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3 February 2014

PROPERTY BAROMETER
- Residential Property Monthly

January 2014 House Price Index grew slightly slower than December, but that has nothing to do with January's surprise interest rate hike yet.

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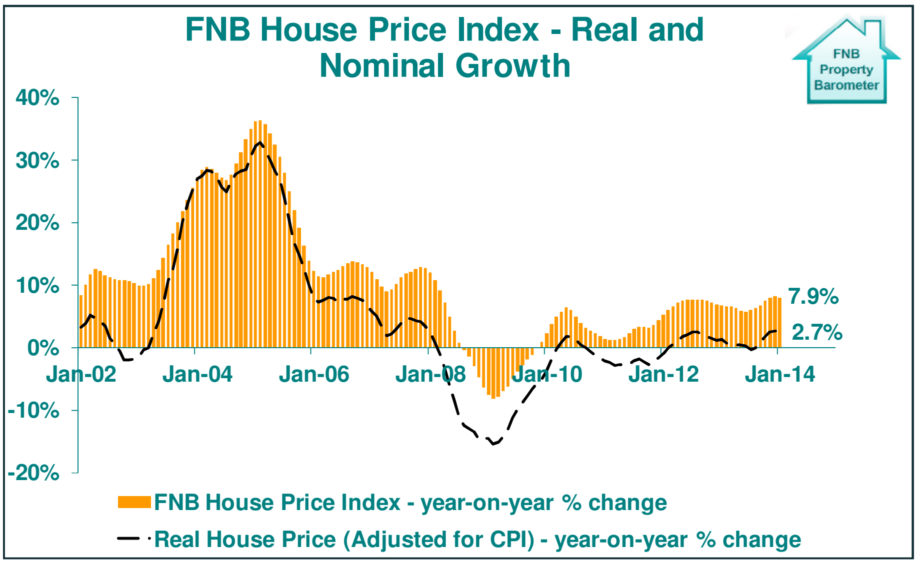
JANUARY 2014 HOUSE PRICE INDEX FINDINGS

According to the FNB House Price Index, the average house price for January 2014 rose 7.9% year-on-year, very slightly down from a revised 8.2% in December.

Real house price growth (i.e. when house prices are adjusted for consumer price inflation), came in at 2.7% year-on-year in December (January CPI not yet available), with CPI inflation 5.4% in that month

The average house price of homes transacted was R924,261.



In real terms, the FNB House Price Index remained well-above levels of a decade ago, up 26.8% from January 2004. However, compared with last decade's real average price peak, reached in December 2007, the December 2013 real price was still -18.5% lower.

In nominal terms, the January 2014 average price was 122.5% higher than the January 2004 price level, but only 16.7% above the December 2007 level.

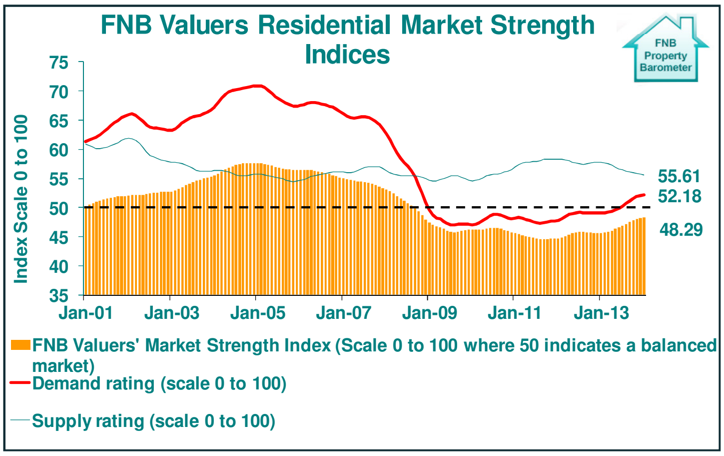
Therefore, as at January 2014, real price levels remained well- above the levels of a decade ago, but still do reflect a significant cumulative downward "correction" since 2007.

