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What is the likelihood of severe property price correction?

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Hong Kong residential property market entered into a correction phase since September last year. Based on the Centa-City Leading Index (CCL), the residential property prices declined around 13% between September 2015 and mid-April 2016. If it is measured by the residential price index from the Rating and Valuation Department (RVD), the residential property prices declined around 12% from September 2015 to March 2016. Even though prices have declined faster than expectation, the Hong Kong residential property market is not likely to have a deep correction ahead if the existing government and HKMA's measures remain unchanged and there is no significant crisis-type event to occur.

There were only two occasions of deep correction since 1980

According to the RVD statistics, there were only two occasions when Hong Kong residential property prices had declined by more than 30% since 1980. The first time happened between Q3 1981 and Q3 1984 when the residential property prices declined by around one-third. At that time, both the economy and property market performed badly amid concerns over the change of sovereignty in 1997. The second time happened between Q4 1997 and Q3 2003 when the property prices declined by two-thirds, as Hong Kong suffered from severe recession and deflation after the Asian Financial Crisis, tech stock bubble and SARS etc. The Hong Kong property market then declined for six years. However, the market revived since 2H 2003 and the up-cycle lasted for 12 years. Even though there were still ups and downs in the latest property up-cycle, like the residential property prices once declined around 17% during the global financial crisis in 2008, no sharp correction was recorded at that time since prices recovered swiftly after the central banks around the world had implemented aggressive monetary easing. Currently, the Hong Kong residential property market has entered into a correction phase again and declined around 13% from its peak. The market raised concerns about sharp correction, particularly amid an elevated global economic uncertainty, huge financial market volatility, US interest rate hike, and increase in land supply.

Four factors have led to the recent property market correction

1. The residential property market increased sharply during the up-cycle, and the small and medium-sized flats faced an increasing downward pressure. The residential property market has surged since 2003, with the prices of small and medium-sized flats (units with the size of 100 sq m lower) increased much faster than large-sized flats (units with the size of 100 sq m or above). From the trough in 2003 to the peak in 2015, the prices of small and medium-sized flats increased 4.3 folds, while the large-sized flats only increased 3.2 folds. Comparing with the peak in 1997, the prices of small and medium-sized flats increased 78%, higher than the 53% increase of large-sized flats. Given the property market in 1997 was in a highly unsustainable condition, the roughly same pace of nominal GDP growth and property prices between 1997 and 2015 also likely reflects the unsustainable condition, and does not see much meaningful improvement. However, the current mortgage rate is just around 2%, much lower than the 10% or above in 1997, leading to a relatively less frothy condition than 1997.

In addition, it is not a normal phenomenon that the prices of small and medium-sized flats increased much faster than large-sized flats, given the housing stock of the small and medium-sized flats accounted for over 92% of total in Hong Kong, while the large-sized flats only accounted for less than 8% of total. The prices of small and medium-sized flats rising faster than large-sized flats are mainly because of the increasingly stringent government's demand management measures and Hong Kong Monetary Authority's (HKMA) prudential measures for property mortgage loans. These measures increase the costs of property upgrading, investments by overseas individuals as well as local and overseas companies, leading to the more biased demand towards small and medium-sized flats. Indeed, if the peak in Q3 2015 is taken as an example, the affordability ratio for a median income household to purchase a class A residential flat (with a size below 40 sq m) was around 71% (assuming 2% mortgage interest rate and repayment over 20 years), while the affordability for the top 5% income household to purchase a class D residential flat (with a size between 100 and 159.9 sq m) was 54%. Even though both the affordability ratios were below 95% and 90% at their peak in 1997 respectively, it showed that the share of mortgage payment to household income was quite high for the small and medium-sized flats. With the sharp increase in property prices over the past 12 years, and particularly for the small and medium-sized flats, the property market has entered into a correction phase since September last year.

