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PROPERTY BAROMETER

FNB House Price Index

FNB Property Barometer

1 July 2015

FNB Average House Price reaches the R1m mark. But if you're looking for excitement, look elsewhere. The residential market increasingly looks like "boring equilibrium"...which should excite us

MARKET ANALYTICS AND SCENARIO FORECASTING UNIT

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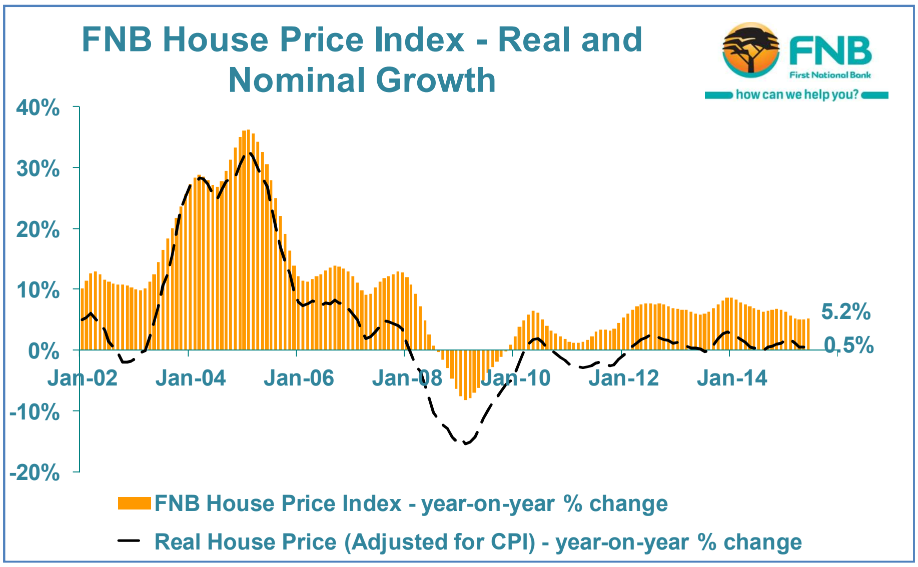
The FNB House Price Index's average price level passed the R1m mark in June for the 1st time. But while this "milestone" deserves mention, this is not necessarily the "big".

The exciting news is that, increasingly, we believe that our national Residential Market Indicators point to a "Boring Equilibrium". But, given the "excitement" happening in other more troubled areas of the economy, "boring" should perhaps excite us.

HOUSE PRICE GROWTH SETTLING NEAR TO CPI INFLATION?

According to the FNB House Price Index, the average house price for June 2015 rose 5.2% year-on-year. This is slightly up from May's 5.0%. This "stalls" the broadly slowing year-on-year price inflation trend that has been in place since early-2014.

And the slowing growth trend "stalls" not far from a level where our "structural" Consumer Price Index (CPI) inflation rate is believed to be, i.e. somewhere between 5% and 6%, and not too far from where CPI inflation currently is. This implies a virtually insignificant house price inflation rate in real terms, i.e. when one adjusts for CPI inflation, of 0.5% in May. This real house price inflation rate has been slowing of late, with CPI inflation "normalizing" upward as the impact of last year's oil price drop works its way out of the numbers. CPI inflation had reached 4.6% by May, and is soon expected to be above 5%



FNB HOUSE PRICE INDEX REACHES THE R1M AVERAGE HOUSE PRICE MARK

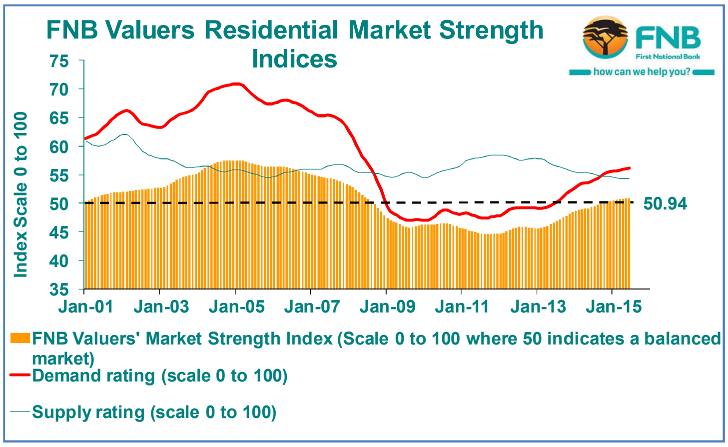
A milestone that was reached during June was the FNB House Price Index reaching an average value of R1m for the 1st time, R1002,122 to be exact. We must issue cautions regarding the interpretation of this number. This is the estimated average price of homes transacted, and is "skewed" to the higher end of the market because middle to higher income households are more mobile and thus buy and sell homes far more frequently than the poor. So, while a house price index can be useful in determining price growth trends, it does not accurately depict the average value of every single home that exists in SA right down to the small "RDP" home. Nevertheless, we thought the R1m mark was an interesting "milestone" worth mentioning.