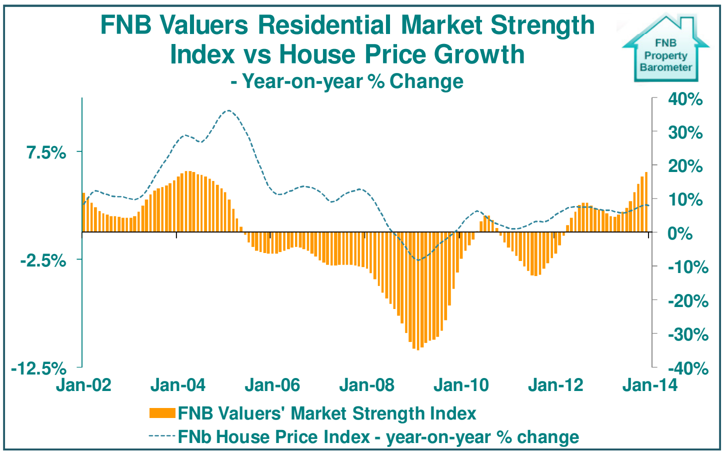
DESPITE SLIGHT SLOWING IN HOUSE PRICE GROWTH, FNB'S VALUERS STILL POINTED TO SOME FURTHER IMPROVEMENT IN MARKET STRENGTH IN JANUARY

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 January 2014,to reach a level of 48.29.

The increase in the Market Strength Index continued to be fuelled by the combination of growth in demand along with mounting supply constraints, as reflected in a rising Demand Rating and declining Supply Rating.

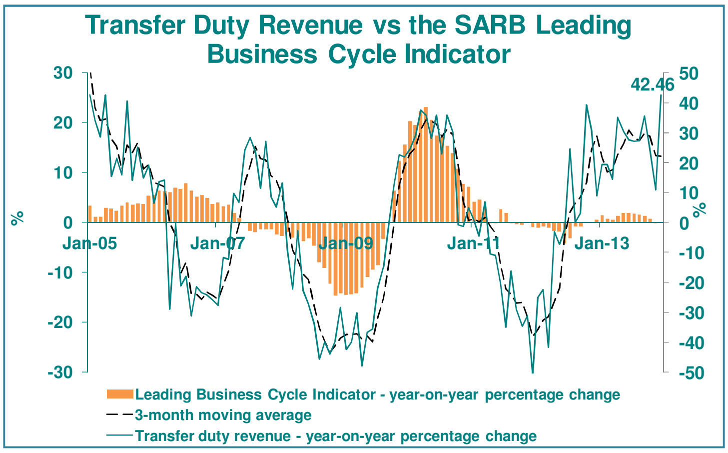
However, the fact that the Market Strength Index still remains below the crucial 50 mark, implying a still slightly better supply rating than the demand rating, and appears to explain why to date in the cycle we have not seen very strong real house price growth.





OUTLOOK

We do not attach much significance to the slight slower in the January year-on-year house price growth rate yet, in the sense that we do not believe that the market was yet weakening in January. Rather, we were of the opinion at that stage that the market was still gathering broad momentum, and that 2014 would possibly see a further mild acceleration in house price inflation.



Indeed, if we were to look to growth in transfer duty revenues as an up to date indicator of property market activity, the 42.46% year-on-year growth rate for December does point to a very strong end to 2013.

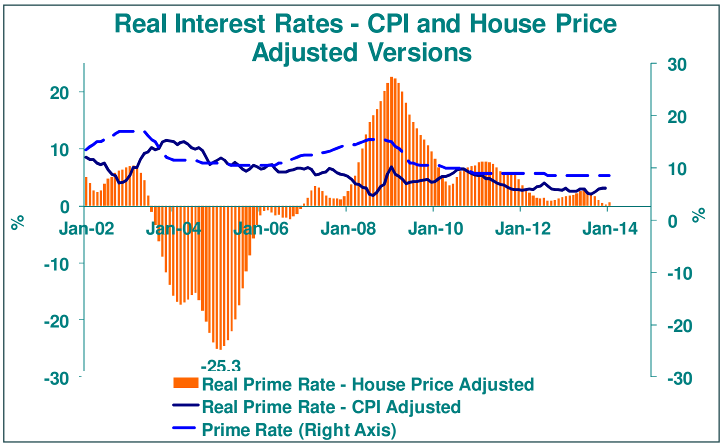
Couple to this reports of mounting residential supply constraints, as reported in both our FNB Estate Agent and FNB Valuer Surveys, and one appeared to have the recipe for stronger house price growth to come in 2014, in spite of an economy whose growth has been pedestrian at best in recent times.

