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ECONOTE No. 95 The Hong Kong property sector: Assessing the bear market 20/10/2020

Summary

The Hong Kong (HK) property markets are integral components of the economy with added fiscal, political and social links. The start of the political instability on June 2019 plus the Covid 19 from January 2020 onwards coming at the time that the economy was decelerating steeply since 1Q.98, dealt severe blows to the office, retail and residential property sectors. In HK there is a close relationship between the depth and duration of the GDP "recessions" (see definition below) and the property cycles, with the difference that the present GDP recession exceed everything that had been experienced in the last 25 years, including the 1995-7 Asian Crisis, SARS in 2003 and the global crash in 2008-9. **After 16 years of nearly continuous rise in housing prices and with a GDP recession likely to last several more quarters, the adjustments in the property sector will very likely match those of the last property recession in 1997-2003.**To ensure transparency, we signify facts with **Facts** and opinions with **Opinion**s. To avoid spurious accuracy all start and ending points of cycles as well as average percentages changes are approximate.

Investment Conclusions

The cycle of the GDP is now dependent on the biological cycle of the human body and that of Covid19. As long as infections continue in global waves they will necessitate country lock-downs and limits to travel and thus GDP growth in Hong Kong may continue to fall, at a slower pace possibly, but with little recovery. The stronger macro performance of China will help Hong Kong assuming that China will avoid a "second wave". The "new reality" facing Hong Kong post Covid 19 in terms of its external competitiveness in general, and within the Greater Bay Area (GBA) in particular, will imply that the current adjustments in the property market may turn out to be structural and not just cyclical. The high dependence of the tourist sector of Hong Kong on China may face deep readjustments which, in its turn, will impact all property sectors. The growing integration with the GBA, by necessity, will tend to average down property prices in Hong Kong given the overall lower property prices in GBA.

A quick summary of property prices and cycles in Hong Kong

Fig. 1 shows (a) GDP growth, yoy, red (b) Prices of all types of private domestic units, green (c) Rentals of all types of private domestic units, blue (d) Rentals of private commercial retail units (yel). **Fact 1** During this period 1995-2020 there were 4 "recessions" in terms of declines of GDP growth. We measure these in broad terms as the period when the GDP growth peaked and then bottomed. In specific :(a) The1997-8 Asian crisis which lasted about 18 months (b) The SARS crisis of 2003 which lasted about 6 months (c) The 2008-9 global crisis which lasted about 18 months (d) the current crisis which started in in 1Q.2018 and has no signs of bottoming yet, a record of 30 months. **Fact 2** The last period of residential property prices (green) **declined** was during 1997 to 2003 with **prices falling by about 66.0%, or an average of about 11.0% fall pa**. There followed 16 years, 2004-2019 of virtually uninterrupted **price rises of 580%, roughly 36.0% pa**. **Fact 3** The causes behind the 16-year boom are well known: (a) zero interest rates in the US since 2007, which were reflected, via the HKD peg to HKD interest rates. (b) HK has had **negative real interest rates,** that is inflation rate higher than nominal interest rates, from 2007 to mid 2020 (c) Relatively steady GDP growth and growth of population which added to housing demand. (d) Mainland buyers, notwithstanding punitive taxes to limit their impact, added to demand, but see below (e) Housing policies, which did little to address the decades- long malaise of the property-taxes nexus. The HK government derives a significant proportion of its revenue from its monopoly of freehold land which favored high land prices. In return the government maintained an exceptionally low tax regime with low income and profits tax, no tax on dividends, interest rates, overseas income and no sales, VAT etc taxes whose benefits were unevenly spread over the population. However the public housing policy ameliorated, in part, these developments by providing subsidized housing, but these policies, in their turn, also favored landlords, developers and owner-occupiers in unequal degrees. **Fact 4** The property-related population statistics which are are summarized in the Factbox showing that households in HK are, very roughly, divided 50%-50% between living in state housing and owning or renting in the private sector. Existing owners buy or sell and/or move to renting as well those renting whom may buy. To those we need to add the 30.0% of households, which rent from the state and which, if they can afford, can aspire to buy. Thus, adding also the corporate sector, there is a very large percentage of the population in HK, which are, can or aspire to participate in the private property market. Hence what happens to property prices and rents does not affect a small percent of "speculators" but can take in a lot of the population of Hong Kong. The role of Mainland buyers has been exaggerated. A recent report (Nov. 2019) from the CUHK Business School has found that over 2001-17 Mainlanders accounted for 3.7% of all buying of residential properties. They paid, on average, 4.4% higher prices and they bought better quality flats. Their buying added to price rise impetus but above their share contribution.

