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## **PROPERTY BAROMETER - HOUSING AFFORDABILITY REVIEW**

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*After a prior trend of strong improvement, affordability levels appear to have settled back at levels around those of 2003/4....but no price inflation boom like back in those days.*

### **SUMMARY**

*The FNB Estate Agent Survey points to the sample of agents surveyed perceiving housing affordability levels (house prices relative to income levels) as having improved significantly since 2008, to levels comparable with those seen around 2004.*

*These perceptions are not totally out of line with our own FNB housing affordability measures, which improved dramatically from 2008 to 2011, driven by period of low house price growth being slower than wage inflation, along with significant interest rate cuts at the time..*

*However, the improving affordability trend may have all but come to an end more recently. The September SARB (South African Reserve Bank) Quarterly Bulletin has enabled us to update our own 2 housing affordability indices for the 1<sup>st</sup> quarter of 2013, using the SARB Average Employee Remuneration Index, the FNB House Price Index, and a Prime Rate time series. And indeed, the improving trend in affordability since 2008 has all but ended according to these 2 affordability measures too. The 1<sup>st</sup> measure, namely the Average House Price/Average Employee Remuneration Index rose (deteriorated) very slightly by 0.2% in the 1<sup>st</sup> quarter of 2013, compared to the level for the previous quarter. The 2<sup>nd</sup> measure, which captures the “Instalment Repayment Value on a new 100% Bond on the Average Priced House/Average Employee Remuneration Ratio” in index form, also rose (deteriorated) by a slight 0.2%. This slight deterioration comes on the back of a lack of any further meaningful improvement since 2011, following a steep decline (improvement) in both affordability indices from 2008 to 2010.*

*This lack of further affordability improvement is due in part to the slowdown in the pace of SARB interest rate cutting post-2009, slower employee remuneration growth subsequent to 2010, and also due to an improved period of house price growth in 2012.*

*In addition, debt-service affordability improvements also appear to have come to an end. Almost in sync with the big housing affordability adjustment from 2008 was a very significant improvement in the affordability of servicing the household debt-burden, as reflected in the household sector debt-service ratio (the cost of servicing the debt expressed as a percentage of household disposable income).*

*However, simultaneous with the end of the improving home affordability trend since around a year ago came the end of the improving trend in the debt-service ratio too. At 7.7% (interest only debt-service ratio), the debt-service ratio as calculated by the SARB is now also slightly up from a low of 7.6% as at the final quarter of 2012.*

*The slight increase in the ratio has much to do with a household debt-to-disposable income ratio which has risen again slightly recently, following a decline from 2009 to 2011, as slow economic and household disposable income growth fails to outpace also-mediocre household sector credit growth. And, of course, we haven't had an interest rate cut in over a year.*

*These apparent ends to both housing and debt-servicing affordability improvements leads us to believe that 2014 will see some de-celeration in residential demand growth (still growing but slower), as well as a mildly slower house price growth year in the*

*expected absence of any key factors that could meaningfully improve housing or debt affordability. No significant acceleration in average employee remuneration growth is foreseen in these mediocre economic times, while interest rates are expected to stay at current levels through 2014.*

*Indeed, house price growth in the 1<sup>st</sup> 3 quarters of 2013 is already below the 8% year-on-year high reached in the 3<sup>rd</sup> quarter of 2012, at 6.4% year-on-year in the 2<sup>nd</sup> quarter of 2013, perhaps already reflecting the constraining influence of a lack of improvement in the abovementioned affordability measures.*

*Some may find it strange that we point to affordability measures back down at relative lows last seen around 2003/4, but yet those years were a time of extreme house price growth whereas the current period is definitely not. We believe that there is a good explanation for this, and it relates to a very different market psychology now compared to then. Around 2003 to 2005, there was far stronger evidence of speculative property buying as well as far higher levels of buy-to-let buying than in more recent times. In addition, we believe that there was significantly more “buyer panic” back then than now, which increased the sense of urgency of aspirant new entrants to the market, believing that if they “didn’t buy now” it may be too expensive later.*

