3rd Quarter Residential Property Review

– *Weakening demand and strong supply sees price growth slowing, with the household still battling to rebuild the balance sheet*

FNB Property Barometer

FNB PROPERTY MARKET ANALYTICS

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JOHN LOOS:
FNB HOME LOANS STRATEGIST
011-6490125
John.loos@fnb.co.za

EWALD KELLERMAN:
PROPERTY MARKET ANALYST
011-6320021
ekellerman@fnb.co.za

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1. SUMMARY

According to the FNB House Price Index, year-on-year price increase is slowing again, after a brief respite earlier in 2010. In the 3rd quarter, the average house price increased by 7% on a year-on-year basis, down from 11.3% in the previous quarter. The picture was slightly better than the national average in the Full Title Market, with the Full Title Index recording 3rd quarter year-on-year increase of 8.7%, but the overall index was dragged down somewhat by the Sectional Title Market, with the Sectional Title Index increasing by a slower 3.9%.

On a quarter-on-quarter basis, the overall average house price index declined by -1.5%. The FNB House Price Index is not seasonally-adjusted, so one must be cautious with month-on-month interpretations, but other statistics suggest that there is reason to believe that this price slowdown is more than just seasonal.

The FNB Valuers' Market Strength Index has remained negative all through the mini-recovery of 2009/early-2010, which suggests weak demand relative to supply. Recently, this index has started to deteriorate further, with the valuers rating supply stronger in recent times while also perceiving demand to be weakening. In the 3rd quarter of 2010, the Market Strength Index recorded a level of -0.171, which is a slight weakening on the previous quarter's 0.167.

The sample of estate agents surveyed in the FNB Estate Agent Survey effectively also point to an unbalanced market, or otherwise put an unrealistically priced market, with the average time that a property is on the market prior to sale being estimated at a lengthy 15 weeks and 4 days. This would appear too long for the market to be deemed as a strong one, suggesting that asking prices are still too high given the weak level of residential demand. In the healthier times of 2005 and 2006, the average time on the market was generally below 2 months.

Considering the above factors, along with a host of economic factors, we retain the expectation of average price decline for 2011 as a whole, after an expected 6.4% increase in the 2010 average price over 2009's average price.

When the market is unbalanced in favour of supply, either demand has to catch up, supply has to drop, or prices have to fall. Indications are that supply of existing property is strong, with high levels of financial stress-related selling. Indications are also that residential demand is currently weakening. That leaves a price decline as seemingly the logical outcome.

We believe that the following factors have restricted the level of demand even throughout the 2009/early-2010 "mini-recovery":

- *A very high level of household sector debt-to-disposable income ratio, which remains high despite some decline from the early-2008 peak level. The SARB put the 2nd quarter debt-to-disposable income ratio at 78.2% for the 2nd quarter ; only marginally down from the 82% peak early in 2008.*
- *SA's low savings rate, which affects the household sector's ability to afford the deposit requirements that have been re-instituted by banks in recent years. The SARB estimates net dis-saving at a poor -0.2% of household disposable income.*
- *The need for the slow process of rebuilding financial "buffers" after the recession.*
- *The urgent need to address certain fixed investment and important consumption expenditure backlogs, built up in the recession period, which can further delay the recovery in residential demand to satisfactory levels. Home maintenance and vehicle replacement are a possible 2 such expenditure items.*
- *Ongoing mediocrity in the rental market, translating into mediocre average residential yields, which makes the investment buying of property unattractive for many. In addition, this era of low capital growth relative to interest rates contains speculative demand;*

We believe that the following factors have led to a slowing in residential demand from the already mediocre levels of the early-2010 "mini-peak":

- *Signs of slowing global, and thus local, economic growth, which in turn negatively impacts upon household sector real disposable income growth.*
- *A lack of interest rate stimulus since August 2009, which means that the positive impact of the more aggressive part of the rate cutting cycle up until August 2009 is probably starting to wear thin.*

Finally, the traditional housing affordability ratios don't indicate a major problem with housing affordability levels per se. Price/average employee remuneration and mortgage installment/average employee remuneration ratio appear to be back around 2004 levels, reflecting a few years of improvement in affordability. However, these affordability measure don't tell the full story, as job loss has meant that there are less average wage earners around compared with a few years ago. So, much of the pressure on the residential market comes more from other non-property (though some times related to property) expenditure items that suppress residential demand, along with weak economic and household income growth for the household sector as a whole..

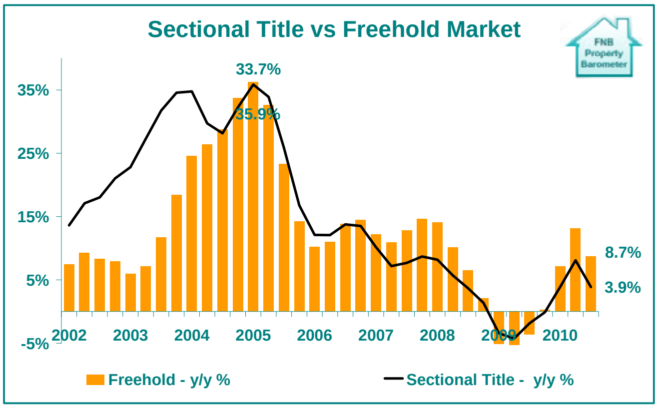
2. FOCUS ON KEY MARKET SEGMENTS – SECTIONAL TITLE VS FREEHOLD

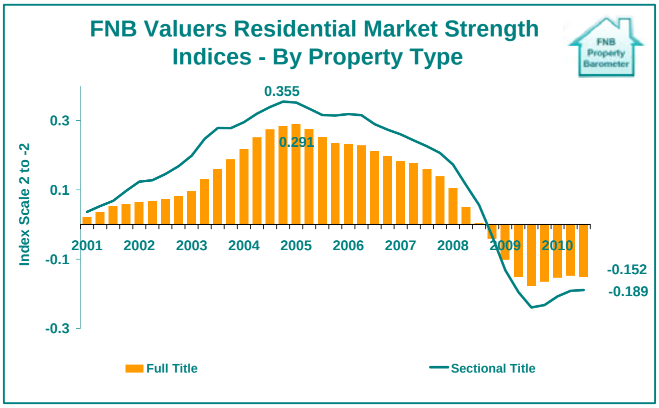
The Full Title Market Segment appears to be more solid than the Sectional Title Market Segment.

Examining trends in some of the key market segments, it would appear that the Sectional Title Market has remained a lot flatter through the recent 2009/10 "mini-cycle", when compared to the Full Title Segment. While both the Full Title and Sectional Title Markets have shown a peaking in the year-on-year rate of average house price increase in the 2nd quarter of 2010, with some slowing in the 3rd quarter, the Full Title average house price increase still measured 8.7% in the third quarter, while the Sectional Title rate of increase was a mere 3.9%.

Further supporting the price trend evidence are the readings of the FNB Valuers' Market Strength Indices. The views of FNB's valuers regarding demand and supply conditions in different areas and for different types of property are used to construct these market strength indices. Each time an FNB valuer values a house, we ask him/her to provide a subjective view of both demand and supply conditions in the area and for a property type. They rate both demand and supply either as "good" (assigned a value of +1), average (a value of 0) or "weak" (a value of -1). We aggregate both the demand and supply ratings, before subtracting the supply rating from the demand rating.

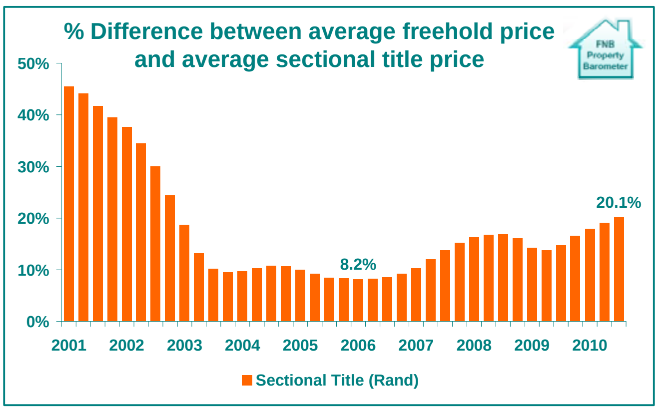
In the 3rd quarter, the difference between the 2 ratings, i.e. the Market Strength ratings, were -0.152 in the case of Full Title properties, and a weaker -0.189 in the case of Sectional Title properties. This is a reversal of the relative positions since the peak of market strength back in 2004/5, when the Sectional Title Market Strength Index peaked at 0.355, while the Full Title Index peaked at a lower 0.291, suggesting a more extreme weakening in the Sectional Title Market, compared to the Full Title Market, since the peak of the boom.





