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Economic Research:

Housing Markets In Israel, Russia, South Africa, And Turkey Show Resilience To Weaker Economic Conditions

Economists:

Tatiana Lysenko, Senior Economist, Paris +33-144206748; tatiana.lysenko@standardandpoors.com
Sophie Tahiri, Economist, Paris 33 1 44 20 67 88; sophie.tahiri@standardandpoors.com
Jean-Michel Six, Chief Economist, Europe, the Middle East, and Africa, Paris (33) 1-4420-6705;
jean-michel.six@standardandpoors.com

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The housing markets we cover have shown resilience to the weakening of economic conditions last year. Strong structural demand for housing, coupled with supply constraints, are supporting the residential property market in Israel, Russia, South Africa, and Turkey. We note that the housing sectors remain sensitive to even the expectations of government programs to spur supply or aid homebuyers.

Overview

- We expect stronger GDP in Israel and a very accommodative monetary policy to support housing prices this year, with affordability and macroprudential measures acting to cap price growth in the medium-term.
- The Russian housing market has weakened considerably, notwithstanding a temporary surge in demand for residential property in 2014 because of the perception that housing is a "safe" investment amid turbulent financial and economic conditions. Government action to contain mortgage rates should support loans and construction activity, but a more sustained revival in the housing market would come only after economic and financial conditions improve.
- The South African residential property market has shown resilience to a weak economy and rising interest rates because of tight supply. However, continued weak economic growth, high consumer indebtedness, and deteriorating housing affordability should restrain home price growth over the next two years.
- Residential property prices in Turkey rose strongly in 2014. Overseas buyers' interest in Turkish real estate will continue to support the market, but strong structural demand from Turkey's young and growing population will remain the key driver of housing market activity.

Israel

The housing market softened last year primarily in response to lower demand around midyear, mainly arising from uncertainties about the timing of a government program to lower costs of homes for eligible buyers. We expect a stronger GDP performance and a very accommodative monetary policy to support house prices this year. We think that declining housing affordability and macroprudential measures--to address systemic risks emanating from rapid mortgage volume increases--will be a cap on longer-term house price growth, however.

Table 1

Israel Housing Market Forecasts					
	2012	2013	2014e	2015f	2016f
Nominal house prices, % change y/y	7.1	7.8	4.5	6.0	3.0
Real GDP, % change	3.0	3.2	2.9	3.2	3.5
CPI inflation (%)	1.7	1.5	0.5	0.2	1.6

Table 1

Israel Housing Market Forecasts (cont.)					
Unemployment rate (%)	6.9	6.3	5.9	5.7	5.7

e--Standard & Poor's estimates. f--Standard & Poor's forecast. Sources: Standard & Poor's, Central Bureau of Statistics, Datastream, OECD.

Recent trends

Activity in the housing market decelerated in 2014. Home prices grew by 4.5% year on year in November last year, down from 9.1% on average in 2013. Prices grew faster in Tel Aviv (10.2% in the fourth quarter, quarter on quarter), while they slowed markedly in Haifa (2.3%). Meanwhile, the annualized number of sales of new houses declined by 14% in November of last year compared with the same month the previous year. Reflecting the decline in house sales growth, mortgage loans slowed despite very low interest rates. Housing loans grew by to 5.2% year on year in November of last year, compared with 7.8% in November 2013.

Meanwhile, weaker home sales activity is weighing on residential property construction. Softer building activity suggests that the relative shortage of housing will only diminish slowly, which should support price momentum over the years ahead. Permits for residential buildings in the private sector declined to 27,727 units in the first 10 months of 2014, down by 8% from the same period the previous year. In October, the total annualized number of dwellings completed was just above 40,000, which is the volume consistent with the average annual increase in the number of households in the past decade. Between 2003 and 2012, however, the number of dwellings completed was consistently below this number. As a result, household formation has tended to surpass the supply of homes.

The softening in the housing market last year is primarily due to a decline in housing demand around midyear. Uncertainties about the Gaza conflict in July and August 2014 lowered consumer confidence, leading potential homebuyers to delay purchases until the end of the fighting. More importantly, expectations among households about the implementation of a government housing reform, which may lower costs of homes, may have led eligible buyers to defer home purchases and contractors to postpone construction projects.

The government has indeed proposed a value-added tax (VAT) exemption on home purchases for many first-time buyers. The aim of the reform was to make the market more affordable for this category of buyers. However, disagreement among members of the governing coalition on the efficiency of the proposal was instrumental in causing the coalition's collapse in December last year and calls for early elections in March 2015. At the end of the year, however, housing demand resumed on expectations that the government's housing reform will not go through at least until new elections. As a result, purchase transactions of new houses reached 2,600 in December, the highest in 15 years. Meanwhile, more new mortgages were taken out (New Israeli shekel (NIS) 5.5 billion in December, compared with NIS4.3 billion on average for 2014, according to the Bank of Israel).

Future trends

We expect stronger macroeconomic performance in Israel this year and subdued inflation to continue to support house prices in Israel. The Israeli economy is starting the year with strong momentum: real GDP recovered significantly in the fourth quarter of last year, growing by 7.2% on a quarter-on-quarter annualized basis. Growth was strong across the board, with fixed investment and government consumption rising significantly, while net trade also contributed positively. Growth improved as economic activity normalized after weakness in the second and third quarter owing to the conflict in Gaza and a stagnant export sector, arising from sluggish global demand and the strong

shekel in the first half of 2014. As a result, the Central Bureau of Statistics (CBS) estimates that full-year 2014 growth surprised on the upside to reach 2.9%, higher than the preliminary estimate of 2.6% in December.

