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FNB Commercial Property Finance
Property Insights

July SARB Interest Rate Decision and the Main Implications for Property Markets.

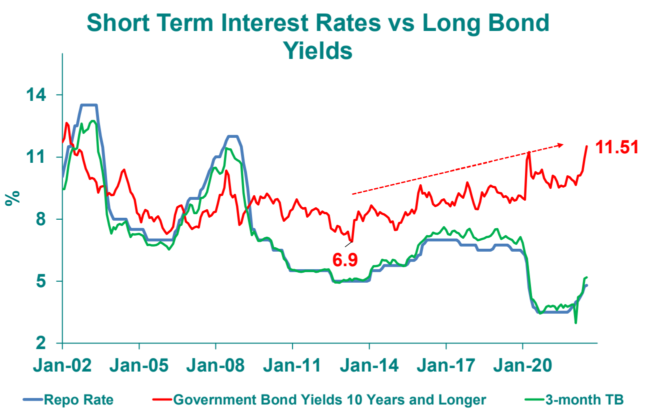
SARB hikes rates for the 5th time in the cycle, speeding up the pace of hiking as inflation accelerates. This greater magnitude of rate hiking is expected to broaden the near-term property demand slowdown, while sustaining the downward pressure on real property values. The Residential Rental Market could receive some mild support, however.

This week, the SARB (South African Reserve Bank) Monetary Policy Committee (MPC) made the decision to raise its policy repo rate by a further 75 basis points, following on its 4 previous hikes since late-2021.

This 75 basis point hike represents a "speeding up" in the pace of rate hiking from the prior meeting's 50 basis point hike.

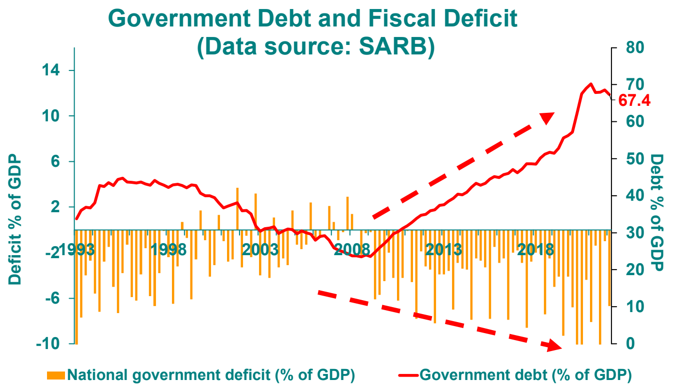
The cumulative rise in the cycle to date is now 200 basis points, and this will bring average Prime Lending Rate of the main commercial banks to 9%.

The deteriorating inflation environment that has led this faster pace of interest rate hiking, along with the rising short term interest rate cycle itself, does contribute additional upward pressure to long bond yields, and we have seen a noticeable increase in average long bond yields recently.



The upward multi-year drift in long Government bond yields began in 2013, from a monthly average low of 6.9% for bonds 10-years and longer reached in May 2013.

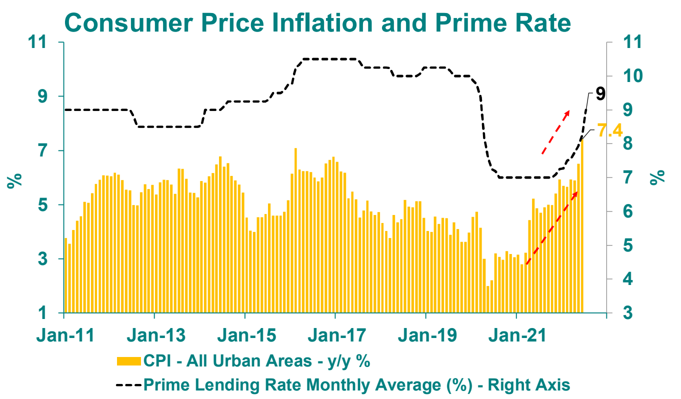
In the earlier years the upward drift in yields, a deteriorating government financial situation, bigger deficits and greater supply of bonds was arguably the key driving force.



Of late, however, a deteriorating global and domestic inflation environment has been key, precipitating the onset of rising short term interest rates.