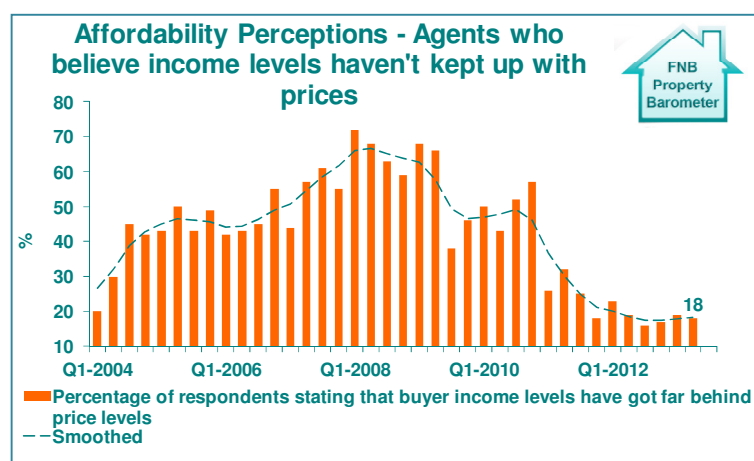
*Neither of these features seem prevalent in the current market environment, and this is largely due to what happened in years prior. The pre-boom interest rate cuts from late-1998 came at a time where property prices were extremely affordable, thus initially precipitating massive demand surge and strong primary residential demand-driven price growth, which would later attract speculators and less sophisticated buy-to-let buyers to the market in large numbers, along with some “panicky buyers”. By comparison, the sharp post-boom interest rate cuts from late-2008 precipitated a far less extreme demand surge because they came at a time when housing was at a relatively in-affordable level. Therefore, the initial demand growth post-2008 was never going to be strong enough to achieve price growth momentum that could attract such groups of people in significant numbers. Today, it remains a very “sane” market, low on speculative and buy-to-let buying, and where buyers shop around and bide their time. Therein lies key reason for such a difference in price growth performance between the present and a decade ago, despite similar affordability levels.*

*A few “secondary” explanations for the difference in price growth between then and now also emanate from certain other affordability measures. These point to a deterioration in affordability in some key housing related costs in the form of municipal rates and utilities tariffs, weighing mildly on housing demand, while competing expenditure items in the form of consumer goods and services have improved their affordability since a decade ago significantly, thus making housing less “price competitive” over the past decade or more.*

## 1. ESTATE AGENT PERCEPTIONS OF HOUSING AFFORDABILITY

*In the FNB Estate Agent Survey, we ask a sample of estate agents for their perceptions and estimates regarding a wide variety of factors in the residential market, including one question relating to home affordability.*

*In this question, admittedly a subjective one, we ask them to agree with 1 of 3 options, namely “Income levels have kept up with house prices”, “Income levels are a little behind house prices”, or “Income levels are far behind house prices”. Needless to say, their estimates of “in-affordability” were at their worst around 2008, a year when real house price levels were not far off their peak levels, interest rates were also at their peak, and the recession hampered disposable income growth.*

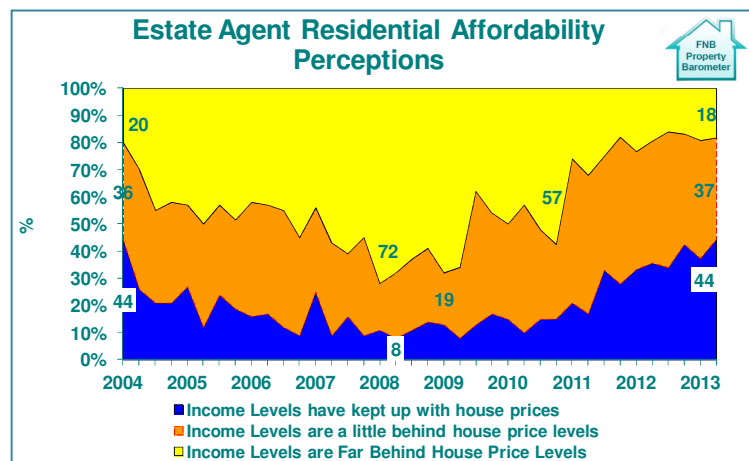


*In the 1<sup>st</sup> quarter of 2008, 72% of agents stated that “Buyer income levels had got far behind house price levels”. The onset of interest rate cuts, a recovering economy and real house price declines, ultimately led to a drop in the percentage of agents in this affordability category to a low of 16% by the 3<sup>rd</sup> quarter of 2012, the lowest percentage witnessed since the inception of the survey back in 2003 and also coinciding with the most recent interest rate cut by the SARB.*

*Since then, however, the trend appears to have changed from one of decline (improvement) to one of “sideways” movement, with the most recent percentage being a slightly higher 18% as at the 2<sup>nd</sup> quarter 2013 survey.*

This is not yet quite the end of the improvement in overall affordability perceptions of estate agents, however, as the next category “Income levels are a little behind house price levels (37%)” is still on a declining trend, translating into the rising trend in the percentage of respondents in the “Income levels have kept up with house prices (44%)” category continuing.