While the 2 Market Strength Indices show different levels of strength, it is also noticeable that both the Full Title as well as the Sectional Title Index are moving in a similar direction, with the 3rd quarter Full Title level slightly weaker and the Sectional Title index level flattening out after a few quarters of improvement.

Our belief is that the Freehold Segment, anchored by the "suburban" 3 bedroom family market, was less of a first time buyer and buy-to-let target during last decade's boom than was the Sectional Title Market. This, we suspect, was important in keeping the Full Title Market a little more stable through the cycle, because established family demand is more steady, not "shooting the lights out" in demand booms while also not sinking to quite the same lows in the bad times as does non-essential "buy-to-let buying, or 1st time buying.

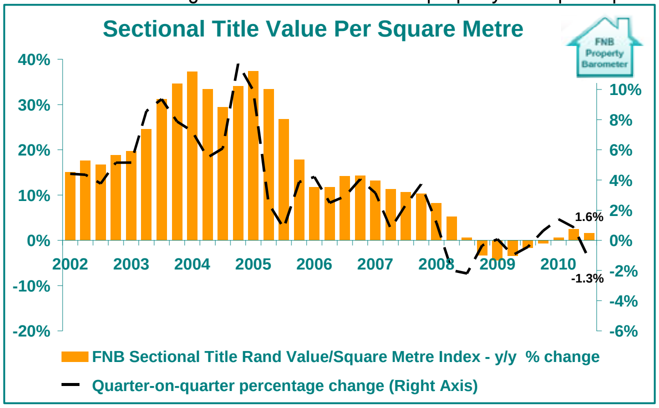


In addition, during the boom years, the creation of new stock was far more vigorous in the Sectional Title Segment, arguably helping to create a more oversupplied market thereafter.

All of this has meant that since around 2007, the Full Title Market has noticeably widened the gap between its own average price and the average Sectional Title Price to 20.1%, from a low point of only 8.2% early in 2006. This came after we had witnessed a rapid narrowing in the gap from 2001 to 2004, the period in which the property boom was gathering momentum and sectional title demand was extremely strong.

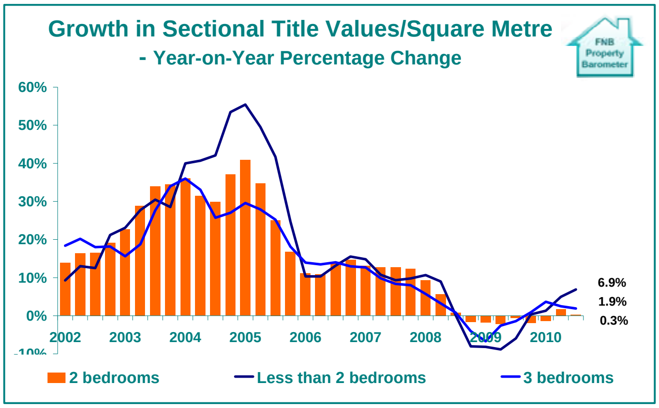
A per square metre Sectional Title Value Index.

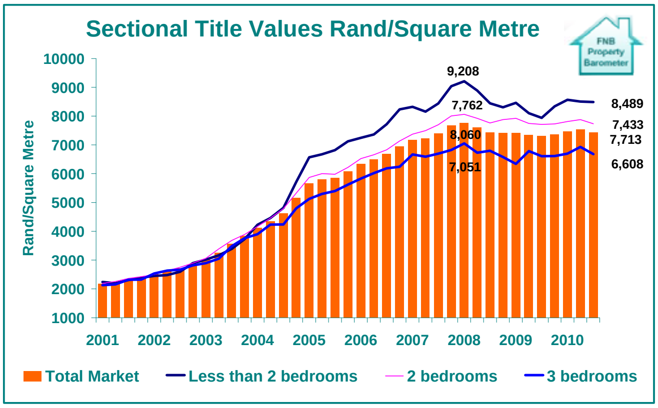
In order to dig deeper into Sectional Title Market trends, we have developed the FNB Sectional Title Value Per Square Metre Index, which estimates the average value of sectional title property on a per square metre basis. This is a more accurate measure of price trends, as it reduces the effect of changes in the size composition of property transactions over the cycle. The index is a fixed-weighted average of the 4 main Sectional Title Market sub-segments, i.e. the "Less than 2 Bedroom Segment, the 2 Bedroom Segment, the 3 Bedroom Segment and the 4 Bedroom Segment". The 2 Bedroom sub-segment is by far the largest of the Sectional Title Market, accounting for almost half of the overall index.



On a per square metre basis, the average value of sectional title properties rose by 1.6% year-on-year for the 3rd quarter, down from the previous quarter's 2.5%. On a quarter-on-quarter basis, the average value has re-entered decline, to the tune of -1.3% in the 3rd quarter.

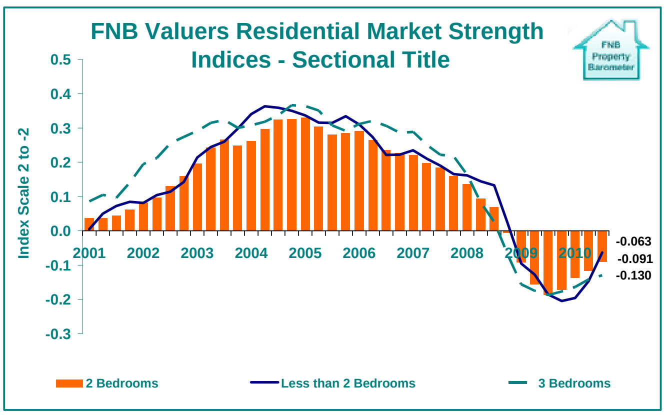
Segmenting the Sectional Title Market into its 3 key segments, the smaller the size in terms of bedroom number the higher the per square metre value. The "Less than 2 Bedroom Segment" showed an average value of R8,489/square metre in the 3rd quarter of 2010, the 2 Bedroom Segment averaged R7,433/square metre, and the 3 Bedroom Segment R6,608/square metre. The Overall index averaged R7,713/square metre. All segments are down from their 1st quarter 2008 peak values, with the total index value down by -4.2% from then.





In terms of price inflation, the Less than 2 Bedroom Segment appears to have made the strongest comeback in the recent "mini-recovery", having risen to a +6.9% year-on-year increase in the 3rd quarter of 2010. This compares well with the +1.9% increase in the 3 Bedroom Segment and the +0.3% of the 2 Bedroom Segment.

Examining the FNB Valuers' Market Strength Indices, one can see a gap developing between the 3 Bedroom and 2 Bedroom Segment Indices (3 Bedroom Index being the weaker of the 2), which may explain the 3 Bedroom Segment's price increase starting to decline a quarter earlier. The Less than 2 Bedroom Segment index, however, has been making a noticeably sharper improvement, which probably explains its superior per square metre average price inflation recorded. It may well be that we are witnessing the need for affordability, in tough economic and financial times, benefiting this smallest sized sectional title segment the most.

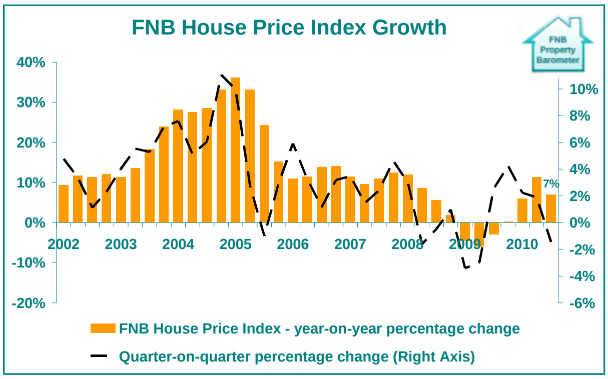


3. PRICE DEFLATION IS A REALITY ONCE AGAIN IN AN UNBALANCED MARKET

As 2010 nears its end, the residential property market is once again on a weakening trend, after a "mini-recovery" that spanned from early-2009 to early-2010. It is often said that the big property cycle can span on average 15 to 20 years - i.e. from peak to peak or bottom to bottom. Such long cycles would typically include a number of "mini-recoveries" (or perhaps "false dawns"), such as the recent one, within the 15 to 20 year period. However, such "mini-recoveries" don't turn into strong and sustained recoveries unless the "underlying fundamentals" driving property are solid. After the extreme economic shock of 2008/9, fundamentals are anything but solid. In this Review, we try to address the factors delaying the residential market's return to "good health".

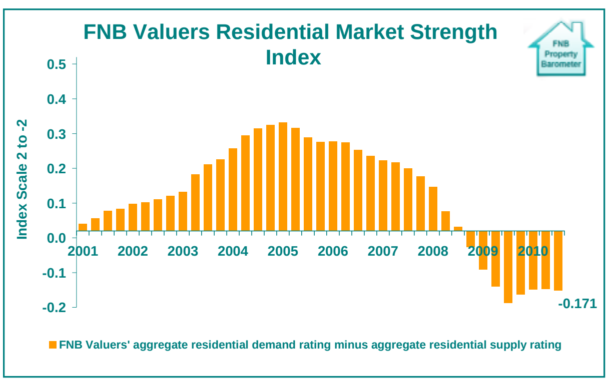
Residential property values head for decline once more.

