Mizuho Economic Outlook & Analysis

June 2, 2016

How should we view the fall of real estate prices in Hong Kong and Singapore?

< Summary >

◆ Steadily rising real estate prices in Hong Kong began to fall from the Oct-Dec quarter of 2015. Likewise in Singapore, prices of residential housing have been declining moderately, while commercial real estate prices appear to have hit their peak.

◆ While the US interest rate hike at the end of 2015 is serving as downward pressures on real estate prices in the two regions, other factors such as the drop in Hong Kong stock prices, a decline in the number of inbound tourists from China, and the worse-than-expected deterioration of Singapore's economy are driving down their real estate prices.

◆ With the relative expensiveness of real estate mostly eliminated in Hong Kong, the real estate market in the future is expected to fluctuate along with supply and demand trends and overall economic conditions. Meanwhile, property prices in Singapore remain relatively over-valued, and are expected to continue declining.

Mizuho Research Institute Ltd.
Hiroshi Inagaki, Senior Economist, Research Department – Asia
hiroshi.inagaki@mizuho-ri.co.jp
Yoshino Tamai, Economist, China Unit, Research Department – Asia
yoshino.tamai@mizuho-ri.co.jp

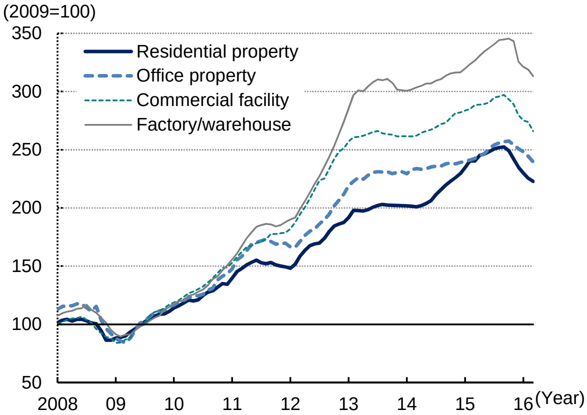
1. Introduction

The surge of real estate prices in Hong Kong and Singapore during the period from 2009 through 2011, subsequent to the slump triggered by the collapse of Lehman Brothers in 2008 (the "Lehman Crisis"), led to the view that the real estate markets in the two areas might be experiencing a bubble. While real estate prices in the two regions continued to follow a gradual uptrend, real estate prices in Hong Kong started to fall from the Oct-Dec quarter of 2015. In Singapore, residential housing prices began to show a moderate decline with commercial real estate prices showing signs of a peak-out (**Chart 1**).

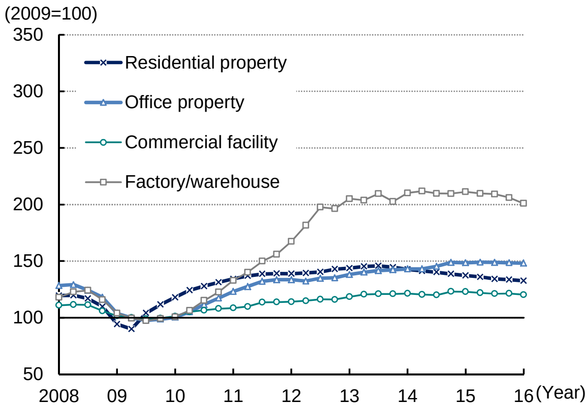
In this report, we shall reexamine the outlook for the real estate markets in the two regions by observing the changes in the surrounding environment of the two markets.

Chart 1: Trend of real estate sales prices

[Hong Kong]



[Singapore]



Source: Made by MHRI based on the Government of the Hong Kong Special Administrative Region Rating and Valuation Department and the Singapore Urban Redevelopment Authority.

2. Recent trends of the real estate markets in Hong Kong and Singapore

(1) Hong Kong

Real estate prices in Hong Kong have mostly maintained an upward trend since 2009 after falling about 20% subsequent to the Lehman Crisis. Although Hong Kong's regulation of real estate investment put an end to the uptrend trend in 2011 and 2013, it did not bring about a full-scale adjustment. Later, real estate prices started rising again from 2014 on the back of a revision to the real estate tax system,[1] among other measures,

