

# Quarterly Residential Property Review

*- The slow affordability adjustment continues, as the residential market stays on the weaker side of the economic spectrum*



## FNB PROPERTY MARKET ANALYTICS

10 February 2011

JOHN LOOS:  
FNB HOME LOANS STRATEGIST  
011-6490125  
[John.loos@fnb.co.za](mailto:John.loos@fnb.co.za)

EWALD KELLERMAN:  
PROPERTY MARKET ANALYST  
011-6320021  
[ekellerman@fnb.co.za](mailto:ekellerman@fnb.co.za)

*The information in this publication is derived from sources which are regarded as accurate and reliable, is of a general nature only, does not constitute advice and may not be applicable to all circumstances. Detailed advice should be obtained in individual cases. No responsibility for any error, omission or loss sustained by any person acting or refraining from acting as a result of this publication is accepted by Firstrand Group Limited and / or the authors of the material.*

First National Bank – a division of FirstRand Bank Limited. An Authorised Financial Services provider. Reg No. 1929/001225/06

### CONTENTS

#### 1. Summary

#### 2. A comment as to why new motor vehicle and retail sales are seemingly performing far better than new home sales

- Affordability is not what it seems, as the usefulness of traditional housing affordability measures may be limited at present.
- The concept of "Relative Affordability" is important in explaining the superior performance of vehicle sales and retail.
- If absolute and relative home affordability deterioration over last decade is not enough, the affordability with regard to home operating costs has also deteriorated significantly in recent years
- Concluding remarks on the relative performances of new vehicle sales versus new home sales

#### 3. Review of key residential market segments

- Whilst there was a general market slowing in the 4th quarter of 2011, the Full Title Market Segment still appears to be slightly more solid than the Sectional Title Market Segment.
- All 3 Full Title sub-segments appear a little healthier than the Sectional Title sub-segments
- Per square metre Sectional Title Value Indices
- The vacant land market remains dead

#### 4. Macro Property Market Review

- The available demand indicators point towards demand weakening.
- Household indebtedness remains troublesome
- The market remains oversupplied.

#### 5. Outlook – some further price decline anticipated in 2011



How can we help you?

## 1. SUMMARY – HOME AFFORDABILITY IS STILL A BIG ISSUE, DESPITE WHAT TRADITIONAL MEASURES MAY SAY.

The FNB Quarterly Housing Review focuses on the key issue of housing affordability, and why residential demand has not grown significantly despite a very significant improvement in the two “traditional” calculations of affordability that are used. These measures are the average house price/average remuneration ratio and the installment value on a 100% loan on an average priced house/average remuneration ratio. Both of the indices reflecting these ratios have fallen (improved) dramatically since their peaks in 2007/8, the price/average remuneration ratio by -22% and the installment/average remuneration ratio by -40.4%, with interest rates providing additional downward impetus for the latter ratio. However, these dramatically improved trends run contradictory to our FNB Estate Agent Survey results where an increasing percentage of agents (57% by the 4<sup>th</sup> quarter of 2010) are stating that income levels have got “far behind home price levels”. Despite the estate agent survey question requiring only a subjective and qualitative answer, our feeling is that their answer is far closer to the mark than calculations using average price and average remuneration. This is in part because of the major decline in formal sector employment from 2008-early-2010, according to the SARB as much as -15.4% over the period. Therefore, the average income earner may be fine, but formal income earners are significantly less in number compared with a few years ago.

However, the issue is more complex than that, because the question has arisen as to how come the likes of new motor vehicle growth far outstrips new home sales (and thus new residential building activity growth)? The motor vehicle sector operates in the same economy as the home market, and is also affected by issues such as recession and job loss. But new motor vehicle sales growth was robust through 2010 to early-2011 (as were retail sales), while the also interest rate-driven new housing demand (and thus building activity) remains virtually in freefall.

Here, the concept of “relative affordability” comes into play to partly explain the differing performances. During the last decade, prior to the recession, both the housing market and the vehicle market had huge demand booms, driven largely by a dramatic reduction in the cost of credit, a healthy economic and household income growth rate, and a far lower household sector level of indebtedness than today. However, the boom time rate of increase in house prices far outstripped that of vehicle sales due to a far greater limit in the supply of new homes to the market. The more severe supply constraint in the housing market is due to building sector constraints, whereas vehicles can be imported rapidly rendering the supply thereof virtually unlimited for a small economy such as our own. The result was that house affordability (price relative to income/remuneration) deteriorated far worse during the boom than was the case for motor vehicles, with vehicle affordability actually improving over the whole decade. This relative affordability deterioration in housing alone must surely have an impact on the relative performances of housing demand versus vehicle demand.

However, the possible reasons go even further. While many people think of home ownership as an essential item, the reality is that for the middle class it is not always essential in the short term. Or, at least, it is not always as essential as vehicles. By this we mean that would-be new entrants to the home market can often rent, or alternatively, delay their entry into property by remaining in their parents home for longer than perhaps originally planned. Mobility, however, is extremely important in the middle to upper income job market, and good public transport is not yet a reality. Private vehicles are thus arguably a more essential middle class item than owning a home.

Motor vehicles also have a shorter lifecycle than houses, meaning a shorter time to replacement. Therefore, one would expect this, too, to cause a more prompt recovery in vehicle demand once economic conditions improve or interest rates fall.

Back to affordability issues, and one must not rule out the impact of rates and utilities tariffs related to housing. These have climbed steeply in recent times, and the multi-year Eskom tariff hikes mean more of the same in 2011 and 2012, outstripping private vehicle related cost increases. Electricity tariff hikes are most prominent in this regard, but assessment rates and water are not far behind.

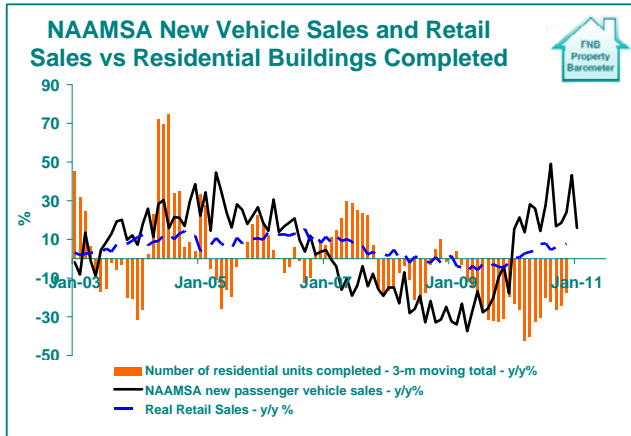
Finally, with regard to access to finance, it probably wouldn't even be necessary for home loans banks to have tighter credit criteria than vehicle financiers in order to have a bigger negative impact on their market. The large value of a home purchase relative to car purchases (on average) mean that a 10% hypothetical deposit on a motor vehicle purchase would be manageable for more people than a 10% deposit on a house. Therefore, SA's severe lack of savings militates far more against a big ticket item such as a home purchase than against items where smaller loans are required.

So, the affordability deterioration of housing relative to both vehicles and overall consumer goods and services (including the relative affordability deterioration contribution of big rates and tariff hikes), over the last decade as a whole, should imply the need for the household sector to re-balance its expenditure basket by reducing the portion spent on housing relative to other items. Many would-be new entrants can do this in the short term, due to the less essential nature of middle class home ownership relative to reliable motor vehicles. Hence, the ongoing decline in new residential building completions in 2010 in stark contrast to sharp growth in new motor vehicle sales. This re-balancing of the household sector expenditure portfolio, along with very weak job creation further hampering new entries to a market that still appears to be oversupplied, and given our expectation of no further interest rate cuts in 2011, leads us to the expectation of mild average house price deflation in 2011. We pencil in an FNB House Price Index decline of around -1%.

While there are no obvious indications of any significant stimulus for the market in 2011, at this stage there are fortunately no obvious indications of any sharp shock to the market either, just a very “flat” and unexciting year. Any “unexpected” shocks to upset the apple cart would probably emanate from foreign sources. What happens to the US economy after their huge stimulus measures wear off? Do capital inflows into SA reverse sharply, causing a sharp currency weakening and an inflation surge? Do global food and oil prices “spike” again? For the time being, though, the 2011 environment appears fairly benign, but with gradually increasing upward pressure on inflation, which in turn is expected to lead to interest rate hikes from early 2012.



## 2. A COMMENT ON THE QUESTION AS TO WHY MOTOR VEHICLE SALES AND RETAIL SALES ARE SEEMINGLY PERFORMING FAR BETTER THAN NEW HOME SALES (AND BUILDING ACTIVITY)



In recent times, some have asked the question as to why new vehicle sales have been growing at a rapid rate, while new home sales (and thus building activity) are still literally in freefall? As at November 2010, the 3-month moving total for residential buildings completed was showing year-on-year decline of -17.8%, having been in year-on-year decline since early-2009. By comparison, new vehicle sales were growing year-on-year by a solid +16% year as at January 2011 (NAAMSA sales), having shown positive growth since the beginning of 2010. Vehicle sales have remained closely inversely correlated to the year-on-year change in prime rate as one would expect in credit-driven markets.

