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PROPERTY BAROMETER –FNB HOUSE PRICE INDEX – OCTOBER 2012

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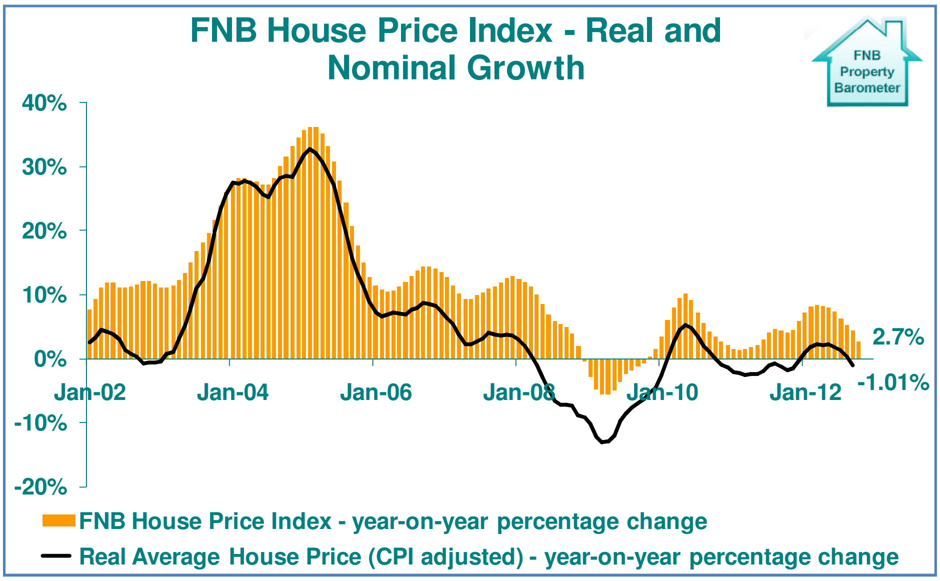
Despite recent signs of demand improvement, house prices continue to "muddle along", the result of a weak economy, high levels of household indebtedness, and a still-poorly balanced market

SUMMARY

The FNB House Price Index for October 2012 showed further moderation in its year-on-year inflation rate, from a revised 4.4% in September to 2.7%. This is the 7th consecutive month of tapering growth since the 8.4% peak in year-on-year growth reached in March 2012. The average value of homes transacted in the FNB House Price Index was R833,659 in October.

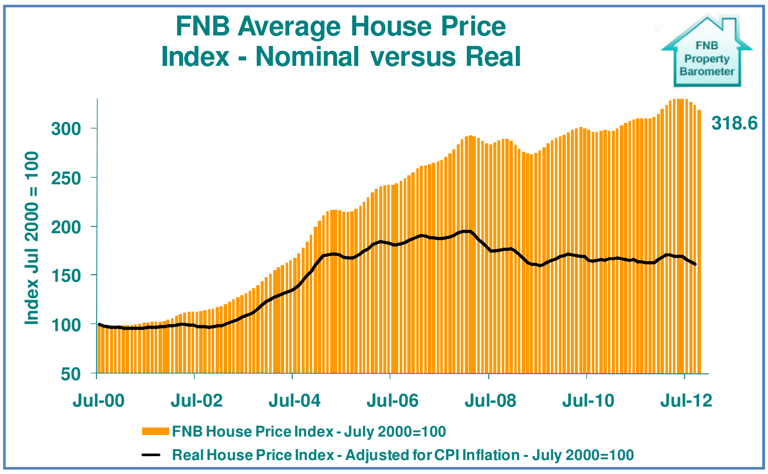
This slowing year-on-year house price growth, to levels back below consumer price inflation, implies a return to declining house prices in inflation-adjusted real terms. As at September (October consumer price inflation data not yet available), the combination of a CPI inflation rate of 5.5% year-on-year, and a 4.4% house price growth rate in that month, translated into a real year-on-year decline of -1.01% in the FNB House Price Index.