Fig.1: HK: Residential and Retail property prices and rents, index levels, GDP YoY%

Source: Bloomberg,

Cycles past and future, factts, opinions, infomration and rationality

The data in Fig. 2 focus on the prices of A class offices (green) and on their rents (blue) and on the prices of private commercial units (mauve) plus HK's GDP growth (red). As with Fig. 1, all starting and ending dates and percentages are approximate in order to avoid spurious "accuracy". **Fact 5**: Office prices fell from 1997 to 2003 by 77.0% but then rose from 2003 to 2018 by 1112.0% or an average of 74.0% pa. Office rents fell from 1995 to 2003 by 71.0% but then rose from 2003 to 2019 by 490.0% or about 30.0% pa. **Fact 6:** Hong Kong is infamous for its high office and residential prices and rents. But it is worth repeating that property cycles can be long lasting and deep with the 1995-2003-property recession seeing residential prices falling by 11.0% pa and rents by 9.0% pa over the same period. Symmetrically, and over roughly the same periods office prices fell by over 12.0% pa while rents by 8.0% pa. **Opinion 1:** Comparing these prices and rent declines with what has taken place since mid 2019 might be inappropriate as the cycle has not yet finished. If a rough average was taken as base line then from mid 2019 till the cycle finishes prices and rents can be expected to fall, by a rule of thumb, by about 10.0% pa. **Fact 7:** The data from Figs 1 and 2 show the following declines in prices and rents in the three main property sectors from their most recent peak to now. Residential (May 2019 to Aug-Sept 2020), prices -4.0%, rents -9.0%. Offices (Central A, Nov.2018 to Aug-Sept 2020) prices -52.0 Rents -20.0%. Shops, (Jan.2020 to June-Aug. 2020) prices -10.5%, rents -10.0%. Not surprisingly, and given that we are looking here at three very different markets, the price declines vary from -52.0% to -4.0%. **Opinion 2**: The residential market both in terms of declines in price and rents appears the most resilient but with mounting evidence of that resilience depending on a very small group of households thus endangering its survivability. The South China Morning Post (SCMP 20/10/20) reports on a study which has found that a small group of households, about 200,000, were crucial in maintaining a core sector of the residential market afloat so far in 2020. Some further evidence of the bear sentiment is the fact during August to October 2020 SCMP published 18 articles on all sectors on the HK property market, all of them bearish on prices, rents and outlook.

We turn now to a near "urban myth" in the Hong Kong property sector. It is generally believed that **Hong Kong landlords would rather keep their proprties empty than lower their prices/rents**.Here we will use "rent" as the benchmark, given that "price of propety" is simply the capitalised value of future streams of revenues/rents.This notion is based on the expectation that holding out will yield, later on, a higher offer.This in its turn, is based on a very simple DCF (Discounted Cash Flow) expectation which has been made all the more the attractive by the near zero interest

Fact Box: Property ownership and use structure, 2016-18

(a) In 2018, **45.4% of all domestic households lived in public** permanent accommodation of which 30.6% was rental and 14.8% was through subsidized sales with some restrictions on resales.