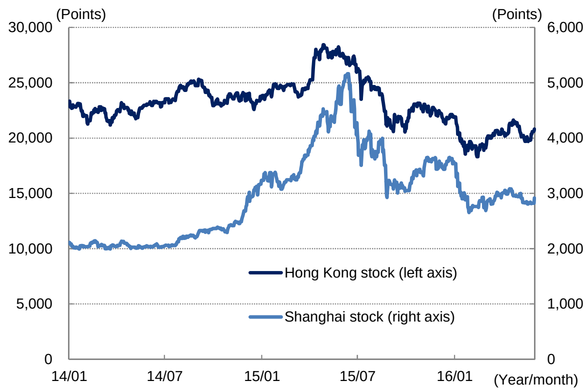
[1] The condition for exemption of the stamp duty (maximum of 8.5%) when buying a home for replacement was revised. Originally, the homeowner-buyer of a replacement home had to sell his existing home within 6 months after concluding the purchase agreement;

and the price rise accelerated in 2015 with the postponement of the US interest rate hike, which had been expected in mid-2015. But from the Oct-Dec quarter of 2015, real estate prices started to follow a clear downtrend triggered by a number of factors that included (1) the significant slump in stock prices in China and Hong Kong from mid-2015, (2) the US interest rate hike at the end of 2015 and the volatility of the Chinese financial markets at the beginning of 2016, and (3) the economic slowdown in the Hong Kong region.

The fall of stock prices mentioned in (1) appears to have led to the fall of real estate prices through downward pressures on real estate demand stemming from the negative wealth effect. In 2015, although stock prices surged temporarily by virtue of the Chinese government's measures to prop up stock prices and excessive expectations among investors for additional policy implementation, stock prices declined sharply once again after the summer. Following such developments, the Hong Kong stock market, where many companies from mainland China are listed, fell sharply (**Chart 2**).

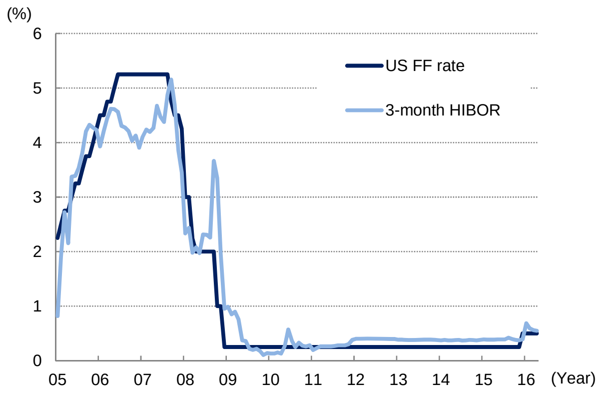
With regard to (2), since Hong Kong adopts a foreign exchange policy that links the value of the Hong Kong dollar to the US dollar, its interest rates also move with US interest rates, and when the US raises its policy interest rate, the regional interest rate in Hong Kong follows suit (**Chart 3**). Since such a move also affects mortgage interest rates, the US interest rate increase at the end of 2015 led to a more cautious view on real estate prices.[2] Furthermore, in early 2016, the weakening of the Chinese yuan and the

Chart 2: Stock prices (China / Hong Kong)



Note: The latest data are as of May 31.
Source: Made by MHRI based on Bloomberg.

Chart 3: US policy interest rate and Hong Kong short-term interest rate



Note: The US FF rate is taken from the upper range.
Source: Made by MHRI based on the Hong Kong Monetary Authority and FRB.

but this was changed to 6 months after conclusion of the delivery agreement. In Hong Kong, presale of a new home usually starts 30 months prior to its completion, and in the case where a buyer concludes the purchase agreement simultaneously with the start of the presale, it is highly likely that the newly purchased home will still be under construction 6 months later and the buyer is unable to move into the new home This made it difficult for a buyer to benefit from the tax exemption. Given the revision, if a buyer concludes the purchase agreement simultaneously with the start of the presale of the new home, the buyer can benefit from the tax exemption if the existing home is sold within 36 months after conclusion of the purchase agreement.

2 In reality, the Hong Kong interbank interest rate did not change much immediately after the US interest rate hike at the end of 2015. Ample liquidity of the Hong Kong Dollar may have curbed the rise of Hong Kong's interest rate.

fall of China's stock prices led to the rise of concerns regarding China's financial markets and triggered an outflow of funds from Hong Kong, which has a close connection with China. Such developments also amplified the upward pressure on interest rates.