The return to low single-digit year-on-year house price growth does not come as too much of a surprise. There was indeed a lone interest rate cut of half a percentage point in July, but against this the market is not yet well balanced between demand and supply, the level of household sector indebtedness remains high and has begun to rise again, and the economy remains under significant pressure.

Therefore, although estate agents and valuers have both reported some recent market improvements, which may well feed through mildly into house prices in the remainder *of 2012,we believe that under the abovementioned SA's buying population will be watching its wallet closely.*

HOW FAR HAS THE MARKET (DOWNWARD) REAL PRICE CORRECTION PROGRESSED TO DATE?



According to the FNB House Price Index, the peak of real house price levels at the end of the most recent boom was in February 2008. From that month up until September 2012, the cumulative real house price decline was -17.1%. While this appears to be a significant downward correction, the real price level remains +61.6% higher than July 2000, the starting month for the FNB Index and also a period early in the last house price boom. In nominal terms, since February 2008 the cumulative increase up until October 2012 was a very mild +8.8%, although still a massive +218.6% up on June 2000.

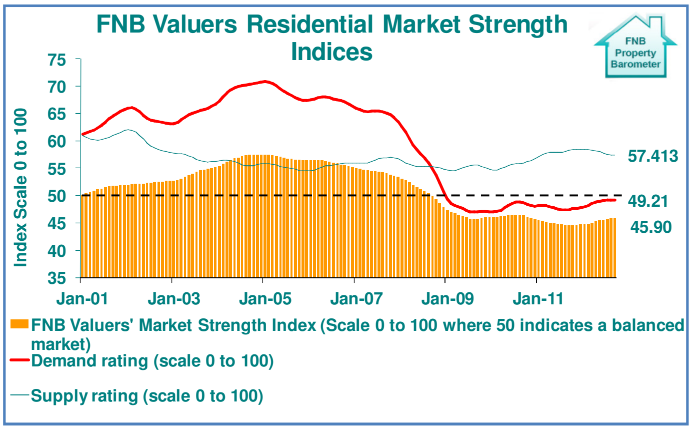
FNB'S VALUERS HAVE ALSO POINTED TO A SLOWING PACE OF IMPROVEMENT IN THE RESIDENTIAL MARKET BALANCE THROUGH THE WINTER, BUT MORE RECENTLY…

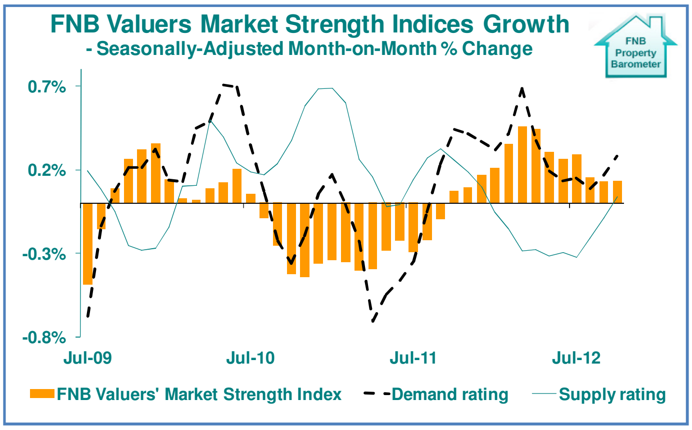
While the FNB Valuers' Market Strength Index has been pointing to some improvement over the course of 2012, its results are not entirely out of line with the slowing year-on-year house price growth trend, as the pace of improvement in the Market Strength Index has indeed been tapering off since earlier in the year.

In the past 2 months, however, the slowing rate of improvement in the Valuers' Demand-side Strength Index has indeed come to an end and a slight acceleration in the pace of growth in the demand rating may reflect some slightly positive response by the market to the July interest rate cut. However, this slight rise in demand has not led to an improvement in the valuers' perception of market balance quite yet, because they also registered an end to the decline in the residential supply rating (decline in supply being a good thing for the market balance), sustaining the broad slowing in the rate of increase in the Market Strength Index, which reflects the difference between supply and demand ratings.