The perceived affordability improvement in the eyes of estate agents since 2008 has been massive, and the percentage of respondents in each of the 3 categories of perceived affordability are comparable to the breakdown as at the beginning of 2004, one of the great years of the boom period.

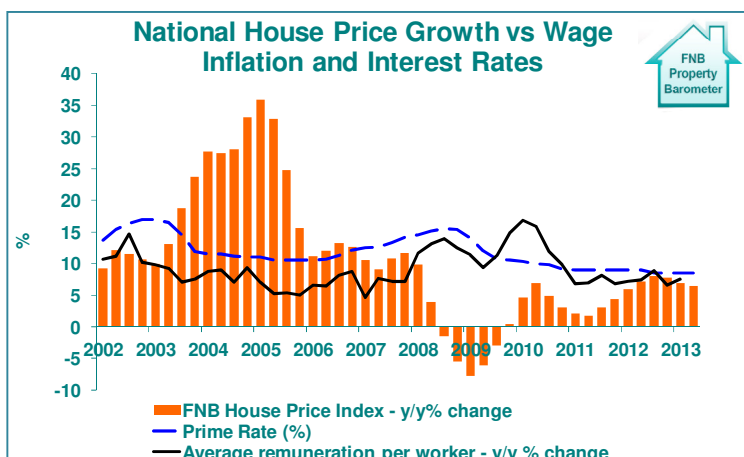
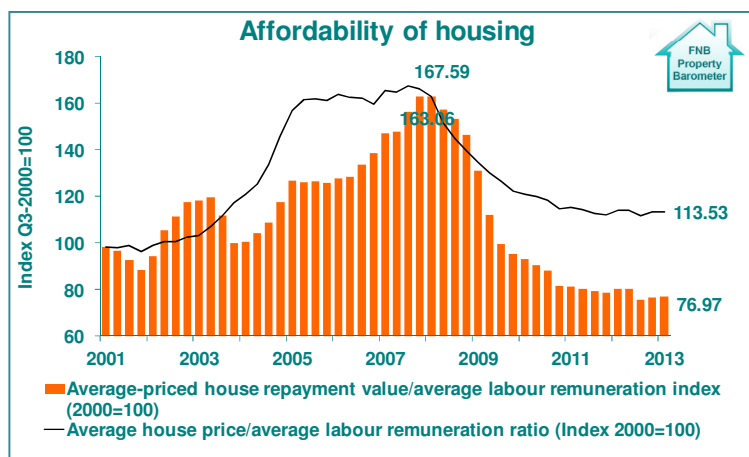


However, the broad flattening out in the percentage of respondents in the “Incomes are far behind prices” category points to a looming end to the perceptions of an improving affordability trend, and our own perception is that such an expectation is justified.

We believe it to be justified on 3 grounds. Firstly, house price growth has been going through a stronger period through much of 2012 and 2013, compared to 2011, as a result of further improvement in residential demand along with higher residential supply constraints. Secondly, interest rate cutting has all but come to a halt, the last rate cut being more than a year ago, while a slowed economic growth rate subsequent to 2010 has exerted some downward pressure on average employee remuneration growth.

## 2. THE FNB AFFORDABILITY INDICES

The September SARB Quarterly Bulletin has enabled us to update our own 2 housing affordability indices for the 1<sup>st</sup> quarter of 2013, using the SARB Average Employee Remuneration Index, the FNB House Price Index, and a Prime Rate time series. Indeed, it would appear as if the improving trend in affordability since 2008 has all but ended according to these 2 affordability measures. The 1<sup>st</sup> measure, namely the Average House Price/Average Employee Remuneration Index rose (deteriorated) very slightly by 0.2% in the 1<sup>st</sup> quarter of 2013 compared to the level for the previous quarter. The 2<sup>nd</sup> measure, namely the “Installment Payment Value on a new 100% Bond on the Average Priced House/Average Employee Remuneration Ratio” Index, also rose (deteriorated) by a slight 0.2%. One can see a broad flattening out in the trend through 2011 to 2013 following a steep decline (improvement) in both affordability indices from 2008 to 2010.



Therefore, both of our own “traditional” measures of affordability point to an end to the improving affordability trend of recent years, since the peak of “in-affordability” back around 2008.

