FNB

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HOUSEHOLD SECTOR – MARCH INTEREST RATE DECISION

The SARB decided to keep its Repo rate unchanged today, effectively giving households valuable time to prepare for further rate hiking. Best we use it.

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27 March 2014

THE CRUX OF THE MESSAGE FROM THE MPC (MONETARY POLICY COMMITTEE)

The Monetary Policy Committee (MPC) of the Reserve Bank (SARB) decided to keep its policy Repo rate unchanged at 5.5%, for the time being, after this week's meeting. This comes after a surprise 50 basis point hike in January, and the unchanged decision comes on the back of a slightly improved inflation outlook, some improvement in Rand performance since January's meeting, and an economic growth outlook that remains fragile.

Nevertheless, the SARB CPI forecast is still for inflation to exceed the upper target limit, and the Governor implied that it would be clever to prepare ourselves for more rate hikes, stating that "the real policy rate is currently below what can be considered normal in the long run and is likely to increase over the medium term…".

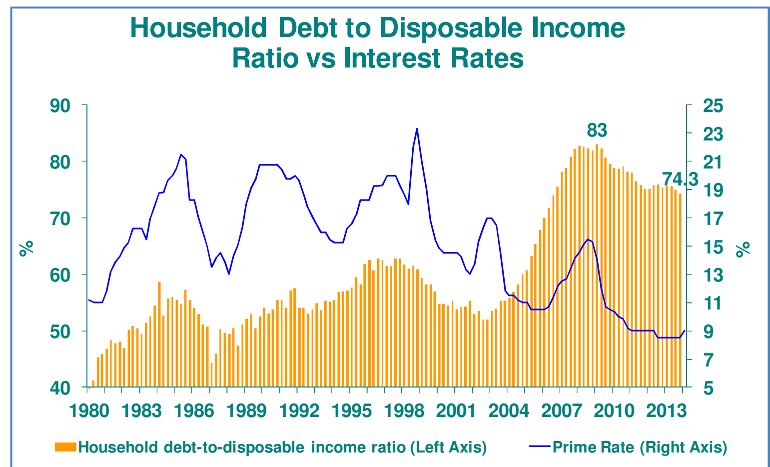
FNB's expectation is for Prime Rate, currently at 9%, to peak at 11% in 2015, in what would be a moderate rate hiking cycle.

Time will tell, and things can change quickly, but as things stand today, the content of the MPC statement suggests that we would be wise to use the time available to prepare ourselves for more interest rate hiking.

IMPLICATIONS OF FURTHER RATE HIKING FOR THE HOUSEHOLD/ CONSUMER SECTOR

- *The impact of an expected moderate rate hiking cycle should be seen as "mildly negative" from a short term consumer point of view, curbing growth in demand for consumer-related credit.*
- *The slowing impact on consumer demand can be both indirect, via a dampening effect on economic growth and thus on household income growth, as well as directly via a dampening effect on consumer credit demand growth as the cost of credit rises.*
- *The most notable area of impact can be expected to be in the area of durable consumer goods consumption, which includes the highly credit-dependent motor vehicle consumption expenditure category. Growth in real durable consumer spend, although still the strongest growth area of overall consumer spend, has slowed considerably already from above 24% quarter-on-quarter annualized in the 2nd half of 2010 to 6.9% by the final quarter of 2013. Further slowing in this growth rate is expected in 2014.Overall real household consumption expenditure is expected to move slightly lower in 2014, from 2.6% in 2013 down into the 1.5-2% range.*
- *The second major area of potential impact is on growth in demand for buying of residential property. In particular, we expect to see the more non-essential categories of home buying, i.e. for buy-to-let and holiday purposes, remaining subdued, while primary residential buying remains "king".*
- *The positive side of a possible containing of residential demand growth is that the interest rate hiking may serve to prevent any thoughts of an "irrational" market from forming, i.e. a market with widespread speculative activity and home buyer "panic" (where aspirant market entrants act with urgency because they fear that if "they don't buy now they won't be able to afford a home later"). Speculation and buyer panic can be instrumental in causing market "overshoots", and monetary policy can greatly assist in preventing this and keeping the property market in line with what are currently weak economic fundamentals.*

- *The other major longer term positive impact of moderate rate hiking is expected to be that this helps to restrict household credit growth to lower rates than household disposable income growth, thereby leading to further much-needed decline in the Household Sector Debt-to-Disposable Income ratio. We have already made significant progress in reducing this ratio from an all-time high of 83% back in early-2009 down to 74.3% by the end of 2013. This significantly reduces the vulnerability of the household sector to "shocks" in the form of interest rate hikes or to income. However, our feeling is that this debt ratio reduction should go further, at least to below 70%, as the most recent level remains high by historic standards. A moderate interest rate hiking cycle, well-timed, may just support this "healing" process.*



CONCLUSION

In short, while further expected interest rate hiking at future meetings holds potential near term negatives for growth in consumer and residential demand, in the longer term this action may well turn out to be positive in terms of keeping the residential market "rational", and thus healthy, as well as further reducing household vulnerability through lowering the household debt-to-disposable income ratio.

