment on a large scale.

It makes sense to speculate in such an environment, borrowing cheap credit to make quick capital gains before selling the property for a handsome profit. In addition, less seasoned investors see times of strong capital growth as the time to invest, seeing recent price growth as a predictor of future growth, often ignoring the rental yield. Big buy-to-let investment sprees thus often take place in such an environment.

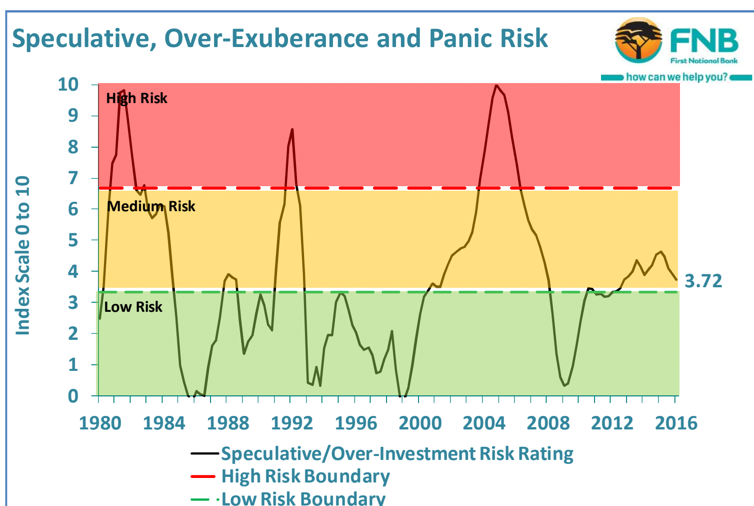
Then there is the issue of 1st time "buyer panic", where aspirant 1st time buyers fear that if they don't buy quickly they won't ever be able to afford a home in future. This can also spark a stampede.

House price growth relative to the interest rate level is thus a crucial in determining the risk of such behaviour emerging.

The compilation of the Index

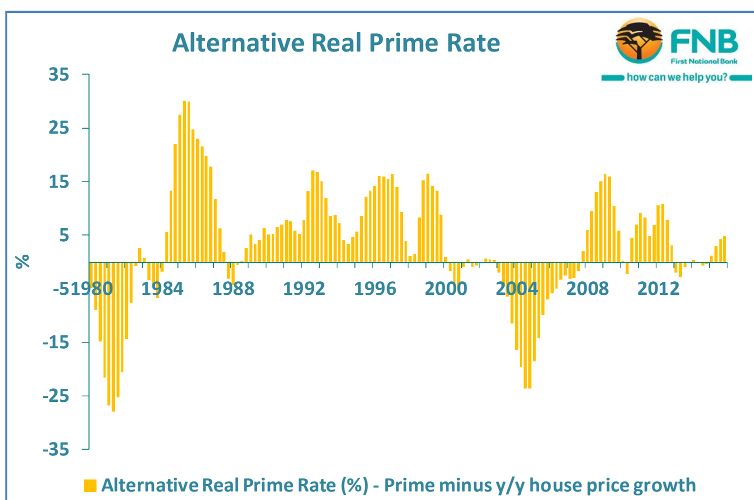
The index is compiled using the FNB Long Term House Price Index year-on-year inflation rate, and a SARB Prime Mortgage rate. We calculate the "Alternative Real Prime Rate" which is the difference between the Prime Mortgage Rate and House Price Inflation. When house price inflation far exceeds the Prime Rate percentage, an environment conducive to widespread speculation, over-exuberance and buyer panic emerges. A lower risk situation prevails when the Alternative Real Prime Rate is positive.

The Index: Speculative, Over-Exuberance and Buyer Panic Risk is at the lower end of the Medium Risk Range.



The Speculative, Over-Exuberance, and Buyer Panic Risk Rating declined further in the 1st quarter of 2016 to 3.72 (scale of 0 to 10), from a previous level of 3.91. This level is firmly in the Medium Risk Range, and on a declining path. It is well-below the multi-decade high point reached in late-2004.

Key Drivers of recent trends in Speculative, Over-Exuberance and Panic Buying Risk Index



Single-digit average house price growth through last year, coupled to a gradually rising Prime rate since early-2014, has served to maintain a positive and rising Real Alternative Prime Rate, which has lowered any risk of widespread speculation, over-exuberance and 1st Time Buyer Panic. The FNB Long Term House Price Index remains firmly in single-digit territory, while Prime Rate is in double digits.