We expect real GDP to accelerate to 3.2% this year and to 3.5% in 2016. Exports are likely to benefit from a weaker shekel and improved economic demand, particularly from the U.S. The NIS has depreciated 14% against the dollar since the middle of last year. Despite the strengthening of the Israeli currency against the euro since December 2014, the nominal effective exchange rate is still 3% lower than in August last year. In addition, fixed investment should recover after collapsing by 2.3% in 2014, as general business activity improves and the construction sector rebounds from diminished regulatory uncertainty surrounding the housing reform. Despite positive signs for the Israeli economy, growth will be limited by still modest external demand, particularly as growth in the eurozone continues its struggle.

Housing demand is set to continue to be supported by an improving labor market and rising disposable incomes. The unemployment rate fell sharply to 5.7% in fourth-quarter 2014, compared with 6.2% the previous quarter. Boding well for household income, the Knesset approved raising the minimum wage from NIS4,300 to NIS5,000, in three stages ending January 2017. More structurally, demographics in Israel are dynamic thanks to a high fertility rate and increasing life expectancy. CBS estimates that Israel's population will grow to reach 11.4 million by 2035, i.e., rising by an annual average 1.6%, according to its intermediate projection.

With still accommodative monetary policy, low borrowing costs are likely to continue to provide some support to demand for housing this year and in the beginning of next year, while a gradual increase in short-term interest rates early next year will prompt a deceleration in mortgage volume growth and price increases. Despite the strengthened growth momentum, we think low inflation will continue to pose a constraint on the Bank of Israel's normalization of its monetary policy. As acknowledged in the February minutes, the BoI would view a stronger GDP report with caution since it comes as a correction following a feeble third quarter, and should keep its main focus on the coming inflation report, inflation expectations, and other leading activity indicators. Inflation for January moved further into deflationary territory to -0.5% year on year from -0.2% in December 2014 and 0.5% on average last year, on the back of falling oil prices and one-off utility price cuts.

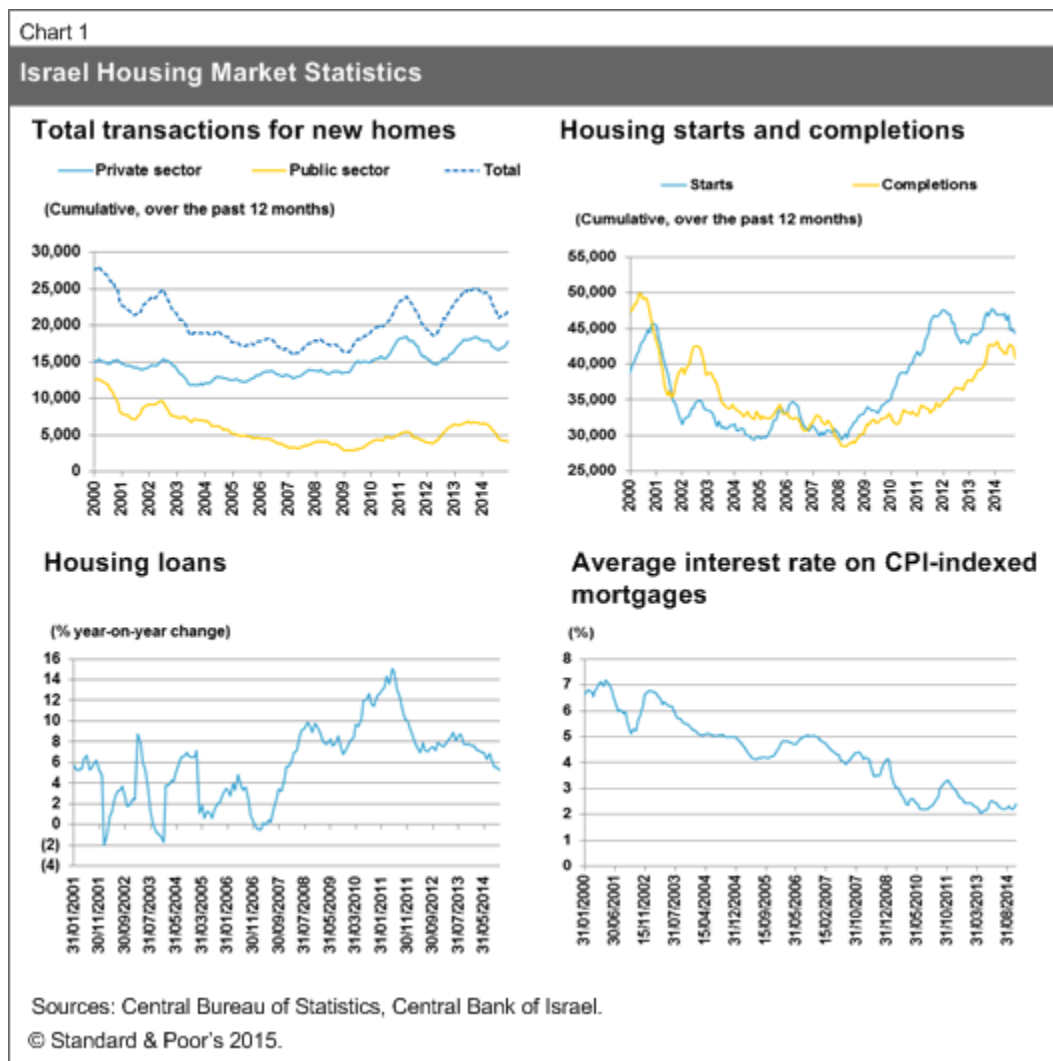
Given concerns that inflation will remain "too low for too long," and the shekel's recently renewed appreciation, the central bank has decided to further cut its key interest rate by 15 basis points (bps) to 0.1% on Feb. 23. We believe the BoI could further ease its monetary policy this year in the event of persisting upward pressures on the shekel. The BoI could rely on cuts in interest rates as well as foreign exchange interventions. We still expect the central bank to gradually start tightening its monetary policy in 2016 when inflation is expected to enter the central bank's target range for price stability. We forecast inflation to recover to 0.2% on average in 2015 and to 1.6% in 2016, on expectations of improving oil prices and of further depreciation of the shekel against the dollar owing to the divergence in monetary policy between the U.S. Federal Reserve bank and the BoI this year.

