afreris@ecognosisadvisory.com

ECOGNOSIS ADVISORY LTD

From the Greek:
ΟΙΚΟΝΟΜΙΚΗ ΓΝΩΣΙΣ, (Ekonomiki Gnosis, Knowledge of economics)

A global financial and economics advisory service covering economic and financial developments, equities, fixed income, forex, commodities and other assets

Dr. Andrew Freris, CEO, ECOGNOSIS ADVISORY LTD,
Level 20, 1 International Finance Centre, 1 Harbour Street, Central, Hong Kong
Tel.: (852) 3167 4591 Mobile: (852) 9738 0944 Email: afreris@ecognosisadvisory.com
Website: www.ecognosisadvisory.com Facebook: www.facebook.com/ecognosisadvisory

Ecosnap No. 10, August 3 2020

The Hong Kong property market: Sleepwalking to a steep decline

The Hong Kong property market: Sleepwalking to steep decline

Introduction

The current feel of the property sector in the Hong Kong seems unreal in that prices and rents of domestic and commercial properties seem to be sleep-walking, especially in the residential sector, but less so in the office sector.The price reactions do not anywhere near reflect the macro gravity and what is yet to come. The economy of Hong Kong will not go through a steep and prolonged depression, **it is going through one**. (See definition of "depression" below).There is a fairly close relationship between the depth and duration of the GDP depressions in Hong Kong and property prices and rents. The difference now is, that the present depression exceeds everything that had been experienced in the last 25 years, including the 1997-8 Asian Crisis, SARS in 2003 and the Global Crash in 2008-9.Over the 2004-2019 period residential property prices rose, almost uninterruptedly, by about 550% or by an average of 34.0% pa. The present trend of GDP growth decline forewarns of steep price declines over the next few years.

The grim facts

Figures 1 and 2 show a selection of property statistics with HK's GDP growth. To avoid too much detail, the analysis is focused on the prices of all types of residential property as this index is fairly closely matched by the indices of the prices and rents of commercial retail units and the prices and rents of A grade offices.

Fact 1. We measure and term "depression " the period during which GDP yoy % growth peaked, fell and then bottomed ,declining negative rates still counting as "depression". The following periods have been classified as "depressions": (a) The1997-8 Asian crisis lasted 6 quarters, (b) The SARS crisis, 2 quarters (c) The 2008-9 global crisis, 6 quarters (d) The current crisis, which started in 1Q.2018, has lasted 9 quarters with no sign of bottoming.

Fact 2 Property prices and rents fell during 1997-2003, briefly during 2008-9 and during a few short periods in 2011 and 2014-15, but in general rose from late 2003 to the summer of 2019 for nearly 16 years by 550% or roughly an average of 34.0% pa.The last period when property prices declined consistently was during 1997 to 2003 falling by about 64.0%, or an average of about 11.0% p.a. with two "recessions" coinciding, 1997-8 and 2003.

Fact 3 What makes the present depression very special vis-a-vis property prices is the delayed reaction of the prices to the start of the current depression in 1Q.2018, with property prices start falling nearly 12 months later. There are three additional issues to consider. (a) The global scale and depth of the depression is record- breaking with the US shrinking an annualised -5.0% in 1Q. 20 and an eye- popping -32.9 % in 2Q.20.The numbers for the EU were equally bad -3.6% in 1Q.20 and -12.1 in 2Q.2020.There is going to be no "global" economic support for Hong Kong for, easily, another year or more (b) China is doing better financially and also CV19-wise, but as its global trade passes partially through Hong Kong there will be not much help from there too, as global trade has declined. Also China, the main source of tourism for Hong Kong, which marked recently a near 100% fall in arrivals (!), will not help while infections accelerate and are not under full control in HK. (c) While a second and even a third wave of infections persists, like virtually everywhere in the world, early loosening driven by popular discontent trades- off some economic relief for the grim danger of unfettered spreading of inflection killing mostly older people. The pressure on the HK economy will persist ,with difficult political decisions on CV19 tainted by the on-going political controversy and irrespective of how well economy and infection-wise China is doing.