Turning to the Hong Kong economy in (3), economic conditions have continued to slow down since 2015, and GDP growth dipped into negative territory (-1.8% q-o-q p.a.) in the Jan-Mar quarter of 2016. As indicated by the unemployment rate of 3.4% in the February to April period in 2016, Hong Kong's economy is enjoying almost full employment and labor market conditions have not deteriorated significantly. Even so, weakening consumer sentiment may have dampened the appetite to purchase real estate properties, serving to push down real estate prices.

While the foregoing is an overview of recent real estate market conditions in Hong Kong and its background factors, note that differences are emerging depending on the type of property. The following section takes a closer look at the respective price movements of residential property, offices, commercial facilities, and factories.

a. Residential property

Residential property prices as of March 2016 have fallen about 12% from the most recent peak (September 2015). The foregoing residential prices are calculated mainly upon transactions in the existing home market. Furthermore, since the transaction volume of existing homes, which accounts for the majority of housing transactions, also fell (**Chart 4**), it can be inferred that residential housing has undergone an adjustment mainly in the existing home market.

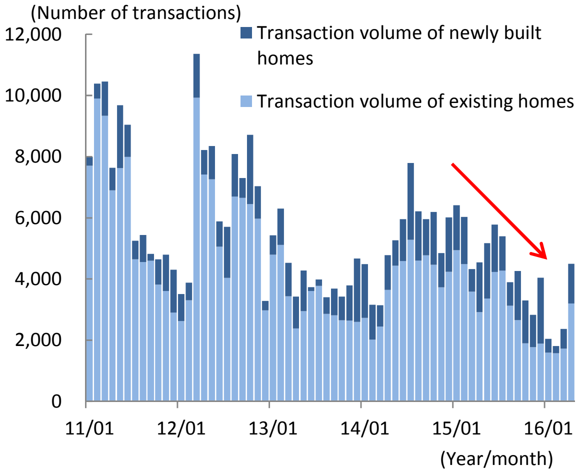
One factor behind this adjustment is the government's policy from 2015 onward to increase the supply of new homes over the upcoming three to four years, which served to sap the incentive to purchase existing homes. According to the Hong Kong government's quarterly forecast on the new housing supply in the upcoming three to four years, while it was expected that around 70,000 units would be supplied from 2013 through 2014, this number increased to over 80,000 in the forecast released after June 2015 and even higher to 92,000 in the forecast as of March 2016. Furthermore, according to government statistics, the number of housing completions is expected to increase in 2016 and 2017 compared with the actual result recorded in 2015 (**Chart 5**). The plan to increase the housing supply most likely stems from political intent to solve the chronic housing shortage in a bid to alleviate the frustration of Hong Kong residents.

Furthermore, the policy to lower the Loan-to-Value Ratio ("LTV"),[3] which was

[3] Specific contents of the policy are (1) the upper limit of LTV for residential property worth HKD7 million or less was lowered to 60%

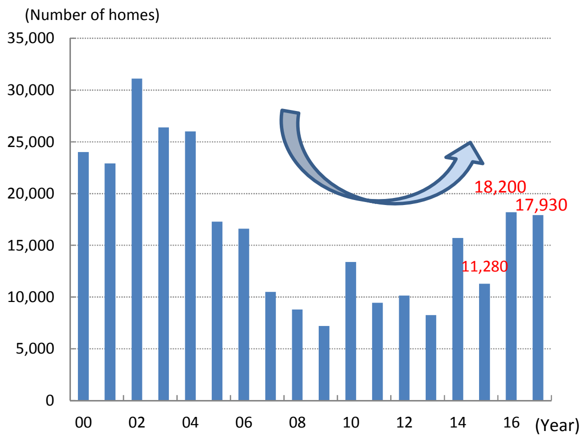
announced in February 2015 for the purpose of curbing rising housing prices from the latter half of 2014, appears to have achieved a certain level of success.

Chart 4: Transactions of new and existing homes



Source: Made by MHRI based on the Government of the Hong Kong Special Administrative Region Rating and Valuation Department.

Chart 5: Number of new home completions



Source: Made by MHRI based on the Government of the Hong Kong Special Administrative Region Rating and Valuation Department (2016).

b. Office property

Office prices as of March 2016 declined by about 7% from the most recent peak (October 2015), and the degree of price decline is relatively small compared with other types of property. One factor explaining this is the strong office demand by companies from mainland China.