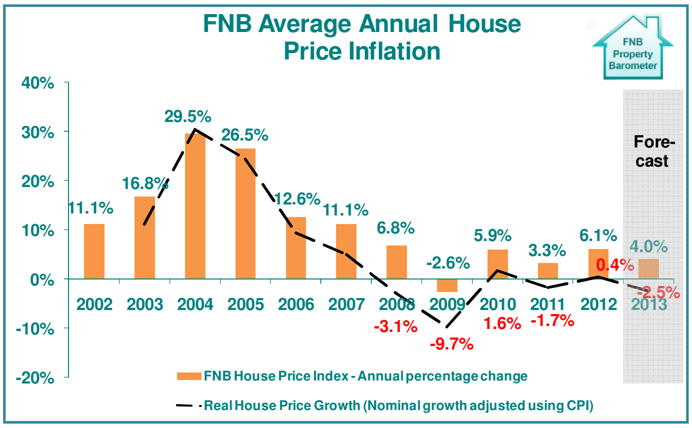
And despite some rise in the Market Strength Index, the fact that it remains well-below the crucial level of 50 implies that the valuers still rate supply as better than demand. This should probably imply further broad house price decline in real terms for the foreseeable future, and this is exactly what the FNB House Price Index is recording once again.

Will the recent rise in the pace of improvement in the Valuers' Demand-side Rating lead to a more rapid pace of improvement in the overall Market Strength Index, resulting in a renewed bout of house price growth strengthening? That will depend on whether this rise can be sustained for any length of time, and that will depend on near term economic events.





OUTLOOK…..



We believe it possible that the declining trend in year-on-year growth in the FNB House Price Index will come to a halt late in 2012, and that indications of recent improvement in residential demand, both from our valuers as well as from our FNB Estate agent survey, will lead to some stabilization in the house price growth rate.

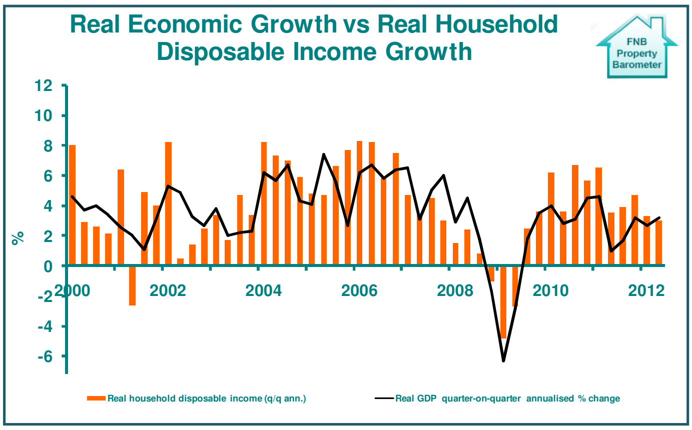
However, looking forward into 2013, while year-on-year price growth may pick up a little from the October low level, we are of the expectation that overall house price growth will be a little slower next year than the average for the entire 2012.This is based on our view of the global and domestic economy, as well as on the level of household sector indebtedness.

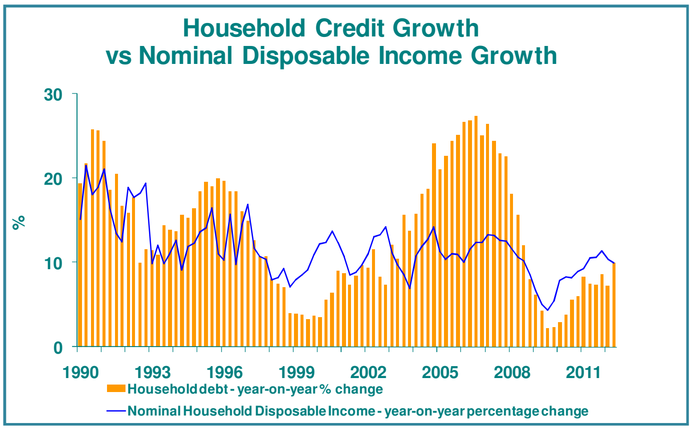
The average price growth for 2012 is projected at 6.1%, with only 2 months' worth of data left to come. However, not only does the global and local economy remain mediocre, but more importantly for the housing market is that we have seen real disposable income growth broadly slowing, since the very strong rates of near to 6% in 2010/early-2011, down to 3.5% by the 2nd quarter of this year. We believe that it will now move in a slower range closer to economic growth rates, because the rapid "normalization" (growth) in the wage bill as well as investment income, off a low base after the 2008/9 recession, has all but been completed.

