

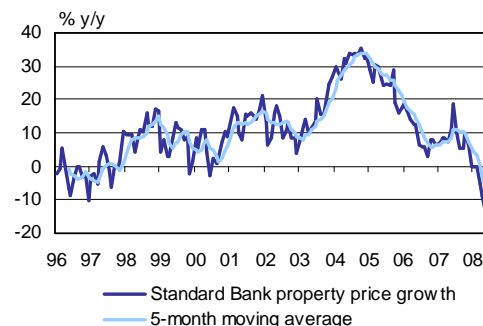
Outlook for South African residential property remains bleak

Standard Bank's median house price fell to R520,000 in May from R530,000 in April. In May of 2007 the median house price had been recorded at R599,000. As a result the year-on-year growth in the median house price for May saw a significant decline of -13.2%. The five month moving average growth rate in the median house price was -5.5%.

In the months leading up to the implementation of the National Credit Act (NCA) a strong upward movement in the median house price occurred. This was a result of the attempts by market participants to process higher end properties to pre-empt the increased rigour in qualifying for mortgage finance that the NCA imposed. As such, a high base from which current year-on-year growth rates are calculated was established. There is thus a technical distortion that suggests that we are overstating the extent of the decline in house prices. Furthermore, the distortive base effect is likely to impact the data for the next two months. This notwithstanding, the downward trend in the median house price also reflects the large decline in demand for residential property. The far softer demand conditions in the residential property market are in turn primarily a function of the deteriorating health of consumer balance sheets. In our view, we have in all likelihood entered a period of national house price deflation which we see as a correction in house prices to more plausible levels. This trend has merely been exacerbated by rising inflation and higher interest rates in an environment of record high household indebtedness.

Conditions in the residential property market are likely to deteriorate further in the coming months. The South African inflation profile has become worse in the first two quarters of 2008. CPI(X), the inflation gauge targeted to remain between 3% and 6% by the South African Reserve Bank (SARB), increased to 10.4% in April from 10.1% in March. Recent CPI(X) outcomes, now substantially above the target band, have been outside the target since April 2007. Furthermore, despite the fact that food and transport inflation have been making the largest contributions to CPI(X) outcomes, there is evidence that the rise in inflation is also becoming increasingly broad based. Excluding the food and petrol components, CPI(X) has also been on an upward trend. This measure of CPI(X) has more than doubled, increasing from 2.5% y/y in June 2006 to 5.5% y/y in March 2008.

Figure 1: House prices – Standard Bank



Source: Standard Bank Group

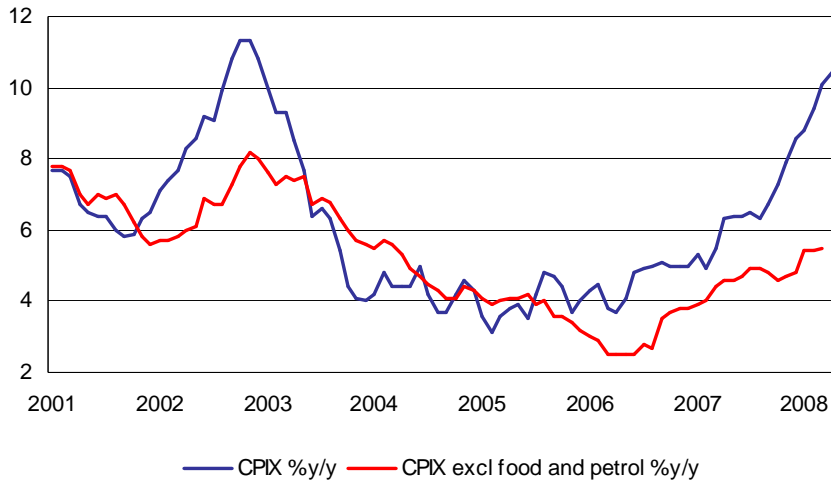
Table 1: Stats at a glance

Indicator	Period	Data
Median house price	May 08	-13.2% y/y
Median house price	5m ma	-5.5% y/y
Median house price	May 08	R520,000
Mortgage advances	Apr 08	21.9 %y/y
Private sector credit extension	Apr 08	19.62 % y/y
Ratio of household debt to income	Q4 07	77.6%
Prime rate	June 08	15.0%