And already, the end of the improving affordability trend may have been starting to exert some small downward pressure on average house price growth. On a quarterly basis, the year-on-year rate of increase in the FNB House Price Index of 6.4% as at the 2<sup>nd</sup> quarter of 2013 is off the high of 8% reached in the 3<sup>rd</sup> quarter of 2012.

Nevertheless, both affordability ratios are at relatively low levels, the price/remuneration measure down at levels comparable with those of the 2<sup>nd</sup> half of 2003, while the repayment/remuneration measure is below anything witnessed since the FNB House Price Index's inception in mid-2000.

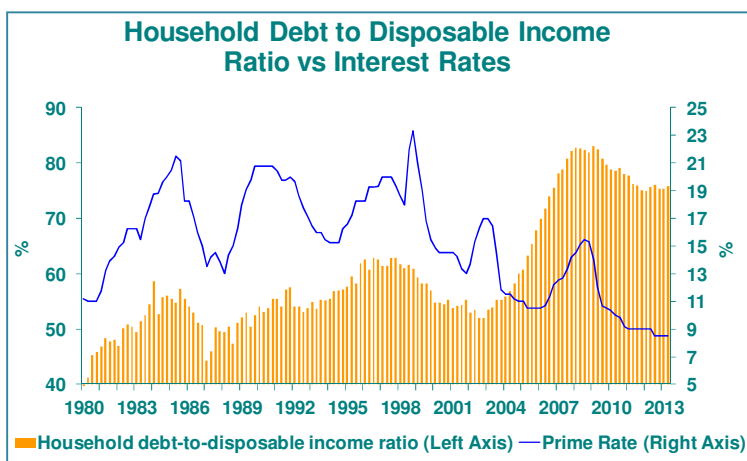
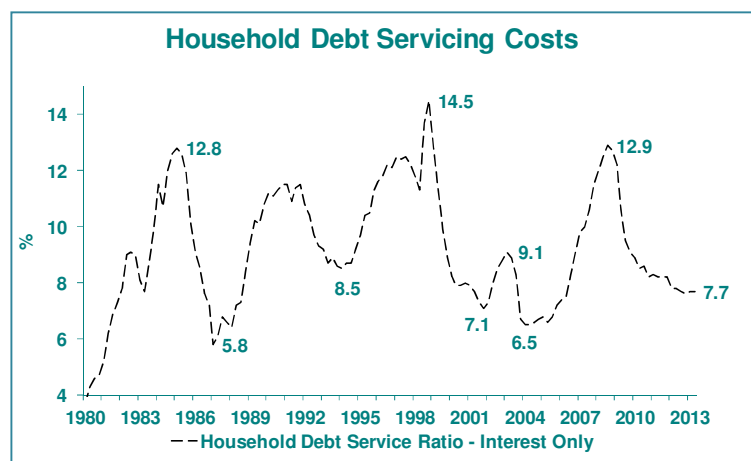
### 3. DEBT SERVICING AFFORDABILITY

Almost in sync with the big housing affordability adjustment from 2008 was a very significant improvement in the affordability of servicing the household debt-burden, as reflected in the household sector debt-service ratio (the cost of servicing the debt expressed as a percentage of household disposable income). This is another key affordability ratio relating to the highly credit-driven housing market.

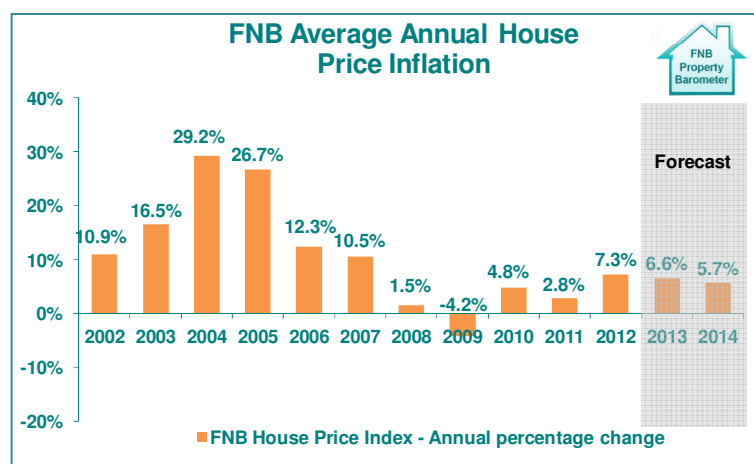
However, simultaneous with the end of the improving home affordability trend since around a year ago came the end of the improving trend in the debt-service ratio too. At 7.7% (interest-only debt-service ratio), the debt-service ratio as calculated by the SARB is now also slightly up from a low of 6.6% as at the final quarter of 2012.

