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Where is the Elusive Correction in Hong Kong's Property Market?

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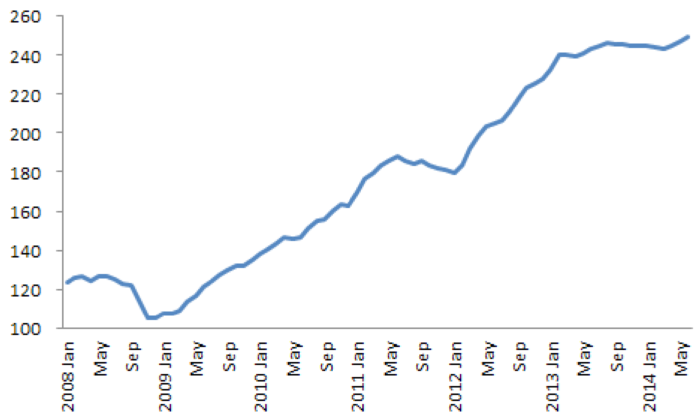
Hong Kong's property market has remained buoyant since 2009. Notwithstanding the occasional speed bumps, prices have been largely trending upwards for 68 months and counting without any significant correction. One of the only notable declines took place 3 years ago. From July, 2011 to January, 2012, private residential prices fell 4.4%. As a rule of thumb in asset markets, a 10% decline is considered a technical correction whereas a 20% drop is widely regarded as bear market territory. In contrast, since Hong Kong's property market bottomed, price declines have never exceeded 5%.

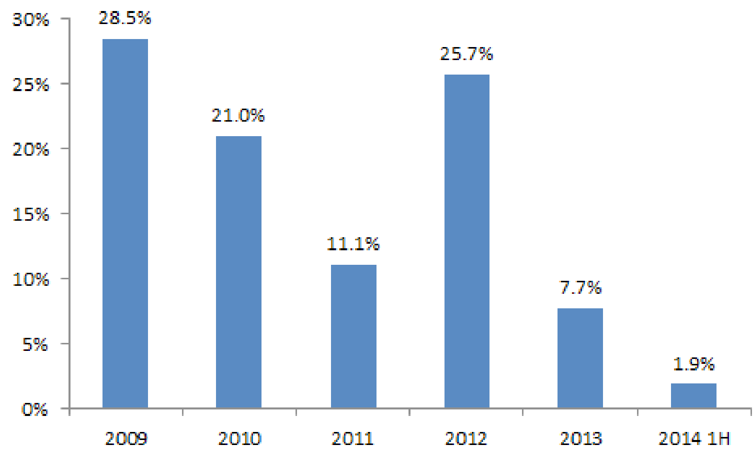
Chart 1 Hong Kong's private residential price index



Sources: Rating and Valuation Department, BOCHK Research

In the meantime, headwinds are growing. The government attempted to suppress demand by imposing stiffer duties on transactions, while apartment construction and completions are expected to increase. Under this backdrop, market sentiment became somewhat pessimistic. As prices climbed to new record highs, momentum has shown signs of fading away. According to the Rating and Valuation Department (RVD), Hong Kong's private residential price index rose to 249.8 in June, 2014, an all-time high and 138% greater than the level at the end of 2008. Nevertheless, from June, 2013 to June, 2014, property prices increased by only 2.7%. Indeed, during this 12-month period, the gain in property prices was weaker than that of nominal GDP, inflation, and personal income.

Chart 2 Annual changes in Hong Kong's private residential price index (2014 figure only for the first half)



Sources: Rating and Valuation Department, BOCHK Research

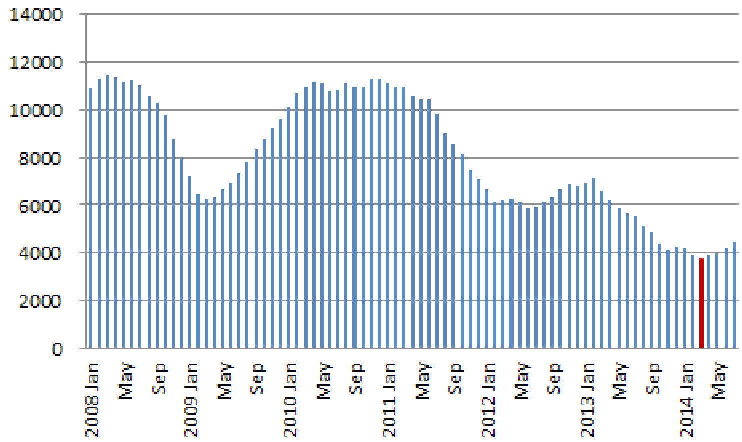
Solid fundamental support for property prices

The housing market is not as strong as media coverage suggests. That being said, it still managed to turn in a respectable performance in spite of slowing economic growth and expectation of rising interest rates. The resilience of the property market is largely due to supply-demand imbalance.