HOME AFFORDABILITY RISK – RATING: 7.60 - HIGH

The rationale: The risk of downward pressure on house prices, in the event of an economic shock or interest rate hiking, is heightened the less affordable housing becomes. We consider 3 main types of affordability. Firstly, the average house price relative to disposable income. Secondly, house prices relative to rental costs are important, because if home values are very high relative to rental, rental may become an attractive option, lowering home buying demand. Thirdly, house prices relative to prices of consumer items are also important, because these compete with housing for a slice of the household income pie, and housing needs to be "competitively priced" in this regard. The higher the house prices relative to these other variables, the less price competitive housing becomes and the higher the Affordability Risk.

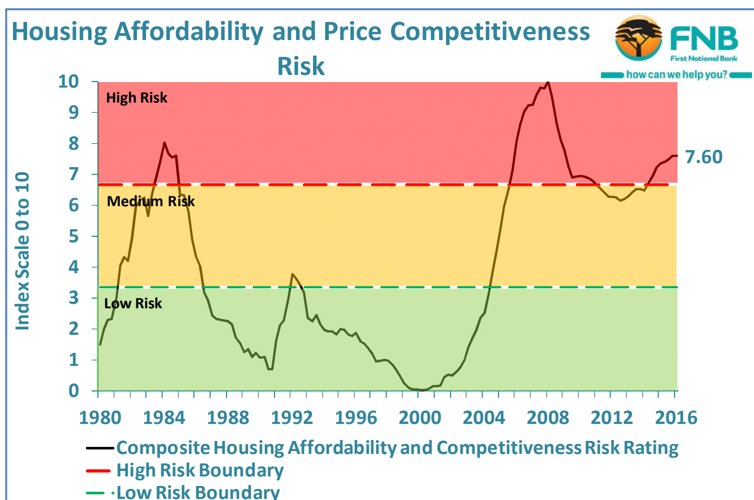
The compilation of the Housing Affordability Risk Index

The Housing Affordability Risk Index is compiled from 3 affordability indices:

- The Average House Price/Per Capita Disposable Income Index.
- The Average House Price/Average Rental Index
- The Average House Price/Consumer Prices Index

In all 3 sub-index cases, the higher the index level, the worse the affordability, or the less price competitive housing is, and the higher the affordability risk becomes.

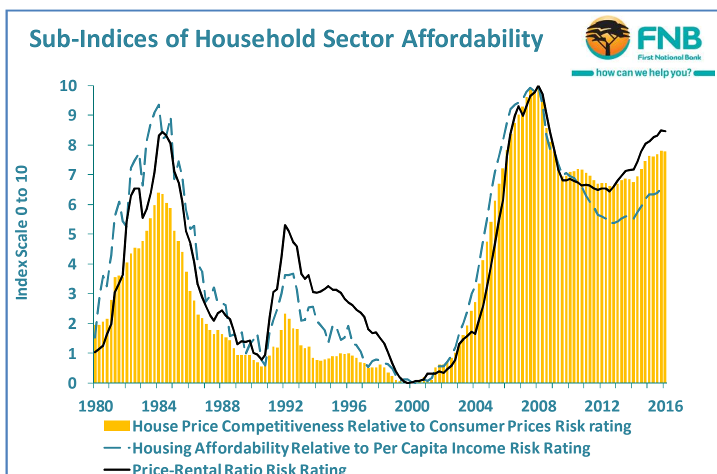
The Index: Home Affordability Risk remains high, but no longer rising steadily