The slight increase in the ratio has much to do with a household debt-to-disposable income ratio which has risen again slightly in recent times, following a sharp decline from 2009 to 2011, as slow economic and household disposable income growth fails to outpace mediocre household sector credit growth.

The debt-service ratio is still at a level higher than the 6.5% low point of the last cycle, reached early in 2004 after an aggressive bout of interest rate cutting in 2003. Nevertheless, the recent level is relatively low, and not far off the 2004 level.



### 4. OUTLOOK – IMPLICATION OF THE END OF THE IMPROVING AFFORDABILITY TRENDS MAY BE MILDLY SLOWER HOUSE PRICE GROWTH YET AGAIN



As mentioned, the FNB House Price Index has shown mildly slower growth in recent quarters since an 8% year-on-year growth high reached in the 3<sup>rd</sup> quarter of last year.

This slightly slower house price growth is believed to be the impact of the end of improvements in housing and debt servicing affordability.

In the expected absence of any further meaningful affordability improvements in the near term, given an expected slower economic and household income growth rate in 2013 compared to 2012 and no further interest rate cuts, our projection is for average house price growth to recede to slightly lower single-digit levels as 2014 approaches.

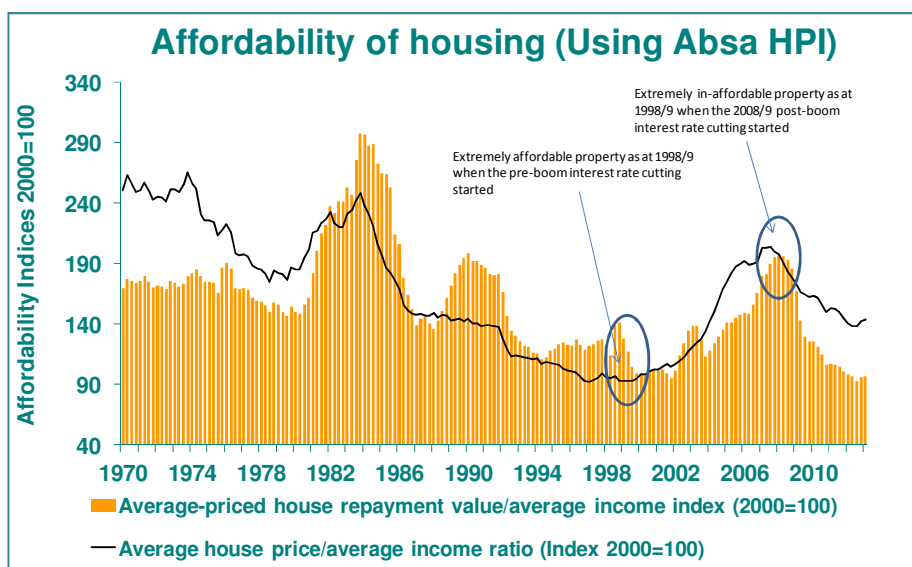
## 5. BUT IF WE'RE BACK TO 2003/2004 AFFORDABILITY, WHY NO PRICE GROWTH BOOM?

The lowly measures of both housing and debt affordability in recent times, at levels not far off those of 2003/4, and in the case of the installment/average remuneration housing affordability measure even better than in those years, prompts the question as to what is so different between the current time and then? 2004 average house price growth was 29.2%, while 2012 was a measly 7.3% by comparison, and it looks set to be slightly lower in 2013.

The potential answer lies primarily in the huge difference in housing affordability levels when the 1998-2001 “pre-boom” interest rate stimulus was applied, compared to the 2008-10 period when the most recent “post-boom” interest rate stimulus was applied, but also in some lesser influencing factors:

- **Post-2008 period not a speculators paradise like 2003-5 period was**

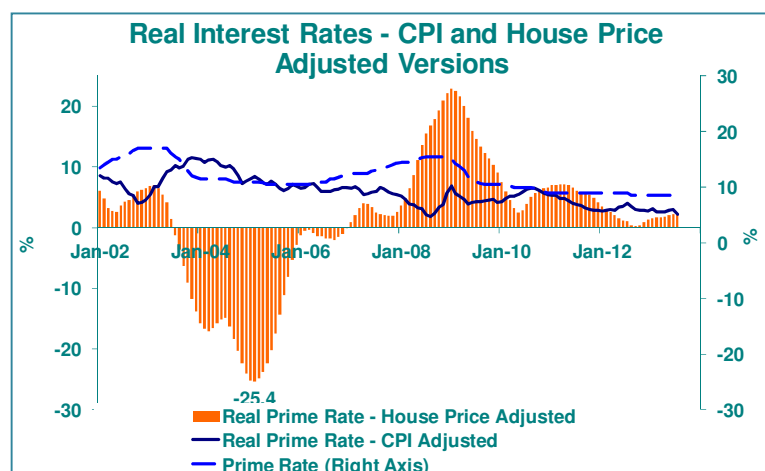
Utilising the Absa House Price Index for its long history, we see that by both measures of affordability, property was dirt cheap around 1998/99, the average price/average remuneration ratio being at the lowest levels in recorded history, while even the repayment/average remuneration index was relatively low despite an extreme prime interest rate peak of 25.5% in the 3<sup>rd</sup> quarter of 1998. So, when the aggressive pre-boom interest rate cutting started in late-1998, and continued into the early stages of the new millennium, causing the debt-service ratio to plummet from an extreme 14.5% at the end of 1998 all the way to 7.1% by end-2001, the response in terms of a housing demand surge was massive, causing a major acceleration in house price growth.



By comparison, the 2 affordability ratios were at relatively high (un-affordable) levels in 2008 as the aggressive post-boom interest rate cutting cycle started. The debt-service ratio fell again by a slightly smaller, but still impressive, magnitude, from a peak of 12.9% late in 2008 to 7.6% by end-2012.

The big difference this time around was that housing was far less affordable, and thus far less appealing to buy, as at 2008/9. Therefore, demand did recover, but the growth in demand around 2009/10 was far less impressive, and did not ignite the same level of price inflation that the rate cuts over a decade earlier had done.

This is important, because the early-boom residential demand surge managed to get house price growth momentum to a level that created a fundamental difference in market psychology compared to the current period, in terms of a different form affordability which I term “speculative investment affordability”. This is depicted by our alternative measure of real interest rates, where instead of using consumer price inflation to convert prime rate into real terms, we use house prices.

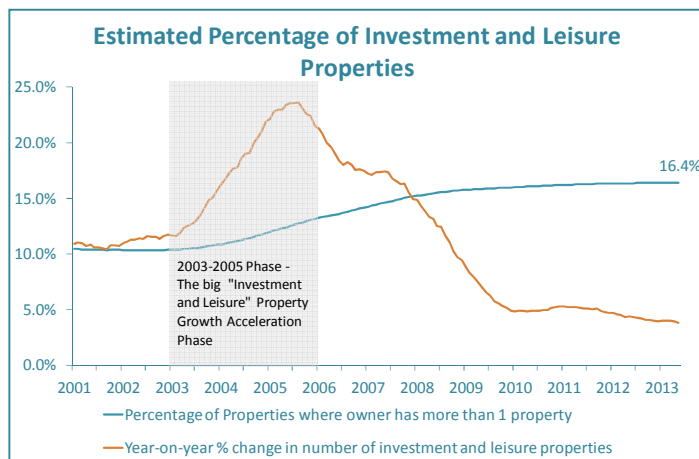
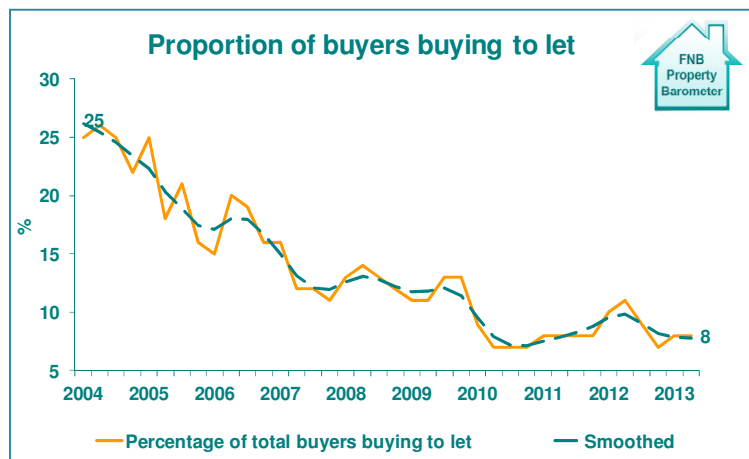


So, what we saw from 2003 to 2005 was a speculators paradise, where this alternative measure of real prime rate was strongly negative, bottoming at -25.4% in February 2005. This implies big short term profits to be made from using credit to buy property that would inflate rapidly in value.