I. Robust pent-up demand

In the past few years, the government implemented a series of demand-management measures that substantially raised transaction costs. Transaction volume subsequently plunged. In March, only 3,141 private residential properties changed hands. To put this number into context, such extreme level of inactivity was never recorded even during the trough of the SARS epidemic. Because monthly data are notoriously volatile, underlying trends are easier to recognize with 12-month moving averages. As Chart 3 shows, March was incidentally also the trough in terms of moving averages. In other words, during this cycle, the market was least active between March, 2013 and March, 2014.

Chart 3 12-month moving average of property transactions

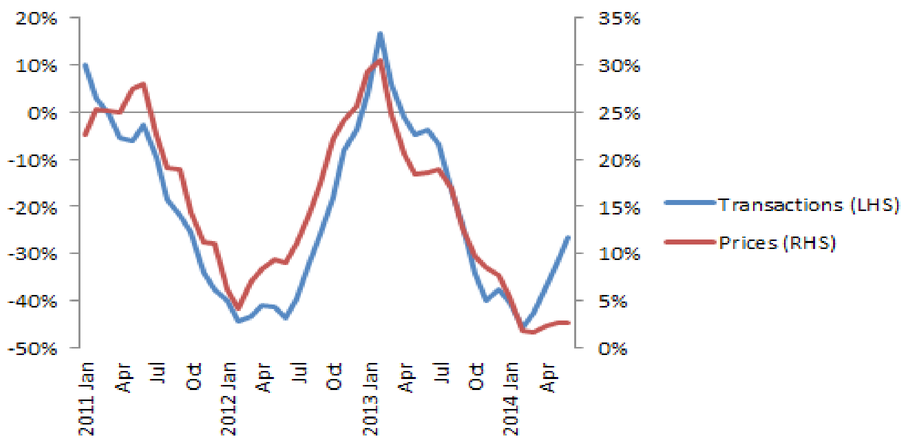


Sources: The Land Registry, BOCHK Research

However, housing demand was only temporarily suppressed by stiff stamp duties. As soon as regulations on the eligibility for double stamp duty exemption were relaxed in May, transactions rebounded very strongly thanks to the release of pent-up demand. Even though officials took pains to stress that the relaxation was purely a technical adjustment, market sentiment improved markedly. In July, the number of private residential transactions reached 7,792, a 21-month high and a whopping 148% greater than the level in March.

Prior to the recent pick-up in activity, subdued transactions failed to result in declining prices. As the trajectory of property prices remained stubbornly upwards, some argued that the correlation between transactions and prices had broken down. Yet this conclusion is premature. There still exists a positive correlation between the two variables. The key is to consider changes compared with the same period last year, instead of the directions in which their respective absolute levels are moving.

Chart 4 Year-over-year change in private residential prices and 12-month moving average of transaction volumes



Sources: Rating and Valuation Department, The Land Registry, BOCHK Research

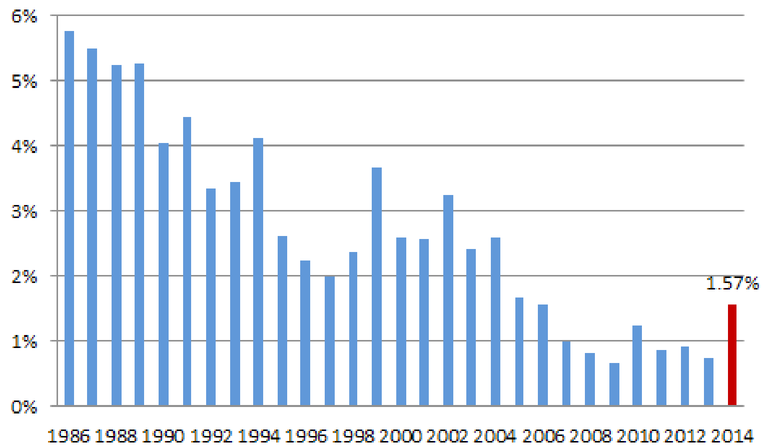
The pattern is fairly clear. As transactions plunged, annual increases in property prices slowed drastically, and vice versa. The changes in momentum of the two variables are remarkably in sync. If history is any guide, an increasingly active property market should bode well for prices.