The global inflation surge was initially driven by Covid-19 supply chain disruptions, accompanied by major demand-side stimulus packages across the globe. This has continued due more to disruptions especially to energy and food prices influenced strongly by the Russian invasion of the Ukraine, along with resultant boycotts and sanctions on Russia.

Consumer price inflation accelerated noticeably over the course of 2021.



It accelerated from a lowly 2.9% year-on-year in

February 2021 to 7.4% by June 2022.

This has put the inflation rate above the upper limit of the SARB's 3-6% CPI Inflation target range, requiring stronger policy action.

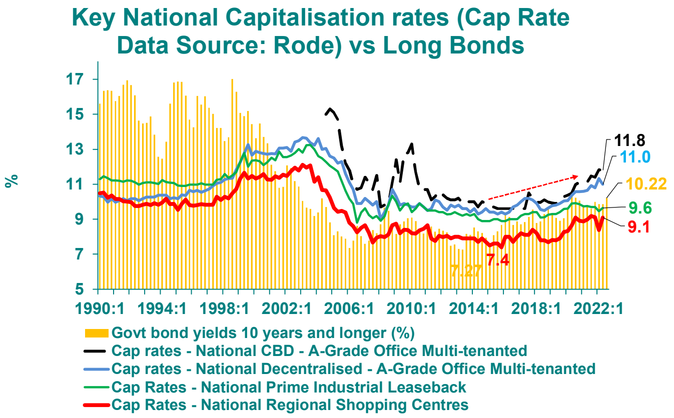
FNB expects rate hiking to continue into 2023, Prime Rate expected to reach 10% early next year.

The main expected implications for the property market are as follows:

- Ongoing upward "drift" in capitalization (cap) rates

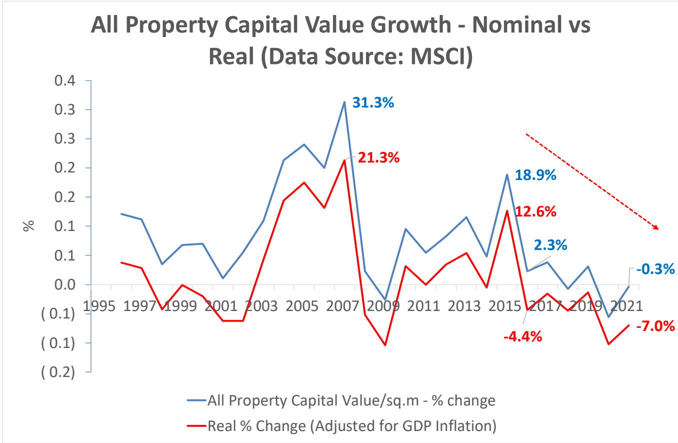
The upward pressure on short- and long-term interest rates, along with weaker near term prospects for property income as the economy comes under pressure, is expected to cause the multi-year upward drift in property capitalization rates to continue in the 2nd half of 2022.

Rode capitalization rate data shows multi-year lows recorded around 2015. Thereafter the multi-year property correction began. By the 2nd quarter of 2022, the average national CBD office cap rate (A-grade multi-tenanted) was 2.2 percentage points higher than the 2015 low, the national de-centralised office cap rate (A-grade multi-tenanted) 1.7 percentage points higher, national regional shopping centres 1.7 percentage points higher, and the national prime industrial property cap rate 0.7 of a percentage point higher.



- Further decline in real (inflation-adjusted) commercial property capital values

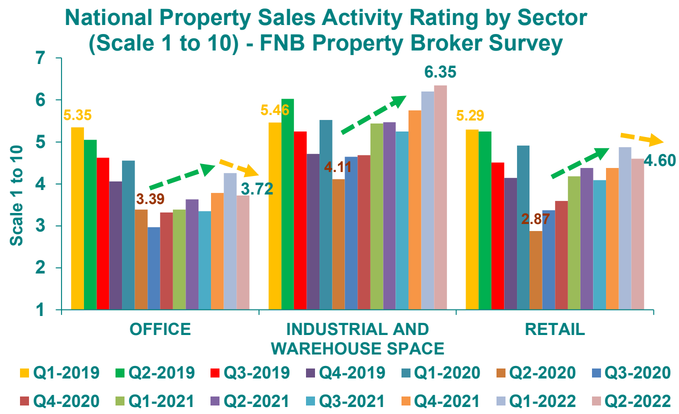
After 2015, real capital values of commercial property thus came under pressure. In all 6 years from 2016 to 2021 MSCI annual data showed a decline in the real (inflation adjusted) All Property Capital Value/Square Metre, with all-out decline in actual (nominal) value in 3 of those years. While we expect low nominal capital value growth for 2021, expected near term rise in cap rates is expected to keep 2022 in negative real growth territory.