Source: Standard Bank Group, SARB



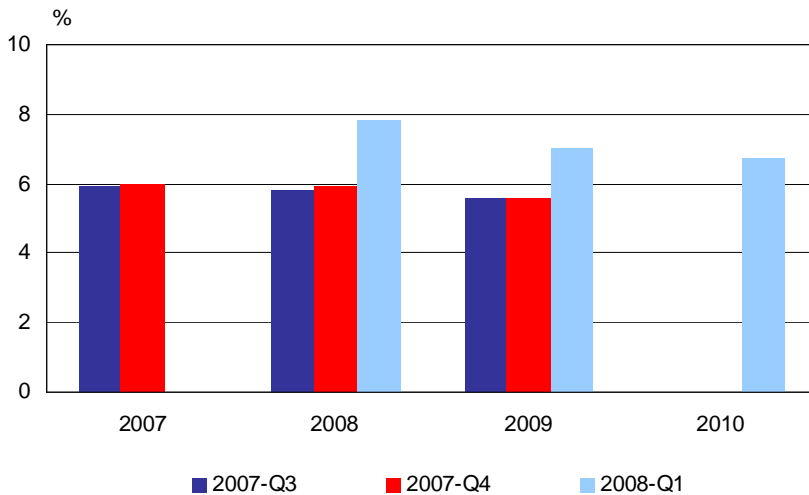
Figure 2: CPIX % y/y and CPIX excl. food and petrol % y/y



Source: StatsSA

However, what is of greatest concern with respect to the outlook for interest rates is that the persistent rise in CPI(X) over the last six months has finally led to a sharp deterioration in inflation expectations. In the Q4 2007 survey of expected inflation, inflation for 2008 and 2009 was expected to average 5.9% and 5.6% respectively. The Q1 2008 survey revealed a sharp deterioration in inflation expectations. According to the Q1 2008 survey, inflation was expected to average 7.8%, 7% and 6.7% for 2008, 2009 and 2010 respectively. Therefore, inflation is now expected to be comfortably above the target band for the next three years.

Figure 3: Inflation Expectations %



Source: BER

The higher rate of expected inflation is likely to lead to higher wage demands and higher wage settlements. This would entrench the upward trend in inflation and incentivise business to pass these costs back on to the consumer. This would clearly increase the risk of an inflationary spiral in the economy. In fact there was already evidence of higher wage settlements last year reflecting the increasing trend in inflation between 2006 and 2007.

The hawkish rhetoric from the South African Reserve Bank (SARB) governor in recent weeks, suggests that the bank is determined to prevent the occurrence of an inflationary spiral and to anchor inflation expectations at lower levels and engineer a return of inflation back to within the targeted range. This implies a continuation of the upward trajectory in interest rates despite the clear negative



effect that the cumulative 450 basis points (bps) of interest rate increases is having and will continue to have on the economy given the lagged impact of monetary policy on economic activity. The SARB will in all likelihood increase the repo rate by another 50 bps at the Monetary Policy Committee Meeting (MPC) meeting later this month. There have even been suggestions of an increase of 100 bps at the June MPC meeting.