Is this due to SA's love affair with its cars, or are home loans banks far more conservative than their vehicle lending counterparts, thereby stifling the recovery of the residential property market? If one looks at recent non-vehicle retail sales, also growing solidly

year-on-year in real terms by 7.8% as at November, it would appear that much of the answer may lie elsewhere.

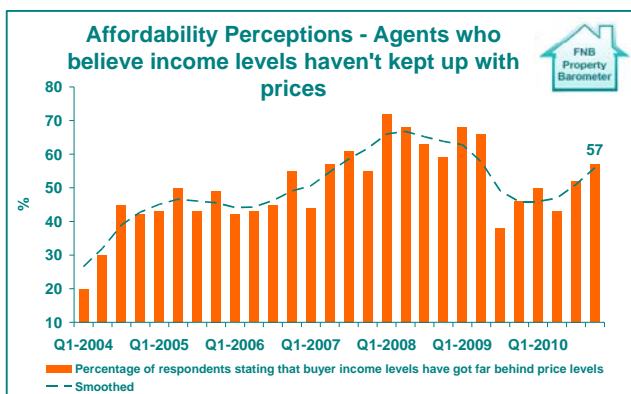
We believe that much of it lies in the more essential nature of reliable private transport, the greater adaptability in vehicle and retail goods supply compared to new home supply, in the steeper increase in home-related running costs, and in the greater deterioration in housing affordability than in the case of motor vehicles and consumer goods/services over the past decade.

Houses for the middle class are not, in the short term at least, as essential as vehicles. By this we mean that would-be new entrants to the home market can often rent, or alternatively delay their entry into property by remaining in their parents' home for longer than perhaps originally planned. Mobility, however, is extremely important in the middle to upper income job market, and good public transport is not yet a reality. Private vehicles may thus arguably be a more essential middle class item than homes, thus helping to cause a more impressive vehicle demand recovery, compared to residential demand, as soon as economic or interest rate times improve.

Motor vehicles also have a shorter lifecycle than houses, meaning a shorter time to replacement. One would also expect this characteristic to prompt a quicker recovery in vehicle demand once conditions improve.

But there are two more key factors which may also be holding the residential market back more than the vehicle and retail goods markets. But first, let's look at where affordability currently is.

*Affordability is not what it seems, as the usefulness of traditional housing affordability measures may be limited at present.*

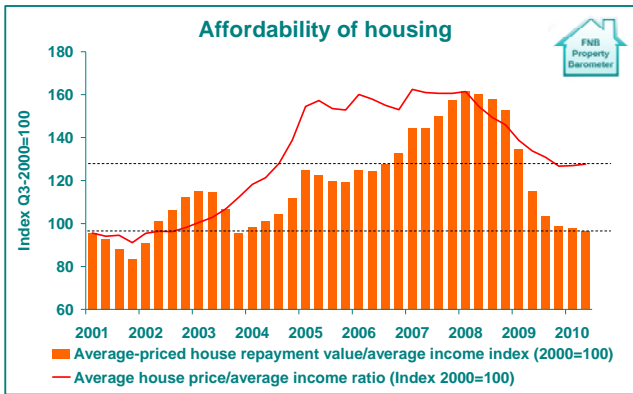


Firstly, what is the state of home affordability? If we refer to our FNB Estate Agent Survey panel, it tells us the affordability situation is currently deteriorating. The question put to the panel is admittedly subjective, asking the panel whether average income levels have "kept up with house price levels", got "a little behind price levels" or have "got far behind price levels"? In the last 2 quarters of 2010 we saw the percentage stating that income levels had got far behind price levels rising from 43% as at the 2<sup>nd</sup> quarter to 57% by the final quarter.

Although the agent survey question is not based on "hard calculations", as are the "traditional" measures of affordability, this is not to say that they are any less accurate. As a matter of fact, we believe that the agents may be far closer to the mark at present than

the "traditional" measures.

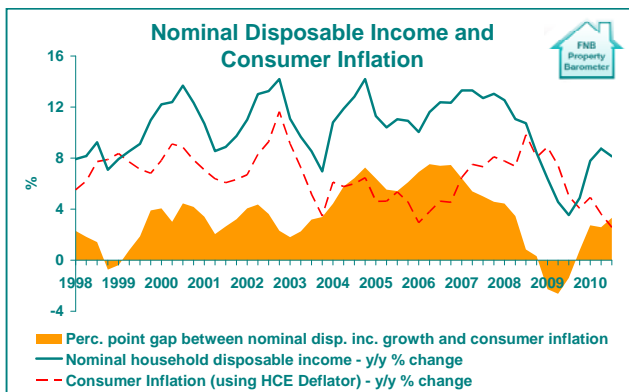
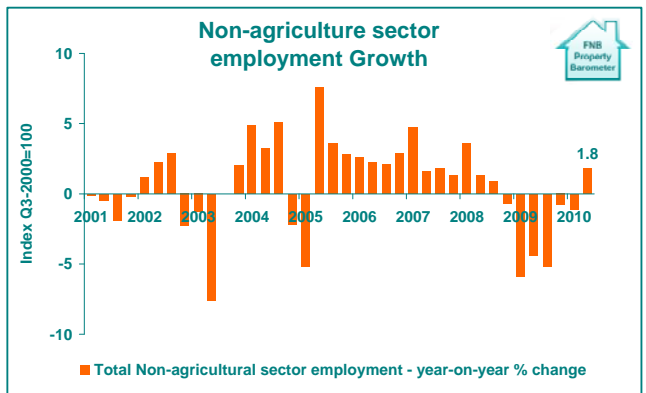
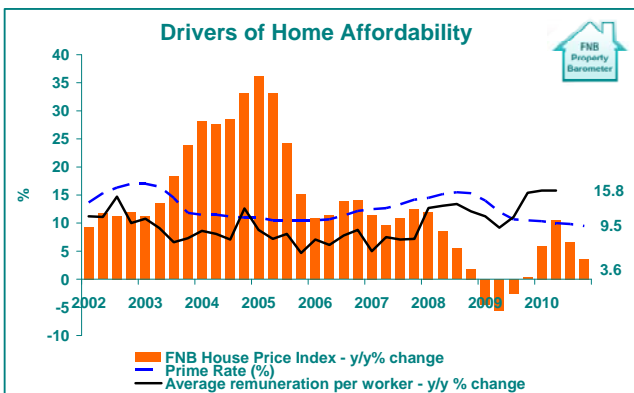
The 2 traditional measures of affordability that we periodically use are the "average house price/average labour remuneration ratio" and the "instalment value of a 100% loan on an average priced house/average remuneration ratio" (both ratios expressed in index form). The former index has declined (affordability improved) from a peak of 162.48, reached in the 1<sup>st</sup> quarter of 2007, to 126.71 by the final quarter of 2009, a cumulative drop of -22%. In the 1<sup>st</sup> 2 quarters of 2010, some renewed house price growth caused this affordability measure to deteriorate mildly to 127.64, but the level is still as low as levels last seen around mid-2004, suggesting that any market "overshoot" in the latter stages of the boom (2006/7) has probably been eliminated from the numbers. The huge improvement in this measure of affordability is the result of the combination of house price decline around 2008/9 along with steady wage inflation.



The 2<sup>nd</sup> measure of affordability, i.e. the instalment/average remuneration ratio, has seen an even more impressive decline (improved affordability) due to huge interest rate cuts since late-2008. From a peak index value of 161.5 in the 1<sup>st</sup> quarter of 2008, this index had declined by -40.4% to 96.2 by the 2<sup>nd</sup> quarter of 2010. This measure of affordability is back to levels last seen in late-2003.

The dramatic improvement in these 2 measures of home affordability were driven by the combination of average remuneration increases (“questionably” at +15.8% year-on-year as at 2<sup>nd</sup> quarter 2010) far outstripping house price growth (peaking at 10.5% in the 2<sup>nd</sup> quarter of 2010 and declining to +3.6% by the 4<sup>th</sup> quarter) since early-2008, while 6.5 percentage points’ worth of interest rate cuts from late-2008 to late-2010 gave the instalment/house price measure of affordability an additional boost.