II. Relatively limited supply

According to estimates of the RVD, 17,610 private residential units are expected to be completed in 2014, which would be a 10-year high. Nonetheless, even if this projection turned out to be accurate, the magnitude of supply would not be nearly enough to put a dent in prices.

First of all, completions in 2014 may reach the highest level since 2004 but would still be a far cry from historical average. Since records began, during the 20-year period between 1985 and 2004, annual completions averaged 28,849 units, or 64% greater than the RVD's projection for 2014. Secondly, the sustainability of rising supply is questionable. In 2015, completions will probably drop to 12,660 units, or 28% fewer than the projected level of this year. Last but not least, the impact of increased supply will be relatively limited. As of the end of 2013, the stock of private residential units in Hong Kong amounted to 1,123,633. As a result, new completions will increase the stock by 1.57%, which would be the biggest jump since 2006 but less than each and every year between 1986 and 2006. During this 21-year period, annual increases in the stock of private residential units averaged 3.37%, or 1.8 percentage points greater than the projected increase in 2014. Therefore, increased supply in 2014 and 2015 should not constitute a major threat to housing prices.

Chart 5 Annual increase in private residential stocks



Sources: Rating and Valuation Department, BOCHK Research

As for the second-hand market, a surge in the inventory of existing properties would be highly unlikely. Speculators have mostly disappeared from Hong Kong's housing market since the government introduced punitive stamp duties. In a property market where buyers are mostly comprised of users with stable income, short-term volatility alone is not likely to trigger fire sales. Therefore, the health of the labor market has become a major determinant of the supply of existing properties for sale. Since the fourth quarter of 2009, Hong Kong's unemployment rate has trended downwards. From the second half of 2011 to July of this year, it fluctuated within a very narrow range between 3.1% and 3.5%. Despite a recent uptick in joblessness, the number of people being employed actually reached new record highs, and the labor market overall is in good shape.

To recap, the combination of strong demand and limited supply has propelled property prices ever higher. As of the end of 2013, the vacancy rate of private residential units stood at 4.1%, the lowest level since 1997 and considerably below the 5.0% average of the past 20 years. Low vacancy indicates supply-demand imbalance, and the fundamentals of the housing market remain solid.

Rate hikes still a major risk factor

Low interest rates are a boon to the housing market. For one, asset prices tend to benefit from low interest rates. When it comes to valuation, the level of interest rates directly influences the discount rate used to estimate the net present value of future cash flows. The lower the prevailing interest rate, the lower the discount rate, and vice versa. The future stream of rental income that can be generated by the property during its lifetime can be discounted using the discount rate, with the resulting net present value being the price of the property. Ultra-low interest rates have thus offered a huge boost to property prices.

For another, low interest rates reduce the burden of mortgage payments on property owners. Rising prices inevitably lower the affordability of properties. However, low interest rates can mitigate the impact of high prices on mortgage payments. According to the HKMA, as of the end of 2013, an average apartment in Hong Kong cost 14.6 times of annual personal income. This price-to-income ratio was as unaffordable as the peak in 1997. However, it is not a foregone conclusion that Hong Kong people are priced out of the property market, as mortgage rates remain very attractive. Mortgage payments now amount to about 64.1% of household income, higher than the long-term average of 50% but considerably lower than the peak of 110% reached in 1997. Therefore, it is highly unlikely that a large number of property owners would be forced to sell due to excessive mortgage payments.

Nonetheless, by the same token, rising interest rates would pressure asset prices as well as increase mortgage payments. According to the HKMA, if mortgage rates went up by 3 percentage points, monthly mortgage payments would increase by over 30%. The impact of rate hikes on the property market should not be underestimated.

Under the linked exchange rate regime, interest rates in Hong Kong and the U.S. generally move in lockstep. As it stands now, the Fed is widely expected to embark on rate hikes in mid-2015. According to projections of the Federal Open Market Committee charged with setting monetary policy, most members believed that the Fed funds rate would rise to 1% — 1.25% as of the end of 2015. In other words, the increase in interest rates in 2015 could be as modest as 1 percentage point. Moreover, the Fed funds rate would still be far lower than historical average. In the 20 years prior to the financial crisis between 1988 and 2007, the Fed funds rate averaged 4.75%. As the pace of rate hikes would be relatively moderate, mortgage affordability should not deteriorate much.

Furthermore, although changes in Hong Kong's prime rate tend to follow the direction of the Fed funds rate, the magnitudes of adjustment are not perfectly symmetric. During the last cycle of rate hikes, Hong Kong's prime rate remained at 5% as the Fed funds rate rose from 1% to 2.25%. While the Fed funds rate approached zero in the past few years, Hong Kong's prime rate did not budge and was stuck at 5%. In fact, the gap between the two has been at its widest on record. Due to ample liquidity in Hong Kong's banking system, future increase in interest rates may trail that of the Fed funds rate.