After a very short period of recovery in average house prices, from late in 2009 until around mid-2010, we once again find a weakening trend, with average price levels still growing by 7% on a year-on-year basis for the 3rd quarter as a whole (3rd quarter 2010 average compared with 3rd quarter 2009), but at a slower rate than the 11.3% recorded in the 2nd quarter. On a quarter-on-quarter basis, however, the 3rd quarter has already seen price decline of -1.5%.



FNB Valuers continue to perceive the market as "unbalanced",.....

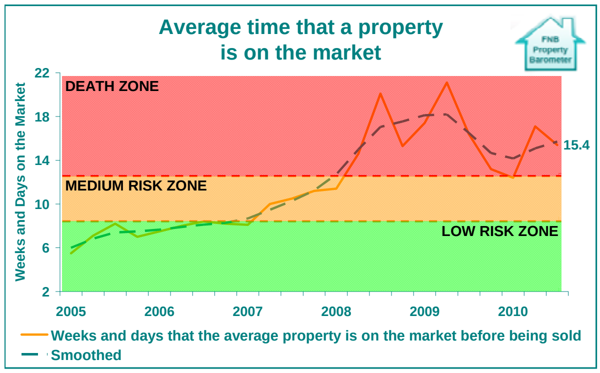
The views of FNB's valuers, as a group, provide some insight as to why the residential market these days so easily moves into average price decline. Each time an FNB valuer values a house, we ask him/her to provide a subjective view of both demand and supply conditions in the area. They rate both either as "good" (assigned a value of +1), average (a value of 0) or "weak" (a value of -1). We aggregate both the demand and supply ratings, before subtracting the supply rating from the demand rating. In the 3rd quarter, the difference between the 2 ratings, i.e. the



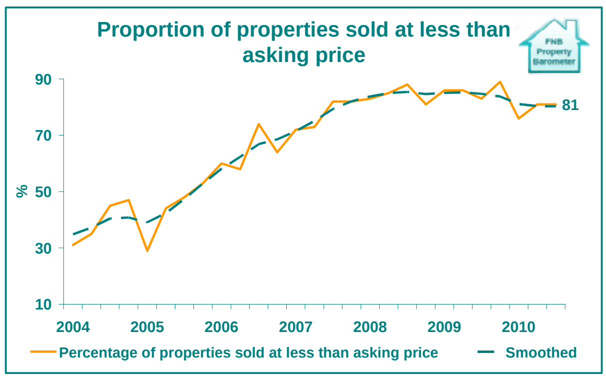
Market Strength rating, was -0.171, which was slightly worse than the 2nd quarter rating, suggesting that the valuers as a group still give supply a stronger rating than demand.

.... While estate agents effectively hold a similar view, through their estimates of average time on the market.

From the FNB Estate Agent Survey, we obtain results similar to those from the FNB Valuers, though expressed in a different way, i.e. the estimated average time that properties remain on the market prior to being sold. Back in 2005 and 2006, when the residential market was strong by all reports, the average time on the market was by and large below 8 weeks. As the slowdown gathered speed in 2007, we saw that average slip to between 2 and 3 months, while from 2008 onward, a period when the market has clearly battled, that average time has been consistently above 3 months (12 weeks). The most recent 2 quarters' readings were 17 weeks and 1 day, and 15 weeks and 4 days, respectively. This, we believe, represents an "oversupplied" market, or otherwise put, an unrealistic average asking price relative to demand. Either demand would need to catch up to supply, or alternatively we believe that prices would have to decline.



A further possible indication of the level of price realism, or lack thereof, is that despite waiting a lengthy time to sell, an estimated 81% of sellers are having to ultimately drop their asking price in order to make the sale. This is a far cry from nearer to 30% at the height of the boom back in 2004. The estimated average drop in asking price was -12% for the 3rd quarter 2010 survey.

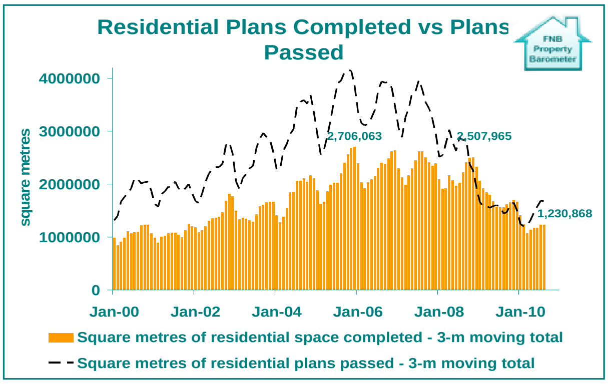


How can we help you?

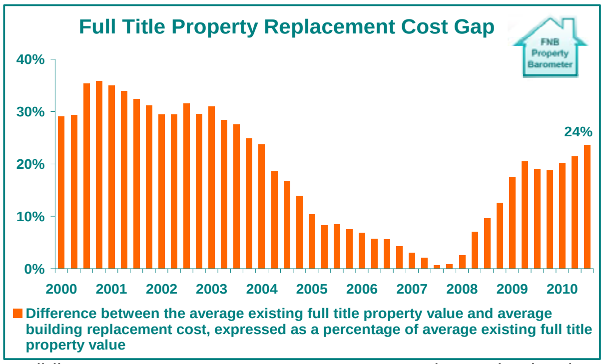
4. RESIDENTIAL SUPPLY REMAINS STRONG DESPITE BUILDING ACTIVITY SLOWDOWN

Residential building activity has been curbed,…..

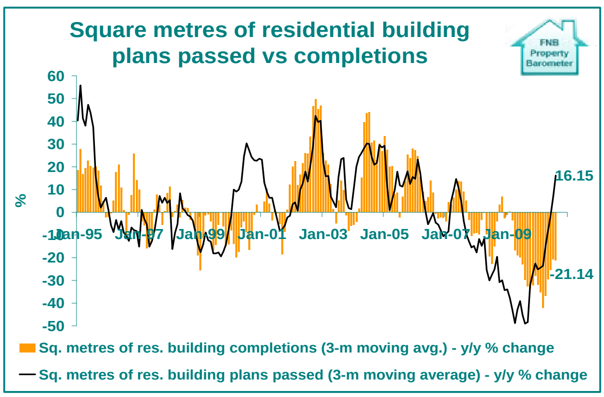
Using a 3-month moving total, total square metres of buildings completed recorded 1.231m for August 2010, a slump to around half of the 2.508m total recorded as at November 2008.



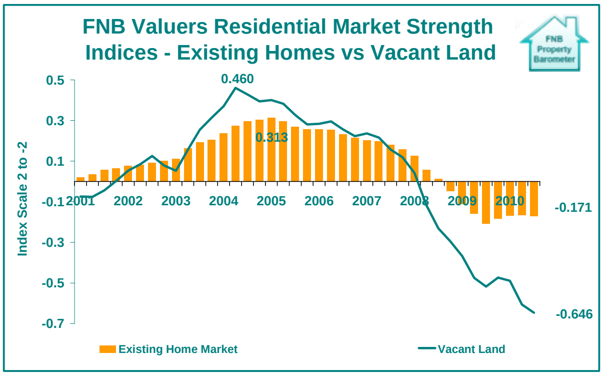
The cause of the building activity slump has been the combination of average price decline in the existing home market during 2008/09, along with a major input cost inflation surge around 2008, which widened the gap between existing house prices and the replacement cost dramatically during 2008 to early-2009. Since early-2009, the pace of widening in the gap has slowed, but we have not seen any sign of narrowing yet, with the replacement cost gap being 24% as at the 3rd quarter of 2010 (i.e. replacement cost 24% higher than the existing home value. to 24%).



Building stats, on a year-on-year percentage change basis, show signs of heightened planning activity, with plans passed growing by +16.15% for the 3 months to July. However, it remains to be seen as to how many of these plans see the light of day, given that they are probably a lagged response to the 2009/early-2010 mini-recovery in demand, which has already petered out.