And so, this period had a completely different psychology to the current period. Despite the usual affordability level in 2013 being similar to those around 2003/4, ongoing moderate price growth keeps our measure of real interest rates positive, thereby not driving strong speculative and buy-to-let activity strongly.

The difference in market psychology between now and a decade ago can be seen in 2 pieces of data. Firstly, in our FNB Estate Agent Survey, as at early 2004, 25% of total buyers were believed to be buy-to-let buyers. The buy-to-let category is believed to have contained a significant amount of the buying that could be deemed to be speculative. But it is also the case that the less sophisticated but genuine buy-to-let investor, perhaps erroneously, can be prone to basing buying decisions on recent capital growth, which is used as a basis for expectations of future capital growth.

In our own study of deeds data relating to transactions by individuals, we have also estimated the number of properties in the database where the owner has one or more other properties. The growth rate in this number accelerated sharply from 2003 to 2005, reflective we believe of strongly negative real interest rates according to our house price-adjusted real prime measure.



More recently, since 2008, the initial recovery in demand was nowhere near strong enough to cause a meaningful speculative and buy-to-let surge, with buy-to-let buying estimated to be only around 8% of total buying. These surges are driven more by strong price growth in the recent past, which in turn is initially caused by a surge in primary residential demand, and this time around this additional source of residential demand has been lacking.

- **Buyer Panic in the boom years is largely absent now, it would seem**

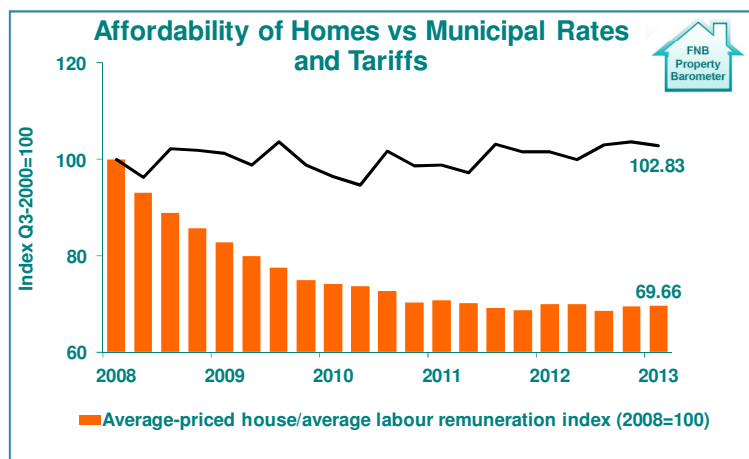
The second driver of boom time demand back around 2003-2005 was that of "buyer panic". Unfortunately we have no past surveys to measure the level of buyer panic in South Africa, but I believe its existence in boom times to be significant.

Buyer panic increases when buyers begin to believe that strong house price growth will eventually make property so unaffordable that they had better "buy now before it is too late". While we have no survey records of its existence at the height of the price inflation boom, we believe that it was indeed far more prevalent then than now.

In the current environment of moderate price growth, one doesn't get the feeling of such panic, with more lengthy estimates of the average time that a property is on the market, compared to the boom years, pointing strongly to a group of buyers "biding their time".

So, a lack of speculative and buy-to-let activity based on recent price trends, as well as a lack of buyer panic, is believed to largely explain why even though the housing and debt service affordability levels are at lows not too dissimilar from those around 2003/4, the rate of price growth is far slower than back then, and unlikely to accelerate in such a manner. This difference in market psychology between now and then has much to do with the differences in what has taken place in the few years prior to these 2 periods being compared.

- **Affordability of housing-related taxes and services**



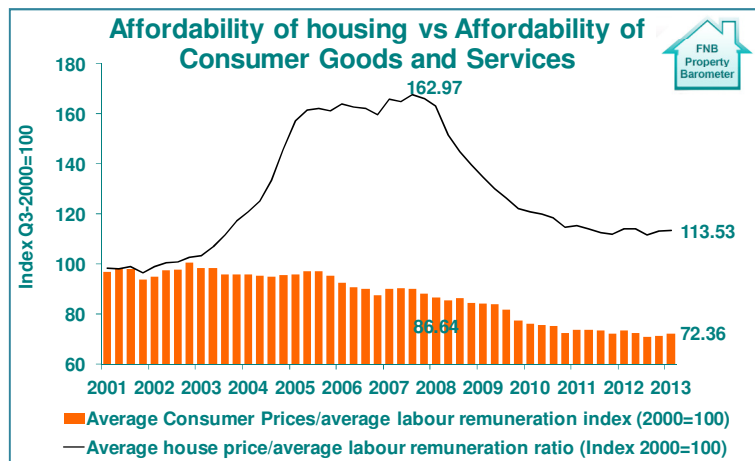
A further affordability measure to consider is one related to home operating costs in the form of municipal rates and utilities tariffs. The sharp rises in most notably electricity tariffs, but also in municipal rates and other utilities tariffs has been high profile news in recent years, as parastatals attempt to increase infrastructure spend and councils attempt to improve sometimes parlous financial situations.