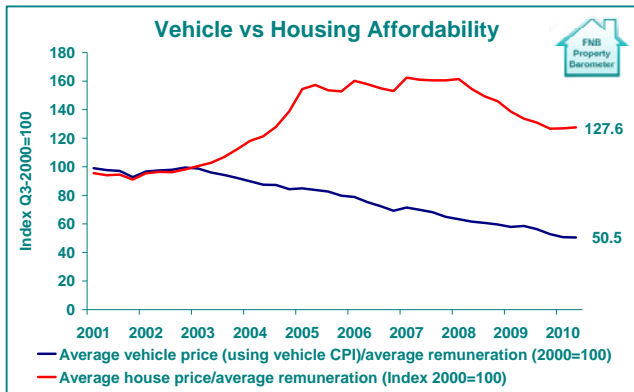
So where is the residential demand if affordability has improved so much? The catch arguably lies in the employment numbers. These traditional affordability measures refer to the average wage earner, and after a severe 2008/9 recession there are considerably less of them around. From the 4<sup>th</sup> quarter of 2008 to the 1<sup>st</sup> quarter of 2010, the SARB estimated continuous year-on-year decline in non-agriculture sector employment, which represents a cumulative job loss of -15.4% over the period. Only in the 2<sup>nd</sup> quarter of 2010 did the SARB begin to report mild job growth of +1.8% year-on-year. Under such conditions of employment level volatility, the above 2 measures of affordability are insufficient to explain the pressure on the housing market.



The weakness of the economy, and resultant lack of job growth, is far better reflected in the year-on-year rate of growth in nominal disposable income than in average remuneration growth. This reached a mini-peak of 8.7% in the 2<sup>nd</sup> quarter of 2010, just over half the growth rate of average remuneration, before slowing to 8.1% in the 3<sup>rd</sup> quarter. These rates are a far cry from the double-digits prior to the 2008/9 recession, and far weaker than recent reported average remuneration growth, suggesting far less of an improvement in housing affordability over the past 3 years than is reflected by the price/average remuneration measure. Our estate agent, therefore, is probably closer to the mark. *But this still doesn't explain the far better relative performance of vehicle and retail sales than of property, because all of them are subject to a weak economy.*

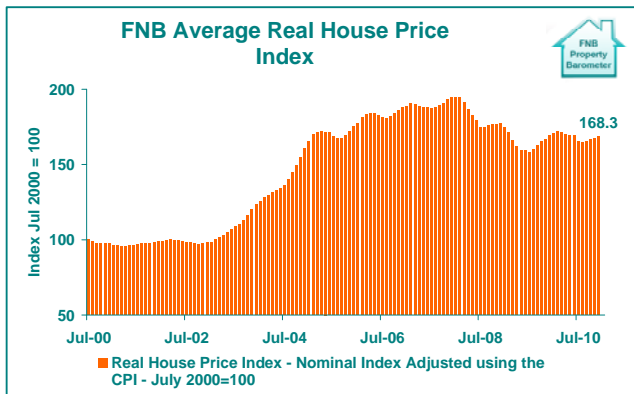
*The concept of “Relative Affordability” is more important in explaining the superior performance of vehicle sales and retail.*

When understanding the relative performances of new residential versus new vehicle sales, it is important to examine the relative affordability trends of these 2 sectors of the economy. And all indications are that, in the past decade prior to the housing market slump, home affordability deteriorated far more than most major consumer items, including vehicles.



supply was far more constrained. Hence, far greater price inflation in the housing market, and over the last decade a big deterioration in housing affordability relative to vehicles.

This relative affordability deterioration, coupled to a shorter life cycle of vehicles than of homes, and the more essential nature of reliable vehicles than of homes (given a lack of good middle class public transport), has arguably contributed to a stronger recovery in new vehicle sales, whereas new home construction languishes in the doldrums.



In the graph below left, one sees the sharply contrasting trends in affordability (average price/average income ratio indices for new and 2<sup>nd</sup> hand/existing) between the housing market and the motor vehicle market (new and existing vehicles using vehicle CPI). Starting last decade on a level of 100, by mid-2010 the vehicle affordability index had declined to 50.5, while the housing affordability index had, even with significant decline from 2008, "gone the other way" to a far higher level of 127.6.

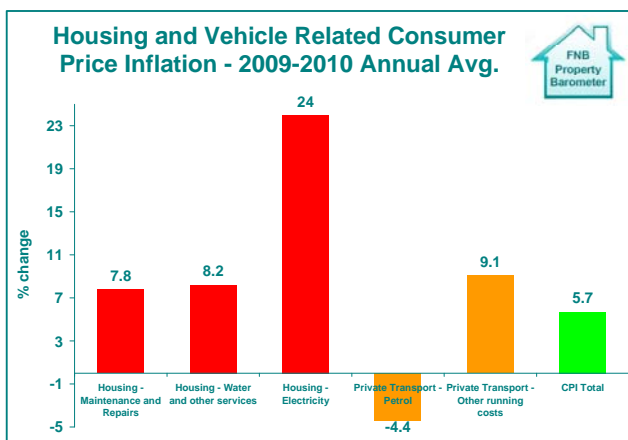
The reason for the contrast is fairly simple. Whereas both industries experienced massive demand booms following huge declines in interest rates post-1998 (coupled to a very strong economy a few years ago), the vehicle sector's ability to supply the surge in demand was virtually unlimited, given that it can import stock easily. Houses can't be imported, so the 100% locally produced new residential

supply was far more constrained. Hence, far greater price inflation in the housing market, and over the last decade a big deterioration in housing affordability relative to vehicles.

So, in short, home values have increased over the past decade far faster than consumer items as a group, and far faster than average motor vehicle prices, implying a very significant deterioration in home affordability relative to other consumer goods and services.

*If absolute and relative home affordability deterioration over last decade is not enough, the affordability with regard to home operating costs has deteriorated significantly as of late*

A final factor partly explaining the better relative performance of retail and motor vehicle demand relative to new housing demand (or even overall housing demand), is the sharp increase in certain costs related to home ownership. Here, we refer most notably to the huge multi-year increases imposed by Eskom to fund its capital projects.



The average annual inflation rate in home electricity costs, according to the CPI survey, was 24% for 2009 and 2010. By comparison, water and other services (which includes assessment rates) ran at 8.2%, and housing repairs and maintenance at 7.8. These inflation rates compare poorly to the average inflation rate for the total CPI of 5.7%. They also compare poorly to the past 2 years of inflation rates in certain costs related to the running of vehicles. Average petrol price decline was -4.4 (although this has reversed recently), while "other running costs" inflated annually by +9.1%.

### *Concluding remarks on the relative performances of new vehicle sales versus new home sales*

There are a number of possible reasons why new vehicle sales growth is currently far outstripping new home sales growth (and thus building activity), besides the possibility that vehicle finance providers may have a slightly more relaxed credit stance than home loan providers (though this is difficult to prove). We list them as follows:

- Home ownership for the middle class is not, in the short term at least, as essential as vehicle ownership. By this we mean that would-be new entrants to the home market can often rent, or alternatively delay their entry into property by remaining in their parents home for longer than perhaps originally planned. Mobility, however, is extremely important in the middle to upper income job market, and good public transport is not yet a reality. Private vehicles are thus arguably a more essential middle class item than homes.
- Motor vehicles have a shorter lifecycle than houses, meaning a shorter time to replacement. Therefore, one would expect a more prompt recovery in vehicle demand once economic conditions improve or interest rates fall.
- Due to more severe limits on new housing supply in the short term, due to building constraints, compared to vehicles which can be imported rapidly, and in the longer term due to growing land constraints, the house price growth during the property boom years was far more extreme than that of vehicle prices, despite both industries experiencing huge demand booms. Relatively speaking, therefore, home affordability has deteriorated far more extremely over the past decade than that of vehicle affordability. This may be constraining home demand to a greater extent than vehicle demand.
- The cost of rates and utilities tariffs related to housing have climbed steeply in recent times, outstripping private vehicle related cost increases. Electricity tariff hikes are most prominent in this regard, but assessment rates and water are not far behind.

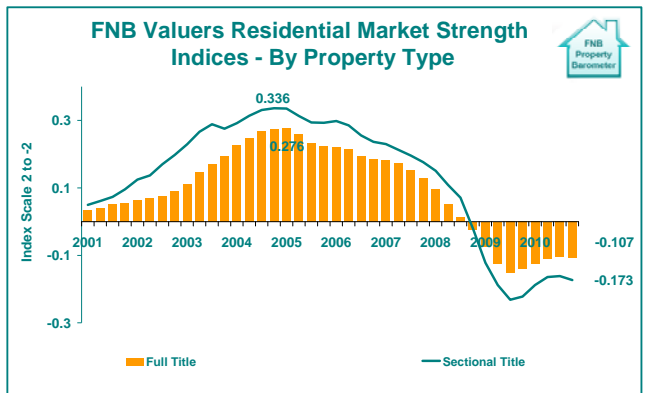
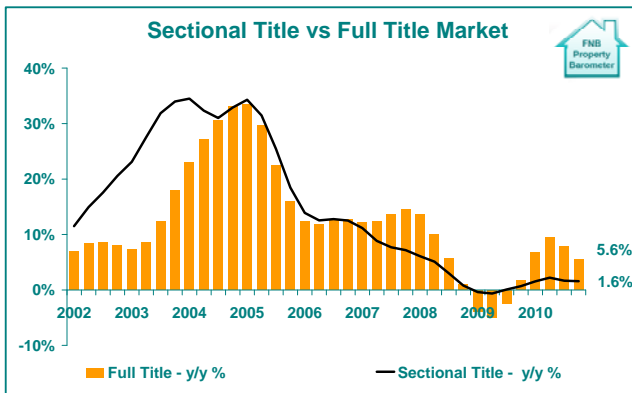
Finally, with regard to access to finance, it probably wouldn't even be necessary for home loans banks to have tighter credit criteria than vehicle financiers in order to have a bigger negative impact on their market. The large value of a home purchase relative to car purchases (on average) mean that a 10% hypothetical deposit on a motor vehicle purchase would be manageable for more people than a 10% deposit on a house. Therefore, SA's severe lack of savings militates far more against a big ticket item such as a home purchase than against items where smaller loans are required.