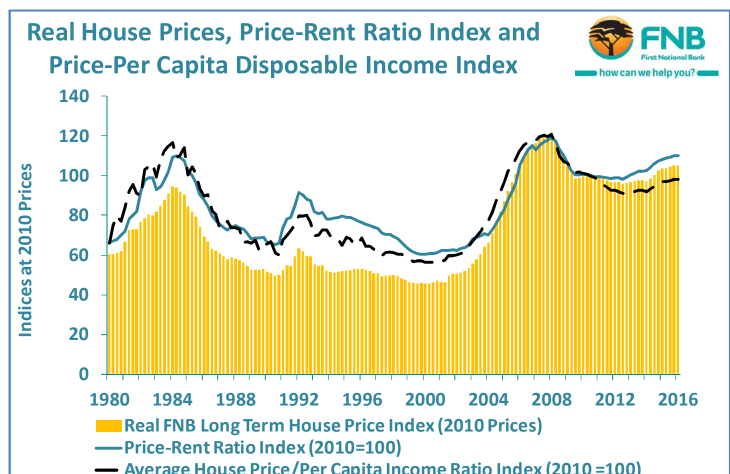


The Composite Home Affordability Risk Index was on a broadly rising (deteriorating) trend from 2012, but this has flattened out in recent quarters. It declined very slightly from 7.61 in the 4th quarter of 2015 to 7.60 in the 1st quarter of 2016. Therefore, while the index remains well up in the "High Risk" range, reflecting a very expensive residential market by historic standards, a slowing residential market may be bringing the rising (deteriorating) trend to an end.

The key drivers in recent trends in Home Affordability Risk:

The Average House Price/Per Capita Disposable Income Index is the lowest of the 3 affordability sub-indices, due to significant average wage inflation over recent years, which outpaced average house price inflation for much of the time since 2008.This index recorded a level of 6.5 (scale of 0 to 10) in the 1st quarter of 2016. The Price-Rent Ratio Risk Index at 8.5, and the Real House Price Risk Index at 7.8, are the main culprits keeping Affordability and Price Competitiveness Risk in the "High Risk" zone though.





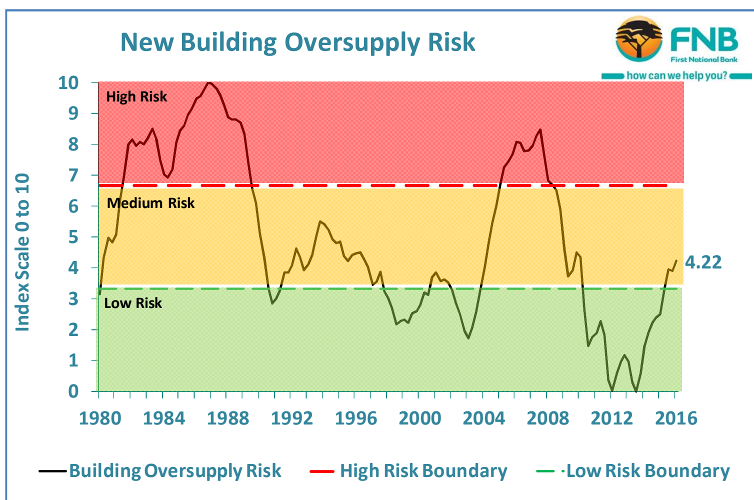
NEW BUILDING OVERSUPPLY RISK – RATING: 4.22 - MEDIUM

The rationale: Key to future market balance is the supply of new residential stock to the market. The cost of building new residential stock relative to the prices of existing homes is key to the level of constraint on new residential supply. When the cost of a new home is significantly above that of an existing home, it is relatively challenging to bring "competitively priced" new homes to the market, and vice versa if there is not price gap between the two or new home costs are lower than existing homes. This implies that the risk of housing oversupply is greater the less that new home prices are relative to existing home prices.

The compilation of the New Building Oversupply Risk Index

The New Building Oversupply Risk Index is compiled using a time series depicting the percentage difference between the average new house price and the average existing house price (Source: Absa house price data) The higher the percentage by which the average new house price exceeds the average existing house price, the more difficult it becomes for the Residential Development Sector to bring new homes to the market than can compete price-wise with existing homes. This constrains the level of new residential development activity and thus new supply. The higher the average new home price is above the average existing house price, therefore, the lower the risk of creating oversupplies, which would lower the New Building Oversupply Risk Index, and vice versa. The Index is on a scale of 0 to 10.