2. Global economic slowdown and severe global financial market volatilities kicked in. Between 2H 2015 and February 2016, the downward pressure of the global economy intensified, together with the US interest rate hike, relatively strong US dollar exchange rate, sharp decline of commodity prices, currencies depreciation and capital outflows from the emerging economies etc. The global financial markets staged a series of extreme volatilities. As a small and open economy, Hong Kong was also affected inevitably. Hong Kong dollar exchange rate had once depreciated towards the weak-side convertibility undertaking in January 2016, leading to a convergence of US dollar and Hong Kong dollar interest rates. Meanwhile, Hong Kong external performance was affected by the sluggish global economic recovery, and the tourism and retail sectors were also under correction. The concerns over weaker economic and employment outlook ahead has no doubt affected the residential property market performance.

3. The US Federal Reserve raised rates in December last year. In December 2015, the US Federal Reserve formally put an end to its zero interest rate policy and raised rates by 0.25 percentage point. At that time, the Federal Open Market Committee (FOMC) participants' assessment of appropriate monetary policy showed that the median participant expected the Federal Reserve will raise rates by 1, 1, and 0.875 percentage point in 2016, 2017 and 2018 respectively. Given Hong Kong has a linked exchange rate system with the US, the Hong Kong dollar interest rate has to follow that of the US. As such, the US interest rate hike in December last year has rekindled concerns over a new interest rate cycle and increasing burden of the mortgage payments in Hong Kong. This further enhanced the expectation of a property market correction, with more landlords willing to cut price to sell their properties, further affecting the residential property market in Hong Kong.

4. Increasing in land supply and the government's housing supply target is within reach. Without doubt, the current government strives to increase short, medium and long term land and housing supply, and is expected to continue this strategy even though the economy is facing an increasing downward pressure. According to the RVD statistics, the number of private housing completion will reach 18,200 and 17,930 for 2016 and 2017 respectively, both are the highest level since 2004 and within close reach of the government's 18,000-19,000 private housing supply target. Moreover, the statistics from the Transport and Housing Bureau (THB) showed that there will be 92,000 potential new private housing supply in the coming three to four years, the highest level since its record began in 2004. The concerns over the increase in housing supply in the near future is another negative factor for the residential property market in Hong Kong.

Low transactions signalled some unhealthy signs of property markets

Low transactions are another characteristic for this round of property up-cycle and the recent correction. In the beginning of the property market recovery between 2005 and 2009, the average monthly residential transactions ranged from 7,000 to 10,000. In view of the continuous rapid increase of residential property prices, the government announced four sets of demand management measures and the HKMA implemented seven rounds of prudential measures for property mortgage loans since 2009 and 2010. These measures are highly successful in preventing the formation of property market bubble and maintaining the financial stability of Hong Kong. However, these measures also increased the tax burden for some upgrading home buyers, as well as the overseas and local investors. Together with the more stringent mortgage loan standards, property buyers now have to pay a higher proportion of down-payment and fulfill the stress test requirement when they buy or upgrade their properties. As such, more and more secondary home owners adopt a wait and see strategy, leading to a sharp decline in secondary home supply. The average monthly residential transactions then declined from around 7,000 in 2011 and 2012 to 4,000 to 5,000 between 2013 and 2015. The transactions declined even further to just around 2,000 in Q1 2016.

Obviously, low transactions in residential property market were partly related to the government's demand management and HKMA's prudential measures, as these measures not only restrained demand, but also secondary home supply. However, fewer secondary home supplies will help stimulate prices to rise more rapidly during the up-cycle, while fewer demand will dominate during the down-cycle, particularly the reliance of first-time home buyers is insufficient to support the overall property markets. Therefore, if secondary home owners want to sell their properties (because of financial needs, property upgrading and change in family conditions) during the down-cycle, they have to cut prices more aggressively so as to attract buyers. This will result in a more rapid decline in property prices. Indeed, property has the characteristic of low liquidity. Its liquidity will be further reduced amid a low transaction environment. This will negatively affect the overall property market and the financial condition of home owners.

No sharp correction for Hong Kong residential property market

Obviously, the government's demand management and HKMA's prudential measures do have notable influence on the Hong Kong residential property market. If there is any change to those measures in the future, it will undoubtedly affect the development of the residential property market in Hong Kong. Based on the following factors, and assuming the continuation of the existing government and HKMA's measures, and there is no significant crisis-type incident to occur, the Hong Kong residential property market is still not likely to have a deep correction ahead.