The number of mainland China companies holding offices in Hong Kong stood at 1,091 in 2015, up around 52% from 2006 a decade ago, and the growth rate was particularly strong in 2015 with the launch of reciprocal stock transactions between Hong Kong and Shanghai in November 2014 triggering the advance of mainland China companies into Hong Kong, comprised mainly of financial institutions such as banks, brokerage companies, and asset management firms. As a matter of fact, the purchase of office buildings by mainland China firms has been increasing recently. The number of developers coming to Hong Kong from mainland China is also gradually rising in a bid to capture such real estate transactions with mainland China companies.

In addition to demand-side factors such as the foregoing, supply-side factors have also affected office prices. According to reports compiled by real estate research firms

across the board from 60% to 70%, and (2) the debt repayment ratio (ratio of repayment amount against income) for the purchase of a second residential property or property for investment purpose (including industrial and commercial property) was lowered to 40% from 50%. Refer to the Hong Kong Monetary Authority (2015) for details.

such as JLL (2016) and Colliers International (2016), the vacancy rate in the grade A office market, which includes top-grade office property, was significantly low at 3% as of the end of March 2016. Furthermore, according to disclosures by the Hong Kong government, the level of office vacancy rates throughout the entire Hong Kong region covering a wider range of offices as of the end of 2015 was also lower than in the past.

c. Commercial facilities

Commercial facility prices as of March 2016 declined about 11% from the most recent peak (October 2015). Also, looking at the statistics of Colliers International, commercial facility rents in the major downtown areas (Causeway Bay, Central, Mongkok, Tsim Sha Tsui) as of February 2016 showed a substantial decline of around 25% to 37% from the peak (4Q 2013). Such a fall in commercial facility prices and rents appears to have been caused by the fewer number of mainland Chinese tourists and lower consumption expenditure per tourist (since the value of spending by tourists from mainland China amounts to as much as one-third of retail sales in Hong Kong, the consumer spending trends of mainland Chinese tourists has a significant impact on the Hong Kong retail market and commercial facility prices).

With the introduction of the thrift ordinance in China in 2013, spending by Chinese tourists mainly in luxury consumption items such as jewelry and watches fell sharply, and the amount of spending per tourist hit the ceiling. Furthermore, the number of tourists from mainland China began to fall in 2015. Other factors possibly affecting Chinese tourists' consumption include the worsening of relations between Hong Kong and China after the autumn of 2014 caused by the pro-democracy movement reinvigorated by the Hong Kong Chief Executive election, and the establishment of a travel limit for multiple visas (to once a week) issued to residents of Shenzhen, China visiting Hong Kong from April 2015.

d. Factory and warehouse

Although factory and warehouse prices surged on the back of tight supply and demand, they peaked in October 2015 and have fallen about 9% since then. Just like offices and commercial facilities, the factory and warehouse market is susceptible to the situation in China. In 2015, the volume of total imports and exports between mainland China and Hong Kong contracted by 1.2% y-o-y, marking the first decline since 2009 when trade transactions shrank due to the impact of the Lehman Crisis. As the global economy continues to lack strength, the volume of total imports and exports continued to shrink in the Jan-Mar quarter of 2016 (-8.5% y-o-y).

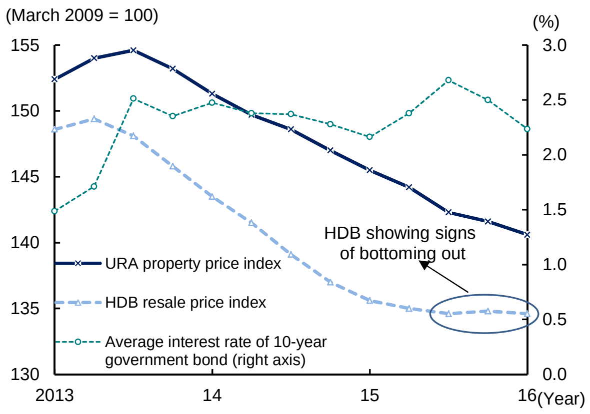
(2) Singapore

Subsequent to the fall following the Lehman Cisis in 2008, real estate prices in Singapore began to rise in the latter half of 2009 and reached a historical high during the period from 2013 (residential property) to 2015 (office property). However, prices have been declining moderately since then. As in Hong Kong, interest rates in Singapore are mostly linked to interest rates in the US and the tightening of the US monetary policy is believed to have strengthened the downward pressure on Singapore's real estate prices.