Property prices have benefited greatly from ultra-low interest rates. Although the Fed is likely to raise rates within a year, the Fed funds rate at the end of 2015 may be less than a quarter of the 20-year average prior to the financial crisis. Therefore, monetary policy will still be accommodative. Moderate rate hikes will not presage the end of low interest rates.

In summary, the fundamentals of Hong Kong's housing market are still solid in spite of growing headwinds. Looking ahead, even though expectation of rate hikes may depress market sentiment to some extent, the actual pace of interest rate adjustment should be fairly benign. Risks are thus contained but should not be ignored altogether. It is entirely possible that rising inflationary pressure in the U.S. could compel the Fed to act sooner and more forcefully. Under this scenario, the property market would become very vulnerable, and the elusive correction could finally take place.

主要經濟指標 (Key Economic Indicators)

一 . 本地生產總值 GDP	**2012**	**2013**	**2014/Q1**	**2014/Q2**
總量 (億元) GDP($100 Million)	19,644	20,372	5,174	5,309
升幅 (%) Change(%)	1.5	2.9	1.8	2.6
二 . 對外貿易 External Trade	**2012**	**2013**	**2014/7**	**2014/1-7**
外貿總值 (億元) Total trade($100 Million)				
港產品出口 Domestic exports	588	544	51	32,767
轉口 Re-exports	33,755	35,053	3,210	20,110
總出口 Total exports	34,343	35,597	3,262	20,438
進口 Total imports	39,122	40,607	3,683	23,484
貿易差額 Trade balance	-4,778	-5,010	-421	-3,046
年增長率 (%) YOY Growth(%)				
港產品出口 Domestic exports	-10.4	-7.6	7	4.3
轉口 Re-exports	3.2	3.8	6.8	3.4
總出口 Total exports	2.9	3.6	6.8	3.4
進口 Imports	3.9	3.8	7.5	3.9
三 . 消費物價 Consumer Price				
綜合消費物價升幅 (%) Change in Composite CPI(%)	4.1	4.3	4.0	3.9
四 . 樓宇買賣 Sale & Purchase of Building Units			**2014/8**	**2014/1-8**
合約宗數 (宗) No. of agreements	115,533	70,503	7,902	51,491
年升幅 (%) Change(%)	6.2	-29.9	54.6	3.7
五 . 勞動就業 Employment	**2012**	**2013**	**2014/4-2014/6**	**2014/5-2014/7**
失業人數 (萬人) Unemployed(ten thousands)	12.45	11.84	12.6	13.3
失業率 (%) Unemployment rate(%)	3.2	3.2	3.2	3.3
就業不足率 (%) Underemployment rate(%)	1.5	1.4	1.5	1.5
六 . 零售市場 Retail Market	**2012**	**2013**	**2014/7**	**2014/1-7**
零售額升幅 (%) Change in value of total sales(%)	9.8	11.0	-3.1	-1.5
零售量升幅 (%) Change in volume of total sales(%)	7.2	10.6	-4.5	-1.5
七 . 訪港遊客 Visitors				
總人數 (萬人次) arrivals (ten thousands)	4,862	5,430	537	3,390
年升幅 (%) Change(%)	16	11.7	11.2	12.3
八 . 金融市場 Financial Market	**2012**	**2013**	**2014/6**	**2014/7**
港幣匯價 (US$100=HK$) H.K. Dollar Exchange Rate (US$100 = HK$)	775.05	775.4	775.1	775
貨幣供應量升幅 (%) change in Money Supply(%)				
M1	22.2	9.7	14	17.6
M2	11.1	12.3	15	15.9
M3	11	12.4	15	16
存款升幅 (%) Change in deposits(%)				
總存款 Total deposits	9.3	10.6	13.3	14.1
港元存款 In HK$	11.7	5.1	13.1	15.4
外幣存款 In foreign currency	7	16.2	13.6	13.5
放款升幅 (%) in loans & advances(%)				
總放款 Total loans & advances	9.6	16.0	16.0	15.5
當地放款 use in HK	7.1	13.8	14.9	15.6
海外放款 use outside HK	16.5	21.4	18.9	15.5
貿易有關放款 Trade financing	10.2	43.8	11.6	9.7
最優惠貸款利率 (%) Best lending rate (%)	5.0000	5.0000	5.0000	5.0000
恆生指數 Hang Seng index	22,657	23,306	23,191	24,757