PROPERTY BAROMETER – JANUARY FNB HOUSE PRICE INDEX

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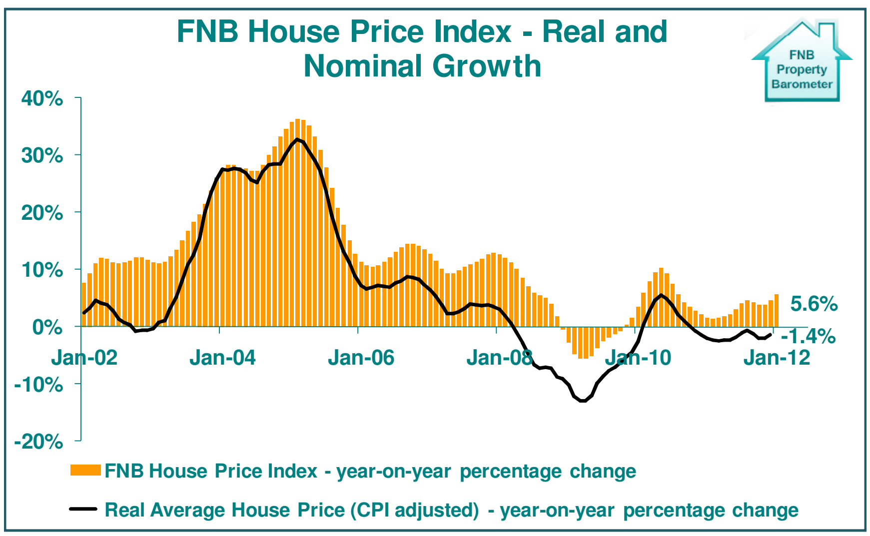
Is the housing market 25% over-valued? We don't think it is possible to say, but nevertheless do expect some further real house price decline.

HOUSE PRICE GROWTH ACCELERATED MILDLY IN JANUARY

The January 2012 FNB House Price Index showed a slight acceleration entering the new year, rising from revised year-on-year growth rate of 4.7% in December to 5.6% in January. This is the highest year-on-year growth since August 2010.

In real terms, however, the recent growth rates imply that real house price decline continues. Consumer price inflation for December (January not yet available) was around 6.1%, and a 4.7% house price growth rate in that month translates into about -1.4% real decline.

This means that in real terms, the latest revised figures put the average house price in real terms (adjusted for consumer price inflation) at -15.5% lower than the peak of February 2008.



In recent times, the fluctuations in the house price index are probably not too dissimilar from those of certain key economic growth indicators.

After two very weak 2nd and 3rd quarters, South African economic growth is believed to have done slightly better in the final quarter of 2011. The Manufacturing Purchasing Managers' Index made a mild come back out of contraction territory, while previously slowing real retail sales growth had also showed something of an unexpected strengthening late last year.

Indeed, our own FNB Estate Agent Survey had also pointed to a surprising slight improvement in residential demand in the 3rd quarter of 2011, and this is believed to have been feeding through into house prices with a mild lag.

CAN THE RECENT MILD IMPROVEMENT PROVE SUSTAINABLE? AND IS THE MARKET REALLY "25% OVERVALUED"?.

This FNB House Price Index release comes at a time when something of a mild storm appears to be raging in the residential industry as a result of the release of the recent Rode and Associates Report which claims the residential property market to be about 25% "overvalued". This, I interpret to mean that it would require a very significant decline in house prices in real terms in order to get back to what Rode deems to be an "appropriately priced market" that would be in "balance" or "equilibrium. Needless to say, many industry players are, rightly or wrongly, seemingly unhappy with the statement. It has been the focal point of the past few days, and we have been questioned frequently about it.

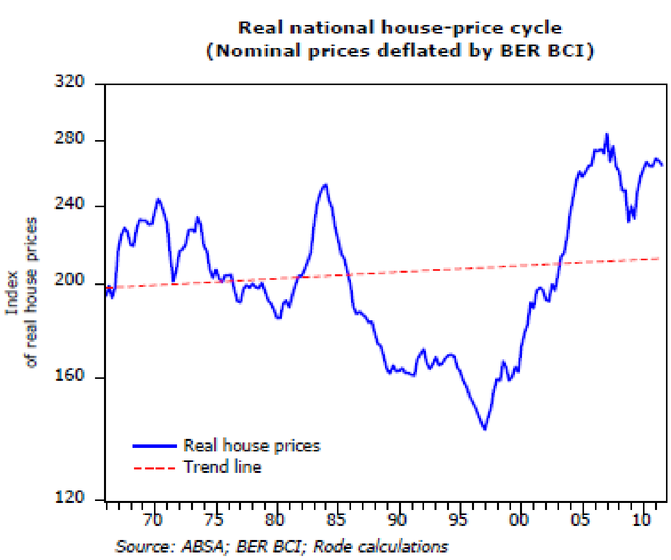
Perhaps some people have over-reacted to the report a little, as Rode is not predicting a sudden downward price correction. Rather, he expects a gradual real price decline over some years. Nevertheless, the fact that it has grabbed the attention of the industry suggests that it is worth debating.