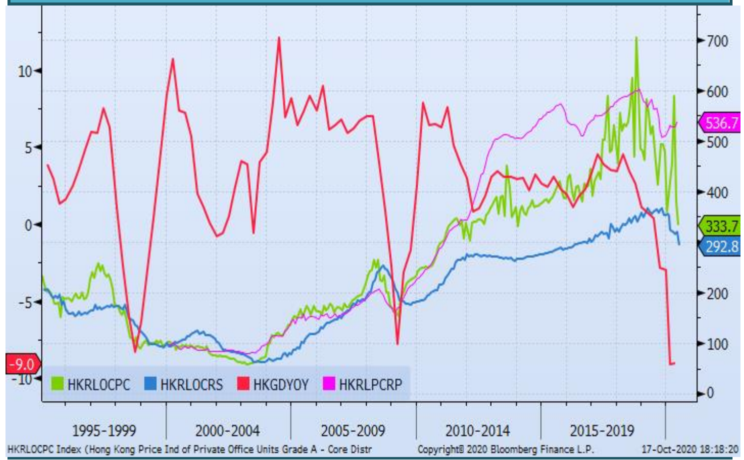
(b) In 2018, **53.8% of households lived in private** accommodation, of which 48.5% (of the 53.8%) were owners and 46.8% were tenants.

(c) Another 0.7% households lived in different type of accommodation including that provided by employers.

Aside from the corporate sector which buys to own, resell or rent, the private sector owning accommodation consists of (53.8 x 0.485) = 26.1% of all households in Hong Kong while the private rental market consists of (53.8 x 0.468)=25.1%. There is discrepancy of 2.6% in the total caused by data from different years.

All data for 2016-18 taken from the HK Housing Authority and Housing Department, the HK Transport and Housing Bureau and the HK 2016 Census. Some of the calculations are simplified in order to bring in line quarterly cyclical data of the GDP with the monthly indices of the property sector.

Fig.2 HK: Prices and rents of offices and retail shops, index levels, GDP YoY%



Source: Bloomberg

Expectations,absence of information, pride and rationality

now ruling the markets. The present day value (PDV) or the compounded value (CV) of X HKD over a Z period at near zero interest rates are almost identical thus making intertemporal choices very easy or irrelevant. Equivalently, the carry cost is also near zero. The following hypothetical example is simple and approximate but points to the distortions that can be induced by near zero interest rates and expectational decision –making based not on factual information but on pride and personal belief.

A landlord faced with decision whether to cut rent by half from HKD 100 to HKD 50 for a Z period lease, or leave the property empty for a Z period thus holding out for the HKD 100 rent as before, has the following cash flows to consider. **(a)**Holding out for a HKD 100 price foregoes now the HKD 50 that could be received by accepting the deal at a lower price, and which has a PDV value (or indeed a CV) at near zero interest rates, at almost HKD 50. **(b)**If the expectation over holding out turns out right, and after Z period a deal is struck at HKD 100, then the net gain is HKD 50, that is the HKD 50 foregone now deducted from the HKD 100 received later on. The PDV of the expected net future gain is again the same- HKD 50 at near zero interest rates. **(c)**If the expectations prove wrong and the deal can only be struck at HKD 50, then there is a loss of HKD 50 which could have been received earlier, but whose present day value is also HKD 50.The net gain is zero.With zero carry rates both gains and losses by postponing the decision and holding out are reduced.

However the crucial issue over holding out, is the expectation that in Z period the markets will be back to normal.In the case of the property market in Hong Kong under CV19 and of its unchartered impact on the macro economy, this expectation is unfounded .Refusing HKD 50 now on the basis of no information but just on optimism is foolish. Current information is better, that is the deal at HKD 50, than no information at all. Accepting the deal at HKD 50 makes informational sense. **Opinion 3** :There is, always, the "pride" effect and the notion that landlords, persons or corporates, can afford to wait and will not be browbeaten to give discounts. Everything in life has a price and irrational behaviour in markets is utterly rife. You only need to look at Bitcoins for a good example of buying something with no intrinsic value or returns whatsoever but purely on the expectation that other people will, later on, want to buy it as well.

In sum. The GDP downturn in Hong Kong may last much longer than expected as it is driven by biology and not market forces.Hence the property sectors will continue to stay under pressure while this is happening. (Andrew Freris, writing completed 20/10/2020)