### 3. REVIEW OF KEY RESIDENTIAL MARKET SEGMENTS

Whilst there was a general market slowing in the 4<sup>th</sup> quarter of 2011, the Full Title Market Segment still appears to be slightly more solid than the Sectional Title Market Segment.

Examining trends in some of the key market segments, it would appear that the Sectional Title Market remained a lot flatter through 2010, when compared to the Full Title Segment. Both the Full Title and Sectional Title Markets showed slowing year-on-year price growth in the 4<sup>th</sup> quarter of 2010. The Full Title price index saw its year-on-year growth for the 4<sup>th</sup> quarter decline from 7.8% in the previous quarter to 5.6%, while the Sectional Title index growth slowed from 2.6% to 2.1% over the same period.

Further supporting both the absolute and relative price trend evidence are the readings of the FNB Valuers' Market Strength Indices. The views of FNB's valuers regarding demand and supply conditions in different areas and for different types of property are used to construct these market strength indices. Each time an FNB valuer values a house, we ask him/her to provide a subjective view of both demand and supply conditions in the area and for a property type. They rate both demand and supply either as "good" (assigned a value of +1), average (a value of 0) or "weak" (a value of -1). We aggregate both the demand and supply ratings, before subtracting the supply rating from the demand rating.

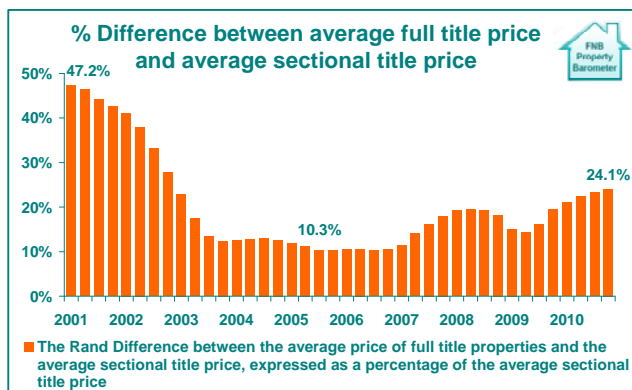


In the 4<sup>th</sup> quarter, the 2 ratings, i.e. the Market Strength ratings, for the Full Title and Sectional Title segments both showed a weakening on the 3<sup>rd</sup> quarter readings, the Full Title reading from -0.105 to -0.107, and the weaker Sectional Title reading from -0.161 to -0.173.

Our belief continues to be that the Full Title Segment gets its stability largely from the "suburban" 3 bedroom family market, which was less of a first time buyer and buy-to-let target during last decade's boom than the Sectional Title Market. This, we believe, was important in keeping the Full Title Market a little more stable through the cycle, because established family demand is more steady than 1<sup>st</sup> time buyer and buy-to-let demand.

However, affordability is also seen as an important driver of the Full Title segment's relatively better performance. This may seem strange, because the average estimated average price of a sectional title unit of R703,202 for the 4<sup>th</sup> quarter was lower than the average price of a Full Title property of R851,217.

However, it is the differing compositions of the two major segments that cause the average full title price to be higher, because the Full Title market is dominated by 3 bedroom stock while 2 bedrooms and less are far more dominant in the Sectional Title market. Full Title is arguably more affordable than the Sectional Title segment when one splits up the two segments and compares "like with like". In other words, the average price of a 3-bedroom full title property was estimated at R885,793, while the average price of a Sectional Title 3 bedroom unit was estimated at a higher R942,386 in the 4<sup>th</sup> quarter of 2010. Similarly, the average price of a full title 2 bedroom unit was estimated at a higher R414,444, with much of this stock being in the so-called Affordable Housing segment, while the average sectional title 2 bedroom unit was estimated at R632,963.



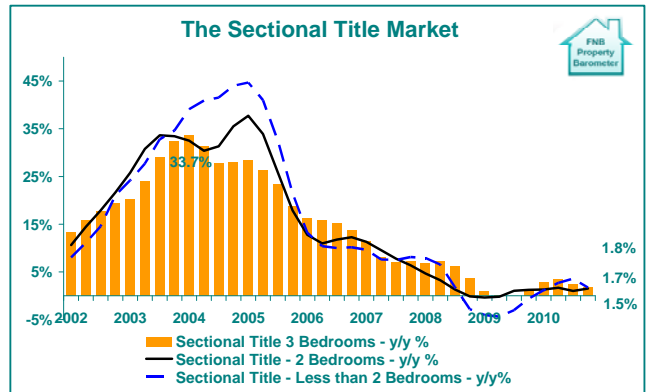
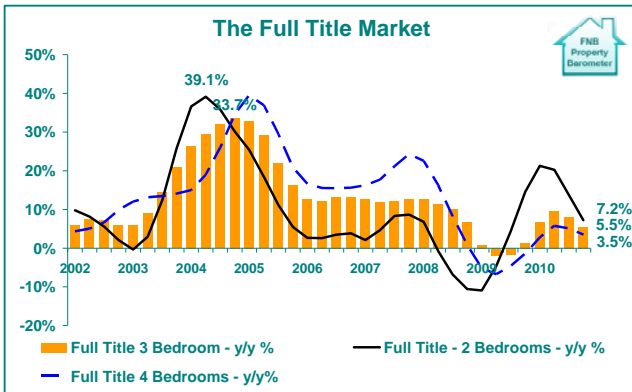
Therefore, although in the longer term, the drive to reduce operating costs may boost sectional title demand once more, the recently tough financial times have driven an affordability search, and existing full title stock comes out a little better off as a result.

Therefore, it is perhaps not surprising that the percentage gap between the average full title and sectional price increased further in the 4<sup>th</sup> quarter of 2010 from a previous quarter's 23.2% to 24.1%.

**All 3 Full Title sub-segments appear a little healthier than the Sectional Title sub-segments**

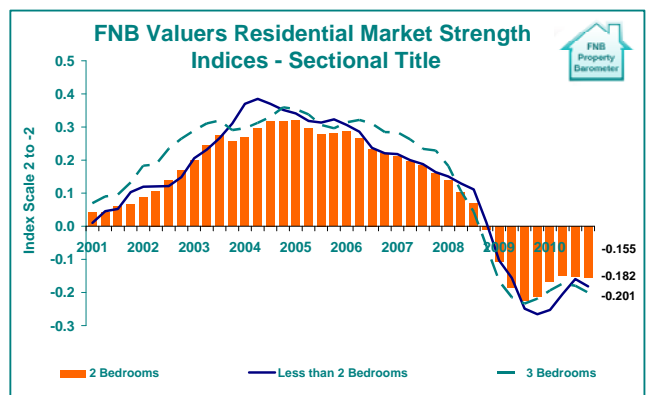
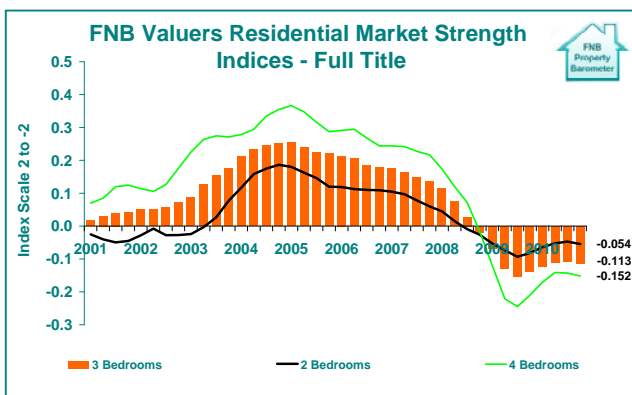
Examining trends in the key sub-segments of the Full Title and Sectional Title Market segments, the relative stability of the Full Title 3 Bedroom sub-segment still shows. In the 4<sup>th</sup> quarter, with this sub-segment's average price growth measuring 5.5%, compared to the 7.2% of the more cyclical Full Title 2 Bedroom sub-segment's 7.2% and the weaker Full Title 4 Bedroom sub-segment's 3.5%.