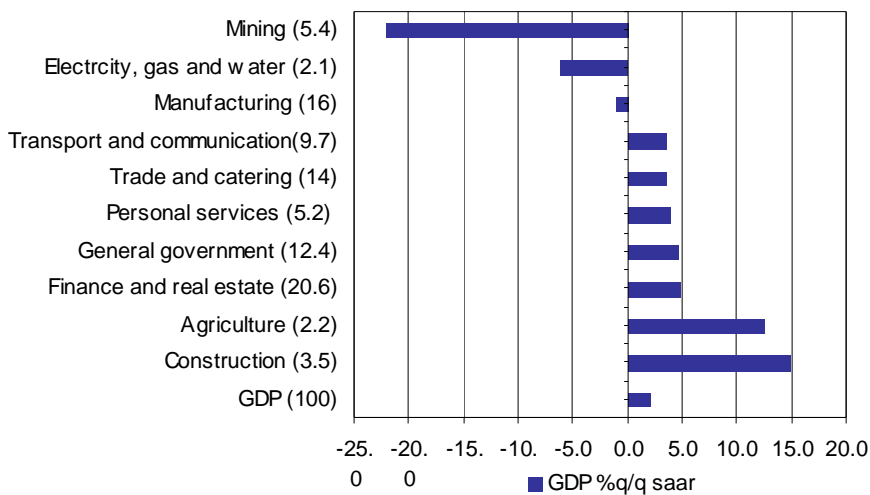
Table 2: Monthly mortgage instalments (Rands)

Loan amount	Prime rate 10.5%		Prime rate 15%		Prime rate 15.5%		Prime rate 16%		Prime rate 16.5%	
	Monthly instalment	Required income	Monthly instalment	Required income	Monthly instalment	Required income	Monthly instalment	Required income	Monthly instalment	Required income
100000	998	3328	1317	4389	1354	4513	1391	4638	1429	4763
300000	2995	9984	3950	13168	4062	13539	4174	13913	4287	14289
500000	4992	16640	6584	21946	6769	22565	6956	23188	7145	23815
1000000	9984	33279	13168	43893	13539	45129	13913	46375	14289	47630
1500000	14976	49919	19752	65839	20308	67694	20869	69563	21434	71445
2000000	19968	66559	26336	87786	27078	90259	27825	92750	28578	95260
2500000	24959	83198	32920	109732	33847	112823	34781	115938	35723	119075
3000000	29951	99838	39504	131679	40616	135388	41738	139126	42867	142890

Source: Standard Bank Group

A further interest rate increase will merely cause more deterioration in the affordability of residential property, will lead to a further reduction in the volume of new mortgages granted and registered and lead to even softer house price growth. A prime rate of 15.5% p.a. will mean that the monthly mortgage instalments will be approximately 36% more than they were in June of 2006 when the current bout of interest rate increases commenced.

Figure 4: Real GDP growth % q/q saar



Source: StatsSA

The slower pace of economic growth also implies that employment growth, another key driver of residential property will be slower than in recent years. The momentum of real GDP growth slowed down markedly in Q1 2008 to 2.1% q/q seasonally adjusted and annualised (saar) from 5.3% q/q saar in Q407. In sum, the short-term outlook for residential property remains bleak.

**Table 3: Building plans passed and building plans completed %/y Constant 2000 prices**

	Building plans passed				
	2004	2005	2006	2007	Q1 2008
Total	35.7	36.3	8.1	-2.7	-1.7
Residential	42	29.8	2.7	-3.5	-8.9
Non-residential	23.8	53.6	31.7	-5.9	8.8
Additions and alterations	29.1	41.6	5	1.4	6.7
	Buildings completed				
Total	26.2	25.7	21.4	9.8	-3.2
Residential	38.4	32.7	16.7	1.5	-6.4
Non-residential	8.2	6.7	30.6	48.8	-6.1
Additions and alterations	7.9	18.1	33.1	6.6	9.9

Source: StatsSA

However, while the demand for housing is facing serious headwinds and may worsen over the rest of 2008, the decline in the supply of residential property is likely to provide a floor for residential property pricing. The value of residential buildings completed declined from a growth rate of 16.7% in 2006 to a meagre 1.5% in 2007. Buildings completed contracted further, by 6.4% y/y, in Q1 2008. With regards to pending supply, the real value of building plans passed contracted by 3.5% in 2007. The reduction in the supply of residential property is possibly a response to the softening demand for housing. This is encouraging as it implies that we will not have a dislocation in the supply and demand conditions for housing. The lack of excessive supply should provide some support for the housing market, the weaker demand conditions notwithstanding.

