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2011 FNB HOUSE PRICE INDEX WRAP AND 2012 OUTLOOK

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2011 was a year of slow house price growth after the "mini-recovery" of 2010, and 2012 promises to be "more of the same"

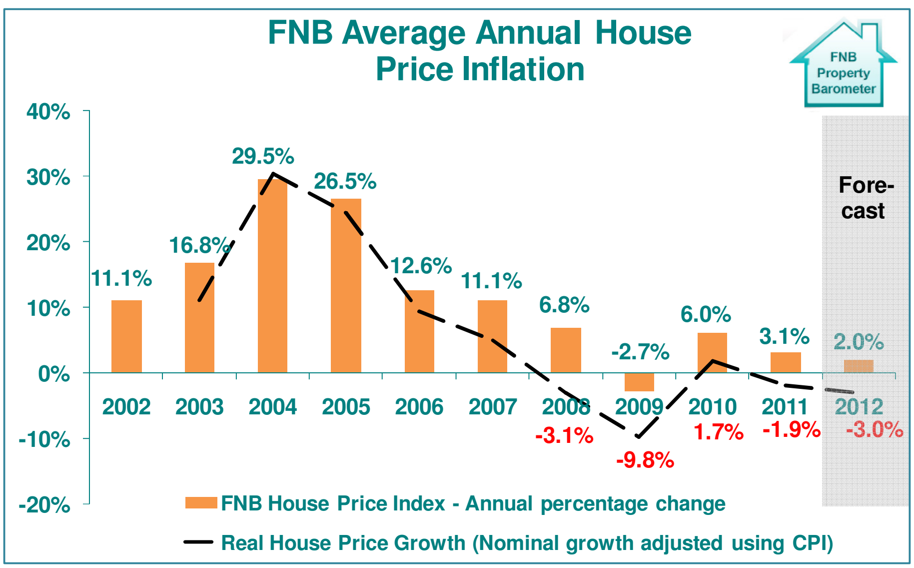
HOUSE PRICE GROWTH SLOWED IN 2011

The FNB House Price Index paints a 2011 picture of a residential market "flattening out" after what we call the "mini-recovery" of 2010. Following the recession of 2008/9, causing the 2009 average house price to decline -2.7%, 2010 saw the market gaining some relative strength, and the average price in that year recording a 6% increase on 2009. The market in 2010 had been buoyed by major interest rate cutting from December 2008 to August 2009 and a global economic recovery of sorts.

2011, however, saw slowing growth in residential demand, with economic growth slowing noticeably in the middle two quarters of the year, and no further interest rate stimulus following only minor interest rate reduction late in 2010 (1 percentage point reduction in total in 2010). The result was that the 2011 average house price of R802,988 was only 3.1% higher than the average 2010 price of R779,041.

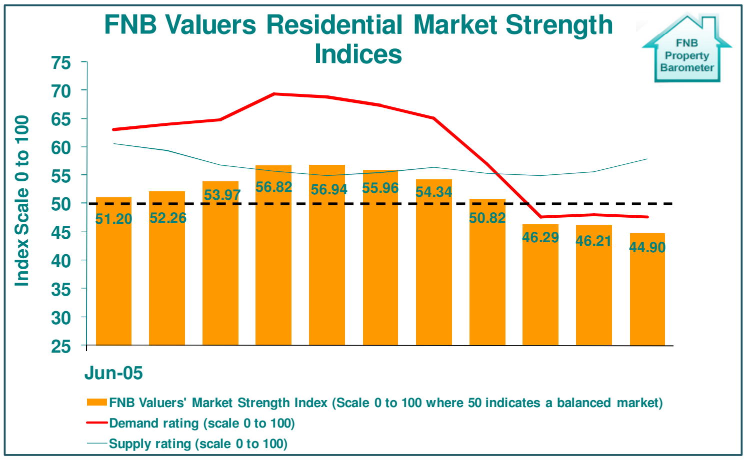
In real terms, adjusting for consumer price inflation (CPI), this translates into a probable decline of -1.9% (we say probable, because the December CPI number is not yet available), with the 2011 average CPI inflation rate looking likely to be in the region of 5%. This is a return to real price decline after a mild real average price increase of +1.7% in 2010.

In short, the "downward correction" in prices continued in 2011 when examined in real terms.



FNB'S VALUERS MARKET STRENGTH INDEX IN 2011 POINTED TO A SLIGHTLY BIGGER SUPPLY-DEMAND MISMATCH

The FNB Valuers' Market Strength Index continues to provide a plausible explanation for the ongoing weakness in nominal price growth in 2011, and real price decline, because it continued to point to weakness in demand relative to supply. The Market Strength Indices, i.e. the Demand Rating, the Supply Rating, and the Market Strength (Balance) Index are all calibrated on a scale of 0 to 100. 50 reflects the perfect balance between supply and demand in the Market Strength Index (in the valuers' opinions), below 50 indicates excess supply and above 50 that demand is rated stronger than supply.