The Index: Building Oversupply Risk has recently moved up from Low to Medium

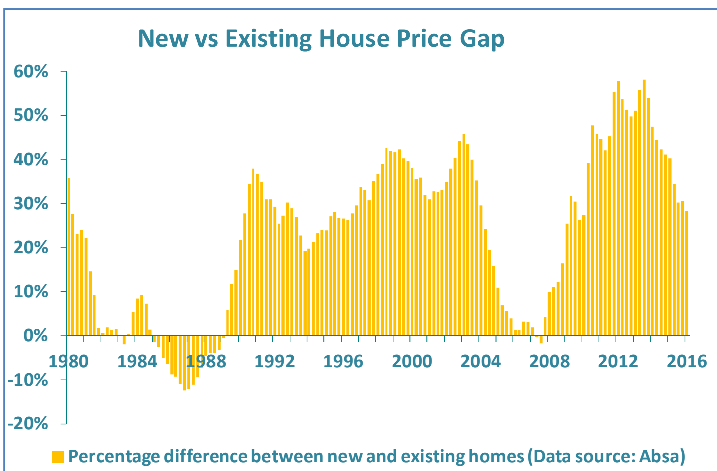


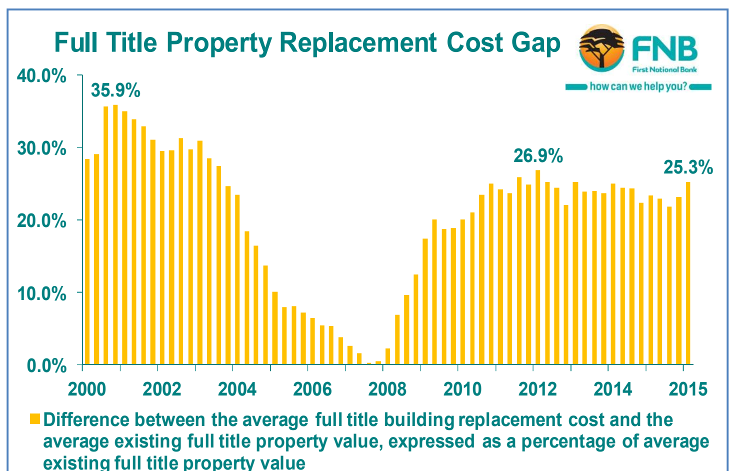
The New Building Oversupply Risk Index recently moved from the "Low Risk" into the "Medium Risk" range, rising steadily. In the 1st quarter of 2016 it rose further to 4.22, up from a previous quarter's 3.9.

However, this Rating remains on the low side of the Medium Risk Zone, suggesting little cause for any concern over residential building activity reaching levels that could lead to major oversupplies any time soon.

Key Drivers of recent trends in New Building Oversupply Risk

The residential market does not appear at great risk of creating a "massive" oversupply of new residential units at present. Examining the FNB Full Title Replacement Cost Gap, the average replacement cost of a Full Title home was 25.3% higher than the existing home value. Although the gap is mildly narrower than the 26.9% back at a stage of 2012, it remains very significant, likely prohibiting any strong growth in residential building activity. The New vs Existing home price gap from Absa data has narrowed, but remains significant too.





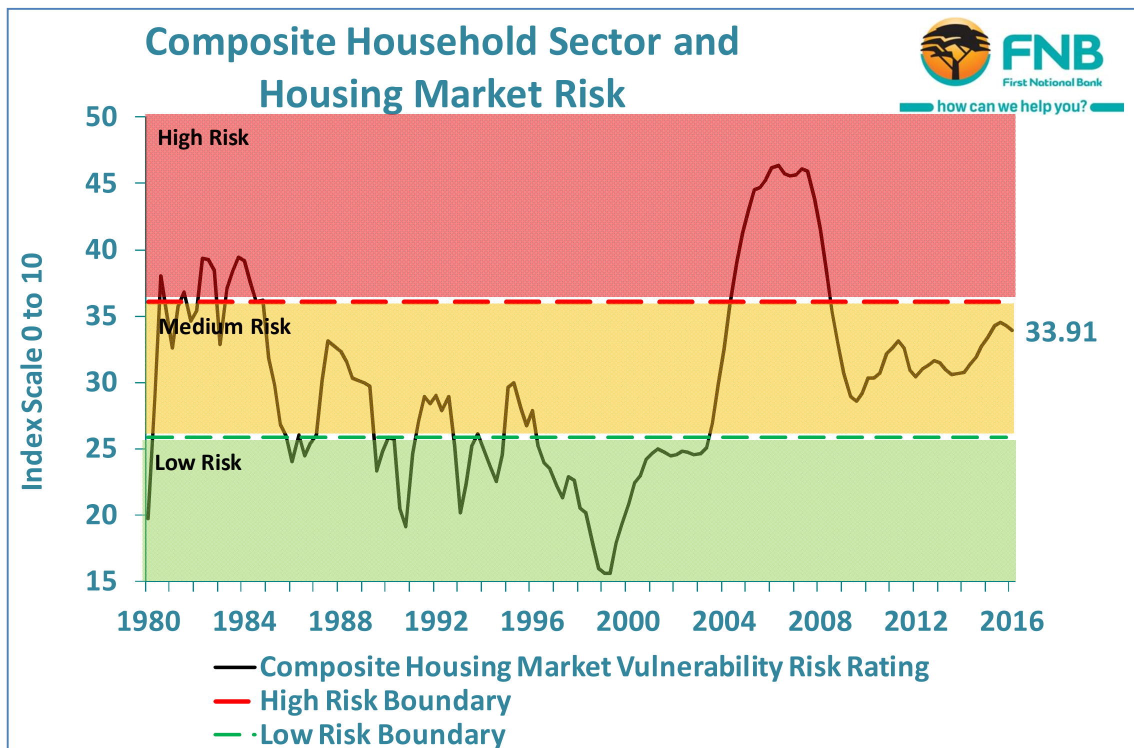
COMPOSITE HOUSING MARKET RISK– RATING: 33.91 - MEDIUM