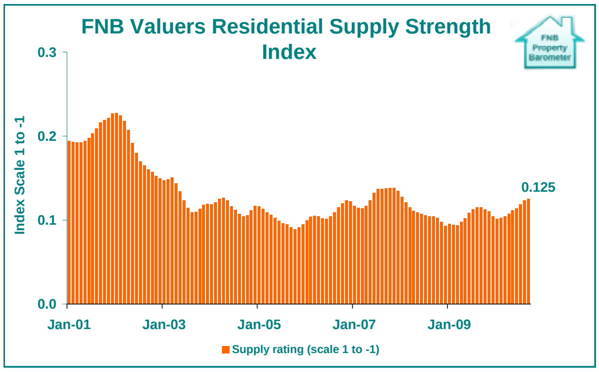


If demand for vacant land is a good indicator of longer term development planning, the FNB Valuers' Market Strength Index for Vacant Land hints at a development market remaining flat for some time. Whereas the Market Strength Index value for existing homes is a weak -0.171, the vacant land index recorded an extremely weak -0.646 in the 3rd quarter of 2010.

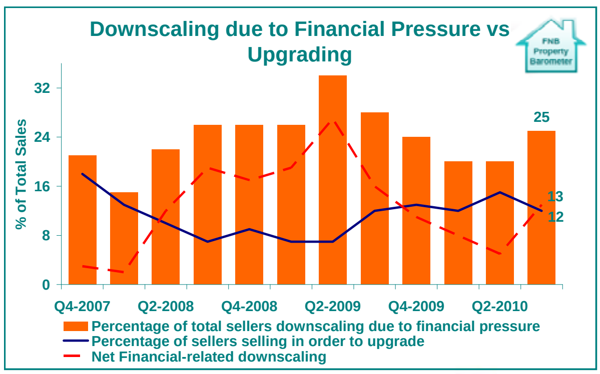


….but indications are that strong supply in the secondary market is still a strong contributor to the market imbalance.

The FNB Valuers' Residential Supply Strength Index shows FNB Valuers as a group pointing towards improving supply over the course of 2010. The aggregate supply rating was 0.125 by September, the highest level since January 2008.



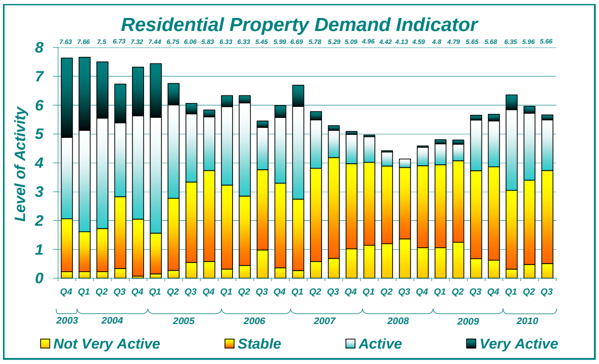
It is possible that a high level of financial stress continues to contribute strongly to a strong supply of residential property in the secondary market. While supply measures are tough to come by, the FNB Estate Agent Survey still points to a high percentage of financial stress-related selling. As a percentage of total sales, the sample of agents surveyed estimated that, as at the 3rd quarter of 2010, 25% of suburban sales were believed to be "selling in order to downscale due to financial pressure".



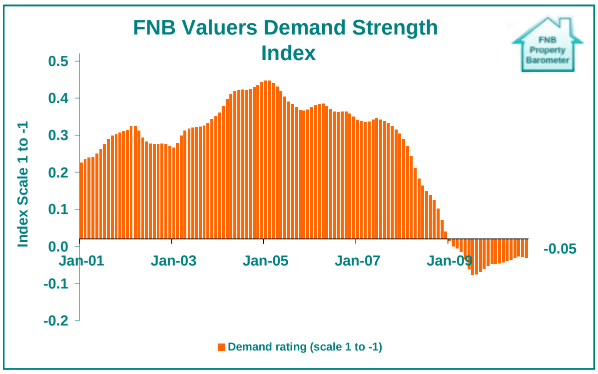
5. SEVERELY CONSTRAINED DEMAND SIDE IS WEAKENING AGAIN

The available demand indicators point towards demand weakening.

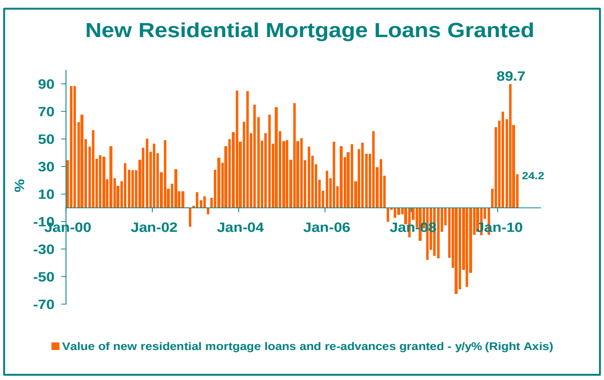
Our first indicator of demand comes from the FNB Estate Agent Survey, where we ask agents to provide us with a demand activity level rating for their areas on a scale of 1 to 10. After a peak level of 6.35 in the 1st quarter of 2010, we have seen 2 consecutive quarters of decline in this rating to a level of 5.66 in the 3rd quarter survey.



FNB's Valuers have recently started to express similar sentiment as a group. When providing their ratings of demand, i.e. good (+1), average (0) or bad (-1), the aggregated result per month show a slightly weakening over the past 2 months, measuring a negative -0.05 in September.



A 3rd indicator of demand, at least for the credit-driven part of the residential market, is the SARB's time series for the value of new mortgage loans and re-advances granted. Here, we have seen year-on-year growth decline from a peak of +89.7% as at April to +24.2% in June, while rand values of loans granted actually declined month-on-month for the 3 consecutive 2nd quarter months.



6. FOCUS ON THE VARIOUS FACTORS CAUSING CONSTRAINED DEMAND.

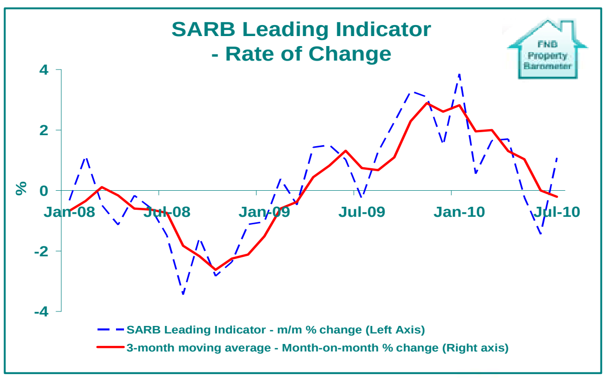
In this section, we discuss the main factors that we perceive to be influencing the direction and level of residential demand. These include:

- Signs of slowing global, and thus local, economic growth, which in turn negatively impacts upon household sector real disposable income growth.
- A lack of interest rate stimulus since August 2009.
- Housing affordability ratios.
- A very slow pace of reduction in a high debt-to-disposable income ratio of the household sector, which constrains the household sector's ability to grow its borrowing.
- SA's low savings rate, which affects the household sector's ability to afford the deposit requirements that have been re-instituted by banks in recent years.
- The need to rebuild financial "buffers" after the recession.
- The need to address certain essential expenditure backlogs, built up in the recession period, which can further hamper any recovery in residential demand to solid levels.
- Ongoing weakness in the rental market, translating into low residential yields, which constrains investment buying of property.

- *Mediocre and slowing economic growth,....*

Since late-2009, the broad trend in the Leading Business Cycle Indicator of the South African Reserve Bank turned to one of slowing month-on-month growth, when using a 3-month moving average index value to smooth out the month-to-month volatility. This turn in the trend was very much in line with most major Global Leading Indicators, which also started to show declining month-on-month growth and then, more recently month-on-month decline, or negative month on month growth.

A slowdown in the Leading Indicator usually signals some slowdown in real economic growth to come in the short term, and this time around things have been no different to date.



How can we help you?

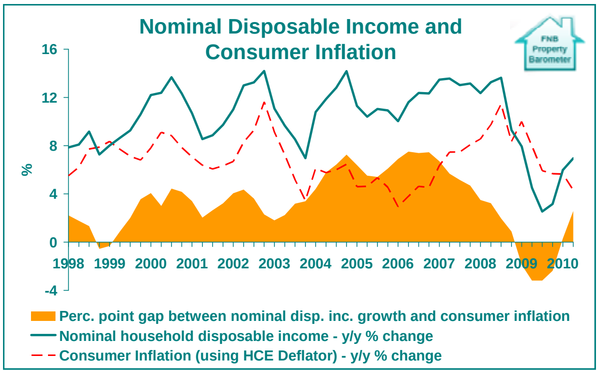
The World's largest economy, the United States, saw its real economic growth decline, from a peak of 5% at a quarter-on-quarter annualised rate in the final quarter of 2009, for 2 consecutive quarters to 1.7% by the 2nd quarter of 2010.

Widespread signs of slowing economic growth globally have led to the International Monetary Fund now projecting a slower global economic growth rate of 4.2% in 2011, after an expected 4.8% for 2010. However, despite 4.2% still sounding respectable, the Fund does believe that the downside risks "remain elevated".