On the sectional title side, all 3 main segments appear weaker than the Full Title segments, and there is no meaningful difference between any of the 3 sub-segments' price increases in the 4<sup>th</sup> quarter 2010. The "Less than 2 Bedroom" sub-segment recorded a meagre 1.7% year-on-year price growth in the 4<sup>th</sup> quarter, the 2 Bedroom sub-segment 1.5% growth, and the 3-Bedroom sub-segment 1.8% growth. The 2 bedroom sub-segment's meagre growth rate was the only sub-segment that showed a slight increase on the previous quarter's rate.

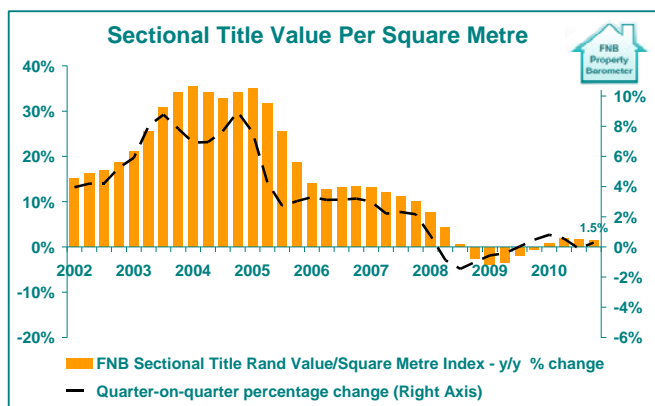


The FNB Valuers' Market Strength Indices appear to support the recent price trend findings. The 3 main sub-segments for the Full Title Segment all show better (or less weak) readings than the 3 Sectional Title sub-segments. The Full Title sub-segment showed a -0.054 market strength reading for the 4<sup>th</sup> quarter, followed by the Full Title 3 Bedroom sub-segment with -0.113, while the 4 Bedroom sub-segment may be largely reflecting greater pressure in the higher priced segment, having the weakest Full Title reading of -0.152.

In the Sectional Title segment, the 2 bedroom sub-segment has the strongest market strength reading of the three, at -0.156, followed by the "Less the 2 Bedroom" sub-segment, while the 3 Bedroom segment now has the weakest reading of -0.201. These relative positions of the Sectional Title sub-segments suggests, perhaps that while the 2 bedroom sub-segment doesn't show the strongest price growth at present, it may hold up best of the three going into 2011.



### The per square metre Sectional Title Value Indices

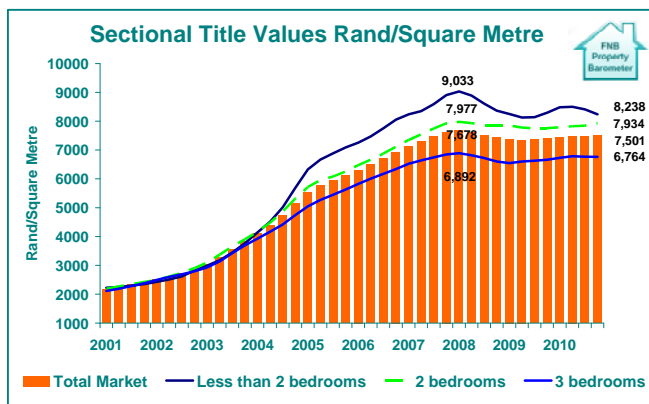
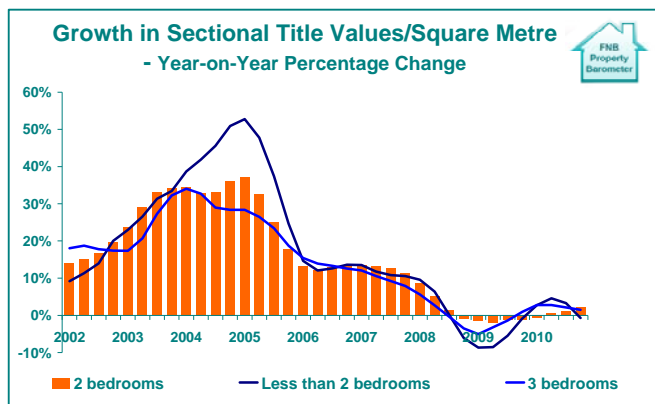


The FNB Sectional Title Value Per Square Metre Index, which estimates the average value of sectional title property on a per square metre basis, is an attempt to reduce the effect of a change in the size composition of property transactions on property indices over time, thereby getting a more accurate reflection of true property value trends in this property category. The index is a fixed-weighted average of the 4 main Sectional Title Market sub-segments, i.e. the "Less than 2 Bedroom Segment, the 2 Bedroom Segment, the 3 Bedroom Segment and the 4 Bedroom Segment". The 2 Bedroom sub-segment is by far the largest of the Sectional Title Market, accounting for almost half of the overall index.

On a per square metre basis, the average value of sectional title properties rose by 1.5% year-on-year for the 4<sup>th</sup> quarter, down from the previous quarter's 1.7% revised figure. On a quarter-on-

quarter basis, the average value registered very slight positive growth of +0.3%.

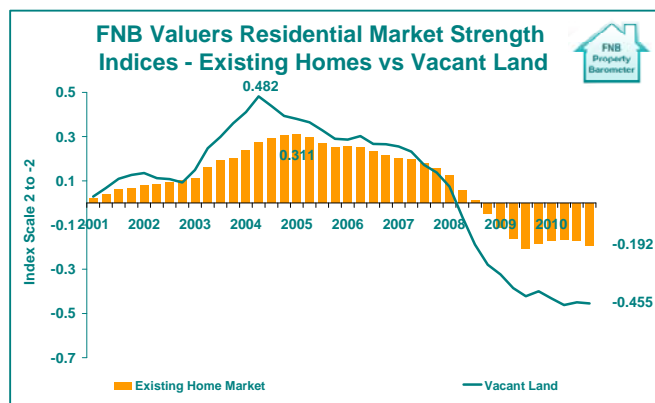
Segmenting the Sectional Title Market into its 3 key segments, the smaller the size in terms of bedroom number the higher the per square metre value. The "Less than 2 Bedroom Segment" showed an average value of R8,238/square metre in the 4<sup>th</sup> quarter of 2010, the 2 Bedroom Segment averaged R7,934/square metre, and the 3 Bedroom Segment R6,764/square metre. The Overall index averaged R7,501/square metre.



All segments remain at lower average per square metre values than their 1<sup>st</sup> Quarter 2008 peak values, with the "Less than 2 Bedroom" sub-segment being most negatively affected. This sub-segment is -8.8% lower than its peak average value, while the 2 Bedroom segment at -0.5% down and the 3 Bedroom sub-segment -1.9% appear to have been more stable through the tougher market times of recent years, holding their value better.

It is believed that the 2 bedroom and 3 bedroom sub-segments were less targets for buy-to-let investors, speculator and 1<sup>st</sup> time buyers, than the less than 2 bedroom segment, all sources of demand that can be more cyclical than primary residential demand from established families.

### The vacant land market remains dead

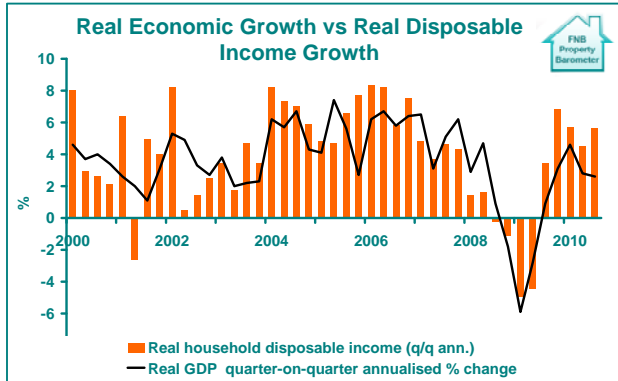


The oversupplied nature of the residential market in recent years, and the resultant building slump, has had a dramatic impact on the vacant land sub-segment, now the weakest property sub-segment. Whereas the FNB Market Strength reading for the entire existing home market was -0.192, the vacant land index reading was a far weaker -0.455, and no sign of strengthening was visible. This would suggest another weak year on the property development front in 2011.

