PROPERTY BAROMETER – POTENTIAL IMPACT OF PROPERTY ON INTEREST RATES

The start of interest rate hiking is likely to cause a moderate increase in the upward pressure exerted on consumer inflation and interest rates by the residential property market.

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One of the most obvious impacts of yesterday's Reserve Bank (SARB) interest rate hike would be a dampening of residential home buying demand in the coming weeks and months, as certain aspirant property buyers perhaps adopt a "wait and see" approach, postponing their residential purchase until the interest rate hiking cycle appears to have passed.

This impact is likely to be seen in the form of a decline in 1st time buyers as a percentage of total home buyers, as many younger buyers have greater flexibility, being able to remain in their parents' home for longer or to hang out in the rental market for the time being.

The impact will also be likely felt among those sellers selling in order to downscale due to financial pressure. Not only could rate hikes raise the numbers of this category of sellers of property, but it is also expected to raise the portion of these sellers that downscale into rental properties for the time being as opposed to buying a cheaper property.

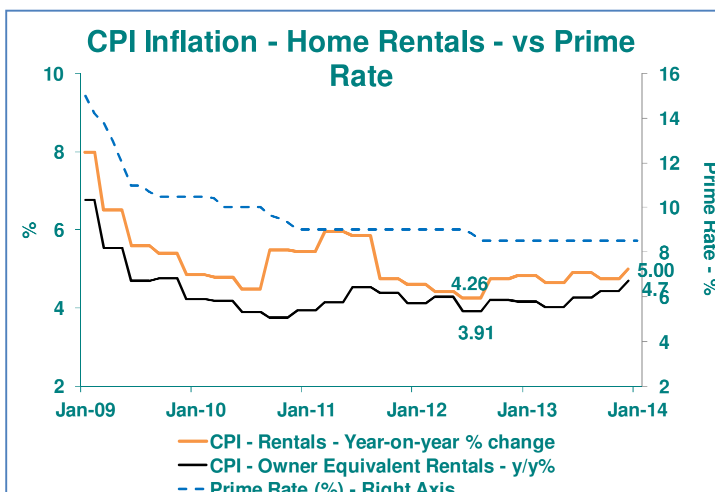
This all leads to one likelihood…..stronger growth in demand for rental properties.

Simultaneously, interest rate hiking can normally be expected to curb already-weak buy-to-let home buying, which according to the FNB Estate Agent Survey hovers around 8% of total home buying, a far cry from the 25% of total buying recorded in the survey back in 2004.

All in all, therefore, rising interest rates should imply stronger growth in demand for properties to rent, accompanied by slower growth in supply of properties to rent. The combination is likely to see higher rental inflation, just as we saw the last time interest rates peaked around 2008.

The relevance of all of this is that the residential rental component (combining actual rentals and owner equivalent rentals) of the consumer price index (CPI), the key measure for determining the SARB's interest rate stance, has a large weighting of 16.2% in the overall CPI. This is larger than the weighting of food, the more highly-publicised big ticket item in the CPI.

Interest rate hiking thus raises the possibility of an acceleration in rental inflation, which then in turn raises the possibility of additional upward pressure on CPI inflation and interest rates. This in turn raises the question as to whether it is appropriate to have such a large residential rental component in the inflation measure on which interest rate policy is based, due to an often positive correlation between the 2?



How extreme could the influence be? Well, fortunately the rental market is not as volatile as food markets and prices, so one is unlikely to see rental inflation peaks that are quite as extreme as some of our historic food price spikes. But if we look back to January 2009 (when the current CPI weightings were introduced), actual rental inflation was as high as 8%, and Owner Equivalent Rental inflation at 6.8%.

The onset of interest rate cutting at around that time saw the 2 rental categories' inflation rates

declining steadily to 4.3% and 3.9% respectively by mid-2012 (around the end of the rate cutting cycle), and it was indeed rental inflation that was the unsung hero in containing overall CPI inflation at times when food price inflation and others often threatened to get out of hand.

Since mid-2012, however, the CPI – Actual Rentals inflation has risen to 5% year-on-year, while the CPI – Owner Occupied Rentals has risen to 4.7%, prior to interest rate hiking, purely on the back of mounting supply constraints. This is possibly a different environment to 2008, where supply may well have been far more abundant following a huge buy-to-let buying boom in prior years. This time around, there has been no buying boom preceding the rate hikes, and as early as late-2012 TPN (Tenant Profile Network) surveys of letting agents started to point to supply constraints. Now for the acceleration in rental demand as interest rates rise.

How big can the impact be? That will depend on how far this interest rate hiking cycle goes, but we would expect rental inflation to be more sensitive (with a positive correlation) to interest rate hiking this time around, compared to 2006-8, because of our sense that there are probably greater rental supply constraints today than back then.

With a weighting of around 16%, it would take between 7 and 8 percentage points of combined actual and owner equivalent rental inflation to add 1 percentage point of inflation to the overall CPI inflation rate, not impossible should a few more rate hikes take place and boost rental demand significantly. While the CPI rental inflation measures have been slow in reflecting a strengthening rental market to date, our own FNB-TPN rental measure has accelerated a bit more strongly to 6.6% by the 3rd quarter of 2013, while the PayProp measure has already reached double-digit rental inflation.

Would such an impact be severe? Not if food and oil prices and other big ticket CPI items play ball, but with many of these prices in part globally determined, the current state of the Rand makes that a hazardous assumption.

At this stage, it is very early days in the interest rate hiking cycle, and probably not the time to be predicting magnitudes. And ultimately, if interest rate hiking goes far enough it will eventually dampen rental demand too, because tenants also have their financial limits and they also often have debt. But in the initial stages of the interest rate hiking cycle, we would expect rental inflation to be positively correlated to interest rates, and thus anticipate some acceleration in rental inflation to feed through into the CPI numbers, thereby conceivably posing some additional upside risk to interest rates.

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