Meanwhile, uncertainty about the implementation of housing reforms after the March elections is likely to continue to weigh on the market. Activity is likely to slow around election time, and until it is clearer if and how the measures will be introduced. We think that the measures would support the market's affordability and is likely to increase housing demand. Indeed, cutting VAT for some buyers could fuel demand, and, in the context of a supply shortage, might add price inflation pressure. An inelastic response in supply to increasing demand diminishes the effectiveness of fiscal

policies aiming to support housing through targeted subsidies. Further, the government subsidy could benefit contractors more than homebuyers. If the reform is cancelled as many expect it will be, we think transactions will rebound strongly, spurred by strong pent-up demand.

However, two main factors are likely to put a cap on house price growth in the medium term. Housing affordability has eroded since 2009 with the climb in residential property prices of 85% between 2008 and third-quarter 2014. The price-to-rent ratio is well above long-term average, suggesting that homes were likely overvalued by 10% as of third-quarter 2014. Besides, household debt has surged in recent years in parallel with rising house prices, and as a result, Israel's household debt currently represents around 40% of GDP. While the levels of leverage in Israel have not reached those in other developed countries (household debt in the eurozone is around 60% of GDP), this development has led to the central bank's macroprudential measures to address the systemic risks emanating from rapid mortgage volume increases. The BoI is using a range of tools to restrict mortgage lending and try to prevent the formation of a housing bubble, including limits on loan-to-value and payment-to-income ratios. We think these measures could curtail housing demand and house growth inflation.

We expect house price growth to accelerate to 6% in 2015, driven by a release in pent-up demand before decelerating to 3% next year as interest rates gradually rise.



Russia

Deteriorating economic and financial conditions have considerably weakened the Russian housing market, in our view. We note, however, a temporary surge in demand for residential property in 2014 because of the perception that housing is a "safe" investment amid turbulent financial and economic conditions and uncertainty about future economic developments. We forecast 4% home price growth this year, which will translate into a steep decline in real terms in 2015 due to projected high inflation, and a moderate decline in real prices in 2016. The government program of subsidies to banks to keep the mortgage interest rate at the level not exceeding 13% should support the mortgage market and construction activity, but a more sustained revival in the housing market would come only after economic and financial conditions improve.

Table 2

Russia Housing Market Forecasts					
	2012	2013	2014e	2015f	2016f
Nominal house prices, % change y/y*	12.1	3.6	5.1	4.0	4.0
Real GDP, % change	3.4	1.3	0.6	-2.6	1.9
CPI inflation (%)	5.1	6.8	7.8	13.5	6.5
Unemployment rate (%)	5.5	5.5	5.2	6.0	6.0

*Existing properties. f--Standard & Poor's forecast. Sources: Standard & Poor's, Rosstat.

Recent trends

The Russian housing market has experienced several shocks over the last 14 months. Emerging market turbulence at the beginning of 2014, geopolitical tensions and international sanctions, as well as the rapid decline in oil prices in the fourth quarter of last year hit the economy, while creating highly uncertain conditions for the residential property market. The Russian ruble lost more than 40% of its value over 2014, and 18% in January 2015 alone, before regaining some of the losses in February amid stabilizing oil prices. Sharp currency depreciation, coupled with a food supply shock, due to Russia's countersanctions--a ban on a large number of agricultural products from the countries that imposed sanctions on the country--has fuelled inflation (see "Risks Mount For A Longer Downturn In Russia," published on Oct. 8, 2014, on RatingsDirect). Consumer price growth reached 16.7% year on year in February 2015, well above nominal wage growth. The latest statistics show that real wages fell by 8% year on year in January.

The Central Bank of Russia (CBR) hiked its key rate several times during 2014 to stem exchange rate and inflationary pressures. In December alone, the CBR raised the policy rate by 750 basis points (bps) to 17% amid extreme volatility in the currency market. While the central bank reduced the key rate to 15% in January 2015 and to 14% in March, it is still 850 bps higher than at the beginning of last year. The average mortgage interest rate, already elevated at above 12% at the beginning of 2014, started to rise in fourth-quarter 2014. In December, a number of banks stopped issuing mortgage loans due to the uncertainty caused by the ruble's nosedive and the rate hikes, while others set the mortgage interest rate at prohibitive levels of 30% and more, according to the Agency for Housing Mortgage Lending (AHML). CBR statistics show that the average mortgage interest rate climbed to 14.2% by January 2015. According to AHML, the minimum mortgage interest rate for most banks stood at 14.5%-16% in January, but some banks offered special rates as part of joint promotion campaigns with construction companies.

Deteriorating economic and financial conditions have considerably weakened the housing market, in our view. We note, however, a temporary surge in demand for residential property because of the perception that housing is a "safe" investment amid turbulent financial and economic conditions and uncertainty about future economic developments. Potential buyers also appear to have brought forward their plans to purchase a property. Overall, the number of mortgage deals increased by 22% in 2014, up from a 19.3% increase registered in 2013. However, lending for house purchases in January was down by about 10% compared with the same month of 2014. We believe that in a similar fashion, people frontloaded purchases of durable goods during the episodes of rapid ruble depreciation and volatility in the first quarter of 2014 and then again in December. Testifying to this trend, retail sales remained robust in the first quarter of 2014, despite the weakening economy, while in December, they surged by 5.3% year on year. In January 2015, retail sales dropped by 4.4% year on year.

Residential housing completions increased by 15% in 2014 to more than 80 million m2, the fastest increase since 2008. This is a step forward to alleviate supply-demand imbalances that exist in the market. Structural demand for better quality housing remains high in Russia (see "Emerging Market Housing Report: Demand Outstrips Supply in Israel, Russia, South Africa and Turkey," published on Aug. 11, 2014), and housing supply has been insufficient to meet demand, in particular because some of the newly built dwellings are replacing demolished stock.