#### 4. PROPERTY MARKET AND ECONOMIC OVERVIEW

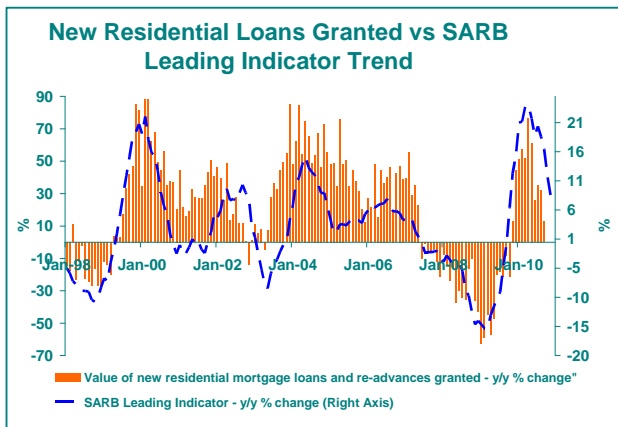
Economic growth slowed in the 2<sup>nd</sup> half of 2010, and although some sectors show signs of strengthening, the SARB Leading Indicator suggests a mediocre start to 2011, at least from a residential point of view.

3<sup>rd</sup> quarter Gross Domestic Product growth showed further slowing from a quarter-on-quarter annualised rate of 2.8% in the previous quarter to 2.6% in the 3<sup>rd</sup> quarter on a seasonally-adjusted basis.



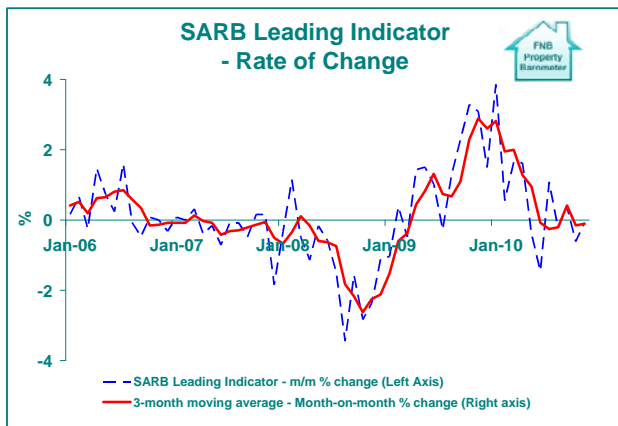
However, real disposable income growth surprised on the upside, with quarter-on-quarter annualised growth rising from 4.5% in the previous quarter to 5.6% in the 3<sup>rd</sup> quarter of 2010. This was largely the result of a combination of stronger wage bill growth in the 3<sup>rd</sup> quarter, probably more due to wage inflation than job creation, and lower consumer price inflation compared to the 2<sup>nd</sup> quarter.

Global and local indicators may be suggesting that economic growth figures should begin to show some acceleration in the near term. The 6-month moving averages for the USA and G7 Leading Indicators have been seeing month-on-month growth accelerations late in 2010 after a lengthy slowing phase starting back late in 2009. Big questions still remain, however, as to where the next stimulus will come from once these the effects of the most recent round of quantitative easing (QE2) have been fully felt.



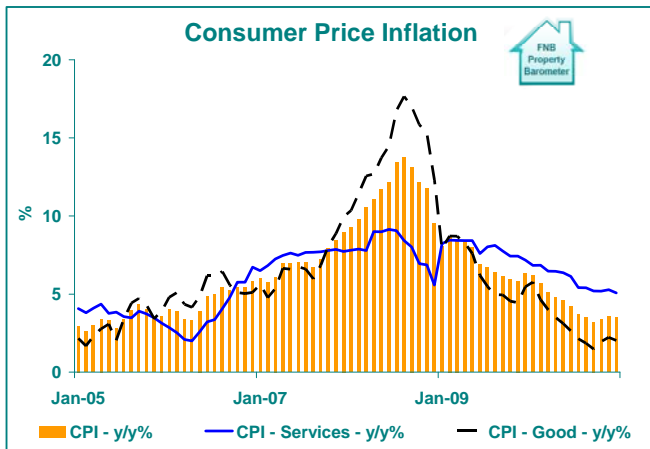
Domestically, though, the SARB Leading Indicator has been far from convincing. The 3-month moving average turned to positive month-on-month growth briefly in September, perhaps largely due to an interest rate cut in that month, but turned negative once again in October and November, the month between the 2 interest rate cuts.

Different economic sectors have differently shaped cycles, but the Leading Indicator is very well-correlated to trends in residential mortgage demand. The accompanying graph shows the year-on-year growth rates of the Leading Indicator against the value of new mortgage loans granted, and one can see the good correlation that exists. Since May, a broad year-on-year growth slowdown in the Leading Indicator has been accompanied by a similar slowdown in mortgage grants growth.



On a month-on-month basis, late in 2010, the fact that the Leading indicator was muddling along in a state of slight month-on-month decline, suggests a very flat residential property market as we entered 2011. This seems to be the state of affairs at present in the market.

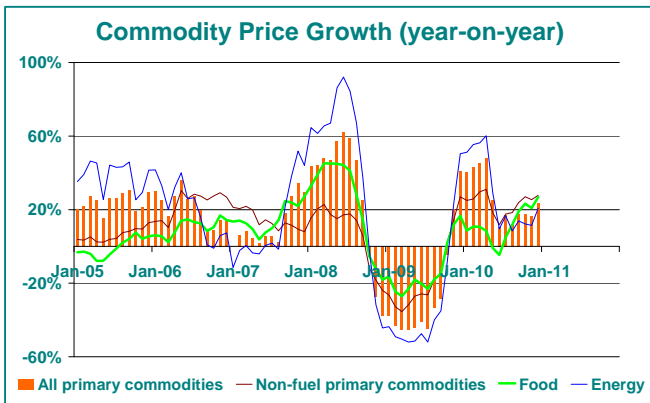
While inflation is not yet troublesome, the signs are that the downward trend in consumer price inflation has come to an end



Consumer price inflation is far from troublesome at present, but nevertheless appears to have reached the end of its downward trend, and the Reserve Bank Governor has been increasingly warning on inflation risks in recent weeks. These risks are partly caused by rising global commodity prices, notably oil and food prices, which raise the risk of imported inflation, along with a weakening in the pace of year-on-year strengthening in the trade-weighted rand index, and domestically rising petrol prices.

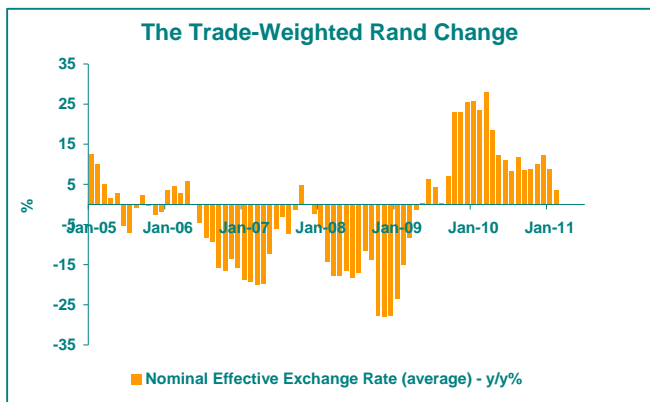
By December, the IMF Global Commodity Price Index was showing year-on-year growth of 23.4%, while the food component was growing by 26.8%.

The risks are heightened by recent rand weakness, which has led to a decline in the year-on-year strengthening of the trade-weighted rand index from a peak of +27.9% in March 2010 to +3.6% for February to date. This implies very little positive impact left on imported inflation emanating from rand strength.



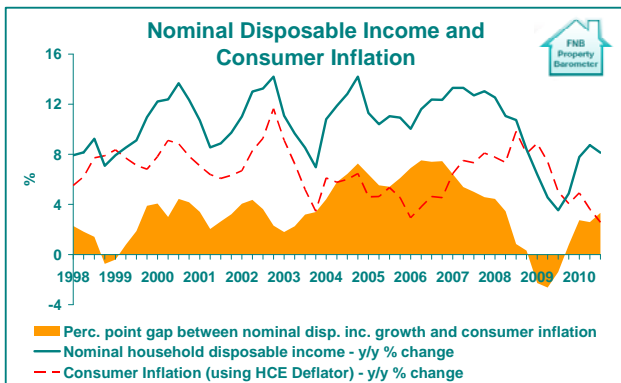
The CPI year-on-year inflation rate has hovered between 3.5% and 3.6% over the past 3 months, after bottoming at 3.2% in September 2010.

Also a previously noted concern was a rise in residential rental inflation in the September CPI survey, but this tapered slightly in the December survey. Nevertheless, the rental component of the CPI will be watched closely, as it is a major component, and a lack of buy-to-let buying implies a slow growth in supply of rental homes. This is expected to translate into a rental market strengthening in 2011, which in turn could mean higher rental inflation in the CPI.



While there can be no talk of hiking in the near term, it is expected that the SARB will keep the repo rate steady at 5.5% for the time being, which means an expected lack of stimulus in 2011.