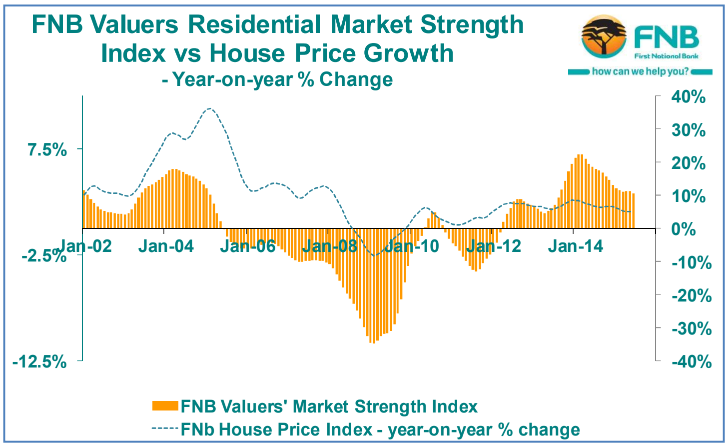
HAS THE RESIDENTIAL MARKET REACHED "BORING EQUILIBRIUM"?

A question we have asked ourselves of late is whether the Residential Market has entered a phase of what could perhaps be termed "boring equilibrium".

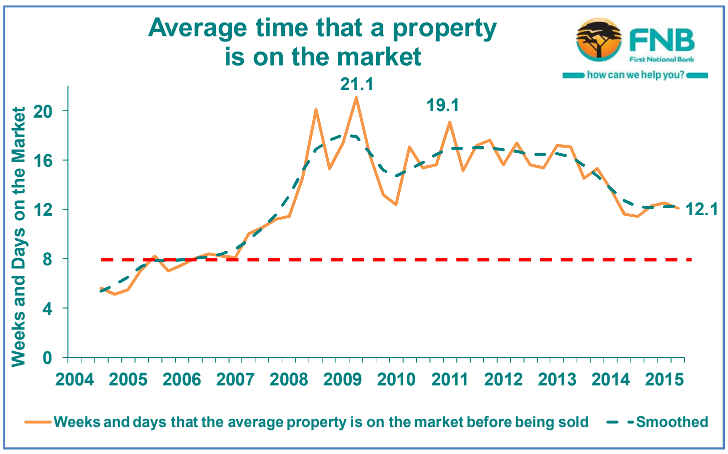
And certainly, while on an area basis there will always be undersupplied and oversupplied "pockets", many of our main national residential indicators give the impression of a very well-balanced "equilibrium" position.

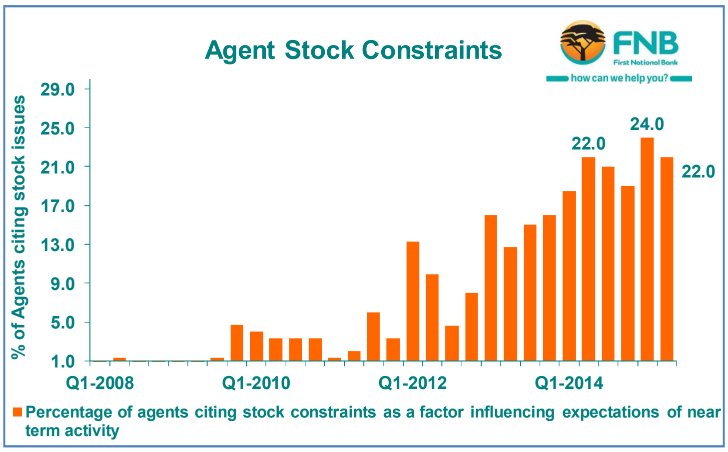
Certainly a real house price inflation rate close to zero suggests a good market balance. In an evenly balanced market between supply and demand, we should in theory expect around zero percentage house price growth in real terms. Our FNB Valuers' National Market Strength Index appears to support the perceptions of good market balance, hovering at near to the 50 mark (on a scale of 0 to 100), reflecting a Valuers' Aggregate Demand Rating that is only marginally above their Aggregate Supply Rating.





The FNB Estate Agent Survey points to something similar. A very significant percentage of agents do point to "stock constraints" in their area, i.e. 22% of total agents, versus a lesser 5% who point to ample stock while the majority are silent. But this percentage of agents citing stock shortages has not noticeably increased since a year ago. Then there is that very good indicator of balance between supply and demand, namely the "Average Time that a property is on the market prior to sale". This average time on the market appears to have settled, too, hovering at around 3 months over the past year or so. This is nicely in between the near 5 month peak around 2008/9 recession time, on the one hand, and the 2004/5 boom period lows of below 2 months.





"BORING", YES, BUT BE CAREFUL WHAT YOU WISH FOR

It is always difficult to ascertain the exact point of market equilibrium, but the strong impression that we get from the abovementioned indicators is that, on a national average basis, the residential market is about as close as we can get to "equilibrium".

This, however, doesn't please all industry role layers. We often get asked "where is the good news"? People are normally looking for strong growth…..growth in home values if you are a home owner (but not if you are still wanting to enter the market in future), growth in transaction volumes if you are an estate agent, or growth in demand for new building if you are a developer. And, yes, growth would be nice.