Our own opinion is that it would be extremely difficult to ascertain as to by how much the market is "over-valued" or unrealistically priced, and that in any case, the equilibrium price level (if one could determine it) is very much a moving target, fluctuating frequently as economic fundamentals change. However, that is NOT to say that we ourselves don't expect some real house price decline in 2012. We do. But our reasoning is based more on our perceptions of a very weak economy and very little stimulus for the market, as opposed to what we would regard as "technical analysis" based simply on a long term trend.

The Rode methodology. It is essentially what we would call a "technical analysis" as opposed to a fundamental analysis. A long term real house price time series is calculated using the Absa House Price Index, the only house price index dating back to the mid-1960s, and the Bureau of Economic Research Building Cost Index. ***Let us emphasise that both indices are well-respected and their validity is not being questioned here.***

In brief, the rationale behind the using building costs with which to adjust house prices into real terms has to do with the view that building costs drive property values over the long term. Assuming that supply of new homes can be added by developers "at will", in other words, there are no constraints to supply due to urban planning requirements or land availability, then building costs determine house prices in the long term.

If existing house prices were above building costs, supply of newly-built homes would increase, bringing house prices back down into line with building costs, and if existing house prices move too far below building costs the new supply would slow until the demand-supply balance had been restored and house prices moved higher and closer to building costs.



Therefore, according to the theory as we understand it, real house prices, as calculated through deflating nominal house prices with building costs, should move in the broad sideways band over the long term. If the real price level is significantly above the long term trend line, as is currently the case when using 1966 as a starting point, the theory is that the market is "overvalued", and the current Rode estimate that it is overvalued by 25.

We have some reservations about using this methodology.

Firstly, while the theory could indeed work under the assumption of totally elastic supply of new homes as required by the market, we are no longer convinced that such elasticity is a reality in South Africa any more.

Cape Town, for one, has a relative land scarcity for property development (especially around the mountain), which keeps its average property values above those of Joburg in spite of Joburg having higher average per capita income (and thus higher purchasing power).

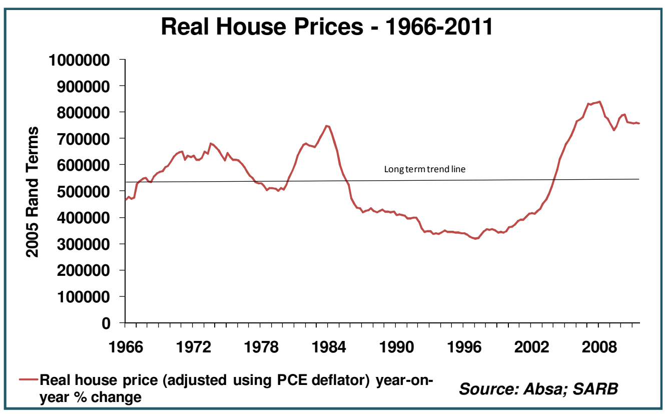
As urbanization continues, one would expect land scarcity in our cities to increase. Theoretically the landlocked cities could continue to sprawl, but it would be the increasing urban congestion and infrastructure constraints that make this increasingly impractical.

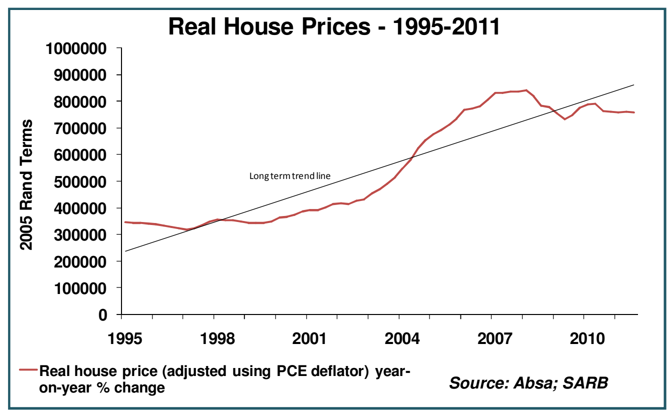
Therefore, we believe it conceivable over the long term that real house price can increase significantly, and that South African cities can and will become far more expensive places to live as time goes by, and indeed we believe that this is already taking place.

Our second, and key, reservation with the Rode approach, however, is that when using long term trend lines to determine whether a market is under or over-valued, one can literally pick your starting point to "prove" whatever theory you wish.