a. Residential property

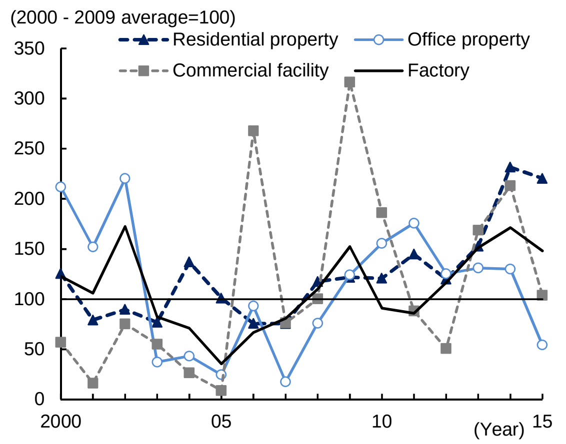
Since the end of 2013, residential prices have been following a gradual downtrend. The direct cause of this trend is the tightening of purchase restrictions on HDB properties targeting the low to middle income brackets in August 2013. But it should be added that soon after, the URA property price index, which indicates the price trend of high income residential housing, also started to decline (**Chart 6**). Factors behind this movement include the dampening of investors' purchase incentive due to the rise of long-term interest rates and an increase in supply of private residential housing from 2013 (**Chart 7**). Currently, HDB housing prices have started to show signs of improvement, but prices of URA properties are continuing to fall given its supply glut.

Chart 6: Housing prices and long-term interest rate



Source: Made by MHRI based on the Singapore Urban Redevelopment Authority, Singapore Housing & Development Board, and CEIC Data.

Chart 7: Supply of real estate properties



Note: Residential property includes only private homes.
Source: Made by MHRI based on the Singapore Urban Redevelopment Authority.

b. Office property

With regard to offices, which are in relatively short supply compared with residential property, prices followed a moderate upward trend until the first half of 2015 but peaked out in the latter half of 2015. Singapore's sluggish economy, with its 2015 real GDP growth rate hitting the lowest level since 2010, is most likely the main factor behind this price trend.

c. Commercial facility

The rise of commercial facility prices was relatively weak compared with residential property and office prices since the latter half of 2009. This is attributable to the relatively high level of commercial facility supply. Furthermore, despite some fluctuation, commercial facility prices have remained more or less flat since 2013. Factors behind this trend include the challenging business environment in the retail industry due to the labor shortage and a slump in the number of inbound tourists in 2014 and 2015.

d. Factory and warehouse

Even though factory and warehouse prices surged in the past, they are currently declining after peaking out since 2014. This can be explained by the deterioration of the export environment of goods due to the slowdown of the Chinese economy.

3. Future outlook of the real estate market

In order to provide an outlook of real estate prices in the two regions, we use a simple method to ascertain the extent to which current real estate prices are overvalued. The value derived by adding the average yield gap (real estate investment yield[4] - 10-year government bond yield) during the period from 2011 to 2012 to the 10-year government bond yield of each term is deemed as the adequate investment yield for each period. Upon calculation of the gap between the adequate investment yield and the actual investment yield, the greater the value, the greater the relative expensiveness of the real estate prices, and the smaller the value, the greater the degree of relative cheapness[5] (**Chart 8**). According to this analysis, the relative expensiveness in Hong Kong has been declining recently. In terms of property category, factories are the most expensive,

[4] We used statistics compiled by the Government of the Hong Kong Special Administrative Region Rating and Valuation Department for the investment yield in Hong Kong. Investment yield in Singapore was calculated using the following formula: annual rent ÷ real estate price.

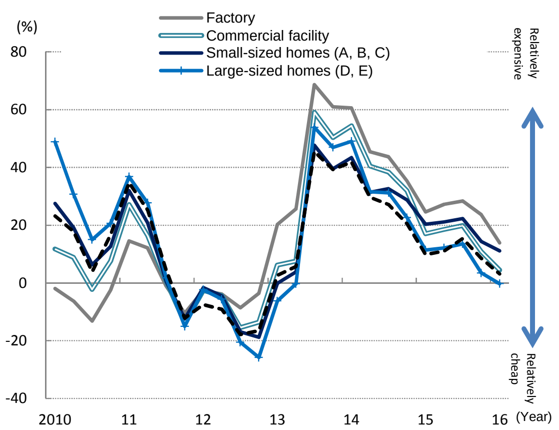
[5] We set the standard period as 2011 through 2012 considering the fact that (1) the rise of real estate prices in the two regions peaked out in 2011, (2) although Hong Kong real estate prices continued to rise in 2012, their relative expensiveness was diminishing from the perspective of the yield gap, and (3) real estate prices in Singapore were stabilizing in 2012.

followed by small-sized residential property, commercial facilities, offices, and large-scale residential property. In Singapore, although the relative expensiveness has been easing, real estate prices are still at a high level when compared with the past. In the order of expensiveness, factories at the top, followed by commercial facilities, offices, and residential property.