The FNB expectation is for Prime rate to end 2014 a little higher at 10%, and rise further in 2015 to peak at 11%. This would be far more moderate than the 15.5% Prime Rate peak of 2008, and given the lower level of indebtedness relative to income today compared to back then, the combined result should be a far more modest rise in the level of bad debts compared to the extremes of 2008/9……if household borrowing growth continues to "behave".

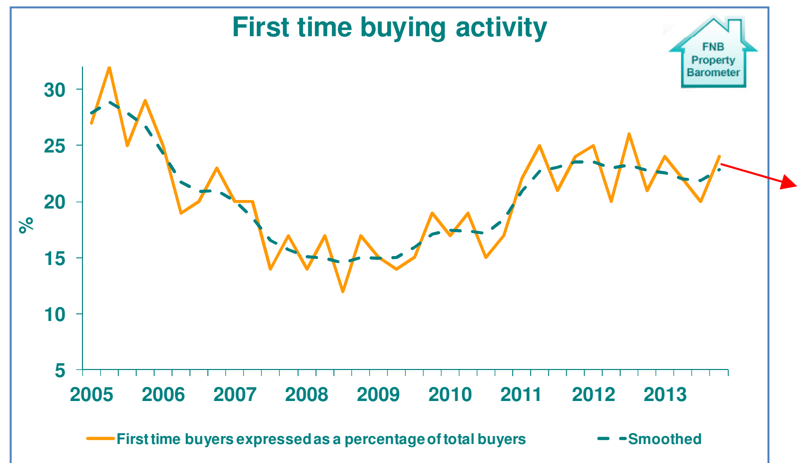
SOME PRECAUTIONS AND POSSIBLE CONSIDERATIONS FOR HOUSEHOLDS

- *Whilst the Governor of the Reserve Bank has hinted at a moderate interest rate hiking cycle, and indeed we too expect this, it is always prudent to borrow at such a level that one can absorb a good few interest rate hikes, because the outlook can quickly change from MPC meeting to meeting. If one cannot absorb at least a "normal" South African interest rate hiking cycle, with the past 2 rate hiking cycles being 4 and 5 percentage points in magnitude respectively, then perhaps it would be clever to rethink one's level of planned borrowing, or home buying, and "buy down".*

  The reality is that a very significant number of home buyers over commit on their homes. This is reflected in the FNB Estate Agent Survey, which as at the end of 2013 showed an estimated 14% of home sellers believed to be selling "in order to downscale due to financial pressure". While this percentage is far below the 34% registered back in the 2nd quarter of 2009 survey, it remains a very significant number. So a significant number of home buyers continue to "get it wrong", and the transactions costs involved with having to downscale later are large.

- *In many cases, over-commitment on home purchases doesn't come from a misunderstanding of how much the repaying of debt costs, but rather a misunderstanding of how much it costs to maintain and operate a home. So besides making provision for interest rate hikes, understand the overall costs of running a home, and allow for significant cost inflation in that area too, because these costs often combine with interest costs to exert financial pressure on households.*

- *If one does the calculations, and cannot right now afford the house that one ultimately aspires to, the rental option and a few more years of saving for a mortgage deposit is always there. This option is one often taken by aspirant 1st time buyers in tougher economic and interest rate times, and we would thus expect to see a mild drop in the percentage of 1st time buyers in the market as rates rise further, in the same way, though not as extremely, as was the case in 2008/9.*



- *The fixed interest rate option always exists. The onset of interest rate hiking in January, and changed market expectations regarding future hikes as a result, may have led to less attractive fixed rates on offer than previously was the case. However, the fact is that fixed rates can be a useful tool with which to obtain certainty over a portion of one's cash flows, and thus remain potentially useful. They should be viewed in this "cash flow stability"way as opposed to being seen as a tool with which to speculate and try to "beat the market".*
- *Finally, a great alternative way to increase certainty regarding repayment cash flows, without fixing rates, is to set the monthly repayment significantly above the required monthly payment (and adjust one's lifestyle accordingly), which would imply that up until a certain magnitude of rate hikes one's monthly loan repayments would not change, thereby improving cash flow certainty.*

MORTGAGE LOAN INSTALMENT TABLE

To give an example of the direct impact of the cost of the interest rate hike on mortgage loans, we take a R1m 20 year mortgage loan at prime rate. The January rise from 8.5% to 9% implied a R319/month increase in the instalment value, for most people not breaking the bank. However, should prime rate rise to 11% next year as we expect, the cumulative monthly instalment increase from 8.5% Prime Rate would be a more substantial +R1,644.