However, our expectations for further mild improvement in 2014 were based on the all-important assumption that interest rates would not rise until early-2015, or perhaps at earliest very late in 2014.

And in a highly credit-driven market such as the residential property market, an interest rate "surprise" changes a lot. No longer do we expect a mild strengthening in 2014 but instead a mild slowdown in the market. While one lone interest rate hike doesn't make a massive difference to instalment repayment values, we believe it will have a significant impact on buyer sentiment, because many aspirant buyers will know that interest rate hiking in South Africa, once it starts, normally doesn't stop at one lone hike.

We would thus expect a more cautious group of households in the near term.

Rate hike to prevent any possibility of widespread speculative activity



The rate hike has a positive side to it in the sense that it will probably curb any possibility of short term speculative behavior mounting. As the hype around residential property grew in recent months, and house price growth got stronger, there was perhaps an increased risk of this unhealthy form of buying creeping into the market. It wasn't yet a speculators paradise, as was the case back around 2004/5 when house price inflation far exceeded prime rate. Our alternative calculation of real prime rate, using house prices with which to adjust (as opposed to the usual CPI adjustment) prime to real terms, was at -25% at a stage of 2005, making it seemingly very attractive to borrow money with a view to making short term capital gains.

By the end of 2013, the positive real prime rate had been declining to near zero, and was at risk of turning negative should house price growth have accelerated further. But the combination now of a higher prime rate (and some further increase to be expected) and the prospect of some slowing house price growth, arguably takes the initiative firmly away from the speculator once more

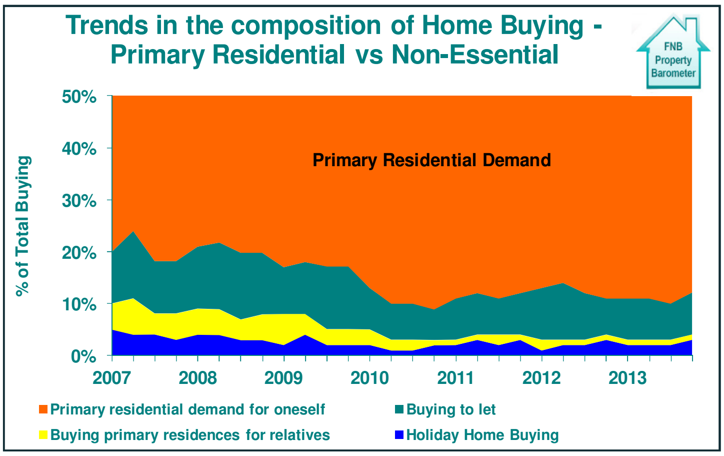
Non-essential home buying demand to soften

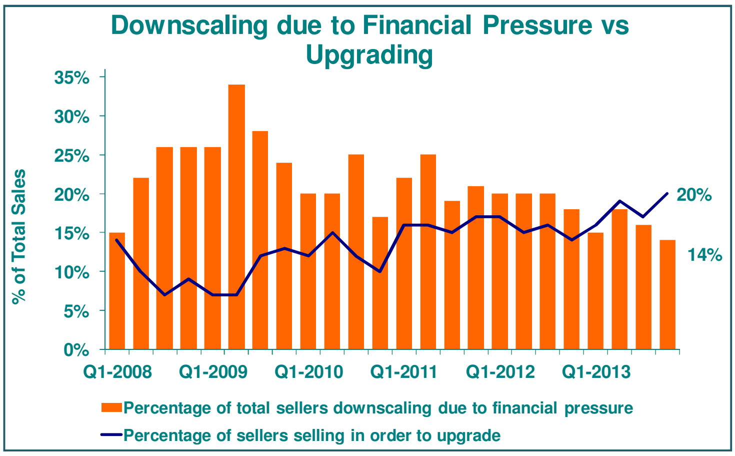
The reality is that we should probably also a slowing in growth in other non-speculative forms of demand.