The Composite Housing Market Risk Index includes the following risk sub-indices:

- Household Debt-Service Risk Index
- Household Sector Savings Risk
- Disposable Income Windfall Risk
- Residential Property Speculative, Over-Exuberance and Panic Risk
- Housing Affordability Risk
- New Building Oversupply Risk

This Composite Index attempts to capture Household Sector Financial and Housing Market-specific conditions and risks, excluding mounting economic risks which are later captured in the Macroeconomic and Current Economic Pressures Indices.

The Composite Housing Market Risk Index declined slightly in the 1st quarter of 2016, from 34.31 previous to 33.91. However, it had until recently risen noticeably since 2013. It remains in the upper part of the Medium Risk Zone, well below the all time high reached in 2006, but at the same time far above the historic low of early-1999.



MACRO-ECONOMIC RISK– RATING: 7.50 - HIGH

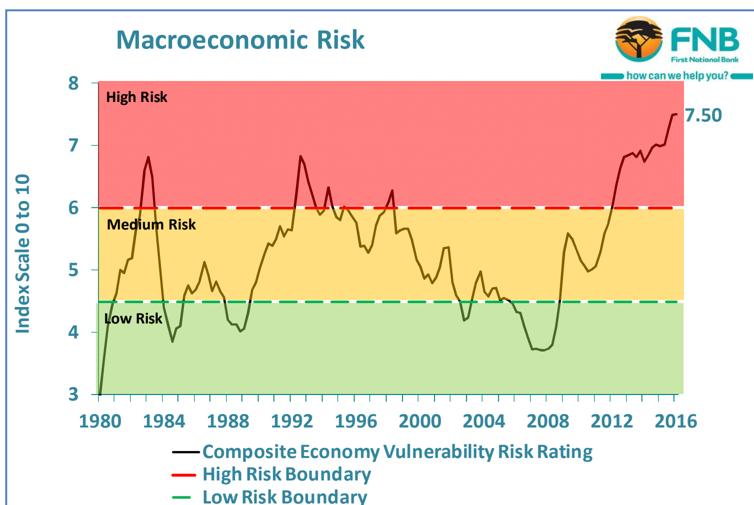
The rationale: Risks to Macroeconomic performance are key to the housing market, as the economy drives employment and household income. The risks are very much determined by the extent to which the country is living/not living within its means, as reflected in the Current Account Balance. They are further determined by the scope for future Monetary and Fiscal stimulus. This is determined by the current level of real interest rates (low implying less scope than high current real rates) and the Government Debt-to-GDP Ratio. Finally, current economic growth is key, as low growth has the potential to dent investor confidence (and thus future growth) as well as to fuel social tensions and economic disruptions in future.