This indicator would lead to the conclusion that real estate prices in Hong Kong will stop declining in the near future, given the evident decline of their relative expensiveness. In contrast, real estate prices in Singapore which are still overvalued in comparison to Hong Kong, have more room for prices to fall. However, in reality, actual real estate prices cannot be explained solely by a return to equilibrium and may be affected greatly by economic conditions, interest rates, and the supply-demand balance. The next section analyzes the outlook on real estate prices in the two regions (by property category) by taking these factors into account.

Chart 8: Relative expensiveness of real estate prices

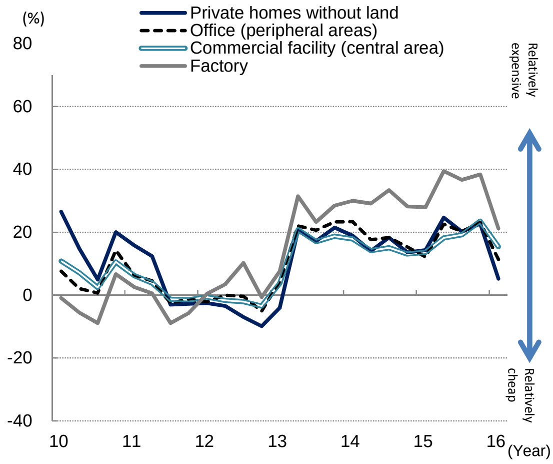
[Hong Kong]



Note: Office represents the average of grade A and B. Small-sized home is under 100 m^2 (average of grade A to C) and large-sized home is over 100 m^2 (average of grade D and E).

Source: Made by MHRI based on the Government of the Hong Kong Special Administrative Region Rating and Valuation Department and the Hong Kong Monetary Authority.

[Singapore]



Note: Due to statistical constraints, office includes those located in peripheral areas and commercial facility includes those located in the central area.

Source: Made by MHRI based on the Singapore Urban Redevelopment Authority and MAS.

Before this analysis, it would be necessary to set forth our view on US monetary policy which has a strong impact upon interest rate developments in the two regions. The Federal Reserve Board (FRB) raised its policy interest rate at the end of 2015 and but has not raised interest rates since then. Looking forward, the FRB will most likely resume raising interest rates toward 2017, but the pace of increase is expected to remain slow in order to avoid a sharp appreciation of the US dollar and global financial market turmoil.

(1) Hong Kong

Concerning residential property prices, the situation differs between small- and large-sized homes. Looking at the relative expensiveness mentioned in the previous section, since small-sized homes are relatively more expensive than large-sized homes, there is more room for a price decline. Furthermore, as indicated in section 2 (1) a, Hong Kong plans to expand its housing supply, with most of the supply believed to be small-sized homes. This will serve as another factor driving prices down. On the other hand, given that the relative expensiveness of large-sized homes is diminishing and that the supply of large-sized homes is not expected to increase as much as for small-sized homes, their prices will probably stop declining.

Turning to offices, there is not much room for prices to fall further. The indicator of relative expensiveness reveals that its deviation from the adequate level is currently contracting. In addition, given the progress in liberalization of cross-border capital transactions in mainland China, the transaction volume between mainland China and Hong Kong is expected to continue growing. In light of this, demand for offices from companies in mainland China is expected to remain firm for some time. Added to this, factors such as the low office vacancy rate and tight demand-supply balance should underpin the market.

On the other hand, commercial facility prices may continue declining in the future. Although commercial facility prices are already relatively cheap, such factors as (1) continued decline in the number of inbound tourists centered on China, and (2) dampening of consumer sentiment due to the deterioration of employment conditions in Hong Kong, will serve as downward pressures on prices. Concerning (1), there is no indication that the restriction on the number of entries to Hong Kong for visa holders will be relaxed, and therefore there are no factors that might turn around the downtrend of inbound tourists from mainland China. Furthermore, upcoming political events such as the Hong Kong Legislative Council election in September 2016 and the Hong Kong Chief Executive election in March 2017 may intensify tensions between mainland China and Hong Kong's pro-democracy faction. In such case, the number of tourists coming from mainland China may decline even further.