The most obvious forms of demand to be constrained would be those that can be considered to be "luxury items" or non-essential purchases. Amongst these would be buy-to-let buying, along with holiday property buying. Expect, therefore, that primary residential demand will remain "king". This implies that, in our FNB Estate Agent Survey, we would expect to see estimated Primary Residential buying remaining at near to 90% of total buying, with buy-to-let, holiday property, and buying residences for others, remaining at around 10%.

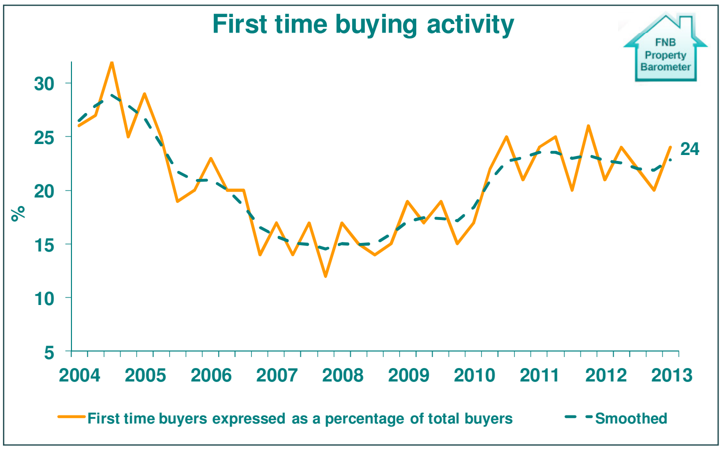
This is very different to the boom years of last decade where buy-to-let buying alone was once estimated as high as 25% of total buying back in 2004.

The scaling back of non-essential buying is also expected to be seen in the form of a decline in the percentage of home sellers selling in order to upgrade, with a greater proportion now expected to stay put for the time being. This percentage had been growing steadily since 2009 to reach 20% of total sellers in the 4th Quarter 2013 FNB Estate Agent Survey.





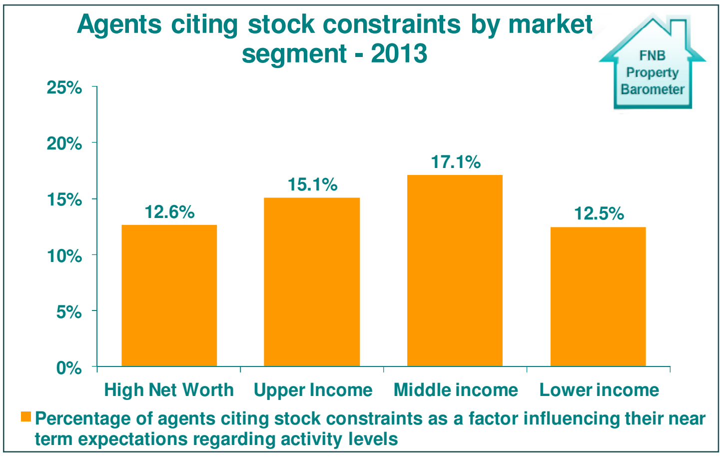
And a greater portion of aspirant 1st time buyers may now decide to "wait it out"



1st Time buying, too, is expected to recede in significance mildly. This form of home buying is normally more sensitive to interest rate cycles than is the overall residential market, due to the flexibility that 1st time middle class buyers often have. Many have the option of remaining in the rental market until "danger" has passed, or alternatively remaining in their parents' home for longer, thus delaying their 1st home purchase.