Domestically, real economic growth started to slow in the 2nd quarter of 2010. After a short recovery up until the 1st quarter of this year, to a quarter-on-quarter annualised rate of 4.6%, the 2nd quarter growth rate recorded a lower 3.6%.

....means weak real disposable income growth, also with early signs of slowing.

A return to positive economic growth late in 2009 has translated into some increase in nominal disposable income growth on a year-on-year basis. In addition, an improving (declining) consumer price inflation situation along with this strengthening nominal disposable income growth translated into a return to a positive gap between disposable income growth and inflation in the 1st half of 2010.

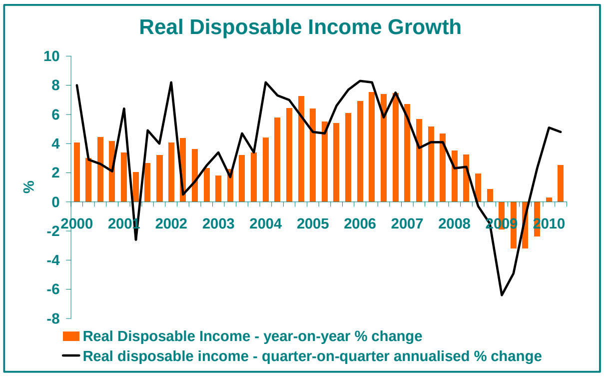


The gap was not large, with year-on-year growth in nominal disposable income having only rebounded to 7%, from a 2.5% low point in the 3rd quarter of 2009. But consumer price inflation over the same period declined from 5.9% in the 3rd quarter of last year to 4.3% year-on-year in the 2nd quarter of 2010 (using the household consumption expenditure deflator to calculate consumer inflation).

The return of the positive gap between nominal disposable income growth and consumer inflation translated into accelerating year-on-year disposable income growth in real terms to 2.5% by the 2nd quarter.

However, when examining quarter-on-quarter annualised growth in real disposable income, a better momentum indicator than the year-on-year calculation, we see that there was a slightly slower growth rate of 4.8% in the 2nd quarter, compared to the 1st quarter's peak of 5.1%. This may just be the 1st sign of the slowing impact that slowing economic growth should begin to have on real disposable income growth, suggesting that declining inflation can't totally offset the negative impact of slowing economic growth.

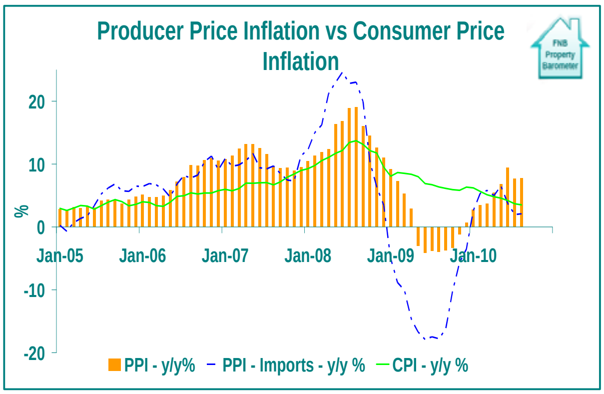
Whilst the 3rd quarter income and economic growth figures are not yet available, the slowing trend in the Leading Indicator would suggest that possible further economic growth slowdown may well have taken place in the 3rd quarter. This may have translated into further slowing in real disposable income growth momentum, which in turn would be mildly negative for housing



- *A lack of further interest rate stimulus since August 2009, despite inflation being benign*

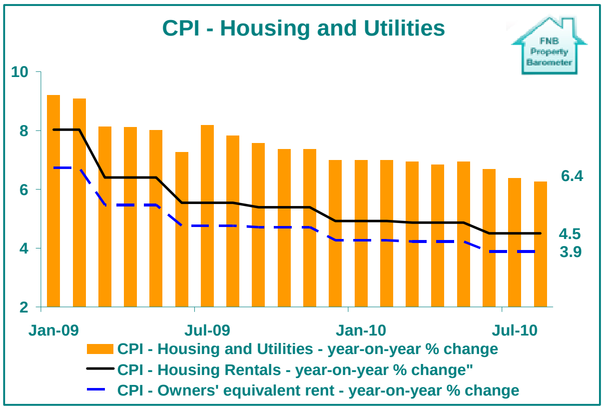
Inflation shows very little sign of being troublesome in the near term. Given that the SARB runs interest rate policy based on its consumer price inflation target of 3%-6%, this bodes well for interest rates.

The consumer price inflation rate has receded to 3.5% year-on-year as at August, which is almost at the bottom of the target range. Being such an open economy, much of South Africa's inflation comes from imported sources. The producer price inflation rate for imports is thus very often a good direction indicator, not only for the overall producer price inflation rate, but more importantly for the consumer price inflation rate. The combination of receding year-on-year global commodity price inflation in 2010, compared to 2009, as well as a solid performance of the rand, have helped the producer price inflation rate for imports to decline from a 2010 high of 6.5% year-on-year in May to 2.1% by August.

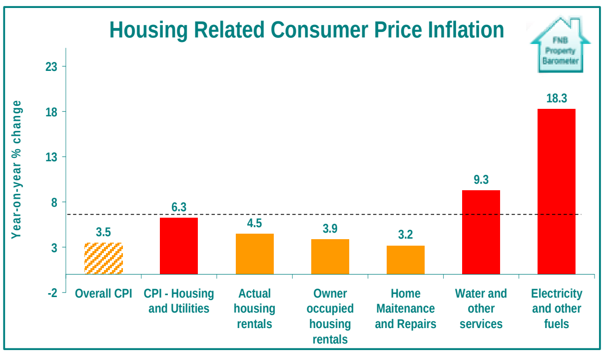


With regard to home grown inflationary pressures, the residential property market plays an extremely important role in influencing the overall consumer price inflation, and from an interest rate point of view we are fortunate to have a weak rental market. The overall housing and utilities CPI inflation rate was 6.4% as at August, implying that the housing CPI contributed 1.4 of a percentage point to the 3.5% overall CPI inflation rate. Housing is thus the single-most important driver of CPI inflation at present.

However, were it not for the steady decline in rental inflation, with actual rental inflation measuring 4.5% year-on-year and owners' equivalent rental inflation at 3.9%, the sharp increases in municipal rates and utilities tariffs would make the CPI Housing index picture look a lot worse. The Housing and Utilities component of the consumer price index has the highest weighting of all of the sub-indices that make up the CPI, accounting for 22.6% of the overall CPI, with the rental components accounting for 15.7% of total CPI.



The graph below shows the August inflation rates of the housing CPI, demonstrating the troublesome nature of the electricity, water and other services components.

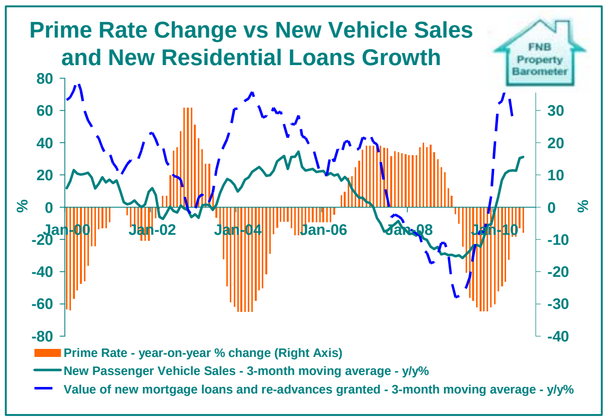


So, despite sharp housing-related rates and tariff increases, the Housing CPI inflation rate continues to decline, thanks to a weak rental market, while the goods components of the consumer price index have been suppressed by a lack of imported inflation, leaving little to be concerned about in the way of inflationary pressures in the near term.

If anything, therefore, the SARB may be biased towards further interest rate reduction.

However, it is important to understand that the Bank has slowed the pace of interest rate cutting dramatically. Herein lies the "lack of stimulus" that we regularly to talk about, with the positive impact of the first 5 percentage points' worth of rate cutting in the current cycle, which took place up until August 2009, beginning to wear thin in the credit-driven markets.

Calculating the prime rate year-on-year percentage change is perhaps a good way to demonstrate the interest rate stimulus, plotting it on a graph along with the year-on-year percentage change in new vehicle sales and new residential mortgage loans, both interest rate sensitive markets. One sees a broadly inverse correlation between year-on-year percentage change in vehicle sales/residential loans on the one hand, and year-on-year percentage change in prime rate on the other. One also sees that the year-on-year rate of decline in prime rate was at its most extreme, in the current cycle, as at late-2009, and has since been making its way upward closer to zero as a result of a far slower pace of interest rate cutting since August 2009. Recently, continuing the inverse correlation, we have seen year-on-year growth in new residential loan value start to turn downward from the peak, and one would expect new vehicle sales growth to do the same soon too, as the stimulus wears off. Therefore, while benign inflation may lead to further interest rate cutting, it would appear that the SARB intends to move at a slow pace going forward, which would keep the stimulus far less extreme than was the case in 2009.