This in turn curbs the growth in purchasing power growth of households. On top of this, we have recently started to see accelerating household credit growth draw level and start to overtake nominal disposable income growth. This accelerating household credit growth is driven by very strong growth in the non-mortgage credit components, and is the cause of a resumption of an unhealthy rise in the debt-to-disposable income ratio for the household sector. Strong growth in non-mortgage credit could increasingly constrain the household sector's ability to purchase property going forward.

And finally, we head towards 2013 with a mildly rising consumer price inflation rate, with a recent US drought exerting recent upward pressure on food prices, and rand weakness also having some impact on higher petrol prices. Within the CPI, housing-related Municipal rates and utilities tariffs remain troublesome, and are not set to stop their strong rise soon, with Eskom preparing the next round of multi-year tariff hikes.

These are the realities that we look set to have to face in 2013, and the expected result is a year of low average house price growth of 4%, which, given a higher expected consumer price inflation rate, would translate into further real (CPI inflation-adjusted) house price decline to the tune of -2.5% as the long term downward correction in real prices continues.





Notes:

Note on The FNB Average House Price Index: *Although also working on the average price principle (as opposed to median or repeat sales), the FNB House Price Index differs from a simple average house price index in that it could probably be termed a "fixed weight" average house price index.*

One of the practical problems we have found with house price indices is that relative activity shifts up and down the price ladder can lead to an average or median price index rising or declining where there was not necessarily "genuine" capital growth on homes. For example, if "suburban segment volumes remain unchanged from one month to the next, but former Black Township (the cheapest areas on average) transaction volumes hypothetically double, the overall national average price could conceivably decline due to this relative activity shift.

This challenge of activity shifts between segments is faced by all constructors of house price indices. In an attempt to reduce this effect, we decided to fix the weightings of the FNB House Price Index's sub-segments in the overall national index. This, at best, can only be a partial solution, as activity shifts can still take place between smaller segments within the sub-segments. However, it does improve the situation.

The FNB House Price Index's main features are as follows:

- *The weightings of the 10 sub-segments were determined by their relative transaction volumes over the 5 years from 2003 to 2007. The weightings are fixed (to be revised periodically):*

- *Sectional Title:*
  - *Less than 2 bedroom (Weight – 0.0718)*
  - *2 Bedroom (Weight – 0.2106)*
  - *3 Bedroom (Weight – 0.101)*
  - *4 Bedrooms (weight – 0.0031)*
  - *More than 4 Bedrooms (Weight – 0.0002)*
- *Full Title:*
  - *Less than 2 Bedrooms (Weight – 0.053)*
  - *2 Bedrooms(Weight – 0.1092)*
  - *3 Bedroom(Weight – 0.3561)*
  - *4 Bedroom (Weight – 0.0811)*
  - *More than 4 Bedroom(Weight – 0.0139)*

- *The Index is constructed using transaction price data from homes financed by FNB.*
- *The minimum size cut-off for full title stands is 200 square metres, and the maximum size is 4000 square metres*
- *The maximum price cut-off is R10m, and the lower price cut-off is R20,000 (largely to eliminate major outliers and glaring inputting errors).*
- *The index is very lightly smoothed using a Hodrick-Prescott smoothing function with a Lambda of 5.*

Note on the FNB Valuers' Market Strength Index: **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.*