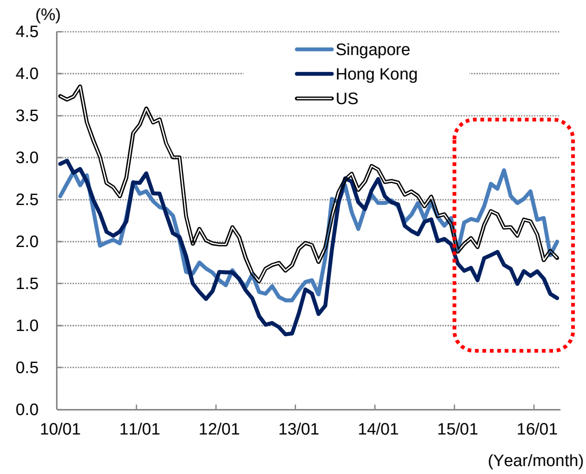
Since factory and warehouse prices remain relatively expensive compared with other types of property, their prices may decline even further. Given the absence of signs of recovery in the global economy, and forecasts of a gradual slowdown of the Chinese economy which is Hong Kong's largest trade partner, Hong Kong's trade activities are projected to remain sluggish, exerting downward pressures on the factory and warehouse market. Nonetheless, (1) the limited supply and low vacancy rate of factories and warehouses, as well as (2) the rising demand of warehouses for e-commerce, will serve to underpin factory and warehouse prices.

It should be noted that since the interest rates in Hong Kong are basically linked to those in the US, we believe that real estate prices in Hong Kong will be weighed down when the US resumes raising its interest rates. Small-sized homes, commercial facility, and factory and warehouse prices are expected to be particularly affected since they are subject to additional factors which may drive down their prices.

(2) Singapore

As shown in **Chart 8**, the relative expensiveness of real estate prices in Singapore slightly exceeds that of Hong Kong, because long-term interest rates in Singapore have not declined to the extent seen in Hong Kong (**Chart 9**). Since Singapore has eased the pace of its efforts to push the value of its currency higher for the purpose of curbing inflation since 2015, expectations toward a higher Singapore Dollar has faded, which in turn may have lowered investors' appetite to invest in Singapore Dollar-denominated bonds.

Chart 9: Long-term interest rates



Source: Made by MHRI based on MAS, HKMA and FRB.

Looking at the different types of property, the price of residential property may stop falling in the near future. Even though HDB housing prices have already shown signs of bottoming out, as we mentioned before, the room for a further price decline for private residential property may be limited. Among the reasons are that the vacancy rate that has more or less stopped rising since 2015, the number of properties under construction is falling, and the negative impact upon labor market conditions is limited due to the continuing labor shortage despite the sluggish economy. Hence, even if the US resumes its interest rate hike, residential housing prices should remain on solid footing.

In contrast, prices of real estate properties for business purpose will likely continue to fall. Factors behind this include (1) reports of an increase of office supply in 2016 despite Singapore's sluggish economy, (2) the increase of construction and rise of the vacancy rate of commercial facility amid the current upturn of the number of inbound tourists, and (3) the rise of the vacancy rate of factories despite the decrease of factories under construction amid the prolonged slump in the manufacturing sector. In particular, in view of fast pace of the rise in vacancy rate of commercial facilities, the downward pressures appear relatively stronger. In the event of full-fledged US interest rate hikes, prices of property in this category will most likely fall at a faster pace.

(3) Acceleration of the interest rate hike in the US may run the risk of triggering a sharp drop in real estate prices

We have thus far described our view on the outlook for real estate prices in Hong Kong and Singapore, but in the last section we would like to set forth a risk scenario. In the event interest rate hike in the US is implemented at a faster pace than expected, the pace of decline in real estate prices in the two regions may be accelerated. Furthermore, it should be noted that if the US interest rate hike triggers another major turmoil in China's financial markets, as in the beginning of 2016, it may lead to upward pressures upon interest rates particularly in Hong Kong, causing an acute drop in Hong Kong real estate prices.

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