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Weak Economic Conditions Are Weighing On South Africa's Housing Market

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Weak Economic Conditions Are Weighing On South Africa's Housing Market

A weak macroeconomic environment, still-high household indebtedness, and rising interest rates have weighed on the South African housing market. Annual growth in home prices slowed down in the third quarter of 2016 to 5.0% from 9.6% in 2014, and in real terms (adjusted for inflation) prices were falling in the first half of 2016. The situation improved at the end of 2016 as financial conditions stabilized, and home price growth is likely to have reached 7% for the year as a whole. Still, subdued economic growth, persistent very high unemployment, and elevated consumer indebtedness do not bode well for the South African housing market in the near term, especially if interest rates continue to rise, as our baseline scenario anticipates. We project muted growth in nominal home prices of 5.5% in 2017 and 6.5% in 2018. In the longer term, however, the imbalance between strong structural demand for better-quality housing and insufficient supply should support the market.

Overview

- The South African housing market faces several near-term challenges, including weak economic conditions and high household indebtedness.
- Residential property prices stagnated in real terms in 2016, as above-target inflation eroded nominal price gains, and construction activity has been soft.
- The imbalance between high structural demand for better-quality housing and insufficient supply should support the market over the longer term.

South Africa Macroeconomic And Housing Market Forecast

	2014	2015	2016e	2017f	2018f
Nominal house prices (% year-over-year change)	9.5	5.2	7.0	5.5	6.5
Real GDP (% change)	1.7	1.2	0.5	1.4	1.8
CPI inflation (% annual average)	6.1	4.6	6.3	5.7	5.4
Unemployment rate (%)	25.1	25.4	26.1	26.2	26.0

e--S&P Global Ratings' estimate. f--S&P Global Ratings' forecast. Sources: Absa, S&P Global Ratings, SARB, and Statistics South Africa.

Recent Trends

The macroeconomic environment in South Africa remains weak, with feeble growth and above- target inflation. Economic growth decelerated to 0.5% in 2016, by our estimate, from the already-low figure of 1.2% in 2015. This implies that GDP growth remained negative in per capita terms for the second year in a row. Meanwhile, consumer price inflation has been above the upper limit of the central bank target range of 3%-6% for most of 2016, fueled by currency depreciation over the second half of 2015 and early 2016, as well as rising food prices on the back of a severe draught.

Unemployment exceeded 27% in the third quarter of 2016, the highest level in more than a decade. At the same time,

household disposable income growth has decelerated in real terms, as slightly higher nominal income gains of about 7% in 2016 (compared with 6.3% in 2015) were more than offset by rising inflation. We estimate that real disposable income grew by just above 1% for 2016 as a whole.

In response to exchange rate and inflationary pressures, the South African Reserve Bank (SARB) raised the repurchase rate to 6.0% from 5.75% in July 2015, and did so again at each of the three consecutive meetings between November 2015 and March 2016. The policy rate has since remained unchanged at 7%, as more favorable external conditions—a resumption in foreign capital flows to emerging markets and the recovery in commodity prices—helped strengthen the rand and improved the inflation outlook.

The weak macroeconomic environment has weighed on the residential property market. In the middle segment, quarterly growth in prices slowed to 1.3% on average in 2015, down from 2.2% over 2013-2014, according to Absa Bank data. Residential property prices showed similar dynamics in the first three quarters of 2016. Annual growth slowed to 5.0% in the third quarter of 2016, down from 9.5% in 2014. (The data refer to a property price index for the middle segment—comprising homes of 80-400 square meters priced up to 4.4 million rand in 2016—which is widely used as a benchmark for South African residential property prices.) In real terms (adjusted for inflation) home prices were falling in the first half of 2016, as rising inflation eroded the nominal price gains.

Absa data show that the slowdown in 2016 was even more pronounced in the affordable houses segment, with growth in prices softening to 2.9% year-on-year in the third quarter from 8.7% in 2015. Annual price growth of luxury houses rebounded in the third quarter to 9.0% after 2.6% in the previous year. Luxury houses account for only a small number of transactions and may not be representative of the state of the housing market, however.

Recent data show a rebound in the middle segment of the market toward the end of 2016, with home prices rising by 2.5% over September-November. Taking into account the recent boost, we estimate that residential property prices in the middle segment grew by 7% in 2016, up from 5.2% in 2015. Adjusted for inflation, property prices stagnated in 2016.