*The household sector debt ratio remains troublesome, refusing to decline*

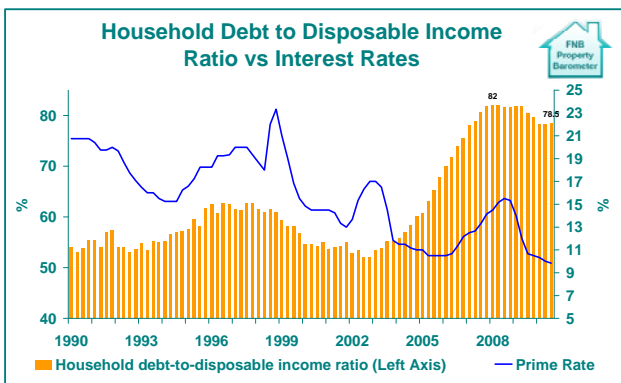


Although nominal household disposable income growth has accelerated following the recession, by the 3<sup>RD</sup> quarter of 2010 it was still limping along at 8.1% year-on-year.

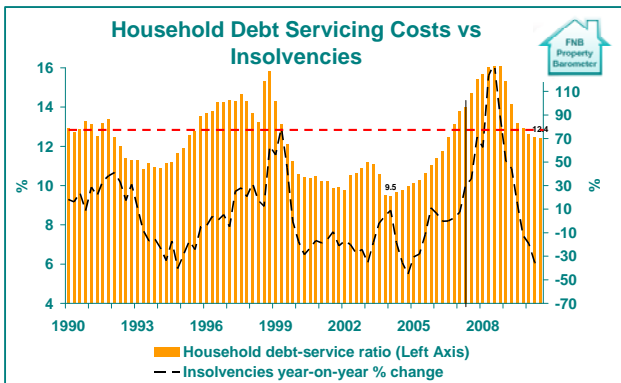
This was sufficient to outstrip lowly consumer price inflation, thereby translating into solid real disposable income growth.

However, it was not enough to prevent quarter-to-quarter household sector credit growth from exceeding it and translating into a slight rise in the household sector debt-to-disposable income ratio (78.5%) in the 3<sup>rd</sup> quarter.

This is a key risk to the well-being of the residential property market. Although the main lending growth to households appears to be coming from lending categories outside of the residential mortgage sector, notably "other loans" and instalment sales credit, the entire level of household indebtedness has a key bearing on the ability of the household sector to service its mortgage debt as well.

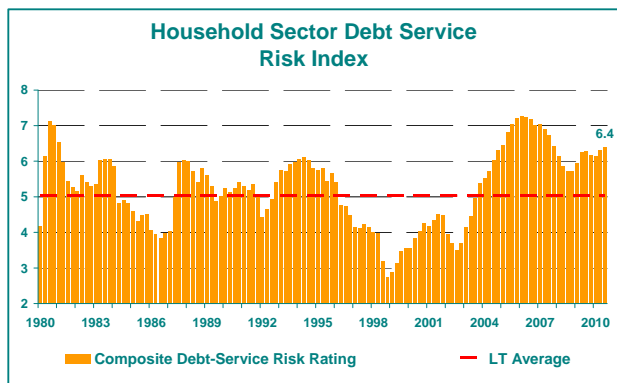
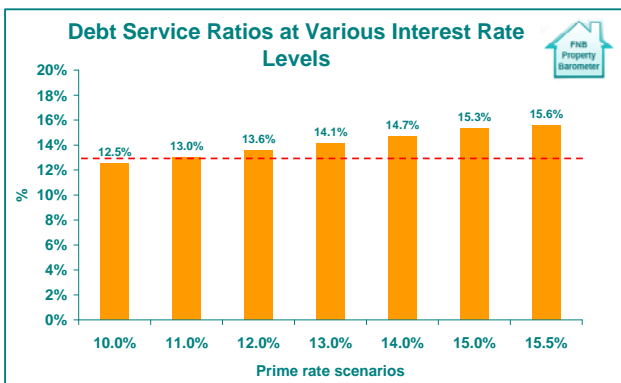


After some quarters of decline, the household debt-to-disposable income ratio rose slightly in the 3<sup>rd</sup> quarter of 2010 from 78.2% previous to 78.5%. This is a high risk level, only 3.5 percentage points below the all-time peak reached in the 1<sup>st</sup> quarter of 2008. The high level of indebtedness also means that the household sector debt-service ratio (the cost of servicing the debt burden expressed as a percentage of disposable income) remains relatively high at 12.4%, slightly down on the previous quarter due to a September interest rate cut, but still dangerously close to what is believed to be the "point of pain" of 13%.

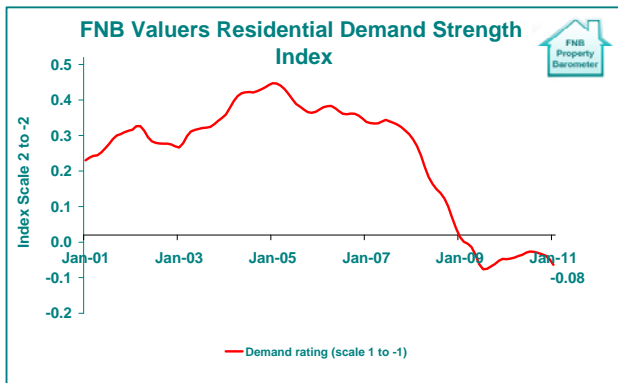


Putting it another way, given our subjective "pain threshold" assumption of a 13% maximum debt-service ratio, interest rate hiking (were it to happen now) to 11% would still be "acceptable". Anything more would take the debt-service ratio above 13% and into "painful territory".

*The high debt-to-disposable income level, along with its loss of downward momentum, and the fact that SA's interest rates have moved down very close to the "structural" inflation rate (which limits the scope for further rate cutting and raises the probability that the next rate move is up), all translates into a rise in our Household Sector Debt-Service Risk (Vulnerability) Index for the 2<sup>nd</sup> consecutive quarter to 6.4. This suggests a peak forming at a higher risk level than all other peaks except the early-80s boom peak and the 2006 all-time high.*

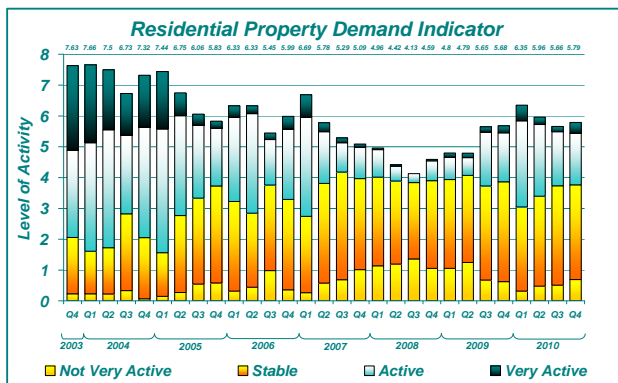


**Residential Demand Conditions – Valuers still believe demand is weakening, while agents pointed to a slight strengthening (mostly seasonal though) in the 4<sup>th</sup> quarter**



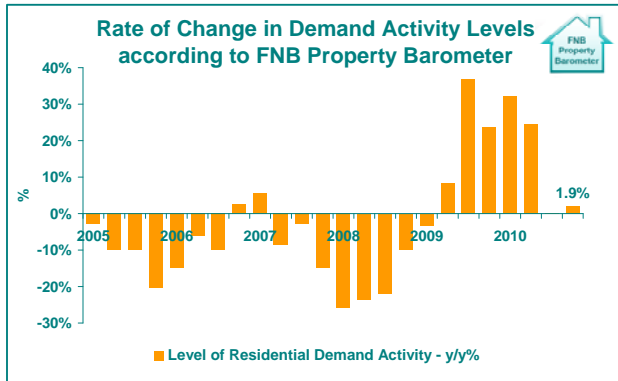
FNB Valuers, upon valuing homes, are required to provide their ratings of demand as well as supply for homes in the area of valuation. The ratings are either “good” (+1), “average” (0) or “weak” (-1). The aggregate rating for January 2010 was -0.08, which represents the 6<sup>th</sup> successive quarter of mild weakening in the already-weak demand rating.

Estate agents, perhaps, can experience demand changes a little before valuers do, and this may explain a slightly more confident view emanating from the FNB Estate Agent Survey. In the FNB Estate agent survey, estate agents, upon estimating demand strength on a scale of 1 to 10, rated demand mildly stronger in the 4<sup>th</sup> quarter than in the previous quarter, at 5.79 (compared to previous 5.66). This follows on 2 previous successive quarters of decline.