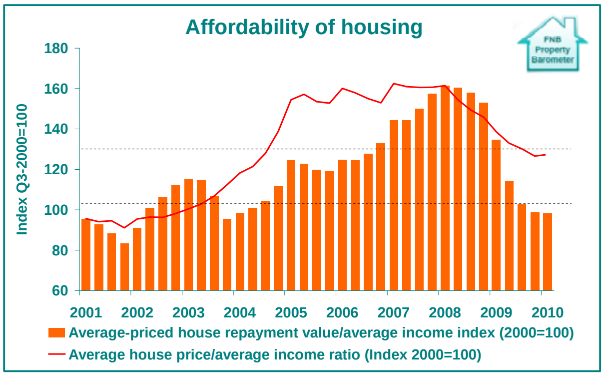


- *The affordability challenge is not serious, but is partially masked by SA's inflexible labour market.*

By the 1st quarter of 2010, we were witnessing a levelling out in the 2 traditional measures of affordability, after about 2 years of steady improvement (decline in the indices). The 1st of the 2 measures of affordability, average house price/average employee remuneration (in index form) remained almost unchanged in the 1st quarter from the previous quarter, and has receded since its early-2008 peak back to a level more-or-less equal to those seen in the 2nd half of 2004.

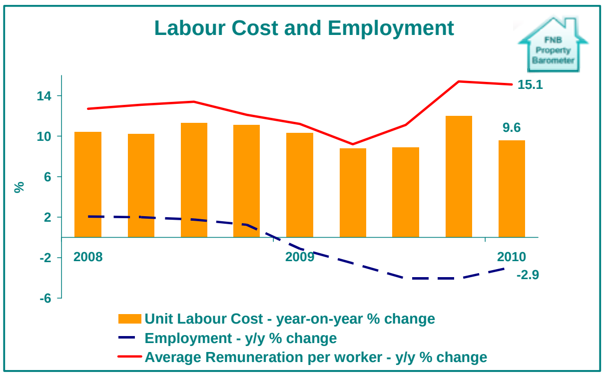
This is not to say that price levels are back to 2004 levels, remembering of course that average wage has inflated substantially since then.

The 2nd measure, i.e. the instalment repayment value on a 100% loan on an average-priced home/average employee remuneration ratio (in index form), has declined more sharply from its own early-2008 peak due to a series of interest rate cuts since late-2008, along with price decline or low price inflation since then. This index, too, is back to levels of affordability last seen in 2004. This index, too, started to level out in early-2010, due to the combination of accelerating price growth at the time, as well as a slowdown in the pace of interest rate cuts since August 2009.



But if we're back at 2004 affordability levels, what's the problem? Why aren't more people buying houses? Besides the matter of higher levels of indebtedness since 2004, which we will discuss shortly, as well as spending backlogs that may have built up in tougher times and are now being addressed (also to be discussed), part of the answer also lies in that the above indices refer to the average wage earner, and there are less of those around. High average employee remuneration increases, mostly in double-digits since 2008, have assisted job losses from early-2009, as the commercial sector battles to suppress unit labour cost increases in a slow growth economy.

The traditional affordability indices, therefore, only tell part of the story.

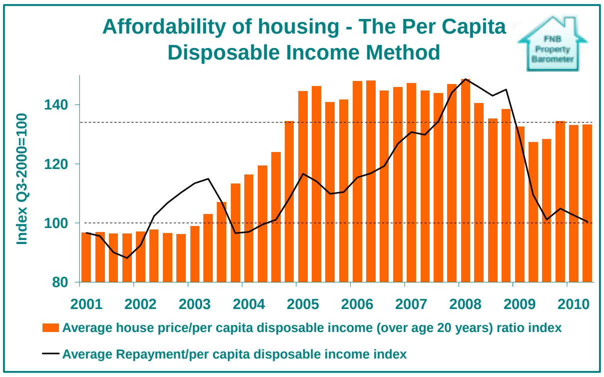


We try a new affordability calculation in order to capture affordability trends a little better, using a per capita disposable income approach instead of the average remuneration per employee.

In the 1st calculation, we have taken the average house price/estimated per capita disposable income for the population over the age of 20, using Globalinsight population statistics. Once again, this measure of affordability as at the 2nd quarter of 2010 was back at late-2004 levels. The difference from the average remuneration per worker approach was that we did see a noticeable deterioration in this new affordability calculation in the 2nd half of 2009, as price growth started to recover. This affordability calculation, therefore, probably better reflects the real world situation as opposed to using the average wage earner only, because the number of wage earners varies significantly over time.

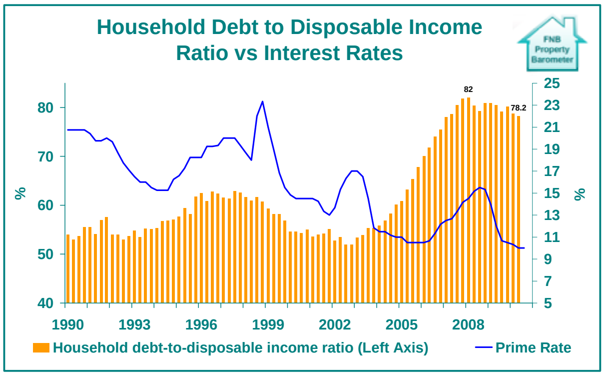
The 2nd measure of affordability, i.e. the instalment value on a 100% loan on the average-priced house/per capita income (of the over-20 population) ratio index, also shows affordability to be back around 2004 levels, and very near to 2001 levels too.

From these measures of affordability, one gets the impression that, for the credit buyer, affordability is little different to the early stages of last decade's boom, although admittedly for the average cash buyer (for whom the 1st ratio is more applicable) homes are significantly less affordable than 10 years ago.

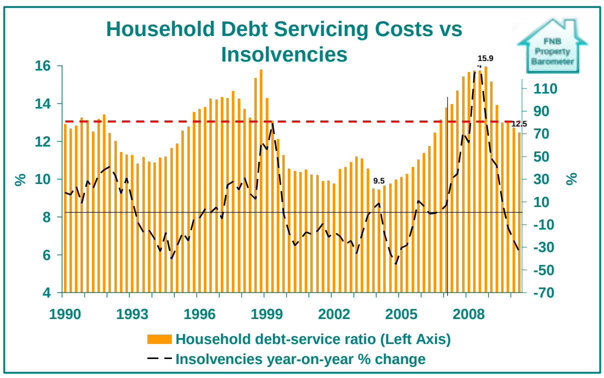


- *Household indebtedness on the right track (down), but the pace is slow and the level is still high, constraining new credit demand*

Many would have expected a more impressive improvement in credit-driven residential demand following the massive interest rate reduction since late-2008, from a prime rate of 15.5% to the current 9.5%. The main reason for this not having materialised is the high level of indebtedness in the household sector in recent years. During the 1st quarter of 2008, the household debt-to-disposable income ratio reached an all-time high of 82%. Since then, a more cautious borrowing/lending environment has led to some decline in this ratio, which recorded 78.2% in the 2nd quarter of 2010. However, this remains a very high level by our historic standards, reflecting a very slow pace of decline, arguably constrained by the low rate of disposable income growth that these weak economic times bring about.



The still-high level of indebtedness means that, despite multi-decade lows in current interest rate levels, the household sector debt-service ratio (the estimated cost of servicing the household debt burden, interest + capital, expressed as a percentage of household sector disposable income) remains high, and herein lies much of the answer as to why credit-driven home buying has not proceeded at a blistering pace this time around. At 12.5%, the debt-service ratio remains relatively high, despite having been brought down, from the early-2008 peak of 15.9%, predominantly by huge interest rate cuts.



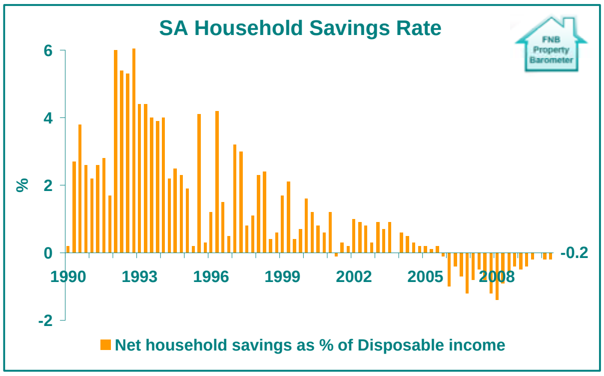
This is very different to the 9.5% low in the debt-service ratio that occurred in the 1st quarter of 2004, after a series of interest rate cuts late in 2003, and with the debt-to-disposable income ratio having been far lower in those days. Small wonder, then, that 2004 was a year of very strong growth in demand for home loans, and also the year with the highest house price inflation of last decade's boom.