So, whereas 1st time buying in recent years has rebounded nicely to fluctuate between 20-25% of total buying, this may recede moderately in the near term.

A decline in the level of residential stock constraints, and a resultant moderation in house price inflation



The overall result of the start of interest rate hiking on the home buying market is expected to be seen in the form of a moderation residential stock constraints for the market as a whole, and we would expect a lower percentage of respondents in our FNB Estate Agent Survey to point to stock constraints as a factor in influencing their expectations of near term residential activity levels.

Given that interest rate hiking introduces an increased affordability challenge, we would expect the higher end areas to be slightly more affected.

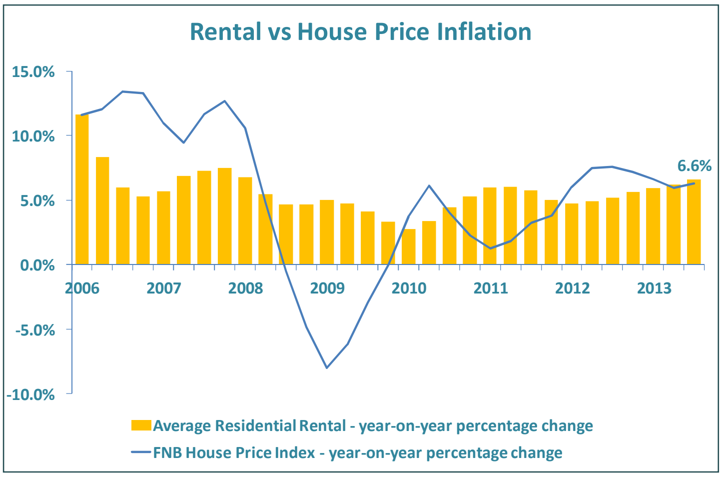
The impact of a mild deterioration in the balance between demand and supply in turn would lead us to expect a slowing in house price growth in the near term, a change from prior expectations of mild increase.

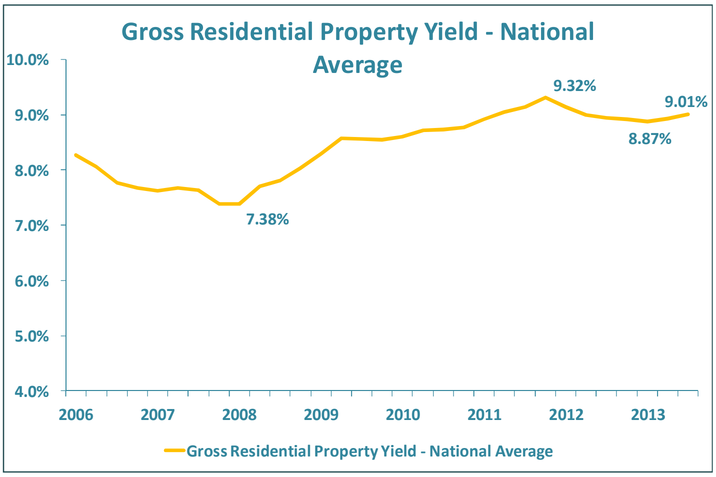
Rental market to gather momentum

Finally, the near term future may be very different for the rental market, which may effectively receive additional support from the start of interest rate hiking. Additional rental demand can be expected from aspirant 1st time buyers postponing their home purchase. In addition, of those sellers selling in order to downscale due to financial pressure, a greater proportion may once again decide to "rent down" as opposed to "buying down".

We would thus anticipate further acceleration in rental inflation, in a market already rumoured to have significant supply constraints, supported by the combination of rising demand and ongoing weakness in supply growth due to low levels of buy-to-let buying.

This may see rental inflation rising to higher levels than house price growth, bringing about a noticeable rise in residential yields, as per the FNB-TPN (TPN-Tenant Profile Network) Rental and Yield Indices, and ultimately a better residential investment buying opportunity to come.





__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.*