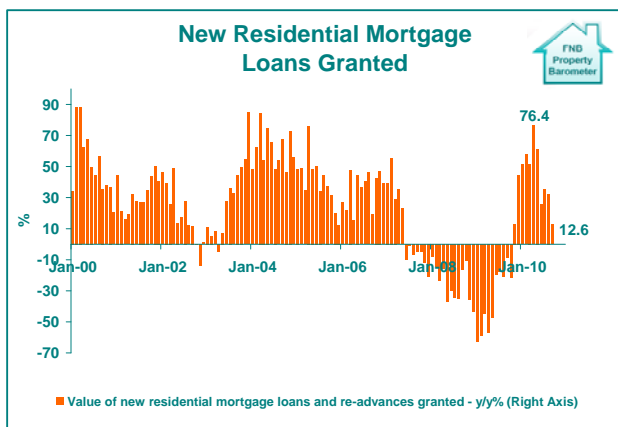


However, eliminating seasonality using a year-on-year percentage change calculation on the demand activity rating, a +1.9% rise in the 4<sup>th</sup> quarter is slightly better than the previous quarter but remains virtually insignificant.

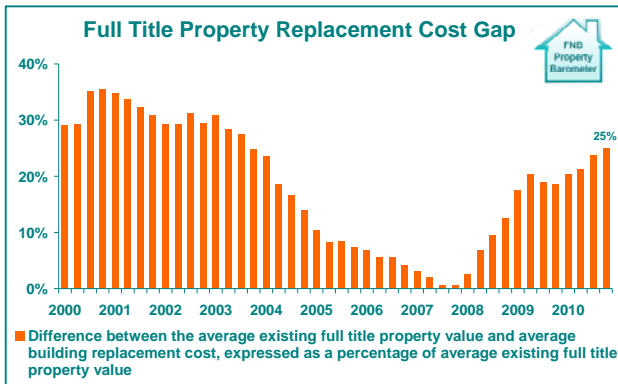
It is plausible that the summer months may have brought about a very slight seasonally-adjusted rise in demand, and that the 2 successive interest rate cuts by the SARB in September and November following a lengthy period of inaction may have boosted the market very slightly further.



The SARB time series for the value of new residential loans granted also pointed to a broad weakening in growth month to month since the 2<sup>nd</sup> quarter, peaking at 76.4% year-on-year in April and reaching 12.6% by September.



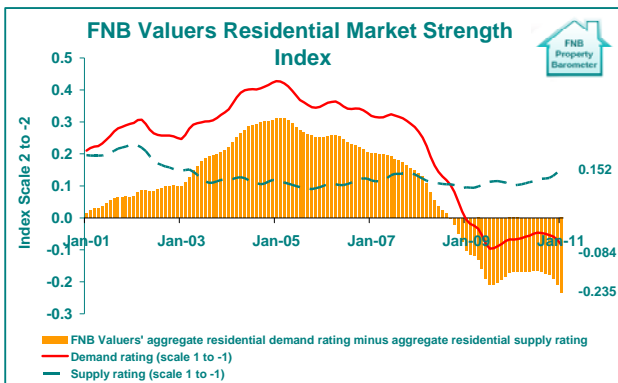
*Oversupplies (or unrealistic pricing) still prevalent*



Despite estate agents pointing to a vague hint of a (largely seasonally-adjusted) rise in demand, although not backed up by our valuers panel, and two further interest rate cuts late in 2010, there is no hint in the available data that any further progress has been made in wiping out oversupplies in the market.

Both estate agents taking part in the FNB Estate Agent Survey, as well as FNB's valuers, continue to point to a weak level of demand relative to supply or, otherwise put, an unrealistically priced market.

On the new development side of the market, a widening replacement cost gap, to 25% has put severe pressure on the development market, with building completions continuing to show strong year-on-year decline late in 2010.

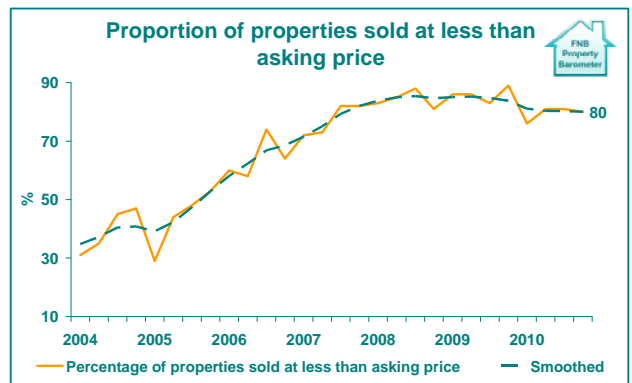
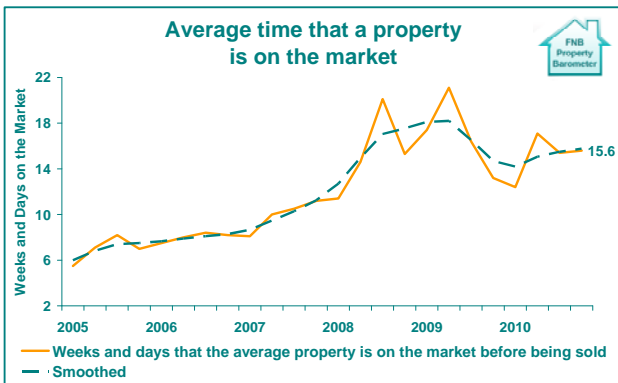


However, widespread financial stress selling, along with mediocre demand, continues to sustain oversupplies in the overall home market. The FNB Valuers' Market Strength Index measured -0.084, a deterioration on previous months, suggesting that our valuers as a group see demand very weak relative to supply.

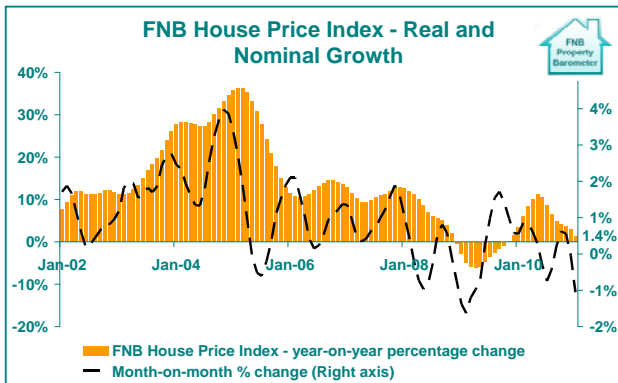
The Estate Agent Survey suggested little different as at the 4<sup>th</sup> quarter, with the average time on the market still well-above the 3-month mark at 15 weeks and 6 days.

We believe that in a healthy, appropriately priced market, the average time should be nearer to or below 2 months. At a level of above 3 months, either demand is required to strengthen, or failing that prices would have to decline, if not in nominal terms at least in real terms.

Also hinting at unrealistic pricing, is the fact that the FNB Estate Agent Survey respondents as a group estimated that 80% of sellers are still required to drop their asking price in order to make the sale. This is still a very high level compared to the level of around 30% when the survey started in 2004, or even compared to the 50-60% levels of 2005-2006.



**6. OUTLOOK – THE 2<sup>ND</sup> ROUND OF HOUSE PRICE DECLINE IS BELIEVED TO BE UNDER WAY, ALTHOUGH NOT YET VISIBLE IN YEAR-ON-YEAR NUMBERS YET**



As a result of the weak demand level relative to supply, the market is believed to have been in a 2<sup>nd</sup> round of average price decline during the 2<sup>nd</sup> half of 2010 and early-2011, after the 1<sup>st</sup> average price decline of the current cycle took place in 2008/9.

This is not yet visible in the year-on-year price growth rate (which still showed a small +1.4% in January 2011), but is possibly visible in the month-on-month growth rate. We say possibly, because the index is not seasonally-adjusted, so part of a dip can often be attributed to seasonal factors. However, the month-on-month declines were frequent since June 2010, and we believe it to be more than seasonal.

It is believed to be the result of a lack of further interest rate reduction since August 2009, where-after the SARB started to move far slower on rate cuts, accompanied by high levels of household sector indebtedness and financial pressure, and of course what we believe to be a market unbalanced in favour of supply.

The Firstrand expectation is for no further interest rate cutting in 2011, while the SARB Leading Indicator points to a very flat start to 2011 for at least the credit-driven part of the residential market. The expected lack of stimulus, along with our indications that the market remains oversupplied, lead to the expectation of some mild average price decline in 2011, and we pencil in an average price level for 2011 that is approximately -1% lower than the average for 2010.

*While there are no obvious indications of any significant stimulus for the market in 2011, at this stage there are no obvious indications of any sharp shock to the market. At this early stage, therefore, we believe that 2011 just promises to be a very quiet year for residential property with some further mild house price decline.*

*Any "unexpected" shocks to upset the apple cart would probably emanate from foreign sources. What happens to the US economy after their huge stimulus measures wear off? Do capital inflows into SA reverse sharply, causing a sharp currency weakening and an inflation surge? Do global food and oil prices "spike" again? For the time being, though, the 2011 environment appears benign, but with increasing upward pressure on inflation, which in turn is expected to lead to interest rate hikes from early 2012.*