- *South Africa's low savings rate is troublesome in times when lending institutions have re-instituted deposit requirements on a large scale.*

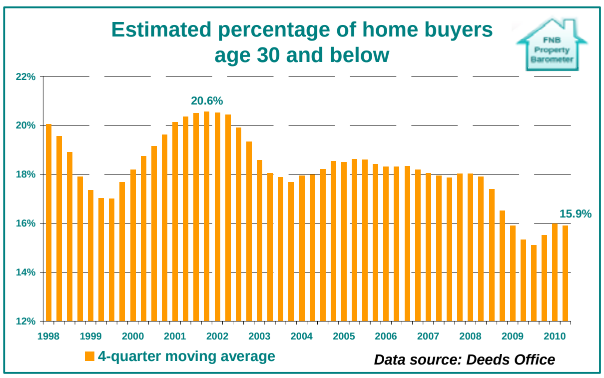
South Africa's dismal savings rate has been well-documented for many years, and has been cited as one of the constraints on our long term economic growth. With banks having re-instituted deposit requirements on home loans, they have unintentionally exposed this shortcoming in our society, and this lack of saving means that being able to put down the deposit and acquire a home loan is tough for many households.

The most recent SARB Quarterly Bulletin reports a net "dis-savings" rate of -0.2% for the household sector, implying that the little gross savings that exists is insufficient to cover the depreciation on fixed assets owned by the household sector.

Since the worst level of -1.4% as at early-2008, the diminishing in the net savings rate to -0.2% does reflect some will on the part of the household sector to improve its savings rates. However, once again it is probably weak income growth playing a role in constraining the pace of improvement in this regard.



The lack of savings is probably more of an issue amongst younger buyers, and this may well be in part reflected in the estimated average age of individual property buyers, which was estimated at 15.9% of total buyers as at the 2nd quarter of 2010. This is still well-down on the 20.6% peak at a stage of 2001, despite some moderate increase through 2009.



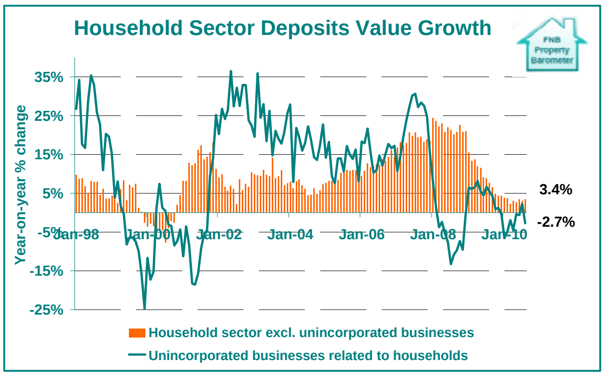
The lack of savings may also be partly reflected in the FNB Estate Agent Survey, which puts the estimate of 1st time buyers as a percentage of total buying at 15%. Once again, this reflects some improvement since 2008, but remains well-down on a near 30% estimate around the year 2005.

- *The need to rebuild financial "buffers" amongst many households can also be a constraint on the pace of home buying, especially buying of a non-essential nature.*

During recessions, and weak economic growth times, one often finds elements of the household sector having to dip into certain of their financial "buffers". Bank deposits are one important financial buffer, and the drop-off in growth in the the value of household sector deposits has been noticeable.

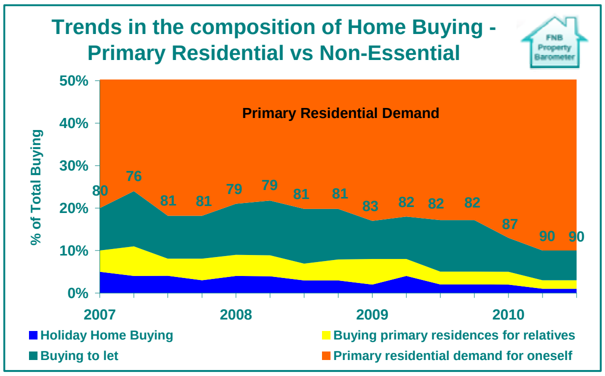
It would appear to be especially the self-employed part of the household sector that has "dipped into" the reserves. This is reflected in the data regarding the value of deposits of "unincorporated business enterprises related to households, with a period of decline (negative growth) in the value of its deposits during 2008, and a 2nd period of negative growth in 2010. As at August 2010, the value of this category of deposits declined year-on-year by -2.7%.

While the value of deposits of the household sector, excluding unincorporated business enterprises, was still growing positively to the tune of 3.4% as at August, this growth has been negative in real terms (i.e. below the rate of consumer price inflation), for most of 2010.



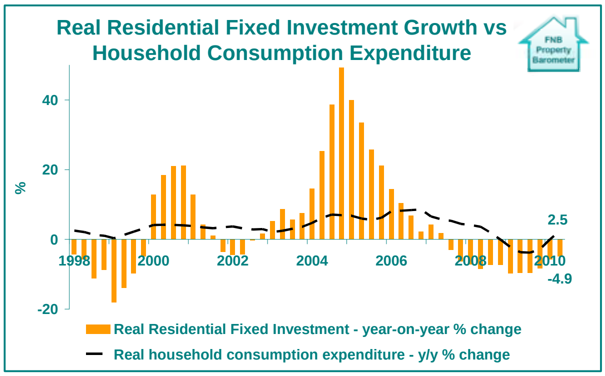
After a big knock, such "financial buffers" will probably require some rebuilding, which should be seen in something of an increase in our weak savings rate, and a resultant acceleration in the growth rate of the value of deposits in the coming years. The extent of the improvement will depend on the pace of disposable income growth, too.

In the mean time, a re-prioritisation by the household sector, as it re-builds its balance sheet, hampers especially non-essential home buying components, i.e. buy-to-let, buying for relatives and holiday home buying, which make up a lowly estimated 10% of total buying around the country's major metros, according to the agents surveyed. Primary residential demand now accounts for the other 90% of total buying, significantly higher than the below-80% estimates recorded at stages a few years ago.



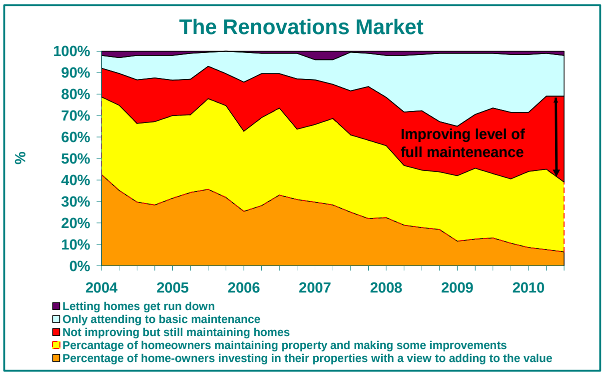
- *The need to address certain capital and important consumption expenditure backlogs can further delay the recovery in residential demand to satisfactory levels.*

During times when disposable income growth is under pressure, one tends to find the household sector neglecting fixed investment expenditure, and perhaps some important forms of "consumption expenditure related to fixed assets, more than it neglects overall consumption expenditure. Therefore, not only did real household consumption expenditure experience a far less pronounced dip in 2009 than did real fixed investment expenditure, but is has already returned to positive year-on-year growth of +2.5%, whereas real residential fixed investment expenditure (household sector dominated) was still declining by -4.9% as at the 2nd quarter of 2010.



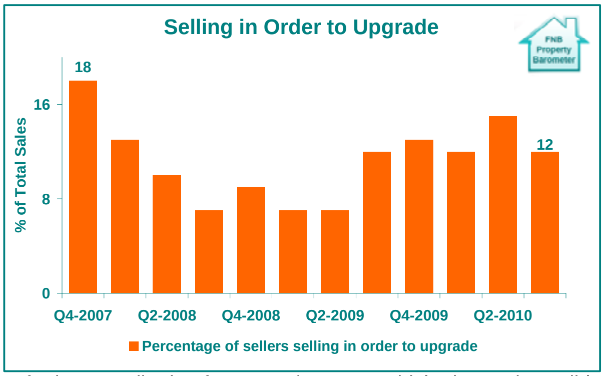
Insofar as real fixed investment relates to building of new homes, there is little reason why such activity should recover quickly, given the seemingly ample supply of existing properties on the market.

However, addressing the depreciation on homes that may have taken place, due to a lack of maintenance during the recession and high interest rate period, is a key priority in many instances. Indeed, from early 2009, as interest rates started to fall, the FNB Agent Survey indicated a noticeable rise in estimated percentage of homeowners returning to doing full maintenance on their homes, and a noticeable decline in the percentage of homeowners "only attending to basic maintenance", suggesting that the process of addressing maintenance backlogs had begun.