We'll demonstrate. For various reasons, we prefer to use consumer price trends (as reflected in the private consumption expenditure deflator of the Reserve Bank) with which to convert nominal house prices into real terms. Nevertheless, the long term trend in real house prices using consumer prices as a "deflator" is not too different from the approach of using building costs.

Below, one will see the major difference in the long term trend lines between using 1966 as a starting point and using 1995 as a starting point. The 1966 starting point would suggest that the market is "grossly over-valued", while the 1995 starting point would suggest it "under-valued" if one buys into the long term trend theory. If we had data for a few decades prior to 1966, who knows what the long term trend line would have looked like as a result of SA having come through an Anglo-Boer War, two world wars and a Great Depression?



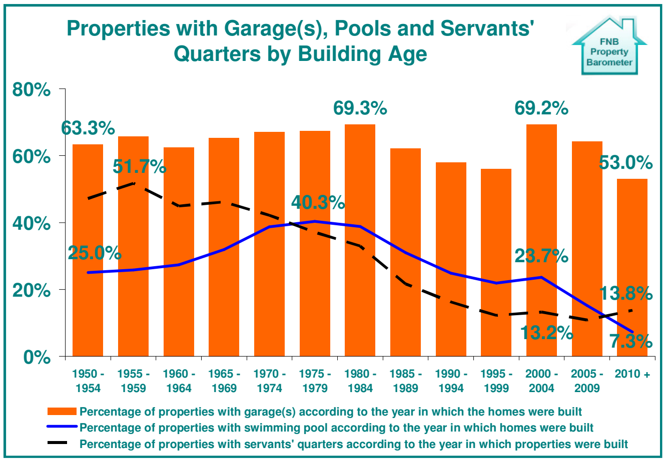


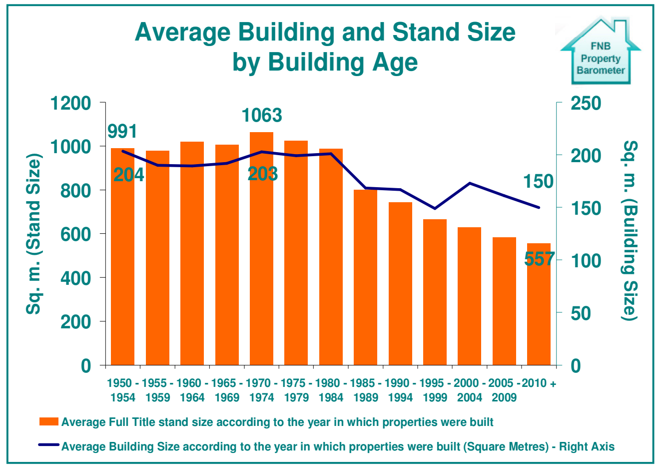
So there we have it, a good graph for the property bears as well as one for bulls (which is what one would expect from a two handed economist I guess). Take note that we're not claiming either of the above graphs to be the correct one.

The third and final consideration with regard to using a long term real average house price trend is that the average house of the mid-1960s is different to the average house of today. Real property values have risen significantly since the mid-1960s but will not necessarily wholly be seen in an index depicting the average house price. The market does not only adjust to real house price surges through a subsequent downward correction in real prices. Real per square metre existing property values can remain permanently higher if land scarcity remains permanently higher, with developers providing smaller homes on smaller stands (as opposed to flooding the market with the same sized units as in previous years).

Indeed, this has been the long term trend. As land scarcity has increased, so average stand size of new homes has diminished dramatically. Over the past decade, full title homes that our valuers have valued that were built between 1970-1974 had an average stand size of 1,063 square metres. By comparison, homes built from 2010 to date had seen their average stand size almost halve to 557 square metres. Over the same period, the average size of a home built had dropped from 203 square metres to 150 square metres. Less "frills" were also the order of the day. Whereas 69.3%

of homes built from 1980-1984 had garages, this had declined to 53% by 2010. Percentage of homes with swimming pools had declined from 40.3% of those built between1975-1979 to 7.3% by 2010+.





Therefore, when analyzing real house prices since 1966, one may well draw the conclusion that the long term real price trend line from that point is more-or-less flat, or has very little rise over time. However, if we could calculate a price index that adjusted for declining stand size/home size and level of luxuries, we would see more of a rising long term real price trend line. Because over the long term, as urban land becomes increasingly scarce, real prices are indeed rising. The real values are staying permanently higher over the very long term, and the development sector is adjusting by providing smaller and less luxurious homes as time goes by.