Bottom line: *The Standard Bank median house price recorded negative year-on-year growth for the third consecutive month in May. The high base established during this period last year as a result of attempts by market participants to pre-empt the NCA continues to distort the point estimates. Thus, we may be overstating the extent of the decline in house price growth. However, the downward trend in house price growth still reflects the decline in demand for housing due to the decimation of housing affordability. Another interest rate increase, which in our view is a strong possibility, will mean that monthly mortgage instalments will be 36% more than they were when the current bout of interest rate increases commenced. However, the moderation in housing supply should provide a floor for house prices.*



Standard Bank house price data

	2001	2002	2003	2004	2005	2006	2007	2008
January	12.8	13.6	8.0	29.6	28.6	18.5	6.9	0.0
February	17.5	6.4	12.0	28.6	25.1	16.6	8.6	0.0
March	15.0	8.7	14.0	26.3	30.6	13.8	8.4	-5.2
April	10.0	15.9	9.8	32.1	29.7	12.5	7.4	-8.6
May	8.1	18.2	11.5	31.0	26.3	12.5	10.9	-13.2
June	15.7	15.2	13.5	33.9	24.1	6.5	18.8	
July	15.0	8.7	20.0	33.3	25.0	6.0	10.4	
August	16.2	11.1	15.4	34.0	24.4	6.0	5.7	
September	15.0	13.0	15.4	33.4	28.8	2.9	5.7	
October	14.3	8.3	19.2	35.5	19.0	8.0	10.2	
November	16.8	8.3	25.0	32.3	16.3	8.0	6.5	
December	21.4	4.0	26.9	33.3	17.5	6.4	0.0	
Average	14.8	11.0	15.9	31.9	24.6	9.8	8.3	