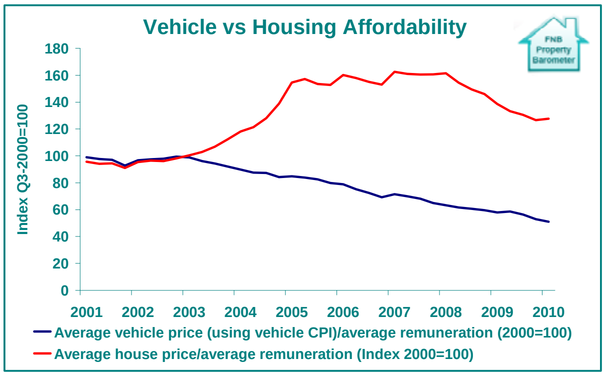
Other important backlogs that need to be addressed may relate to the need to replace ageing motor vehicles after the high interest rate/low growth period. Reliable private vehicles are crucial to many middle class people, in a country lacking in good public transport. Home upgrades and replacements, by comparison, can normally wait longer.

In many instances, therefore, the more pressing need to replace vehicles may also contribute to the slow pace of residential property buying, as many households make do with what they have from a property point of view. Therefore, the FNB Estate Agent Survey continues to point to the percentage of sellers selling in order to upgrade as never reaching the 18% level estimated when we started his question late in 2007, and even that 18% figure was probably fairly low compared to prior boom years.

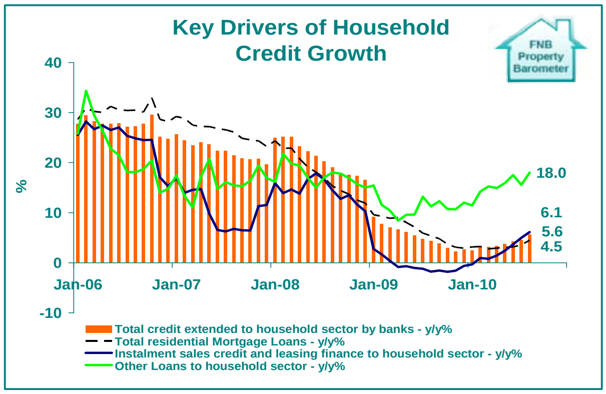


A further contributing factor, perhaps, to vehicle demand possibly outstripping growth in residential property buying, is that the vehicle market didn't experience the same affordability deterioration that the residential property market did. This is due to SA having an unlimited supply of vehicles through the boom years, due to our being able to import what domestic producers can't supply, whereas you can't import houses.

So, as average wage rose over the past decade, the average vehicle price/average remuneration ratio steadily declined, whereas the average house price/average remuneration ratio rose sharply in the 1st half of last decade, reflecting the far greater relative scarcity of property and the resultant rampant price inflation of the time.



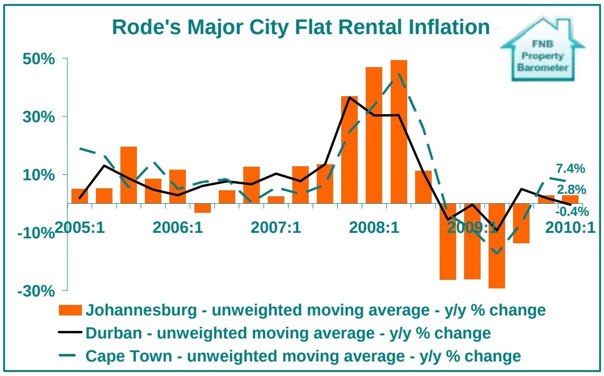
So, what we are witnessing is household sector credit growth being slowly driven stronger by other main forms of credit, i.e. accelerating growth in instalment sales credit and leasing finance (+6.1% year-on-year), which has emerged from negative territory and is strongly driven by the vehicle market, as well as by the "other loans" category (+18%). By comparison, growth in mortgage advances is pedestrian at 4.5% year-on-year.



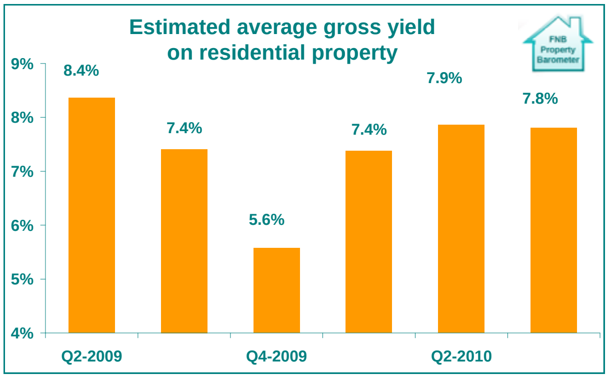
In short, therefore, property demand has to compete with other, often more pressing, needs in a market where indebtedness is high and thus the potential for overall credit growth is limited.

Ongoing weakness in the rental market, translating into low residential yields, which constrains investment buying of property.

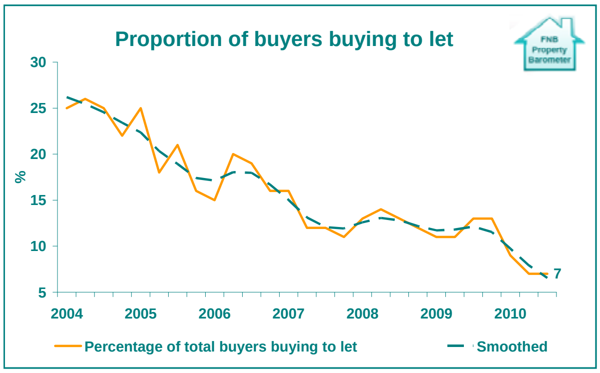
While Rode reports some mild recovery in market rentals earlier on in 2010, this was only from deflation back to single-digit year-on-year inflation, while the CPI for housing rentals is not reporting any fireworks in actual rentals (the combination of market rentals and escalations) either. In addition, our estate agent panel still reports a relatively unattractive average gross yield on residential property.



Estate agents surveyed suggest some improvement in average yields during 2010, after a dip in 2009. However, an average gross yield of 7.8%, where operating/maintenance costs would still need to be covered, would hardly appear enticing on a large scale to a financially stretched household sector.



Therefore, not surprisingly, the percentage of buyers being buy-to-let buyers, according to our Estate Agent Survey, is estimated at a lowly 7%. Therefore, this form of demand is not contributing to overall demand as significantly as in the boom times, at which stage a more cash-flush household sector was often prepared to carry costs not covered by rental income at time of purchase.



7. OUTLOOK – PRICE DEFLATION FOR 2011 AS A WHOLE IS EXPECTED

After all the factors considered above, we retain the expectation of average price decline for 2011 as a whole, after an expected 6.4% increase in the 2010 average price over 2009's average price.

This expectation stems in part from the set of FNB indicators, namely average time on the market and the Valuers' Market Strength Index, which point to a weak level of demand relative to supply or, otherwise put, an unrealistically priced market.

When the market is unbalanced in favour of supply, either demand has to catch up, supply has to drop, or prices have to fall. Indications are that supply of existing property is strong, with high levels of financial stress-related selling. Indications are also that residential demand is weakening. That leaves a price decline as seemingly the logical outcome.

We believe that the following factors have restricted the level of demand even throughout the 2009/early-2010 "mini-recovery":

- A very high level of household sector debt-to-disposable income ratio, which remains high despite some decline from the early-2008 peak level;
- SA's low savings rate, which affects the household sector's ability to afford the deposit requirements that have been re-instituted by banks in recent years.
- The need for the slow process of rebuilding financial "buffers" after the recession.
- The urgent need to address certain fixed investment and important consumption expenditure backlogs, built up in the recession period, which can further delay the recovery in residential demand to satisfactory levels. Home maintenance and vehicle replacement are a possible 2 such expenditure items.
- Ongoing weakness in the rental market, translating into low residential yields, which makes the investment buying of property unattractive for many. In addition, this era of low capital growth relative to interest rates contains speculative demand;

We believe that the following factors have led to a slowing in residential demand from the already mediocre levels of the early-2010 "mini-peak":

- Signs of slowing global, and thus local, economic growth, which in turn negatively impacts upon household sector real disposable income growth.
- A lack of interest rate stimulus since August 2009, which means that the positive impact of the more aggressive part of the rate cutting cycle up until August 2009 is probably starting to wear thin.

Finally, the traditional housing affordability ratios don't indicate a major problem with housing affordability levels per se. Price/income and instalment repayment/income ratio appear to be back around 2004 levels, reflecting a few years of improvement in affordability. Our view is, therefore, is that the pressure on the residential market comes more from other non-property (though some times related to property) expenditure items that suppress residential demand, along with weak economic and household income growth.