The compilation of the Macroeconomic Risk Index

The Macroeconomic Risk Index is compiled from 4 key economic indicators:

- Real year-on-year GDP growth (smoothed)
- Current Account Balance as a percentage of GDP (smoothed)
- Real Interest Rates (as per our Prime Rate adjusted with the 5-year average consumer inflation measure)
- General Government Debt-to-GDP Ratio

The Index: Macroeconomic Risk remains extremely high and rising

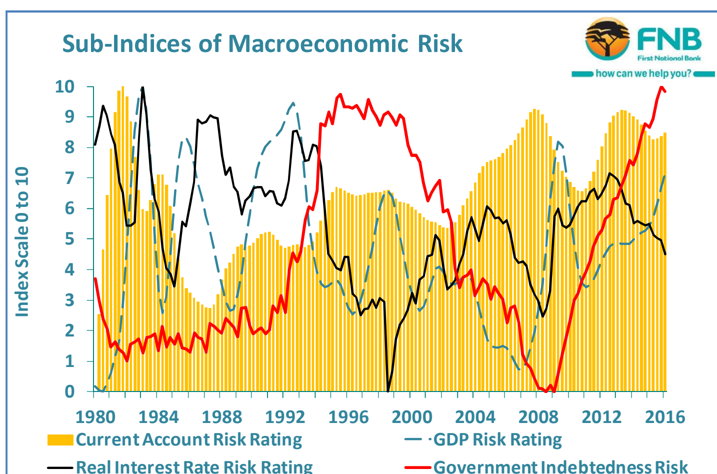


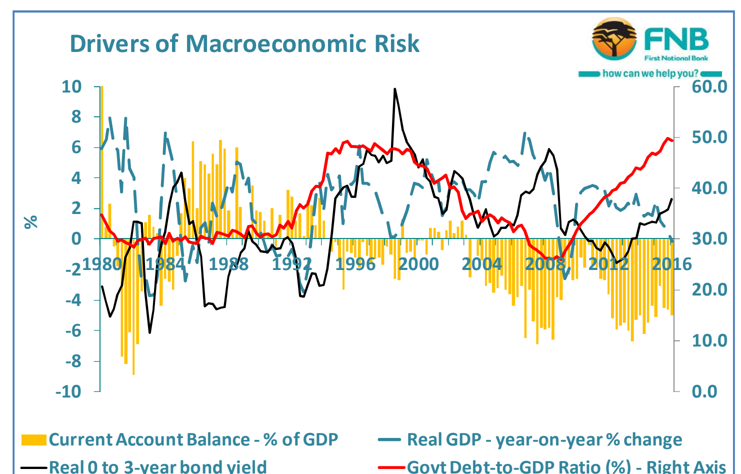
The Macroeconomic Risk Index remains at extremely high levels. In the 1st quarter of 2016, this Risk rating rose further to a multi-decade high of 7.50, from the 4th quarter 2015's 7.49.

It is firmly settled in the High Risk Zone.

Key Drivers of Macroeconomic Risk:

A key driver of Macroeconomic Risk's rise has been a steadily rising General Government Debt-to-GDP Ratio, which reached a revised 49.8% in the 4th quarter of 2015 before recording a slightly lower 49.4% in Q1 2016. This level has surpassed the highs of 1995. This, coupled with still low real interest rate levels, means limited scope for monetary and fiscal stimulus, especially at a time when a 5% of GDP Current Account Deficit already reflects a country living well beyond its means. In addition, the multi-year stagnation in GDP (Gross Domestic Product) growth has driven this risk rating higher. As growth stagnates, so the risk of further loss of investor confidence, as well as rising social tensions and increased economic disruption, increases.