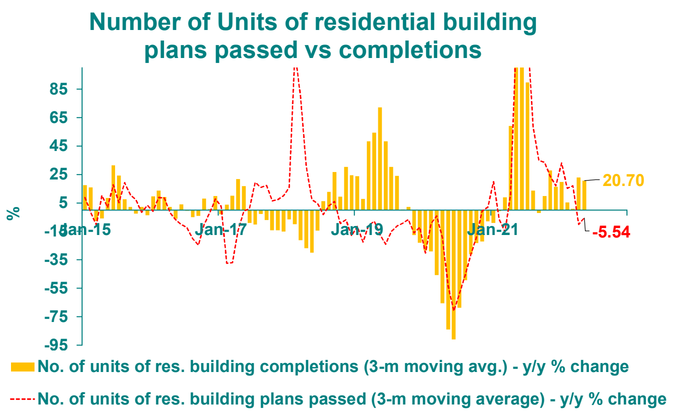
- Slowing property sales activity may spill over into the outperforming Industrial Property Market too

The accelerated pace of interest rate hiking may begin to cause cooling in sales activity to spread to the outperforming Industrial Property Market too.

The FNB Property Broker Survey began to show declines in the Property Sales Activity Ratings in Retail and Office Property Markets in the 2nd quarter of 2022, after prior strengthening, while the Industrial Market's rating continued to accelerate in that quarter. The possibility exists that further rate hiking may see the activity ratings in all 3 property classes decline in the near term.



- Further decline in residential building planning activity expected



The rising interest rate cycle is believed to have already been slowing the pace of new residential development planning, with building plans passed for the 3 months to May having already been in year-on-year decline to the tune of -5.54%.

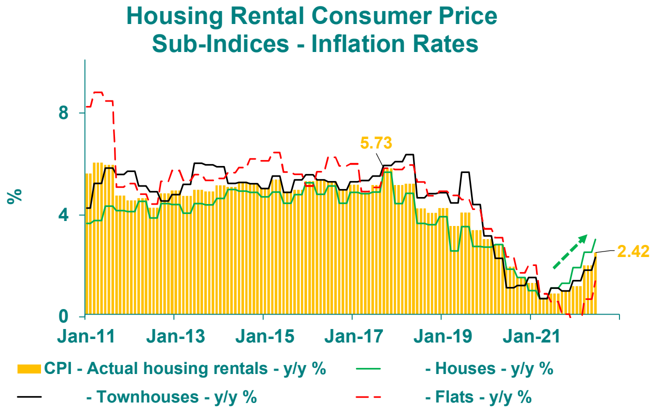
Further interest rate hiking since May is expected to lead to further year-on-year decline in plans passed in the 2nd half of 2022, which should ultimately lead to a declining rate of residential building completions with something of a lag.

- Residential rental market may receive a further mild boost from interest rate hiking

Further rate hiking is expected to provide some mild additional support for the Residential Rental Market. Typically, rising interest rates can see a portion of aspirant home buyers delaying their purchase, taking a "wait and see" approach to the interest rate hiking cycle. This can see the home buyer exodus from the rental market slowing, which in turn can lead to lower vacancy rates and higher rental inflation. In the latter half of 2021 we had already begun to see early signs of a turn in vacancy rates lower and a small recovery in rental inflation, and rate hiking could support a continuation of this mild recovery.

However, the rental tenant population is financially fragile, so interest rate hiking cannot go too far before increased financial pressure begins to hurt tenant performance and dampen the rental market. But in the near term we would still expect some mild strengthening.

By June 2022, the StatsSA CPI for housing rentals showed rental inflation having accelerated to 2.42% year-on-year, from a low of 0.6% early in 2021. TPN data has shown a decline in rental vacancy rates too over roughly the same period, which explains much of this mild rental inflation acceleration.



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