Under the impact of these clashing forces, house prices rose by 5.1% in nominal terms in 2014 in the secondary market, up from 3.6% in 2013. However, in real terms (adjusted for consumer price inflation), they declined by 4% over that period, compared with a 2.7% decline in 2013. In the new home market, prices increased by 5.7% in 2014.

The share of nonperforming mortgage loans has not changed over 2014 and remains very low at about 1.5%, according to the CBR statistics. For ruble-denominated mortgages, which account for more than 95% of the mortgage portfolio of Russian banks, the proportion of nonperforming loans is below 1%. It exceeds 12% for mortgages denominated in foreign currencies, and more foreign currency mortgages are likely to move into the nonperforming category because of the ruble's drop. Most foreign currency mortgages outstanding were issued in the years preceding the 2008 financial crisis, when lower interest rates, compared with those on ruble-denominated loans, coupled with the ruble's appreciation at the time, made such loans look attractive for borrowers that underestimated the currency risk. In the aftermath of the crisis, which made currency risks evident, such mortgages have become relatively rare. Given the low weight of foreign currency mortgages in the mortgage portfolio of Russian banks, the problem with asset quality in this segment does not represent a systemic risk for the banking sector, in our view. Nevertheless, the inability of a group of borrowers to service mortgage debt remains an issue from a social perspective. Over the past three months, some borrowers took to the streets demanding a solution, such as a conversion of their loans into domestic currency ones at an "old" exchange rate. The regulator recommended restructuring the mortgages issues in foreign currency, including by converting them into ruble loans at the official rate as of Oct. 1 (at Russian ruble (RUB) 39.4/\$, compared with the current rate above RUB60/\$) and charging the prevailing interest rate for ruble-denominated mortgages. Given the interest rate hikes, the interest payments may still exceed the borrowers' capacity to service debt.

Future trends

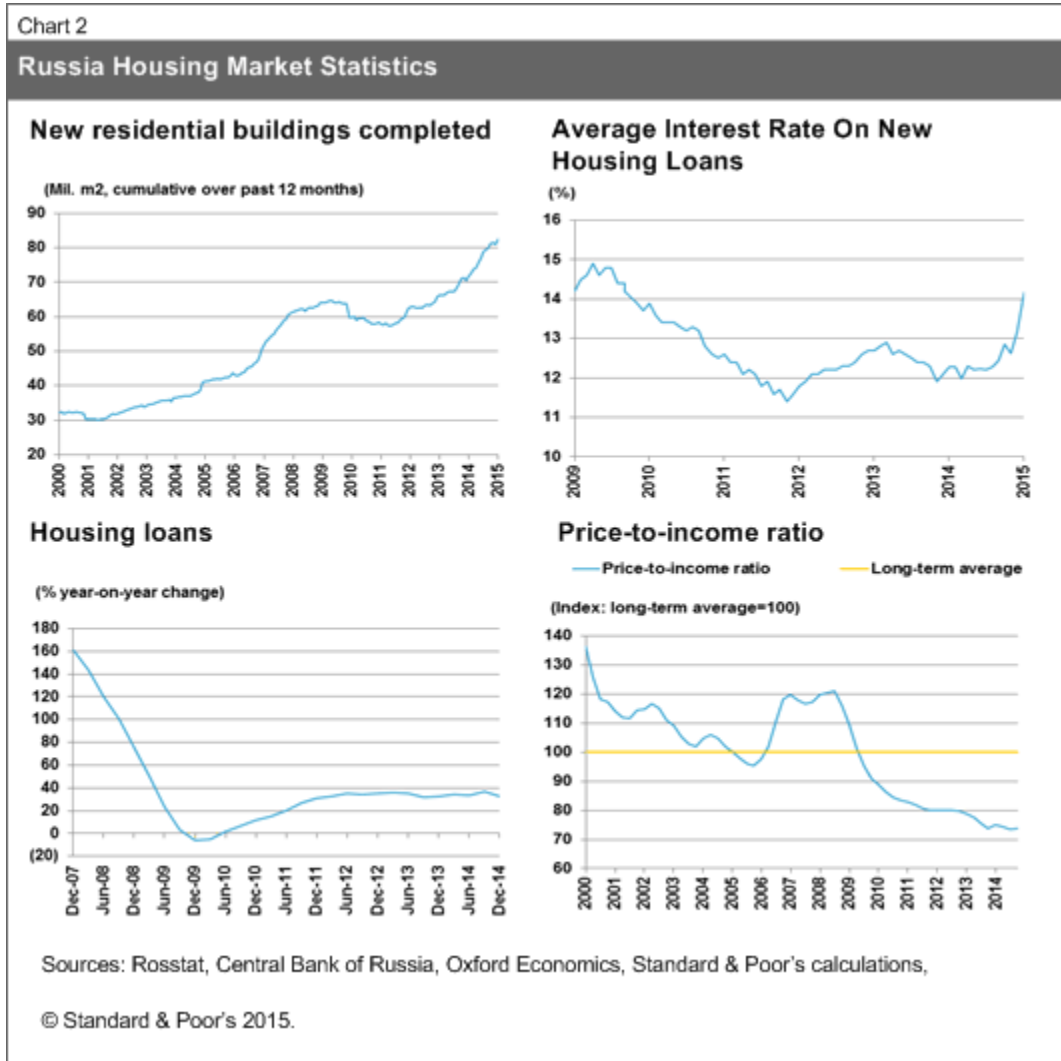
In our baseline scenario, which assumes no further worsening in the external environment, we expect a 2.6% decline in real GDP for Russia this year and a mild recovery in 2016, supported by the rebound in oil prices (See "Standard & Poor's Revises Its Crude Oil And Natural Gas Price Assumptions," published on Jan. 9, 2015). Sharp ruble depreciation, a high inflation rate, and tight financial conditions are depressing domestic demand, which we expect to contract by more than 8% in 2015. A strong projected contraction in imports--by 20% in real terms--should result in a positive contribution of net exports to GDP growth, which would partially offset the sharp fall in domestic demand. We expect that the labor market's adjustment to the external shocks will continue mostly through the fall in real wages, although we forecast a moderate increase in unemployment this year. A more pronounced decline in oil prices, the intensification of geopolitical tensions, additional sanctions--again leading to high currency market volatility--would lead to a more prolonged recession and higher unemployment.