Bond Value (20 years)	Monthly instalment value according to interest rate charged on a 20-year bond											
	15.5%	15.0%	14.0%	13.0%	12.0%	11.0%	10.0%	9.5%	9.0%	8.5%	8.0%	7.5%
R 300 000	R 4 062	R 3 950	R 3 731	R 3 515	R 3 303	R 3 097	R 2 895	R 2 796	R 2 699	R 2 603	R 2 509	R 2 417
R 400 000	R 5 416	R 5 267	R 4 974	R 4 686	R 4 404	R 4 129	R 3 860	R 3 729	R 3 599	R 3 471	R 3 346	R 3 222
R 500 000	R 6 769	R 6 584	R 6 218	R 5 858	R 5 505	R 5 161	R 4 825	R 4 661	R 4 499	R 4 339	R 4 182	R 4 028
R 600 000	R 8 123	R 7 901	R 7 461	R 7 029	R 6 607	R 6 193	R 5 790	R 5 593	R 5 398	R 5 207	R 5 019	R 4 834
R 700 000	R 9 477	R 9 218	R 8 705	R 8 201	R 7 708	R 7 225	R 6 755	R 6 525	R 6 298	R 6 075	R 5 855	R 5 639
R 800 000	R 10 831	R 10 534	R 9 948	R 9 373	R 8 809	R 8 258	R 7 720	R 7 457	R 7 198	R 6 943	R 6 692	R 6 445
R 900 000	R 12 185	R 11 851	R 11 192	R 10 544	R 9 910	R 9 290	R 8 685	R 8 389	R 8 098	R 7 810	R 7 528	R 7 250
R 1 000 000	R 13 539	R 13 168	R 12 435	R 11 716	R 11 011	R 10 322	R 9 650	R 9 321	R 8 997	R 8 678	R 8 364	R 8 056
R 1 100 000	R 14 893	R 14 485	R 13 679	R 12 887	R 12 112	R 11 354	R 10 615	R 10 253	R 9 897	R 9 546	R 9 201	R 8 862
R 1 200 000	R 16 247	R 15 801	R 14 922	R 14 059	R 13 213	R 12 386	R 11 580	R 11 186	R 10 797	R 10 414	R 10 037	R 9 667
R 1 300 000	R 17 600	R 17 118	R 16 166	R 15 230	R 14 314	R 13 418	R 12 545	R 12 118	R 11 696	R 11 282	R 10 874	R 10 473
R 1 400 000	R 18 954	R 18 435	R 17 409	R 16 402	R 15 415	R 14 451	R 13 510	R 13 050	R 12 596	R 12 150	R 11 710	R 11 278
R 1 500 000	R 20 308	R 19 752	R 18 653	R 17 574	R 16 516	R 15 483	R 14 475	R 13 982	R 13 496	R 13 017	R 12 547	R 12 084
R 1 750 000	R 23 693	R 23 044	R 21 762	R 20 503	R 19 269	R 18 063	R 16 888	R 16 312	R 15 745	R 15 187	R 14 638	R 14 098
R 2 000 000	R 27 078	R 26 336	R 24 870	R 23 432	R 22 022	R 20 644	R 19 300	R 18 643	R 17 995	R 17 356	R 16 729	R 16 112
R 2 100 000	R 28 431	R 27 653	R 26 114	R 24 603	R 23 123	R 21 676	R 20 265	R 19 575	R 18 894	R 18 224	R 17 565	R 16 917
R 2 200 000	R 29 785	R 28 969	R 27 357	R 25 775	R 24 224	R 22 708	R 21 230	R 20 507	R 19 794	R 19 092	R 18 402	R 17 723
R 2 300 000	R 31 139	R 30 286	R 28 601	R 26 946	R 25 325	R 23 740	R 22 195	R 21 439	R 20 694	R 19 960	R 19 238	R 18 529
R 2 400 000	R 32 493	R 31 603	R 29 844	R 28 118	R 26 426	R 24 773	R 23 161	R 22 371	R 21 593	R 20 828	R 20 075	R 19 334
R 2 500 000	R 33 847	R 32 920	R 31 088	R 29 289	R 27 527	R 25 805	R 24 126	R 23 303	R 22 493	R 21 696	R 20 911	R 20 140
R 2 600 000	R 35 201	R 34 237	R 32 332	R 30 461	R 28 628	R 26 837	R 25 091	R 24 235	R 23 393	R 22 563	R 21 747	R 20 945
R 2 700 000	R 36 555	R 35 553	R 33 575	R 31 633	R 29 729	R 27 869	R 26 056	R 25 168	R 24 293	R 23 431	R 22 584	R 21 751
R 2 800 000	R 37 909	R 36 870	R 34 819	R 32 804	R 30 830	R 28 901	R 27 021	R 26 100	R 25 192	R 24 299	R 23 420	R 22 557
R 2 900 000	R 39 263	R 38 187	R 36 062	R 33 976	R 31 931	R 29 933	R 27 986	R 27 032	R 26 092	R 25 167	R 24 257	R 23 362
R 3 000 000	R 40 616	R 39 504	R 37 306	R 35 147	R 33 033	R 30 966	R 28 951	R 27 964	R 26 992	R 26 035	R 25 093	R 24 168

**Note: The above rates are indicative only. Actual instalment values can differ mildly depending on the method of calculation applied by a lending instituion*

JOHN LOOS:
HOUSEHOLD AND PROPERTY SECTOR STRATEGIST
011-649 0125
John.loos@fnb.co.za

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