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PROPERTY BAROMETER –FNB HOUSE PRICE INDEX AND 2014 OUTLOOK

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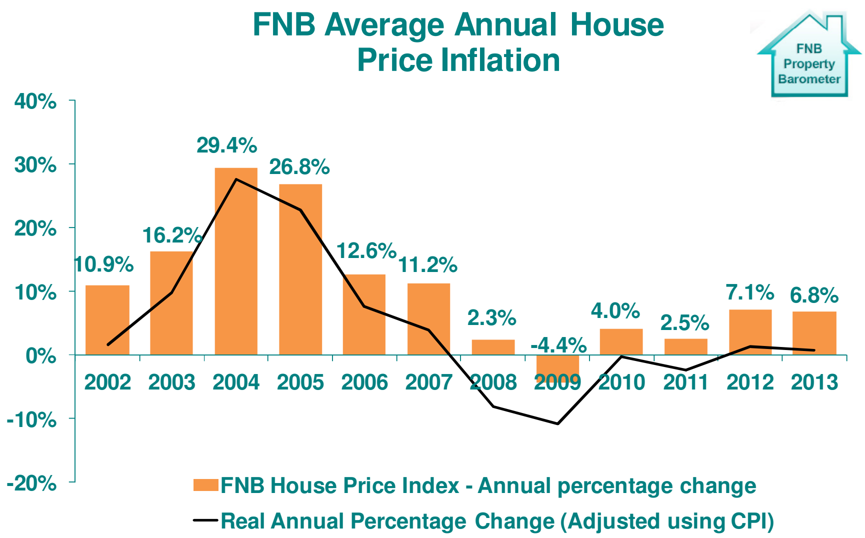
2013 saw slightly slower average house price growth than 2012, but improving demand-supply balance hints at improved average price growth to come in 2014

2013 HOUSE PRICE INDEX FINDINGS

According to the FNB House Price Index, the average house price for the entire 2013 rose by 6.8% compared with the average price for 2012. This was a slight slowing in growth on the revised 2012 average house price growth of 7.1%.

In real terms too, when adjusting house prices for consumer price inflation, 2013 showed a slightly lower rise of 0.8%, compared to 1.3% in 2012. Nevertheless, 2013 saw the 2nd successive year of slight positive real house price growth following 4 prior years of average real price decline.

The average price of homes transacted was R891,976 for 2013, compared with R835,480 in 2012.



In real terms, the FNB House Price Index remained well-above levels of a decade ago, with the real price average for 2013 42.6% above the real average price for 2003. However, compared with last decade's real average price peak, reached in 2007, the 2013 average real price was still -18.5% lower.

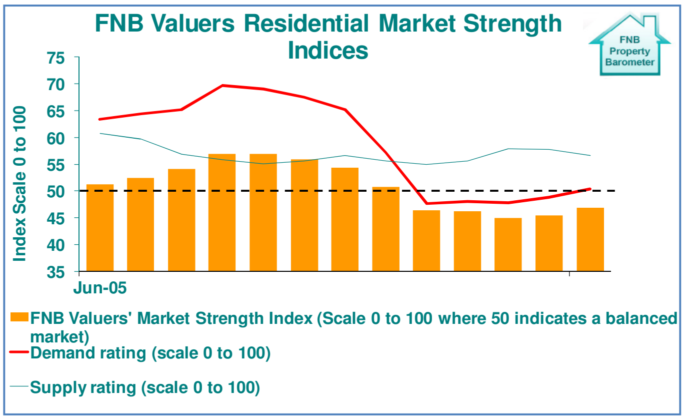
In nominal terms, the 2013 average price was 145.2% higher than the 2003 price level, but only 19.3% above the 2007 level.