Therefore, whereas since the 1<sup>st</sup> quarter of 2008, the average house price/average employee remuneration ratio index has declined by 30.34%, the CPI for municipal rates and utilities tariffs has actually risen by 2.8%, thus keeping a little ahead of inflation in employee remuneration over the period.

In short, while average house prices have become more affordable, certain key housing related costs haven't.

- **Affordability of competing goods and services**

Finally, it is important to compare the affordability of houses with that of competing goods and services, namely the wide array of consumer goods and services. Households prioritize between a wide array of expenditure items, of which homes are but one. And while the average house price/average employee remuneration ratio has indeed declined since 2008, housing remains "disadvantaged" affordability-wise compared to consumer goods and services, relative to where it was as at the year 2000.



To illustrate this, we calculate an average consumer price (Using the private consumption expenditure deflator)/average employee remuneration ratio index where, like the average house price/average remuneration ratio index, its base of 100 is also in the year 2000. Since then, the consumer goods and services affordability index finds itself 27.6% lower, while the housing affordability index still finds itself 13.5% higher.

Therefore, since 2000, housing has become less "price competitive" relative to consumer items.

## **CONCLUSION – HOME PRICE AND DEBT SERVICE AFFORDABILITY LEVELS ARE ONCE AGAIN COMPARABLE WITH LEVELS AROUND 2003/4, BUT DON'T EXPECT A BOOM THIS TIME**

Housing affordability improvements, as per the 2 measures of average house price/average employee remuneration and installment value on a new 100% loan on the average priced house/average employee remuneration, appear to have all but come to an end in recent times.

In addition, debt-service affordability improvements, as reflected by the debt-service ratio, also appear to have come to an end.

This leads us to believe that 2014 will see some small de-celeration in residential demand growth, as well as a mildly slower house price growth year, in the expected absence of any key factors that could meaningfully improve housing or debt service affordability. No significant acceleration in average employee remuneration growth is foreseen in these mediocre economic times, while interest rates are expected to stay at current levels through 2014.

Indeed, house price growth in the 1<sup>st</sup> 3 quarters of 2013 is already below the 8% year-on-year high reached in the 3<sup>rd</sup> quarter of 2012, perhaps already reflecting a lack of improvement in the abovementioned affordability measures.

Some may find it strange that we point to affordability measures back down at relative lows last seen around 2003/4, but yet those years were a time of extreme house price growth whereas the current period is not. We believe that there is a good explanation for this, and it relates to a very different market psychology. Around 2003 to 2005, there was far stronger evidence of speculative property buying as well as far higher levels of buy-to-let buying than in more recent times. In addition, we believe that there was significantly more buyer panic back then, which increased the sense of urgency of aspirant new entrants to the market, believing that if they "didn't buy now it may be too expensive later".

Neither of these features seem prevalent in the current market environment, and this is largely due to what happened in years prior. The pre-boom interest rate cuts from late-1998 came at a time where property prices were extremely affordable, thus precipitating massive demand surge and strong price growth which would later attract speculators and less sophisticated buy-to-let buyers to the market in large numbers, along with "panicky buyers". By comparison, the sharp interest rate cuts from late-2008 precipitated a far less extreme demand surge because they came at a time when housing was at a relatively in-affordable level. Therefore, the initial price growth momentum was never going to be sufficient to attract such groups of people. It remains a very "sane" market where buyers shop around and bide their time. Therein lies the key reason for such a difference in price growth performance between the present and a decade ago, despite similar affordability levels.

*A few “secondary” explanations for the difference in price growth between then and now also emanate from certain other affordability measures. These point to a deterioration in recent years in affordability in some key housing related costs in the form of municipal rates and utilities tariffs. In addition, competing expenditure items in the form of consumer goods and services have improved their affordability since a decade ago significantly, thus making housing less “price competitive” over the past decade or more. Yes, the reality is that housing has to compete with other household expenditure priorities for a “slice of the disposable income pie”.*