We expect consumer price inflation to peak in second-quarter 2015, and decelerate gradually over the second half of the year, as the pass-through effect of currency depreciation on domestic prices dissipates. We note that the CBR

chose to cut rates already in the first quarter of 2015 despite still rising inflation, in anticipation of the slowdown in inflation over the forecasting horizon amid the weakening of economic activity. The move also reflects the CBR's efforts to support the banking sector and economic growth. We expect the CBR to continue to reduce the key rate gradually over 2015.

We expect the housing market to weaken this year, given a decline in real income and a rise in unemployment. We forecast a 4% rise in nominal house prices, which will translate into a steep decline in real prices given a high projected inflation rate. We expect similar nominal price growth in 2016, which will imply a moderate decline in real prices that year under our forecast of decelerating inflation.

We note that the government has approved the measures to support the mortgage market--and also construction activity--by subsidizing banks that issue mortgages between March 1, 2015, and March 1, 2016, at the rate of 13%. Such subsidies would only apply to mortgages issued for the purchase of newly built dwellings. So far, the supply of residential property has continued to expand. In January, 6.2 billion m2 of new dwellings were completed, a 34% increase compared with January 2014. However, the recently completed projects were initiated before 2014, and worsening economic and financial conditions could bring the construction sector to a halt, as was the case in 2008/2009. We believe the government's plan could lend support to the mortgage market and construction activity, but a more sustained revival in the housing market would come only after economic and financial conditions improve.



South Africa

The South African residential property market has shown resilience to a weak economy and rising interest rates. House prices have increased by 9.5% over 2014, the strongest gain since 2007, or by 3.6% in real terms (adjusted for consumer price inflation). Housing supply constraints are supporting the market. The still subdued macroeconomic outlook, high level of consumer debt, and deteriorating housing affordability should restrain home price growth over the next two years, especially if supply constraints ease. We therefore forecast slower nominal and real house price gains over 2015 and 2016. In the medium term, high structural demand for better quality homes will maintain the upward pressure on prices.

Table 3

South Africa Housing Market Forecasts

	2012	2013	2014	2015f	2016f
Nominal house prices, % change y/y	5.4	8.8	9.5	7.5	8.5

Table 3

South Africa Housing Market Forecasts (cont.)					
Real GDP, % change	2.2	2.2	1.5	2.5	2.9
CPI inflation (%)	5.7	5.8	6.1	4.4	5.5
Unemployment rate (%)	24.9	24.7	25.1	24.3	23.9

f--Standard & Poor's forecast. Sources: Standard & Poor's, ABSA, SARB, Statistics South Africa.

Recent trends

GDP and employment growth were subdued in 2014, at 1.5% and 1.9%, respectively. The economy contracted by an annualized rate of 1.6% in the first quarter and recovered only moderately in the second against a backdrop of prolonged labor unrest and electricity supply shortages. Growth improved in the second half of the year as the strikes came to an end.

The South African Reserve Bank (SARB) raised its policy rate in January 2014, for the first time in six years, to counteract exchange rate and inflationary pressures brought about by financial market turbulence at the beginning of the year. Another rate hike in July 2014 brought the policy rate to 5.75%, a cumulative increase of 75 basis points from the beginning of the year.

Unemployment increased to 25.1% in 2014, the highest level in the decade, as employment growth did not keep pace with the increase in the labor supply. The labor market was also under pressure from a prolonged period of strikes, with 11.6 million work days lost due to industrial action in the first nine months of 2014, compared with 4.7 million over the same period of 2013, according to Andrew Levy Employment Publications. Households' disposable income growth decelerated to 7.3% in nominal terms over the first three quarters of 2014, just 1 percentage point above inflation. These trends weighed on private consumption, which grew by merely 1.2% in the first three quarters of 2014, down from 2.9% in 2013 and an average of 4.3% in 2010-2012.

In this environment, the residential property market has demonstrated resilience, with home prices in the middle segment of the market rising by 9.5% in 2014, according to ABSA bank. The ABSA property price index for the middle segment--comprising homes of 80-400m² priced up to South African rand (ZAR) 4 million in 2014--is widely used as a benchmark for South Africa's residential property prices. ABSA data also show that prices for affordable houses (homes of 40m²-79m², priced up to ZAR545,000 in 2014) were up 7.4%, while luxury houses (priced at between ZAR4 million and ZAR14,6 million) saw their values increasing by 15.7% in 2014. For all categories of housing, prices grew faster in 2014 compared to 2013, especially for the luxury segment, although a relatively small number of transactions in this particular niche may distort such comparisons.

Accelerating consumer price inflation partly eroded nominal price gains in the first half of 2014. However, the situation changed toward the end of last year, as inflation slowed down sharply, to 5.3% in December, reflecting a pronounced decline in international and domestic energy prices and a slowdown in food price growth. As a result, in real terms, the middle segment of the housing market gained 1.7% over the fourth quarter alone, and 3.6% over 2014 as a whole.