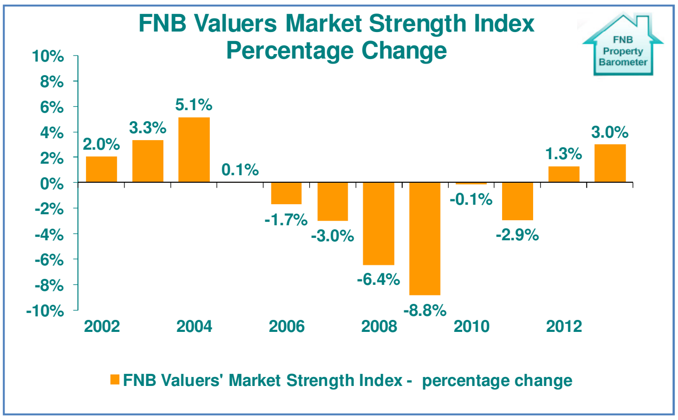
Therefore, as at 2013, real price levels remained far above the levels of a decade ago, but still do reflect a significant cumulative downward "correction" since 2007.

FNB'S VALUERS HAVE ALSO POINTED TO SOME FURTHER IMPROVEMENT IN MARKET STRENGTH FOR 2013 AS A WHOLE

While the FNB Valuers' Market Strength Index (Explanatory notes on page 5) has not yet quite reached the crucial level of 50, implying that the valuers' aggregated supply rating is stronger than the demand rating, the index nevertheless did point to further improvement in the market demand-supply balance in 2013, rising by 3% on the average market strength level for 2012.

Being below a level of 50 probably explains why we have not yet seen strong real house price growth since the 2008/9 recession, despite the improved level since a low point reached in 2011.





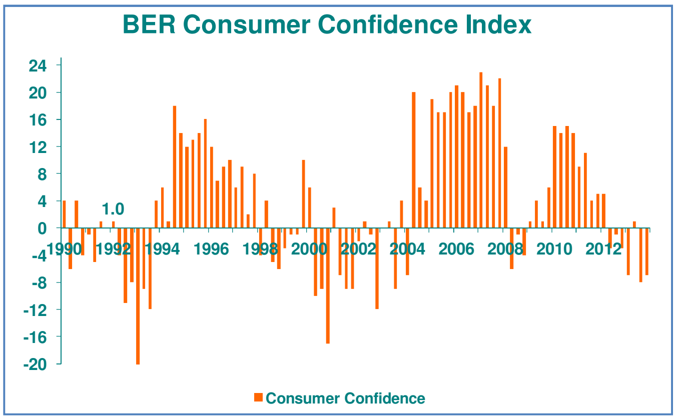
2014 OUTLOOK

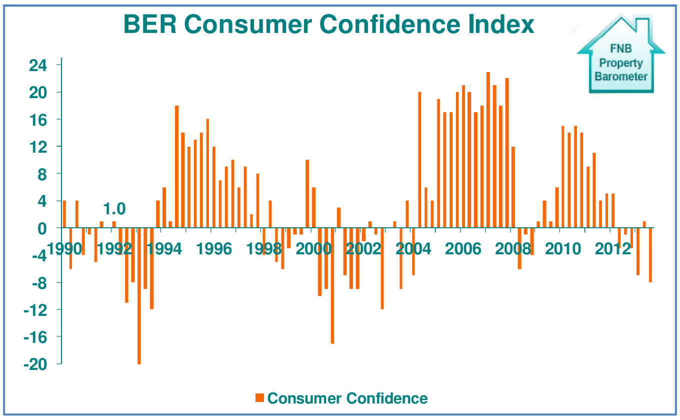
In order to look forward into 2014, it is probably necessary to consider some of the economic trends through 2013 as the year progressed. Doing this leads us to believe that we should not expect to see a large increase in the average rate of house price inflation on that of 2013. The reality is that South Africa has anaemic economic growth at best, with the 2013 average real economic growth rate looking set to come in at near to 2%. Such a rate would mean the 2nd consecutive year of slowdown in economic growth since a more respectable 3.5% rate was achieved in 2011.