However, in an economy whose GDP (Gross Domestic Product) growth potential currently appears to be between 1% and 2%, Household Sector Disposable Income is not going to grow fast, and neither should residential demand therefore.

In this environment, we would thus suggest that an "equilibrium" and "stable" situation is very good news. Last year, I crossed path with a very senior person from the country's troubled mining sector. I remarked that my own sector of the economy was "quite dull" compared to the "fireworks" of especially the Platinum Mining Sector with its major industrial action at that time. His understandable reply was…"could you give us some of that dullness please"?

The "excitement and volatility" in the economy extends past the Mining Sector to the Electricity Sector as well. Volatility can indeed make money for some, and South Africa's pockets of growth do probably lie in areas such as "Alternative Energy Supply", given the troubles of that industry's main player.

And, of course, we have a currency that is permanently at risk of volatile bouts, especially in the face of Rating Agency Downgrades.

At the present time, the residential property market is just not that volatile of big growth area that some may desire. Mortgage lending rates are generally above average house price inflation these days, making it tough to speculate on property for short term capital gain using cheap credit. Slow house price growth is not overly attractive to the "unseasoned" buy-to-let investors who may focus more on capital growth than on yield. And mediocre house price growth is unlikely to unleash a 1st time buyer frenzy based on "buyer panic", buyer panic referring to when 1st time buyers believe that "if they don't buy now it will be too expensive to afford property in future.

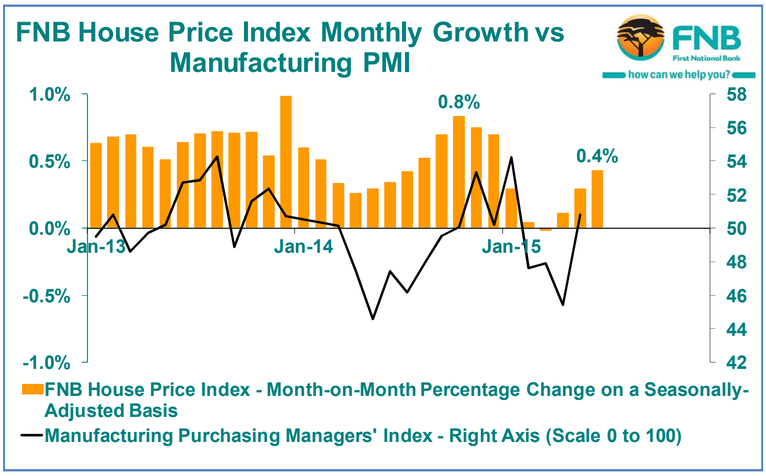
While there is no doubt some speculation and some buyer panic, none of these buying drivers are believed to exist in "large" quantities.

So, in terms of "volatility and excitement", the Residential Property Sector has probably had its day for the time being, with the most extreme boom in our recorded history from around 2000 to 2007, and an almighty "bust in 2008/9, which resulted in severe pain not only for a significant group of highly-indebted homeowners, but also for the Property Services Sector of the economy. According to HIS Globalinsight data, Real Estate Services GDP contracted on an annual basis in both 2006 and in 2010, and reports of a large number of people exiting this industry after the boom's best years were widespread..

So in the current economic climate, a "rational market", largely free of speculative activity, irrational exuberance and 1st time buyer "panic", is probably the best we can hope for. The Residential Market's stability contributes to the relative stability of the Real Estate Services part of the economy, which is not insignificant at near 6% of the country's GDP, and add a bit more if you were to throw in the Building Construction part of the economy.

That's the good news…."Boring Equilibrium" and a far more stable market than the boom-bust of last decade.

The potential bad news, however, is that the Residential Market and Residential Mortgage Lending Sector cannot function is isolation of the economy around it. The economy is its driver, and its well being is thus crucial.



Examining the FNB House Price Index growth rate on a seasonally-adjusted month-on-month basis, we see evidence of the influence that the economy can have on the residential market's direction. The sharp Manufacturing Sector Purchasing Managers' Index (PMI) dips in 2014 and early in 2015 indeed appear to co-incide with dips in house price inflation.

So the Residential Market cannot stay unaffected by a poor economy, and major structural constraints in the economy, especially in the labour market as well as in the Electricity Sector, are key causes for concern.

But the Residential Sector can periodically "cause its own pain" through fuelling irrational behavior, over-exuberance and speculative bubbles from time to time. The good news is that such behaviour is by and large absent and the market appears to be in "boring equilibrium" at least on a broad national basis. In addition, while the residential market is affected by other sectors, it also affects them. Its currently "rational and stable" status makes it possible that it, along with the rest of the Services Sectors of the economy, could be something of a "stabilising sector" in a volatile political-economic period ahead. This is a potential benefit of South Africa's economy being overwhelmingly dominated by the less volatile Services sectors, which can typically be less volatile in "troubled" times, and the potential benefit of a Residential Market that does not currently appear to be in a major "boom-bust" cycle.

That's about the best we can hope for at present. If you want "big excitement", you probably need to look to another sector in the economy. But be careful what you wish for.

Best Regards

John Loos

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.*