Source: Standard Bank Group



Picture Gallery

Figure 1: Buildings: Flats & townhouses

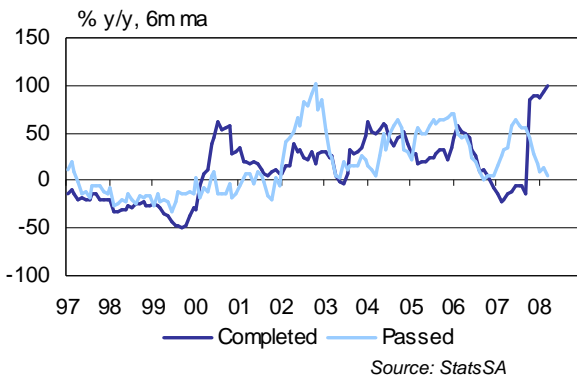


Figure 2: Private sector borrowing

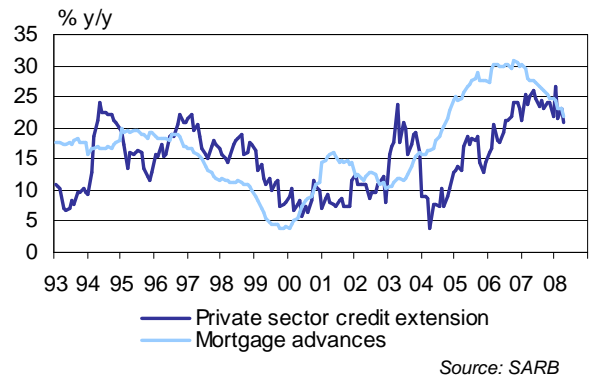


Figure 3: Building cost: Building and construction

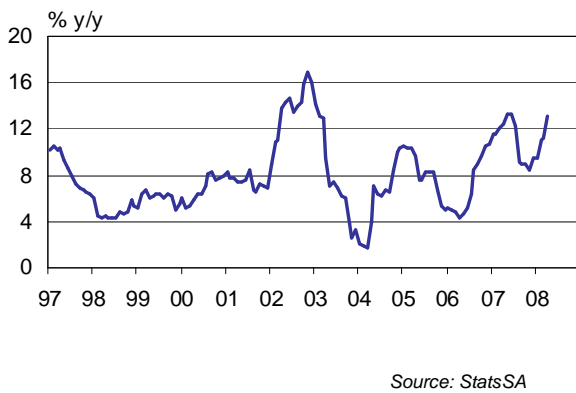


Figure 4: Building cost: Building industries and civil engineering

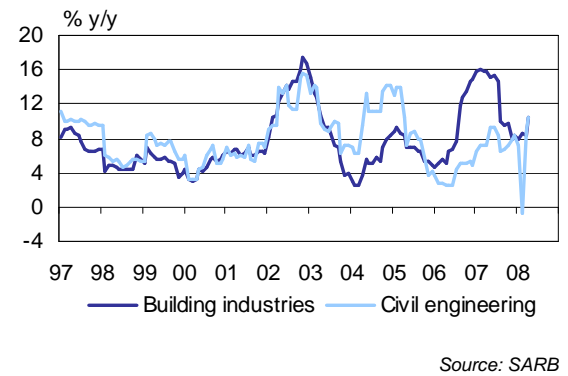


Figure 5: Prime interest rate

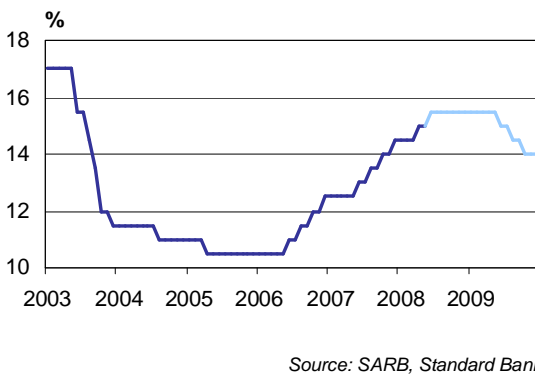
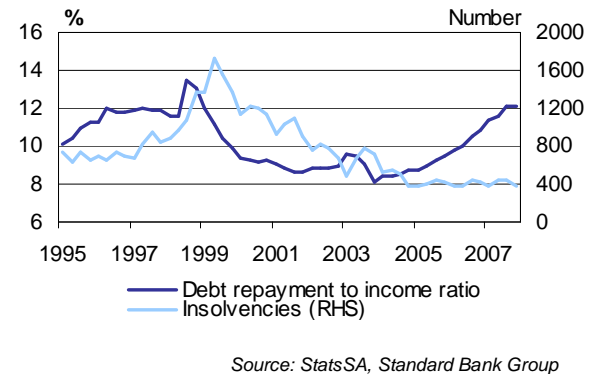


Figure 6: Debt affordability vs insolvencies



Note on the methodology used in calculating Standard Bank's house price index

The way in which house prices are measured means that they are inherently volatile, not unlike many other economic indicators. Measuring house prices is complicated by the fact that the available data usually stem from the properties sold during a particular period, rather than from a well-designed sample that is representative of all houses. This is aggravated by the heterogeneity of houses. Changes in the measured prices may be the result of actual changes in the general price level; or changes in the distribution of the houses being sold, for example more sales of luxury houses may push up the measured house prices even without changes in general prices; or the changes may simply be random.

Given these data challenges, the international best practice is to use the median or middle price, rather than, say, the average house price. The median is the price such that half of all houses are more expensive and half less expensive than that price. It is substantially less volatile and less sensitive to the typical problems found in house price data. Standard Bank's data are therefore based on the median house price of the full spectrum of houses. Furthermore, national data from the Deeds Office are available only with a relatively long lag of up to nine months, so data from Standard Bank, which has a market share of about 27.7%, and whose data are generally highly correlated with those of the Deeds Office, are a good proxy for the national market.



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