CURRENT ECONOMIC PRESSURES – RATING: 6.21 - MEDIUM

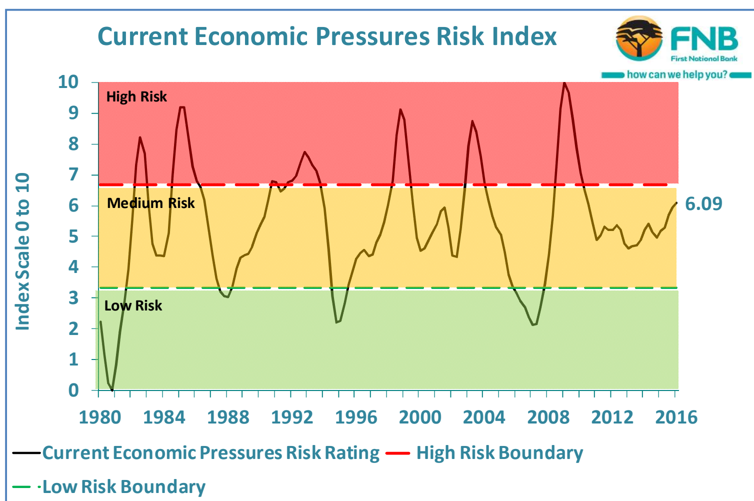
The rationale: Finally, we add current economic pressures, which may not necessarily be due to the imbalances mentioned in the previous section, but rather often due to cyclical forces such as global economic strength/weakness or commodity prices.

These pressures nevertheless need to be taken into account, as they can exert near term influence on the residential market

The compilation of the Current Economic Pressures Index

The Current Economic Pressures Index uses one variable, namely the OECD Leading Business Cycle Indicator for South Africa.:

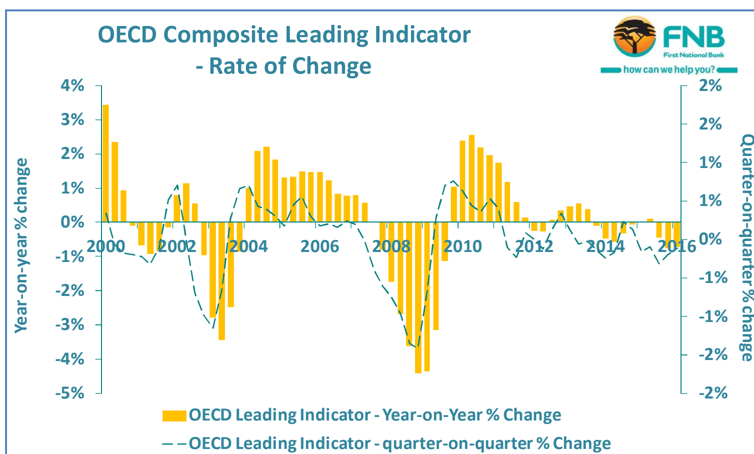
The Index: Current Economic Pressures remain in the Medium Risk zone, but have been rising steadily



The Current Economic Pressures Index remains in the Medium Risk Zone, but rose significantly further in the 1st quarter of 2016 to 6.09, from the previous quarter's 5.94. This is the highest level since the 2nd quarter of 2010.

Key Drivers of Current Economic Pressures

The OECD Leading Business Cycle Indicator, a useful leading indicator of likely near term economic performance, has been in year-on-year decline since late-2013, with the most recent rate of decline for the 1st quarter of 2016 measuring -0.7%. This is the 4th consecutive quarter of year-on-year decline. The Global Economy and weak commodity prices have played a very significant role, but one can't underestimated the impact of South Africa's well-documented structural constraints, along with very little scope left for traditional monetary and fiscal stimulus measures.



COMPOSITE HOUSEHOLD SECTOR, RESIDENTIAL MARKET AND ECONOMIC RISK RATING – RATING: 21.01 - HIGH

Finally, we compile the Composite Household Sector, Residential Market and Economic Risk rating. This index rolls up all 3 of the Major Composite Sub-Indices, namely the Composite Household Sector and Housing Market Vulnerability Risk Index, the Macroeconomic Risk Index and the Current Economic Pressures Index, into one overall risk rating for the Residential Market.

This Composite Index rose noticeably through 2014 and 2015, and moved slightly into the High Risk Zone in the 3rd quarter of 2015. In the 1st quarter of 2016, however, it began to decline slightly from a 20.52 high in the previous quarter to 20.35. This takes it back down to a level marginally within the Medium Risk Zone, but still border on High Risk

It was the Composite Household Sector and Housing Market Risk Index which caused the slight decline in the Overall Risk Index. However, the Macroeconomic Risk and Current Economic Pressures Indices continued to rise (deteriorate), exerting upward pressure on the Overall Index.

What this all says is that the risk emanates more from "outside" of the Housing Market in the broader economy itself. The Housing Market itself is relatively "well-behaved", but the major structural constraints within the broader South African economy, and indeed the global economy, pose the very significant risks to the future health of the Housing Market.