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PROPERTY INSIGHTS
– SARB Interest Rate Decision

SARB interest rate decision likely to keep property market "slowly correcting"

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FNB COMMERCIAL PROPERTY FINANCE

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The Firstrand economic team expects a 25 basis point interest rate hike this week when the SARB (South African Reserve Bank) MPC (Monetary Policy Committee) meets to deliberate on interest rates. This would take its policy Repo Rate from 6.5% to 6.75%, and Prime Lending Rate of major banks from 10% to 10.25% should it happen. It's a "close call", however, with local economists divided over whether the Bank hikes or leaves rates unchanged until next year.

Either way, however, in the currently weak economic environment we would expect real property values (property price growth adjusted for economy-wide inflation) to continue their decline in the near term, despite interest rates still being relatively low.

FIRSTRAND EXPECTS 25 BASIS POINT RATE HIKE

CPI (Consumer Price Index) inflation, at 4.9% as at September, remained well within the 3%-6% target range of the SARB. However, there is a view that the current SARB focuses on the "mid-point" of the target range, i.e. a desire to see the CPI inflation rate moving as close to 4.5% as possible

In addition, Firstrand economists feel that the CPI inflation rate may lift mildly in the coming quarters, in part on the back of the impacts of recent Rand weakness feeding through, weakness that could be exacerbated should the SARB not hike while the US hikes its own interest rates. The feeling is that this year's VAT hikes are still feeding into prices, and we have the impact of recently elevated oil prices still feeding through via domestic fuel prices (November year-on-year inflation in the Gauteng pump price running at 22.3%).

What creates the "split" amongst economists, perhaps, amongst some economists as to whether a rate hike will come this week or only early next year is the Rand starting to show slightly better performance very recently, and oil prices have come down mildly from the $86/barrel early in October (Brent Crude) to around $66/barrel by 15 November.

Does the SARB wait for inflation effects from earlier pressures to feed through and dissipate, or does it take action now?

From a property market point of view, a rate hike is slightly more "dampening" than an unchanged decision, but the difference in impact between the 2 scenarios is unlikely to alter the broadly "softening" direction of the property market at this stage.

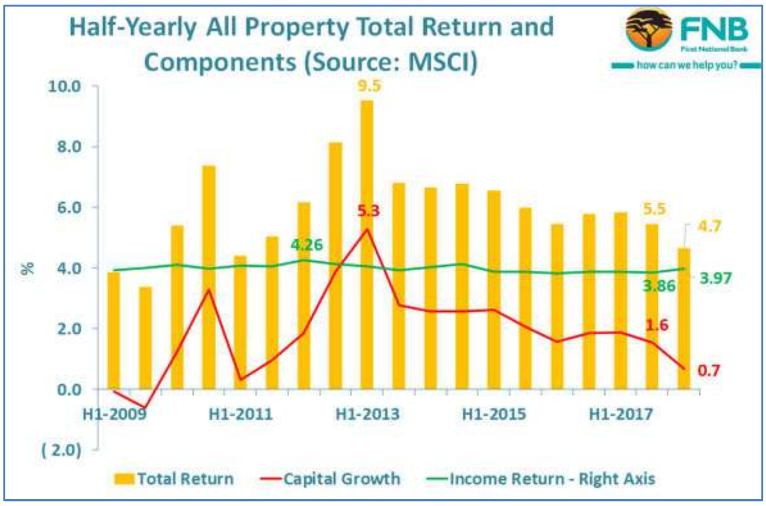
The dominant influence on the property market currently is ongoing economic weakness, after over 5 years of broad economic growth stagnation.

Even the isolated 25 basis point rate cut late in March 2018, after one cut last year, did not appear to change the multi-year weakening trend in the property market.

EITHER AN UNCHANGED OR HIKE DECISION IS EXPECTED TO KEEP THE PROPERTY MARKET UNDER PRESSURE

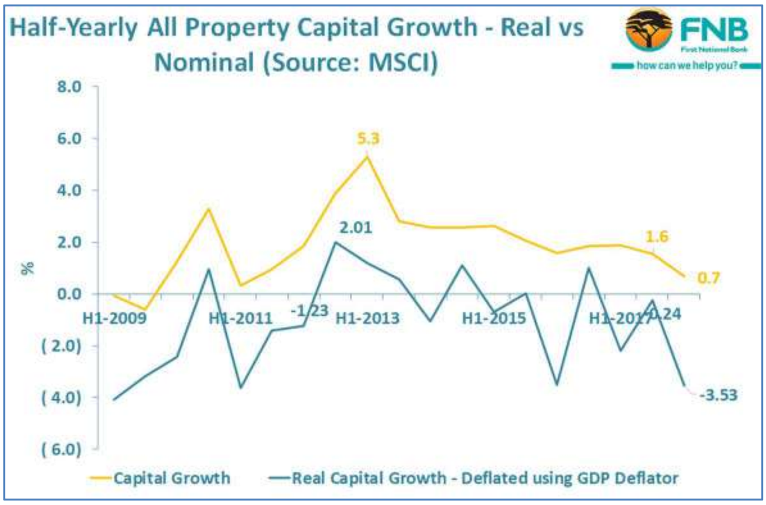
Potential implications for the Commercial Property Market