In our view, one of the key factors that explains the resilience of the residential property market is the gap between housing supply and demand. Structural demand for better-quality housing in South Africa is strong, given the country's young and growing population and rising urban middle class. According to a study on the emergent middle class by

Stellenbosch University, Wits, and the University of Pretoria, the share of population defined as "middle class" based on an income threshold increased to 14% from 8% between 1993 and 2012, with the share of black South Africans in the middle class rising to 41% from 11%. According to the same study, the middle class is far more likely to own a house than the population in lower income brackets.

Investment in residential buildings declined by 7% in the year to third-quarter 2014 compared with the year before, and is now almost 40% below the peak levels of 2006-2007. In another sign of supply constraints, a number of privately financed residential buildings completed in 2014 fell by 11% compared with the previous year, to below 35,000. More than that, a significant part of the existing residential housing stock is of poor quality. We reckon that this imbalance between supply and demand puts upward pressure on home prices.

While the predominant mortgage interest rate has increased to 9.25%, it is still relatively low by historical standards, providing some support to the market. The stock of residential mortgages taken by South African households increased by 2.7% over 2014, up from 2.4% in 2013. While showing some positive dynamics, this is far below the rate of expansion of 20%-30% during the housing boom in the mid-2000s. The level of household debt remains elevated at above 78% of disposable income, according to SARB's revised estimates, even though it has dropped by more than 10 percentage points from its peak of 2008-2009. This entails a substantial debt service cost for households of about 9% of disposable income. What's more, the share of income going to debt service has increased recently, with the SARB's policy rate hikes directly affecting borrowers, since mortgages are issued predominantly at variable interest rates. This limits demand for new loans.

Affordability indicators have continued to deteriorate, as price gains have exceeded households' per capita income growth since 2012. By third-quarter 2014, the deviation of the price-to-income ratio from its long-term average (calculated over 1994-2014) exceeded 14%, up from 8% in 2012.

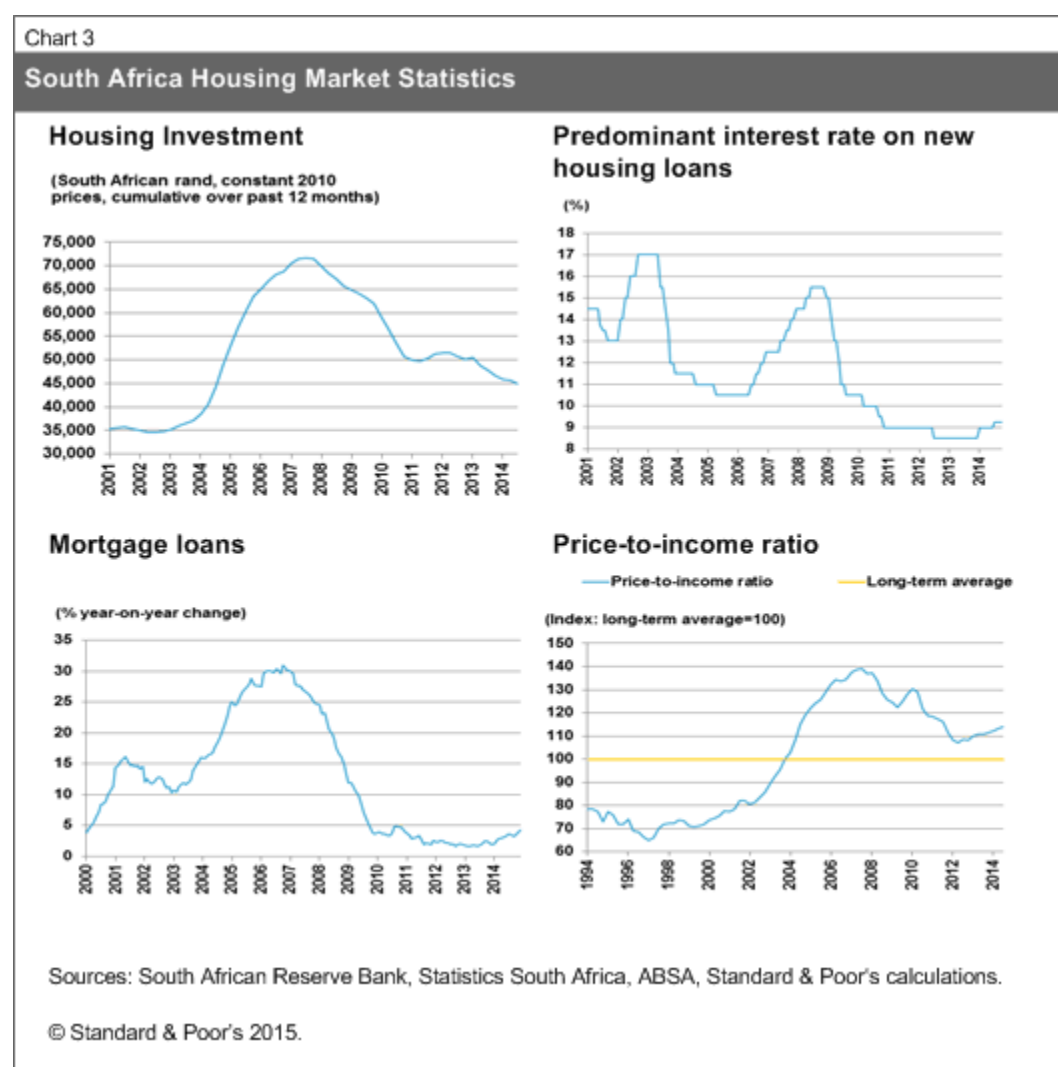
Future trends

Lower oil prices should support disinflation in 2015, improving the purchasing power of South African consumers. On the other hand, we anticipate that power supply constraints will continue to weigh on economic activity through a direct negative impact on production and an indirect impact on confidence. A structural slowdown in China, South Africa's major exports destination, could take a toll on exports. Slower growth in China is also putting downward pressure on prices for commodities exported by South Africa, partially offsetting positive terms-of-trade gains from the falling price of oil. Overall, we expect a moderate pick-up in GDP growth this year and next, to 2.5% in 2015 and 2.9% in 2016. This will translate into 1.6% per capita GDP growth in 2015, and 2% in 2016.