Slowing economic growth, in turn, is influential in slowing the pace of employment, wage growth and thus household disposable income growth. So, whereas real household disposable income growth peaked at an impressive 5.2% in 2011, it looks set to be nearer to 2.7% for 2013 when we receive the data for the final quarter.

Slowing real disposable income growth has already taken its toll on consumer confidence, with the FNB/BER Consumer Confidence Index showing negative readings for 6 out of the last 7 quarters.

We thus enter 2014 still on a broadly slowing economic real disposable income growth path since 2011, a path which has already had a negative impact on overall growth in consumer expenditure. We also enter the new year not forecasting any interest rate cutting, and thus no further stimulus from the SARB either, as consumer inflation continues to move around the higher part of the 3-6% target range.





However, while a slow economy and lack of interest rate cuts could be expected to have a moderating influence the pace of growth in residential demand in 2014, there are 2 other key factors which can possibly have the opposite influence.

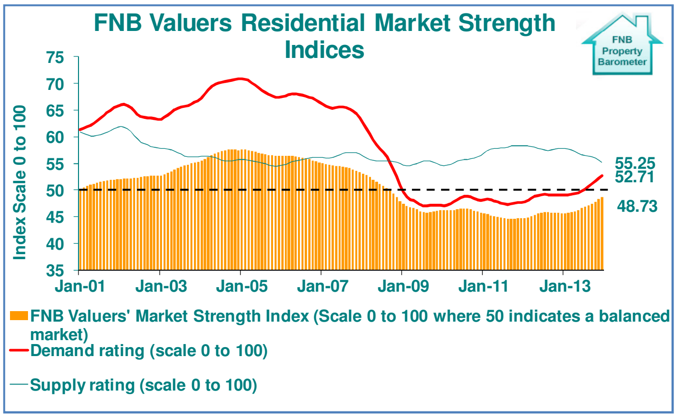
Firstly, the question needs to be asked as to whether banks as a group are beginning to see mortgage lending as a potential source of asset growth after the unsecured credit boom has all but ended. Why not? "Recency bias" in humans suggests that long periods of low and stable interest rates, and better times in recent years regarding bad debts on mortgage books, can often be expected to drive a perception of lower risk amongst lenders and borrowers alike. This could imply relaxations in lending criteria, something which may have been taking place already, and which in turn could be boosting residential demand all other things equal.

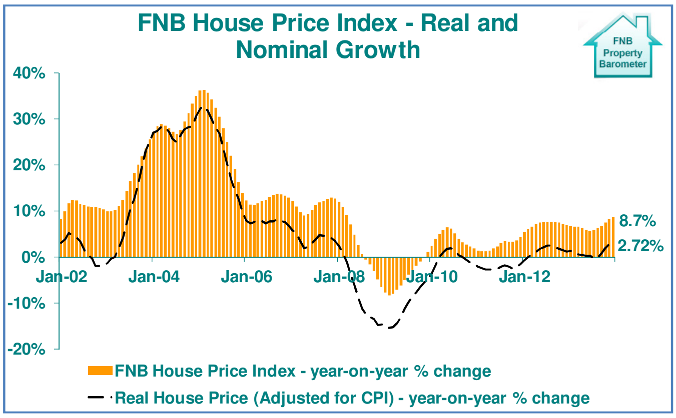
What we do know at least is that the National Credit Regulator data has pointed to accelerating growth in mortgage lending in recent quarters, as well as cutbacks in other forms of credit granted. So, whereas total household credit granted in the 3rd quarter of 2013 grew by a moderate 6.8% year-on-year, the mortgage component of that grew by a very strong 20% in value, and has been on a sharply accelerating growth trend in recent quarters.

The second key factor is the supply side of residential property. This may also be currently supportive of higher house price growth despite a slowed economic and household disposable income growth rate. Residential building activity has surprised on the downside in 2013. The recorded number of residential units completed for the 1st 10 months of 2013 rose year-on-year by a mere 3.2%, and the level of building activity remains not far above half of what it reached at the height of the residential building boom back in 2007.

