

House price indices cause misinterpretation of property values

 By [John Loos](#)

5 Nov 2015

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These claims, or assumptions, around property values are often a little far fetched, and we believe that they stem, in part, from a misinterpretation of the most commonly used measures of home prices, namely house price indices. Home values fluctuate just like any other asset class would in response to changes in economic conditions, but a house price index is something different, not measuring all existing home values but, rather, transaction prices - and there is a big difference. There exists a view that property values are capable of by-and-large 'holding up' in tougher economic times, some even believing that home values 'can only rise'. Such views were even arguably behind the massive mortgage lending boom across much of the world last decade.

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Three important points

Such claims ignore three important points. Firstly, a country such as South Africa, with its general inflation rate, should see average (nominal) house prices rising more than they fall. Indeed, examining the FNB House Price Index, there was only one year in its 14 year history in which the average house price for an entire year declines. Looking back further, using the Absa House Price Index with its 49 year history, we can only find three years in which the average house price for the entire year fell.

However, in real terms, adjusting for consumer price inflation over time, we find 24 such years of decline, a very different picture. Yes, 'downward corrections' are more common than many may believe.

Secondly, the average house price level, as depicted by a house price index, is not necessarily the 'market equilibrium' price. When residential demand slumped back in 2008, not all of the weakness was felt in a decline in the average house price. There was some decline in house prices, but there was also a very significant rise in the average time on the market, as many sellers resisted dropping their asking price to where they could make the sale (as many home owners tend to do). The result was an oversupplied market, with the market price remaining well-above the 'equilibrium price' which would be required to clear the market.

But thirdly, and perhaps most importantly, a house price index is NOT a national home value index. This may sound strange, but there is a big difference. Any of the South African house price indices that exist are based on the value of home transactions. If it were possible to value each and every home every month, we could compile an average value of all the homes in South Africa, but this is impractical. So we use transaction value information.

Bias in transaction value data

There is a considerable bias in transaction value data towards the higher end of the residential market, because people higher up the income ladder are more mobile, relocate more frequently, and this implies that there is a disproportionately large number of transactions in the higher priced segments relative to the number of residential units that exist.

Conversely, towards the low end of the market the frequency that homes get transacted declines. The most affordable segment of the residential market, depending how you segment it, is the group of areas formerly labelled as 'black townships' back in the apartheid era. Here, one finds a massive number of residential units, but with relatively few transactions, because the lowest income groups don't have the means to relocate frequently.

So, in toughening economic times, one can see a slump in the volume of residential transactions being more significant in more financially pressured areas, and of course the number of such financially pressured areas can increase in number during recessionary and stagnant economic periods.

The influence of such areas or market segments on an overall house price index can then decline, whereas stronger market segments' transaction volumes could conceivably hold up better. Such relative shifts in transaction volumes can see house price indices telling a better story than 'on the ground' reality, should the weakest areas' transactions have all but dried up.

Periods of economic weakness

It can get even worse. When certain areas experience extreme decay, as is arguably more likely during prolonged periods of economic weakness, it can get to a level where they exit the formally traded residential market altogether. Parts of the Joburg CBD and surroundings must have come close to this state at the end of the 1990s. If little or nothing gets traded in such areas, then there are no transaction prices to be included in the national house price index.

However, even if derelict and overrun by vagrants, every property still has a value. That value can be zero, and there were probably even properties in the Joburg CBD at a stage that were negative. Yes, negative, meaning that the owner may have to donate the property to someone or even pay them to take the property and its huge rates bill off his hands. But zero value properties don't often change hands, so they 'exit' a house price index in much the same way as a liquidating company will exit the stock exchange's All Share Index.

Such 'exits', or 'diminished influence' of certain areas on an (transaction-based)) index, can become more frequent in an economic downturn, raising the likelihood that a house price index can over-estimate how well residential values have held up in tougher economic times. This, we suspect, may have been leading to claims by some regarding Zimbabwean property values 'holding up' in its economic crisis. The traded market can shrink dramatically in size in such

circumstances, and it is those properties still traded whose prices can hold up reasonably, but not necessarily the broader average value of all property stock.

Stagnating economy

So, in South Africa, with its 'not imploding but indeed stagnating' economy, are we at risk of underestimating the extent of property value decline to come? Yes, it is possible, depending on how weak the economy gets before it gets better.

A slowing house price index growth rate is unlikely to tell the full story of residential weakness should it occur, because such an index only records what gets transacted, and not what has 'exited' the residential market, while the market price can also remain significantly above equilibrium price for lengthy periods of time.

This doesn't render house price indices useless, but, but one has to understand what you are dealing with, and what it can and cannot tell you.

The reality is, though, that home values can and do fluctuate up and down, perhaps more than we think and more than a house price index would tell us. Just ask the property owners in Joburg CBD and immediate surroundings back in the 1990s.

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