A pick-up in real household income growth on the back of falling inflation should prop up housing demand in the short term. However, the market will continue to face headwinds from a still high level of household indebtedness. We nevertheless expect the cost of debt service to fall this year, based on our assumptions of continuing deleveraging and interest rate stability. The latest assumption reflects our expectations of the pause in the SARB's tightening cycle, given the decline in headline inflation and subdued growth prospects for the economy. We note, however, that the SARB has been cautious in interpreting the slowdown in headline inflation as a sustained trend, pointing out to a limited decline in core inflation and the uncertainty about the oil price outlook. An easing of monetary policy in the near term is therefore unlikely, in our view.

We expect supply constraints to ease gradually, based on the pick-up in recorded building plans. According to the South African Statistical Office, the larger municipalities approved building plans for 53,000 privately financed housing units in January-November 2014, a 13% increase compared with the same period of 2013. This should exert downward pressure on home prices over the coming years.

In our view, structural demand for better-quality housing in South Africa will continue to grow in the years to come, based on socio-demographic trends. The above-mentioned study on emergent middle class by three South African universities suggests that the black middle class will continue to expand--assuming moderate economic growth--and strive to attain similar asset levels to the established middle class.



Turkey

Residential property prices in Turkey rose strongly in 2014, gaining more than 16% in nominal terms. Real price gains exceeded 7%, up from 6% recorded last year. The market softened temporarily in the first half of 2014 amid slowing

economic growth and interest rate hikes, but rebounded strongly as monetary conditions loosened and confidence returned. We forecast a continuation of nominal and real home price appreciation over the next two years. Funding conditions are likely to remain supportive for the housing market in the near term. Overseas buyers' interest in Turkish real estate will continue to support the market, but strong structural demand from Turkey's young and growing population will remain the key driver of housing market activity.

Table 4

Turkey Housing Market Forecasts					
	2012	2013	2014e	2015f	2016f
Nominal house prices, % change y/y	11.5	13.8	16.5	14.0	13.0
Real GDP, % change	2.1	4.0	2.9	3.0	3.0
CPI inflation (%)	8.9	7.5	8.9	6.5	6.3
Unemployment rate	8.3	8.9	9.8	10.1	10.3

e--Standard & Poor's estimates, f--Standard & Poor's forecast. Sources: Standard & Poor's, CBRT, Turkstat.

Recent trends

GDP growth slowed in 2014 to 1.7% year on year in the third quarter, as the economy rebalanced away from credit-driven domestic demand toward more exports. The year saw a tightening of external and domestic financial conditions in the beginning of 2014, a hit to consumer purchasing power due to a surge in inflation in the first half, as well as the impact of macroprudential policies to reign in credit--all of which depressed domestic demand. Private consumption growth decelerated to 0.2% year on year in third-quarter 2014, while investment fell by 1.4% in the first nine months of 2014 compared with the same period of 2013. Net exports have been a major contributor to growth, helped by a more competitive currency. We estimate that GDP growth averaged 2.9% in 2014.

The Central Bank of the Republic of Turkey (CBRT) hiked interest rates at the height of financial market turbulence in January 2014, raising the average cost of funding to 10% from 7%. Between April and August 2014, the CBRT gradually eased monetary policy, lowering various policy rates at a different speed, including three cuts in the key policy rate to 8.25% in July from 10% in January. After a five-month pause, the CBRT resumed loosening policy at end-January 2015, cutting the key rate to 7.5% and bringing the average cost of funding to 8% in February 2015. Headline inflation fell to 7.6% year on year in February, a 2 percentage point decline since the peak in August, on the back of falling oil prices. However, a slowdown in core inflation has been much less pronounced. The Turkish lira has been under depreciation pressure since end-January, possibly reflecting concerns of some international investors about a premature loosening of monetary policy due to the perceived weakening of the central bank's independence.

Economic and financial conditions in the first half of last year weighed on the Turkish housing market. The average mortgage interest rate climbed to 13.6% in April 2014, up from 8.3% at the low point in June 2013, and mortgage lending growth started to decelerate. By May 2014, home price growth slowed to 3.6% year on year in real terms, compared with 6% in December 2013. Home sales were down 10% in the first seven months of the year.

However, the loosening of monetary conditions and improving external environment, which boosted confidence, started to prop up the residential property market from mid-2014. Mortgage interest rates have been trending down since April 2014, dropping to 10.8% by mid-February 2015. Lending for house purchases picked up in autumn, although by December growth rates were still twice as low as in 2013, at 13.5%.

Home price growth accelerated in June, and nominal price appreciation for 2014 as a whole exceeded 16%. Real price gains reached 7.4%, up from 6% recorded in 2013. This is the strongest increase since 2010, the year when the CBRT started publishing house price statistics. Istanbul led the market, with nominal prices growing by 25%, up from 20% over 2013. For most regions, nominal home price gains in 2014 were stronger than in 2013. Market activity rebounded, with home sales posting a 15% increase during August-December 2014 on the same period of 2013.

Strong structural demand from Turkey's young and growing population is the main driver of housing market activity, in our view. The number of households increased by 30% to 19.5 million from 15 million between 2000 and 2011, according to the Population Census, reflecting both fast population growth and the decline in average household size. The average home contains 1.1 rooms per person, less than the OECD average of 1.6 rooms per person and is one of the lowest rates across the OECD, according to the OECD Better Life Index (2013). Moreover, a considerable part of the housing stock needs to be modernized or replaced. Testifying to the needs to improve housing conditions, only 67% of people in Turkey say they are satisfied with their current housing situation, much less than the OECD average of 87% and the lowest level among OECD countries, according to the OECD Index.