The weakness in the residential property market has also been reflected in soft construction activity. Housing investment remained sluggish in the past year at 25% below the peak level in 2007. The number of completed residential buildings fell by 0.4% over January-October 2016, and the number of recorded residential building plans passed by larger municipalities declined by 0.9% year-on-year over the same period.

Macroeconomic conditions and increasing mortgage rates are the key factors behind the weakness of the residential property market over 2015-2016, in our view. The predominant mortgage interest rate increased to 10.5% by March 2016 from 9.25% in June 2015, mirroring the series of hikes in the SARB policy rate.

As a result, growth in residential mortgages decelerated to 3.3% in October from a peak of 4.7% annual growth in February 2016. Although positive dynamics are still evident, this is far below the rate of expansion of 20%-30% during the housing boom in the mid-2000s.

Household debt remains elevated at 74% of disposable income as of the third quarter of 2016, although it had dropped meaningfully by 14 percentage points from its peak in 2008. This entails a significant debt service cost for households

of about 9.6% of disposable income. The share of income going to debt service has increased recently, with the SARB's policy rate hikes directly affecting borrowers, since mortgages are issues predominantly at variable interest rates. This limits demand for new loans.

Affordability measures such as the price-to-income and the price-to-rent ratios improved over 2016. However, house prices were still about 10%-12% overvalued compared with their long-term average by the third quarter of 2016.

Future Trends

We think that a range of negative shocks that dragged down GDP growth in South Africa, such as falling commodity prices and a severe drought, have run their course. Meanwhile, the functioning of the electricity sector has improved, with no load shedding since winter 2015 thanks to new capacity as well as reduced demand.

Nevertheless, longstanding structural constraints, such as a skills shortage and rigidities in labor and product markets, still hold back economic growth. Political tensions remain high, weighing on the confidence of domestic and foreign investors. Therefore, our expectations are for subdued growth of 1.4% in 2017 and 1.8% in 2018. This means that, in per capita terms, South Africa's real GDP growth will only move into positive territory in 2018.

The outlook for inflation has improved. This reflects the strengthening of the rand and an expected gradual dissipation of the drought's effect on food prices, although the increase in oil prices partly offsets these positive trends. Meanwhile, expectations of a steeper path for U.S. interest rates following the outcome of the U.S. presidential elections led to a wave of outflows of foreign portfolio capital from emerging markets globally. The impact on South African financial markets has been relatively muted so far, but the rand may come under pressure if outflows persist. We expect that the SARB will raise the policy rate by 50 basis points to 7.5% during 2017. This corresponds to our baseline scenario of two hikes by the U.S. Federal Reserve in 2017, following the hike in December.

Subdued economic growth, persistent very high unemployment, and elevated level of consumer indebtedness do not bode well for the South African housing market in the near term, especially if interest rates continue to rise. We project muted nominal house price growth of 5.5% in 2017, which would imply stagnation of home prices in real terms. We forecast nominal home price growth of 6.5% in 2018.

We expect continued strong structural demand for better-quality housing from South Africa's young and growing population and rising urban middle class. The average home in South Africa contains 0.7 rooms per occupant, according to the Organisation for Economic Co-operation and Development (OECD) Better Life Index (2015). This is the lowest out of the 38 countries in the index (which covers the 35 member countries of the OECD plus three non-OECD countries). Meanwhile, the softness in the construction sector is exacerbating the housing supply shortage in South Africa. This supply-demand imbalance should support prices in the medium-to-long term.