Both a rate hike or rates unchanged scenario is expected to sustain an environment that exerts upward pressure on capitalization (Cap) rates, resulting in property values coming under pressure in real terms. The economy remains very weak, pushing certain vacancy rates higher, and with Government revenue growth under pressure we have continued to see the government debt-to-GDP ratio rising, which has exerted upward pressure on long bond yields in recent years.

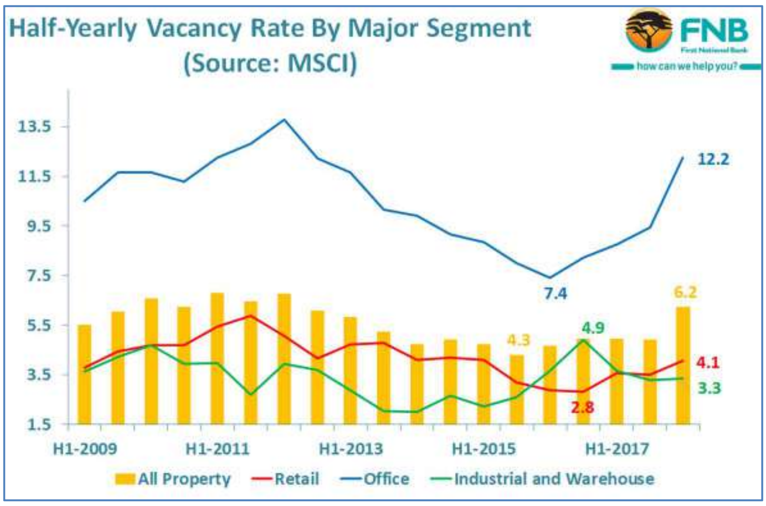


In the Commercial Property Market, even 2 rate cuts in 2017/2018 have not managed to alter the broad gradual softening direction up until the 1st half of 2018.

IPD half-yearly data for the 1st half of 2018 was released in October, and this showed a further decline in total half yearly returns on commercial property, from 5.5% in the final half of 2017 to 4.7% in the 1st half of 2018, continuing a broad decline that started back around 2013/14. Half-yearly returns have gradually tapered from a post-Financial Crisis high of 9.5% reached in the 1st half of 2013.



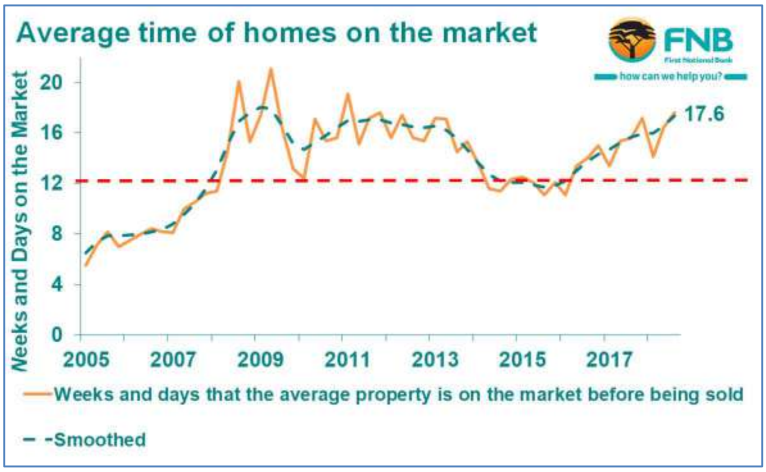
Capital growth slowed from 1.6% half on half in the final quarter of 2017 to 0.7% in the 1st half of 2018, meaning that in real terms (adjusting for GDP inflation) we saw the 3rd consecutive half of decline.



What hampers the property market currently then? Interest rates are low by South Africa standards, so cannot be seen as a major dampening factor. Sentiment plays a key role, and currently, weak sentiment arguably stems more from economic policy uncertainty in addressing the structural problems holding economic growth back.

At economic growth below 1%, demand for commercial property appears insufficient to prevent vacancy rates from rising, and such a rise in the All Property Vacancy Rate has taken place through 2017 and the 1st half of 2018 according to IPD (MSCI) data. Higher vacancy rates ultimately should curb rental income growth, and this should impact on capital growth.