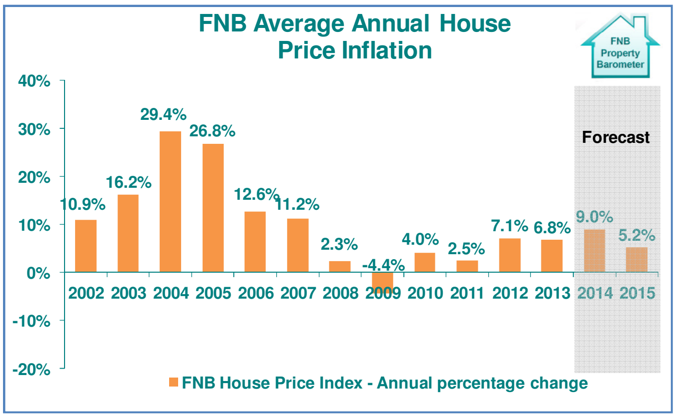
The result of the slow recovery in building activity to date is that, not only do we enter 2014 with residential demand still rising, but supply has also been becoming more constrained according to FNB's valuers. So, when one shows the Demand and Supply Ratings on a monthly basis, we see the gap steadily closing between the two, and at 48.73 by December, the Market Strength Index is getting very close to the crucial 50 level. This level is the best Market Strength Index level since October 2008.

In line with an improving demand-supply balance, we also approach 2014 with accelerating house price growth when viewed on a monthly basis. So, whereas the average price growth for the entire year of 2013 was slower than that of 2012, that was due to growth earlier in 2013 being slower, whereas in the latter parts it was once again picking up speed, reaching 8.7% year-on-year in December.





The net result of all of the above is that, despite a slowed economy in 2013, other factors, most notably some possibly more relaxed lending by banks as a group, and a constrained supply side of the residential property sector, lead us to lift our 2014 average house price growth forecast to 9%, thus up from 2013's growth. In 2015, however, we would expect price growth to once again slow, based on our forecast that interest rates could start to rise in 2015.



Therefore, the residential market of 2013 could be described as a "comfortable and well-balanced market", which was still largely free of extreme or crazy" behavior, and certainly not booming. Despite a weak economy that looks likely to persist, supply constraints could cause 2014 house price performance to be slightly better in our view.

ADDENDUM - 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 short term 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.

With our 2013 re-weighting exercise, we have begun to segment not only according to room number, but also to segment according to building size within the normal segments by room number, in order to further reduce the impact of activity shifts on average price estimates.

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

• *The weightings of the sub-segments are determined by their relative transaction volumes over the past 5 years, and will now change very slowly over time by applying a 5-year moving average to each new price data point. The sub-segments are:*

- *Sectional Title:*
  - *Less than 2 bedroom – Large*
  - *Less than 2 bedroom – Medium*
  - *Less than 2 bedroom – Small*

  - *2 Bedroom – Large*
  - *2 bedroom – Medium*
  - *2 bedroom – Small*

  - *3 Bedroom and More - Large*
  - *3 Bedroom and More - Medium*
  - *3 Bedroom and More - Small*

- *Full Title:*
  - *2 Bedrooms and Less - Large*
  - *2 Bedrooms and Less - Medium*
  - *2 Bedrooms and Less - Small*

  - *3 Bedroom - Large*
  - *3 Bedroom - Medium*
  - *3 Bedroom - Small*

  - *4 Bedrooms and More - Large*
  - *4 Bedrooms and More - Medium*
  - *4 Bedrooms and More – Small*

The size cut-offs for "small", medium" and "large" differ per room number sub-segment. "Large" would refer to the largest one-third of homes within a particular room number segment over the past 5 year period, "Medium" to the middle one-third, and "Small" to the smallest one-third of homes within that segment.

- *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.*