Chart 1

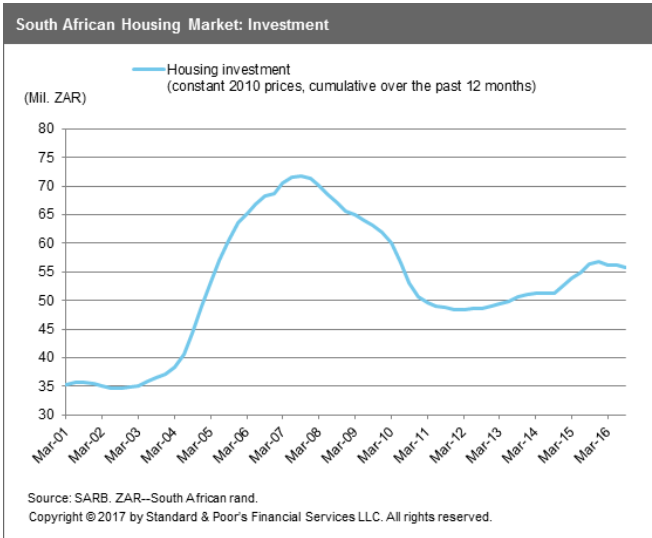


Chart 2

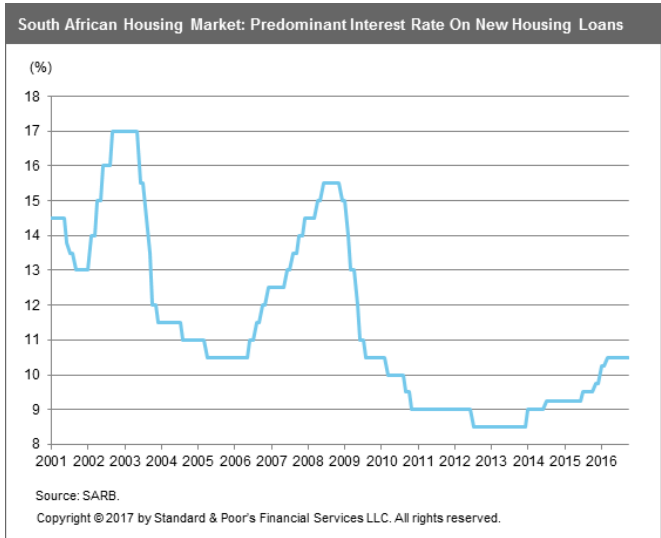


Chart 3

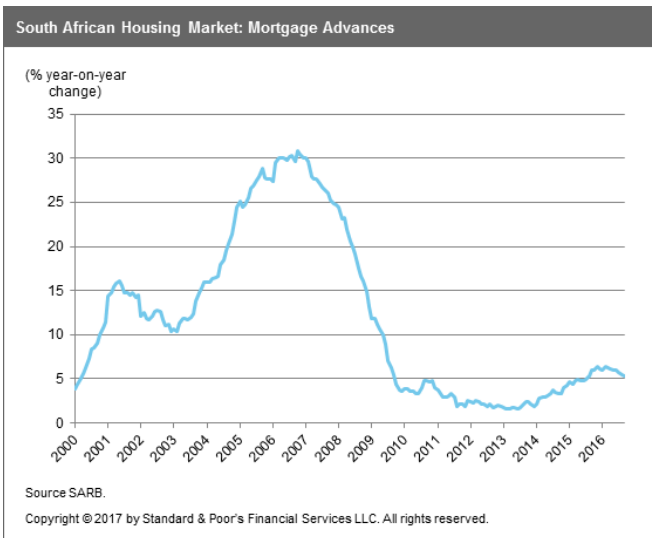
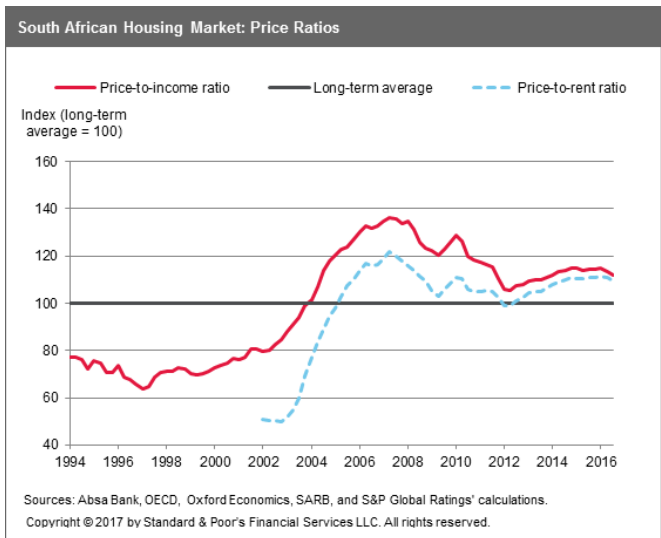


Chart 4



Only a rating committee may determine a rating action and this report does not constitute a rating action.

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