Comments and conclusions The press and media in HK are full of requests, and now by near threats, by tenants of malls and of retail shops, and restaurants in particular, to their landlords asking for rent reductions and relief, only to be met by grudging responses and, more recently in major malls, by downright refusals. Associations of hotel owners and managers are now asking the government for rates relief as they themselves have no landlords to seek relief from ! Government tenants were given waivers of rents and of rates. Private residential prices have been falling but prominence is given to a few successful sales as this could possibly fool the prospective buyers and landlords of what is yet to come.

The old excuse and urban folk tale that HK landlords are experts in hanging on and not yielding to price reductions is, erroneously, backed by 16 years of prices **rises** but with no recent experience of the impact of the macro tsunami hitting HK and the property market. The market is a cruel place because it is impersonal.

Leaving property empty even after tenants pleaded for a lower rent or price, on the basis that holding out will yield later on a higher offer, is based on a very simple DCF expectation .This has been made all the more the attractive by the near zero interest rates 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, of course, extremely simple and numerically approximate only, but touches on the essence of the distortions that can be induced by near zero interest rates and decision making based no information whatsoever.

A landlord faced with decision whether to cut price or rent in half from HKD 100 to HKD 50 for a Z period lease or sale, or leave the property empty for a Z period holding out for the HKD 100 rent or price as before, has the following cash flows to consider.
(a) Holding out for a HKD 100 price/rent 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 of, 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 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 the HKD 50 which could have been accepted 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 impact on the macro economy, this expectation is utterly unfounded .This is because of the complete “novelty” of the CV 19 experience and of the policy measures imposed (the “lockdown” effect) and because it is not based on any past experience, which does not exist, or on reliable information on the future course of the infection. Refusing the HKD 50 now on the basis of no information but just on optimism is foolish. Current information is better (the deal at HKD 50) than no information at all, and accepting the deal at HKD 50 makes informational sense. There is, always, the “macho” effect and the notion that wealthy landlords can afford to wait and will not be browbeaten and humiliated 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 people buying something with no intrinsic value or returns but purely on the expectation that other people will, later on, want to buy it as well.

The zero interest rate assumption is, fortunately or unfortunately, correct as the US Fed, ECB and BoJ have guaranteed zero rates for as long as it takes or for the “duration”. The assumption that future prices or returns will not fall is, however, based on previous history of property cycles, which were driven by economic factors and not by the unpredictable biological cycle of a virus. To spell out the obvious, a return to “normal” economic conditions will depend completely on whether the rate of infection is low enough to eliminate catastrophic loss of human life, and that, will depend to a great extent on human policy action.This is brutally spelled “lockdown”, which raises the issue of the unknown willingness and capacity of societies to sacrifice human lives for economic gain and personal freedom.

If HK landlords and investors in HK property are willing to take a bet that in X months or years we will be back to “normal” and thus holding out on price and rent reductions is a possibly profitable option, they are doing so on the basis of zero information on past market behaviour, as CV19 is a new and unique experience. If there is zero information about the future or how to forecast it, then it is totally foolish not to grab the certainty of what is available now, lower prices and rents, rather than believe that a better option, based only of belief and not on information, will arise

tomorrow.
Hence the very negative conclusions of this report, have nothing to do with disliking “greedy landlords”, and it is not published in an effort to teach property investors and owners how to do their job or to show them the error of their ways, but is a simple analysis based on Economics 101 and basic information theory.
Simple.
PS.A much more detailed version of this report will be published in a forthcoming issue of our free series Econotes. Send you email to afreris@ecognosisadvisory.com and I will send you a copy of the report.Your email will not be used for promos and marketing as Ecognosis is a one-man outfit and , as Clint Eastwood memorably said "A man gotta know his limitations" . **Bang !**

Fig. 1:
Red: HK GDP growth you %
Green: Index, Prices of domestic units
Blue:Index, Rents of domestic units
Orange: Index, Prices comm.retail units

Fig. 2:
Red: HK GDP growth, you %
Green :Index,Prices of A grade offices
Blue: Index,Rents of A grade offices
Orange: Index, Rent of comm.retail units

Our mailing address is:
afreris@ecognosisadvisory.com