Foreign demand for Turkish residential properties has continued to support the market. Demand from overseas buyers has surged following the opening of the market to foreign owners in 2010 and ensuing liberalization measures. Valuations remain attractive: in December 2013, the average price per square meter stood at US\$733, or €535, according to our estimates based on ReidIn data. In upmarket areas of Istanbul, it was about US\$2000 per square meter. Home sales to foreign buyers rose by 55% in 2014, albeit from a low level. The share of sales to foreigners in total house sales accounted for 1.6% in 2014, up from 1.1% in 2013. In another sign of the increased interest of overseas buyers in the Turkish property market, Turkey's central bank reported a rapid rise in foreign direct investment in real estate in the first three quarters of 2014.

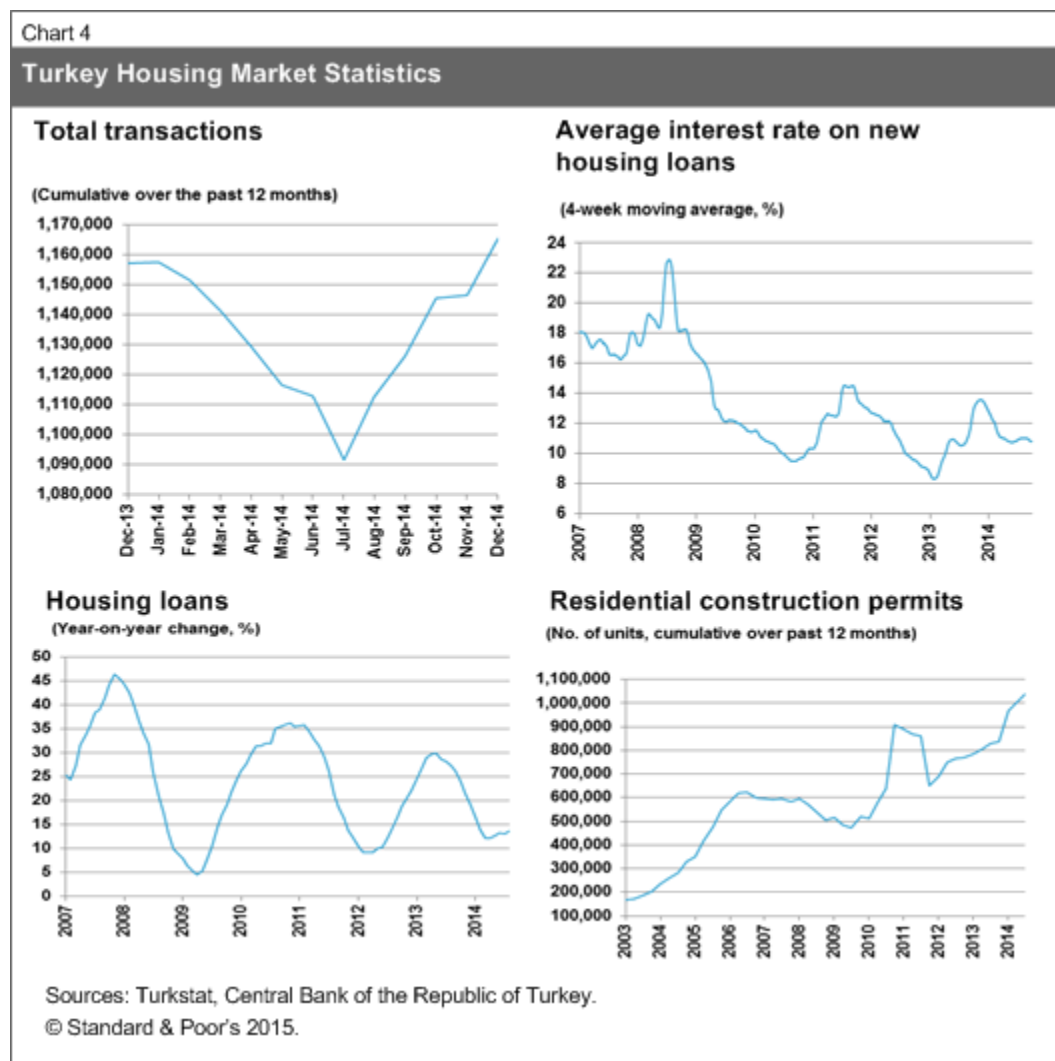
Future trends

We expect domestic demand to rebound in 2015, supported by more accommodative monetary conditions and a boost to real incomes due to falling headline inflation on the back of lower oil prices, supporting demand for residential properties this year. We forecast 3% GDP growth for 2015 and 2016, similar to 2014. We anticipate domestic demand taking the lead in 2015, with net exports contributing only modestly to growth. We note an upside risk to our forecast from a potentially stronger boost to domestic demand from the positive terms-of-trade shock linked to falling oil prices. The diverging monetary policies of major central banks, with a possible rate hike by the U.S. Federal Reserve Bank on the one hand, and quantitative easing by the European Central Bank on another, creates an uncertain environment regarding prospects for foreign capital flows to Turkey. Given Turkey's dependence on such flows, this introduces both upside and downside risks to the forecast.

In addition to our projections for strong housing demand in 2015, we also anticipate a strong supply response. The number of dwelling units authorized for construction exceeded 1 million in the year to September 2014, a 25% increase compared to the same period of last year. If these plans move forward, they should limit price pressures somewhat, although we still expect the market to post strong gains in nominal and real terms, of 14% and 7%, respectively.

Strong underlying demand for housing will support the market in the medium term. The Turkish population is

expected to grow by about 11%-12% between 2012 and 2023, according to the Turkish Statistical Institute. Istanbul's population is projected to increase by 20% over this period, to 16.6 million by 2023. Household formation trends suggest that the number of households may increase even faster. A very strong supply response is needed to accommodate this demand, especially given the need to modernize and replace part of the housing stock.



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