The potential impact on the Residential Property Market

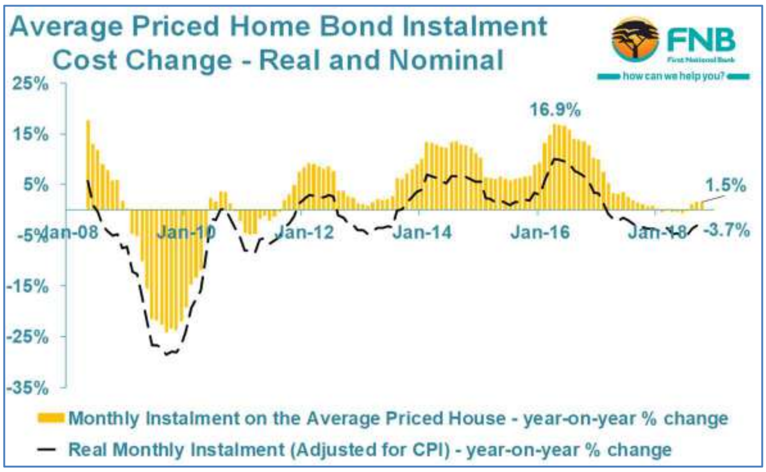


On the Housing Market side, up to the 3rd quarter of 2018 the market continued to move further away from equilibrium ("equilibrium" referring to balance between demand and supply). This is reflected in the FNB Estate Agent Survey's estimated average time of homes on the market prior to sale, which had been on a rising trend since early-2016, reaching 17 weeks and 6 days by the 3rd quarter of 2018. This is up from 14 weeks and 1 day in the 1st quarter survey, and from 11 weeks and 1 day at the start of 2016.

Even the interest rate cut of March did not change this broad trend, the 2nd quarter 2018 survey straight after that rate cut showing a lengthening in the time on the market from the "pre-cut" 1st quarter survey.

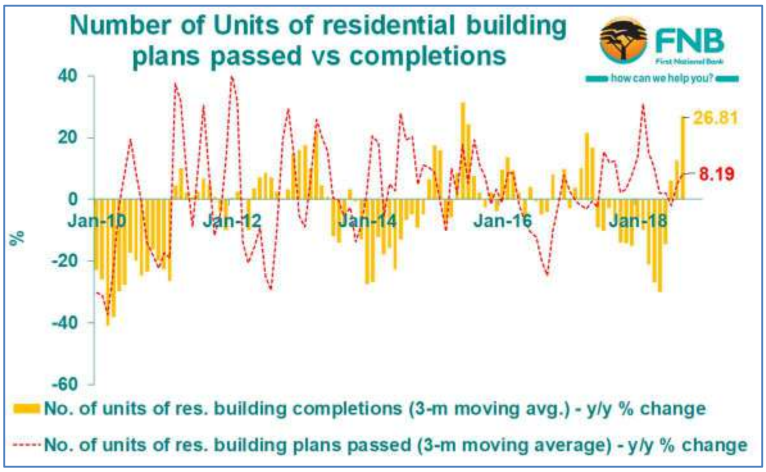
The start of an increasing trend in time on the market, at the start of early-2016, co-incided with nominal house price growth slowing to levels low enough for real year-on-year house price decline to commence from early that year too ("real" referring to house prices adjusted for CPI inflation rates).

This trend of real house price decline since early-2018 has not been halted despite 2 x 25 basis point interest rate cuts, one early in 2017 and one early in 2018.



At current house price growth rates, a 25 basis point rate hike probably wouldn't stop the trend towards greater home affordability either. In October, the year-on-year growth in value of a 100% new loan on the average priced home rose by a mere 1.5%. We calculate that a 25 basis point rate hike would take this growth rate up to 3.3% year-on-year, a rate which still remains below the CPI inflation rate as well as below nominal per capita income growth.

Therefore, it would take more significant rate hiking at this stage to cause the resumption of a deterioration in home affordability, given currently weak nominal house price growth.



And with supply relative to demand looking set to remain strong in the existing home market, the recent "flurry" of growth in residential units built (26.8% year-on-year for the 3 months to September 2018 according to StatsSA building stats), looks set to be short lived, the New Development Sector to be challenged by improving affordability in the existing home market.

In short, interest rate cutting appears the least likely scenario this week, with the debate between unchanged rates and a 25 basis point hike, Firstrand expecting the latter. In the near 1% per annum economic growth environment of recent years, with South Africa's myriad of structural constraints taking their toll on economic growth, the property market has been unable hold its average value in real terms. The gradual real value decline started around early-2016 in the case of residential and a similar time in the case of commercial. 2 small rate cuts in 2017/18 have not arrested real value decline, so we would expect that either an unchanged or rate hike decision would keep the gradual declining trend in real values intact.