The average Market Strength Index for 2011 deteriorated mildly from 46.21 in 2010 to 44.9 in 2011, and more crucially remains firmly below the 50 level. This deterioration in the market balance was not so much due to any major weakening in the demand strength rating in 2011, but rather due to a noticeable increase in the supply rating.

OUTLOOK FOR 2012

We enter 2012 with a residential market showing strong supply relative to demand, and a mediocre economic performance at best. Nothing obvious pops up to suggest that this will change radically in 2012. The International Monetary Fund (IMF) has been hinting at lowering its global economic growth forecast for 2012 from the current 4%.As it was, the 4% forecast would represent a growth rate unchanged from the 4% estimate for 2011, which itself was a slowdown from the 5.1% of 2010. The local housing market, therefore, has merely been tracking the broadly slowing direction of the global and domestic economy, as one would more-or-less expect.

Europe is the key area of economic concern at present, with its credit crisis and possible recession. But it goes wider than that. The World's largest economy, the US, also has very high debt levels, making it highly vulnerable to external shocks such as high commodity prices, and being the major oil guzzling economy, currently high oil prices pose risks to that country's economic growth.

***Interest rate prospects:** In 2012, a real possibility exists for further mild interest rate reduction. Year-on-year commodity price inflation slowed in the latter parts of 2011, and should do so further in the 1st half of 2012 due to high base effects. Therefore, the SARB expects a peak in the rising CPI inflation trend early this year. Given its official inflation target of 3% to 6%, should that inflation peak occur, and the rate start declining thereafter, the prospects for a further interest rate reduction would be enhanced.*

However, we would caution against expecting major reduction. At 5.5%, the SARB's repo rate is already negative in real terms, and the Bank has typically appeared to desire a healthy positive real interest rate. We have seen the SARB cutting very slowly since late-2009, despite a weak economy, suggesting that it is now a reluctant cutter of interest rates. We wouldn't expect any different in 2012, and any reduction would be a minor one, probably not making a major difference to residential demand.

***House Price Growth prospects:** Given the expectation of a slower economic growth year in 2012, and slight interest rate reduction at best, the average house price growth for 2012 is expected to be still slower than in 2011. After the 2010 "mini-recovery" that produced an average house price rise of 6.1% for 2010 as a whole, and 2011's slower rise of 3%, in 2012, we expect still slower nominal growth at around 2%. This would translate into further house price decline in real terms of about -3%, assuming a 2012 average CPI inflation rate of 5%.*

***Household Balance Sheet Re-building to continue:** 2012 is not expected to be without certain key positive developments for the housing market. The household sector balance sheet rebuilding is expected to continue. This includes further decline in the debt-to-disposable income ratio, and households increasingly "cutting the coat according to the cloth". We expect to see estate agents being surveyed continuing to tell us that a very significant percentage of sellers (currently hovering at near to 25%) will be selling their properties in order to downscale due to financial pressure, and we also finally expect SA's dismal household sector savings rate to emerge from a net-dis-savings rate (i.e. gross savings currently too little to cover depreciation on fixed assets) to more respectable levels. Additionally, we have seen households attempting to catch up on some home-*

related spending backlogs, and the levels of home maintenance appears to have improved according to our surveys as well as according to retail hardware sales stats. We expect this process to continue too.

These are the "hard work" processes that are crucial to a healthy property market, but whose benefits are only felt with a long time lag. These are the positive developments that are expected to continue in 2012. But these processes that have to take place to lay the foundation for recovery are slow. The "text book" big property cycle spans an average of 15-20 years. Given that 1998 was arguably the last big cycle bottom point, we are now 13 years into the current cycle. This would suggest a few more years of eliminating the various excesses and imbalances that exist before the market can flourish. 2012 promises progress in reducing the "excesses", but it seems too early to expect this to translate into improved price performance.

Finally, the ongoing financial pressure for the time being, along with household efforts to rebuild balance sheets, leads to the expectation in 2012 that:

- *the more affordable segments of the housing market will outperform the higher priced segments.*
- *High transport costs due to high fuel prices and looming tolls can support demand in close proximity to key business nodes, and….*
- *Smaller homes are expected to be more popular as they contribute to reduced running costs.*

*Notes: *When an FNB valuer values a property, he/she is required to provide a rating of demand as well as supply for property in the specific area. The demand and supply rating categories are a simple "good (100)", "average (50)", and "weak (0)". From all of these ratings we compile an aggregate demand and an aggregate supply rating, which are expressed on a scale of 0 to 100. After aggregating the individual demand and supply ratings, we subtract the aggregate supply rating from the demand rating, add 100 to the difference, and divide by 2, so that the FNB Valuers' Residential Market Strength Index is also depicted on a scale of 0 to 100 with 50 being the point where supply and demand are equal..*

***The FNB House Price Index is a fixed-weighted average of its sub-indices, which are split by room number and by sectional title versus freehold properties. The index is lightly smoothed using a Hodrick-Prescott smoothing function. An index month commences 7 days prior to the end of the previous month to 7 days prior to the said calendar month.*