CONCLUSION

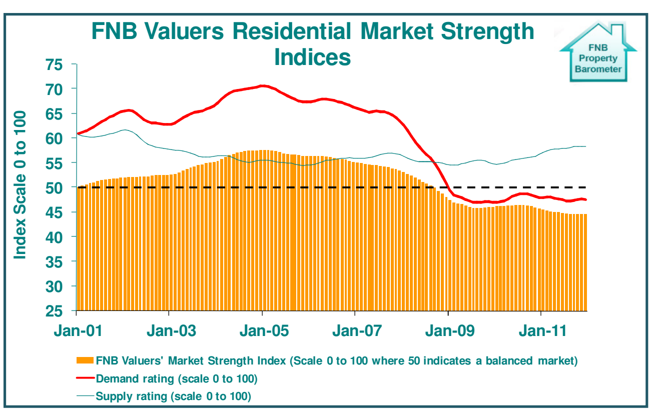
So are house prices overvalued by 25%? We can't contradict the statement. All we can say is that we believe that it is not possible to say.

However, while we have stated the belief that urbanization in SA should bring about significant long term increases in real property values, we must distinguish between the very long term, and the 'shorter" term. The long term move to higher real property values doesn't happen in a straight line, but rather in big cycles driven by shorter term fluctuations between supply and demand.

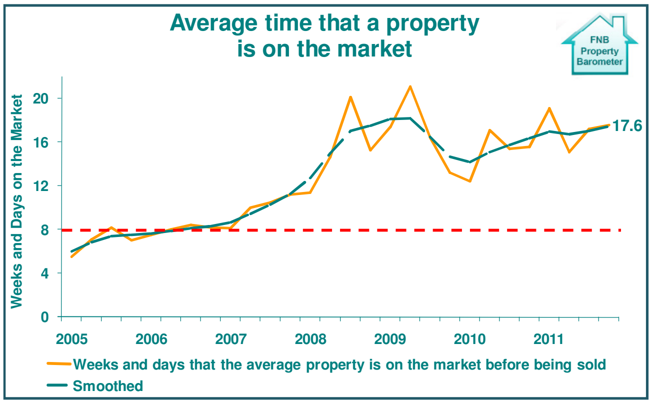
And indeed, in the near term we are also of the opinion that real house prices will decline further.

Our reasoning is somewhat different, however, and based on our perception that the market is unbalanced at present, and that the economy (and thus residential demand) looks likely to be weak in the near term.

The FNB Valuers' Market Strength Index (a measure of our valuers' perceptions of demand and supply) continues to provide a Possible explanation for the ongoing weakness in nominal price growth in 2011, and real price decline, because it continues 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 January 2012 deteriorated very slightly from 44.63 to 44.62, and although the change is insignificant, what is more significant is the fact that it remains consistently well below the 50 mark.



Our Estate Agent Survey for the 4th quarter also continued to point to a somewhat unrealistically priced market, with 90% of sellers having to ultimately drop their asking price to make a sale, and the average time that a property is on the market continuing on its broad rising trend to 17 weeks and 6 days. In our admittedly subjective view, an average time on the market of around 4 months still appears too long for the market to be deemed to be "realistically priced".

Of course, even if the market is unrealistically priced at present, this does not imply that real prices must drop. The alternative is for a strong demand surge to "mop up" the oversupply and alter what was in weaker demand times an unrealistic price to being a "realistic one".

But unfortunately, 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. While late in 2011 we had a mild improvement in global economic activity, the consensus appears to be for a slower economic growth year both world-wide and domestically in 2012. Oil prices remain constrainingly high, Europe still has much work to do in sorting out its debt crisis, while one would think that the US cannot continue indefinitely in ratcheting up its government debt and "printing money" to keep its economy growing.

In recent weeks, therefore, we have seen the World Bank, IMF and UN all revise their global growth forecasts lower, and to lower levels than 2011 growth estimates. Not surprisingly, the Reserve Bank sees our own domestic growth slower in 2012 compared to 2011 too. This expectation is plausible, as it is now expected that consumer price inflation will remain above the 6% target limit for most of 2012, thus allowing little room for any interest rate cutting any time soon.

Given that the stimulus from 2009/10 interest rate cuts is wearing off, that the economy expected to grow slower, and our view that the market remains unbalanced at present, we remain of the view that nominal house price growth will be slower in 2012 than the 3% average for 2011. This would imply a lower-than-consumer price inflation growth rate, which in turn would imply real house price decline.

So, while we have stated that it is very difficult to estimate by how much the residential market is "over-valued", we are nevertheless of the opinion that 2012 will bring about further real house price decline. This is based on our economic expectations, however, and how far the real house price decline will go in the current period of stagnation will also be very dependent on the world's and South Africa's ability to turn things around and get back to a respectable longer term economic growth path in the coming years.

*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.*