1. Whether there is an interest rate hike cycle in the US remains uncertain. Since the US Federal Reserve raised rates in December 2015, the global economy is facing increasingly downward pressure. Together with the highly volatile global financial markets, the Fed could no longer lead other central banks in the world to raise interest rates ahead. Other central banks, like the European Central Bank and the Bank of Japan, even cut interest rates to negative levels, extend or increase the size of quantitative easing. Therefore, the low interest rate environment and global liquidity glut are likely to continue, and the US Federal Reserve might have to consider more on the moves of its counterparts overseas. Indeed, the expectation of rate hike by the FOMC participants has reduced notably between December 2015 and March 2016 meetings, with the median participant currently expected the Federal Reserve to raise rates twice this year, compared to four hikes when they met in December 2015. The Fed funds future has an even lower expectation, with only one rate hike in sight in 2H 2016. Against this background, whether there is an interest rate hike cycle in the US remains

uncertain. As Hong Kong has attracted more than US$ 130 billion of capital inflows since the US implemented quantitative easing in 2008, the Hong Kong dollar interest rate is likely to stay low and the impact of interest rate hike on the property market is largely psychological.

2. Difficult to meaningfully increase medium to long term housing supply. The government announced that there will be 92,000 potential new private housing supply in the coming three to four years, the highest level since the record began in 2004, which is likely to help reach the government's annual private housing supply target of 18,000-19,000. However, given the shortage of construction workers, and more site formation works are required for some new land supply, the construction period is likely to be longer than the normal three to four years. In addition, the medium to long term housing supply target is even more difficult to achieve. The Policy Address stated that the four new development areas (Kwu Tung North and Fanling North, Hung Shui Kiu, Tung Chung New Town extension, and Yuen Long South) will provide a total supply of 197,000 new residential units. Based on the 60:40 proportions between public and private housing, there will be around 118,000 new public housing and 79,000 new private housing units. However, the first of these housing units are expected to be completed in 2023 and will then be completed in phases with full completion in 2031/2037. Assuming all these private housing units will be completed in 10 years, the average annual completion will only be 7,900 units, roughly 40% of the government's target, indicating that the medium to long term private housing supply remains insufficient. Oversupply situation, like the years between 1999 and 2003 with nearly 30,000 private residential completion each year, is not likely to repeat again.

3. The Hong Kong economy is not likely to enter into a recession. While only some food items and supermarket sales recorded small increases, retail sales value declined 13.6% in January and February over the same period of last year, signalling slower economic momentum. This was attributed to the decline of tourism spending and the weaknesses in domestic consumption. The latter was largely affected by the asset price consolidation, increase in outbound tourism as well as the unfavorable social condition. Meanwhile, the external environment remains weak. Together with the relatively high Hong Kong dollar exchange rate, the merchandise exports of Hong Kong were also adversely affected. Exports of goods declined 6.8% in the first quarter over the same period of last year, while imports declined at an even sharper rate of 8.2%. As such, net exports were likely to provide some positive support to the overall economic growth, somewhat offsetting the impact of domestic weaknesses. Therefore, the Hong Kong economy is not likely to enter into a recession. The chance of massive job cuts and leads to sharp property market correction remains low.

4. Financial condition of local residents remains favorable. According to the 2011 Census data, there were 2.368 million of households in Hong Kong, with 52.1% (1.233 million) were owner-occupiers. Among those owner-occupiers, 60.1% (741,000) did not have any mortgage or loans on their property, while the remaining 39.9% (492,000) had a median debt serving ratio of 19.6%. Together with the seven rounds of prudential measures for property mortgage loans implemented by the HKMA, over-leveraging is not a major issue for Hong Kong property owners. The property market is mainly supported by owner-occupiers and they do not have the incentive to cut price aggressively.

Nevertheless, it should be noted that domestic demand is the driving force of Hong Kong's economic growth after the global financial crisis. However, the downward pressure of the Hong Kong economy has intensified since 2H 2015, with the external environment remains anaemic, tourism and retail sectors are also under correction, likely pointing to a slowdown of domestic demand. In addition, the property market performance and the real private consumption spending are highly correlated, with a further decline in the property market likely intensifying the downward pressure of the domestic demand. It could not be ruled out that the real private consumption spending might stagnate and its negative impact on the economy and employment market might start to surface gradually ahead.